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EXAMINING THE STATE OF SMALL DEPOSITORY INSTITUTIONS

HEARING

BEFORE THE

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

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE CURRENT STATE OF SMALL DEPOSITORY INSTITUTIONS, IN PARTICULAR THE STATE OF COMMUNITY BANKS AND SMALL CREDIT UNIONS

SEPTEMBER 16, 2014

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C O N T E N T S

TUESDAY, SEPTEMBER 16, 2014

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

EXAMINING THE STATE OF SMALL DEPOSITORY INSTITUTIONS

TUESDAY, SEPTEMBER 16, 2014

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met, at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I call this hearing to order. Today we have two thoughtful panels that will help us explore the current state of our Nation's small depository institutions.

For many years, it has been a priority of mine to support efforts that tailor supervision and regulations for small, often rural, financial institutions. Such an approach that also maintains appropriate safeguards and consumer protections can help ensure we have a truly level playing field for institutions. To that end, since I have served as Chairman of this Committee, we have had regular meetings, briefings, and oversight hearings, as we are doing again today, to encourage a balanced approach with respect to oversight of smaller institutions.

I believe the regulators have been responsive and are thinking more about small institutions than ever before. Specifically, I believe there have been significant improvements by the regulators regarding exams, rules, and outreach to small institutions. The agencies are also currently undertaking a comprehensive review of their rules, with a specific focus on reducing burdens and duplication for small institutions.

In addition, this Committee has taken other steps to address reasonable concerns of small institutions. It acted on a bill regarding ATM plaques. The Senate acted to ensure that community banks' viewpoints are represented on the Federal Reserve Board. Ranking Member Crapo and I weighed in with the Federal Reserve Board to ensure that community banks were treated appropriately under the new Basel III rules. We asked the NCUA to take another look at the impact of their risk-based capital proposal on small, rural credit unions. And we prioritized incorporating small institutions' ideas into our housing finance reform bill.

When an unintended consequence of the final Volcker rule appeared, Members pushed regulators to swiftly remedy the issue, which they did. The CFPB is also currently reconsidering its defini-

tion of "rural" as it relates to mortgage lending because of concerns raised by members.

I also asked Inspectors General to conduct an audit of each agency's examination process for small institutions to ensure that exams are conducted fairly and transparently, which resulted in improvements at each of the agencies. It is also my hope that the full Senate can unanimously pass Senator Brown and Senator Moran's bipartisan bill regarding privacy notification, another common-sense bill to reduce regulatory burden for small institutions, which is supported by over 70 Senators.

Today we will continue our conversation to find ways to improve the regulation and supervision of small institutions. That said, we must not forget the lessons of the past, and any effort at regulatory relief must find the right balance with safety and soundness as well as consumer protection to succeed. I look forward to hearing the viewpoints of today's panelists on these important questions and issues.

I now turn to Ranking Member Crapo for his opening statement.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman.

This hearing is important because small depository institutions represent the lifeblood of many communities across America, and especially rural Idaho. Yet small financial institutions are disappearing from America's financial landscape at an alarming rate. This is in large part due to an ever increasing regulatory burden that small depository institutions face and cannot absorb. These small entities can only withstand a regulatory assault for so long before considering a merger or a consolidation.

We lost more than 3,000 small banks and more than one-half of the credit unions since 1990. In fact, we lost 85 percent of the banks with less than $100 million in assets between 1985 and 2013.

And what strikes me as particularly worrisome about this number is that the vast majority of those small banks did not fail. On the contrary, the rates of failure, voluntary closure, and overall attrition were lower for these institutions than for any other size group. This means that 85 percent of good small banks with assets under $100 million are no longer serving their communities, which is alarming.

Not only are we losing small banks, but our regulatory framework is discouraging creation of new banks. Only two *de novo* Federal banking charters have been approved since 2009, according to the FDIC.

I heard from Idaho banks and credit unions that regulatory burdens have become so overbearing that small depository institutions can no longer absorb it, so they are consolidating, and new ones are not being created. A streamlining of regulatory requirements is necessary to ensure small depository institutions remain competitive.

The banking regulators and NCUA have commenced a review of unnecessary, outdated, and unduly burdensome regulations as required by law, and I look forward to their recommendations. At our hearing last week, I was encouraged to hear that principals at the

banking agencies are committed to making this regulatory review meaningful and impactful. A main criticism of a similar review completed in 2006 was that the banking regulators subsequently repealed or eliminated only a few substantive regulations. That must not be the case this time. Since 2006 alone, we lost close to 1,000 banking organizations. Those that remain need our help in removing unnecessary obstacles.

I cannot stress enough the importance of this regulatory review. The regulators must not squander an opportunity to make a lasting impact on our regulatory landscape so that another 1,000 institutions do not disappear.

I strongly encourage the agencies to conduct an empirical analysis of the regulatory burden on small entities as a part of this review. Quantifying regulatory cost is not an easy task, but that should not stand in the way of regulators doing the right thing.

I look forward to hearing from our witnesses today about what specific fixes should be made so that small institutions in Idaho and in other rural communities can keep their doors open and continue to serve local communities.

There is bipartisan support to create regulatory environments in which small financial institutions can thrive. Last week Senator Heitkamp said that "too big to fail" has become "too small to succeed." I could not agree more. There are a few specific bills currently that help address these concerns.

Senators Brown and Moran's bill to eliminate a paper version of the annual privacy notice, as indicated by the Chairman, currently has 70 cosponsors.

Senators Moran and Tester's CLEAR Act would go a long way to aid community banks, as would Senators Manchin and Johanns' bill on points and fees for qualified mortgages.

Senators Toomey and Donnelly's legislation to increase the threshold for when regulated depository institutions are subject to CFPB's examination and reporting requirements would alleviate a great amount of regulatory burden.

Senators Brown and Portman's bill to allow certain credit unions in the Federal Home Loan Bank System is another such item.

I look forward to working with Members on both sides of the aisle to make the necessary, common-sense fixes to help community banks and credit unions. I also look forward to working with key stakeholders to get more specific on what should be done to preserve small depository institutions in America.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who would like to give a brief opening statement?

Senator MORAN. Mr. Chairman?

Chairman JOHNSON. Yes.

STATEMENT OF SENATOR JERRY MORAN

Senator MORAN. Thank you, Mr. Chairman. Thank you and the Ranking Member for having this hearing. It seems to me like we have had lots of conversations in this setting. As you described, this is an issue that matters to you. Our States, Mr. Chairman, are very similar, and community banks and credit unions are very im-

portant to the local fabric and the vitality of the towns that comprise our States.

In my view, too many times our hearings have had those represented by the first panel in front of us, and I think without exception we always hear about how cognizant you are of the challenges that small financial institutions face. You express sympathy and concern. You explain to me that you have advisory boards and individuals who make certain that the community bank and credit union perspective is heard. And yet so many times the problems continue, despite your sympathy and care.

I hope that the result of today's hearing is that you will take back with you a recommitment toward finding a way to relieve the burden of those community financial institutions. And while it is useful, I suppose, for you to express to us your desire, your sympathy, your care, your agreement with our position, I hope that today's hearing results in action taken by the agencies to actually make a difference in how you conduct the exams, reviews, and what rules and regulations you place upon those community institutions.

In my view, the burden also lies with Congress. My colleagues have outlined a series of pieces of legislation that have been introduced, but the reality is none of them have been passed. And so while I may sound critical of the regulators, I am also critical of the U.S. Senate where I serve in which we have broad-based support, Republican, Democrat, pieces of legislation. In fact, the bill that has been mentioned has 99 individual Senators who have agreed to allow it to pass. The privacy regulation issue, 99 us have agreed to allow it to pass, but yet we cannot get it across the finish line.

I have two pieces of legislation that I think I am so interested in and would be so useful, but I am not wedded to those specifics of that legislation and would volunteer to all in the audience as well as my colleagues on the Banking Committee that anything we can do in this Committee to work together to find something that is acceptable to the vast majority of us, I am certainly interested in doing it. It does not have to be a piece of legislation that I and Senator Brown introduced. It can be a piece of legislation that we all work on together.

And so while I hope the regulators will do their jobs as it fits their description of what they want to accomplish, my hope and goal is that all of us on this Committee and in the U.S. Senate would work together.

A primary motivation for me to serve in Congress has been a belief in the value of rural America. Relationship banking is a significant component of whether or not many of the communities I represent have a future. It is only that community financial institution that is going to make the decision about loaning to a grocery store in town. It is only that entity that is going to decide that that farmer is worthy of one more year of credit.

And so as we develop policies in Washington, DC, that make everything so uniform, a cookie-cutter approach to lending, it means that many of my constituents and the communities they live in will have a much less bright future and a significant reduction in the

opportunity to pursue their farming and business careers and occupations.

Mr. Chairman, this is an important issue. You have been an ally, and I appreciate that very much. I would conclude by saying that anything that I can do to work with any of my colleagues here on this Committee and the U.S. Senate to see that we do something in addition to having this hearing, that there is actually by unanimous consent or by agreement, that we could pass some of these very common-sense pieces of legislation that would make a significant difference so that I would not have to complain the next time we have the regulators in front of us we still have the same problems. The burden lies with, in my view, you as well as us, and we ought to work together to solve the problem.

Mr. Chairman, thank you.

Chairman JOHNSON. Senator Warner.

STATEMENT OF SENATOR MARK R. WARNER

Senator WARNER. Mr. Chairman, I will be very brief.

One, I want to echo what my friend, the Senator from Kansas, said. I am supportive of his legislation. I cannot understand why the Ranking Member did not list my bipartisan legislation as well in that litany, the RELIEVE Act, but——

Senator CRAPO. Deem it so amended.

[Laughter.]

Senator WARNER. And the only quick point I want to make—and I am sure we will get to the regulators—you know, whether—all of us who supported Dodd-Frank, and even those who did not, we tried to address this with an exemption from a lot of the regulatory responsibilities for institutions under $10 billion. And somehow that got lost in the wash, it seems. And under the guise of best practices, even though there are not statutory requirements on a lot of this regulatory activity, I think the regulators have kind of—echoing what Senator Moran said, with the best practices approach, have used what was intended for large institutions to creep down to smaller. And I really hope this panel can share with us—we can try in kind of this one-off effort that we all have, and—but if there would be a more comprehensive approach, you know, count me in as a supporter, Mr. Chairman, of you and the Ranking Member and all of us, and we can try to get this done.

Thank you.

Chairman JOHNSON. I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and any other materials you would like to submit.

I have a prior commitment and will have to excuse myself before the end of the hearing. Senator Brown will take over the gavel, and I thank him.

Also, I thank the witnesses on both panels for being here today.

Now I will introduce our witnesses on the first panel.

Doreen Eberley is Director of the Division of Risk Management Supervision at the Federal Deposit Insurance Corporation.

Toney Bland is Senior Deputy Comptroller for Midsize and Community Bank Supervision at the Office of the Comptroller of the Currency.

Maryann Hunter is Deputy Director of the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System.

Larry Fazio is Director of the Office of Examination and Insurance at the National Credit Union Administration.

Charles Vice is Commissioner of the Kentucky Department of Financial Institutions. He also serves as the Chairman of the Conference of State Bank Supervisors.

I would like to ask the witnesses to please keep your remarks to 5 minutes. Your full written statements will be included in the hearing record.

Ms. Eberley, you may begin your testimony.

STATEMENT OF DOREEN R. EBERLEY, DIRECTOR, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. EBERLEY. Thank you. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I appreciate the opportunity to testify on behalf of the FDIC on the state of small depository institutions. As the primary Federal regulator for the majority of community banks, the FDIC has a particular interest in understanding the challenges and opportunities they face.

Community banks are important to the American economy and the communities they serve. While they account for about 14 percent of the banking assets in the United States, they now account for around 45 percent of all small loans to businesses and farms made by all banks in the United States. And there are the only physical banking presence in 600 counties in the United States, according to our 2012 community bank data study.

Our study also showed the core community bank business model of well-structured relationship lending, funded by stable core deposits, and focused on the local geographic community performed relatively well during the recent banking crisis. Amid the 500-some banks that have failed since 2007, the highest rates of failure were observed among noncommunity banks and among community banks that departed from the traditional model and tried to grow faster with risky assets often funded by volatile brokered deposits.

Recognizing the importance of community banks, the FDIC strives to reduce the regulatory burden of necessary supervision. Since the 1990s, the FDIC has tailored its supervisory approach to the size, complexity, and risk profile of each institution. To improve our supervision of community banks, in 2013 we restructured our pre-examination process to incorporate suggestions from bankers to better tailor examinations to the unique risk profile of each institution and to better communicate our examination expectations. We also took steps to ensure that only those items that are necessary for the examination process are requested from an institution.

The FDIC also uses offsite monitoring programs to supplement and guide the onsite examination process. Offsite monitoring tools using key data from bank's quarterly Call Reports have been developed to identify institutions that are reporting unusual levels or trends in problem loans or other changes that merit further review, allowing us to intervene early when corrective action is most effective. Offsite monitoring using Call Report information also allows

us to conduct onsite examinations less frequently and to reduce the time we spend in institutions once we are there.

The Call Report itself is tiered to the size and complexity of institutions. Less complex community banks complete only a portion of the report. For example, a typical $75 million community bank showed reportable amounts in only 14 percent of the fields in the Call Report and provided data on 40 pages. Even a relatively large community bank, at $1.3 billion in total assets, showed reportable amounts in only 21 percent of the fields and provided data on 47 pages.

The FDIC also scales its regulations and policies to the size, complexity, and risk profile of institutions where possible. This has been evident in several recent rulemakings where specific provisions have been included to reduce the compliance burden on community banks that may not substantially engage in the activities subject to the rule.

Currently, the FDIC and the other regulators are actively seeking input from the industry and the public on ways to reduce regulatory burden as part of the statutory process under EGRPRA. The Federal banking agencies are seeking comments on our regulations in a series of requests and are already currently reviewing the first set of comments from the public and the industry. The agencies also plan to hold regional outreach meetings to get direct input from stakeholders. As part of this process, the FDIC is paying particular attention to the impact of regulations on smaller institutions.

The best way to preserve the long-term health and vibrancy of community banks and their ability to serve their local communities is to preserve their core strengths of strong capital, strong risk management , and fair and appropriate dealings with customers. We recognize that we play an important role in this equation, and we strive to achieve the fundamental objectives of safety and soundness and consumer protection in ways that do not involve needless complexity or expense. We remain open to suggestions from community bankers about additional ways we can appropriately reduce burden, and we also stand ready to provide the Committee technical assistance on regulatory burden reduction ideas.

Thank you for inviting the FDIC to testify this morning. I look forward to answering any questions.

Chairman JOHNSON. Thank you.

Mr. Bland, please proceed with your testimony.

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

Mr. BLAND. Thank you. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to appear before you today discuss the challenges facing community banks and the actions that the OCC is taking to help community banks meet those challenges.

I have been a bank examiner for more than 30 years and most recently served as the Deputy Comptroller for the Northeastern

District where I had responsibility for the supervision of more than 300 community banks.

Last month I assumed the role of Senior Deputy Comptroller for Midsize and Community Bank Supervision. In this position I oversee the OCC's National Community Bank Supervision Program for more than 1,400 institutions with assets under $1 billion.

I have seen firsthand the vital role community banks play in meeting the credit needs of consumers and small businesses across the Nation. A key element of our supervision is open and frequent communication with bankers, and I personally place a high priority on meeting with and hearing directly from community bankers about their successes, their challenges, and frustrations.

Frequent communications also help me better understand the impact our supervision and regulations have upon the daily operations of community banks. Not only are these meetings one of my favorite parts of the job, they are also quite productive and amongst my most important priorities.

The OCC is committed to supervisory practices that are fair and reasonable and to fostering a climate that allows well-managed community banks to grow and thrive. We tailor our supervision to each bank's individual situation, taking into account the products and services it offers, as well as its risk profile and management team.

Given the wide array of institutions we oversee, the OCC understands that a one-size-fits-all approach to regulation does not work. To the extent that the statutes allow, we factor these differences into rules we write and the guidance we issue. My written statement provides several examples of the common-sense adjustments we have made to recent regulations to accommodate community bank concerns.

To help community banks absorb and keep track of changing regulatory and supervisory requirements, we have developed a number of informational resources for their use. For example, each bulletin or regulation we issue now includes a summary of the issuance and a box that tells community banks whether and how the issuance applies to them.

Guiding our consideration of every proposal to reduce burden on community banks is the need for assurances that fundamental safety and soundness and consumer protection safeguards are not compromised. We would be concerned, for example, about proposals that would adversely impact or complicate the examination process, mask weaknesses on a bank's balance sheet, or impede our ability to require timely corrective action to address weaknesses.

However, we know we can do more to reduce regulatory burden on community banks, and we are exploring several options that we believe will help. For example, we believe community banks should be exempt from the Volcker rule. We also support changing current law to allow more community banks to qualify for an expanded 18-month examination cycle.

We support more flexibility for the Federal thrift charter so that thrifts that wish to expand their business model and offer a broader array of services to their communities may do so without the burden expense of changing charters. And we believe community banks should be exempt from the annual privacy notice require-

ment. Finally, we are supportive of community banks' efforts to explore avenues to collaborate and share resources for compliance or back-office processes, to address the challenges of limited resources in acquiring needed expertise.

I am also hopeful that recent efforts to review current regulations and reduce/eliminate burden will bear fruit. As Chair of the FFIEC, Comptroller Curry is coordinating the efforts of the Federal banking agencies to review the burden imposed on the banks by existing regulations consistent with the EGRPRA process. The OCC, FDIC, and the Fed launched this effort this summer and are currently evaluating the comments received on the first group of rules under review. We are hopeful that the public will assist the agencies in identifying ways to reduce unnecessary burden associated with our regulations, with a particular focus on community banks.

Separately, the OCC is in the midst of a comprehensive, multiphase review of our own regulations and those of the former OTS to reduce duplication, promote fairness in supervision, and create efficiencies for national banks and Federal savings associations. We have begun this process and are reviewing comments received on the first phase of our review, focusing on corporate activities and transactions.

In closing, the OCC will continue to carefully assess the potential effect that current and future policies or regulations may have on community banks, and we will be happy to work with the industry and Committee on additional ideas or proposed legislation initiatives.

Thank you for the opportunity to appear today, and I would be happy to respond to questions.

Chairman JOHNSON. Thank you.

Ms. Hunter, please proceed with your testimony.

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 Johnson, Ranking Member Crapo, and other Members of the Committee, I appreciate the opportunity to testify on the Federal Reserve's approach to regulating and supervising small community banks and holding companies.

Having started my career as a community bank examiner at the Federal Reserve Bank of Kansas City, I have seen firsthand the important role that community banks play in providing financial services to their communities and local economies. I have also seen how critical it is that we supervise these institutions effectively and efficiently and in a way that fosters their safe and sound operations while still allowing them to meet the needs of their communities.

Let me begin my remarks this morning by noting that the overall condition of community banks continues to improve and strengthen in the aftermath of the financial crisis. Community banks have stronger capital positions and asset quality, which not only makes them more resilient but also more willing and able to lend to creditworthy borrowers. Indeed, after several years of declining loan balances at community banks, we are starting to see an increase

in loan origination, which is good news for the local economies that are served by community banks.

In the wake of the financial crisis, we have spent the past several years revising our supervisory programs for community banks to make them more efficient and less burdensome for well-run institutions. For example, we are building on our longstanding risk-focused approach to supervision and revising our monitoring program and field procedures, as well as conducting more examination work offsite to focus examiner attention on higher-risk activities and reduce some of the work that is done at lower-risk, well-managed community banks.

This is important because even similarly sized banks may be affected very differently by a general policy or supervisory approach, depending on their risk profiles or business models.

As Governor Tarullo testified before this Committee last week, we recognize that burden can also arise from regulations that may not be appropriate for community banks given their relative level of risk. To address this, we work within the constraints of the law to draft rules so as not to subject community banks to requirements that would be unnecessary or unduly burdensome to implement.

A number of recently established rules have been applied only to the largest, most complex banking organizations, and to give just one example, the Federal Reserve and the other banking agencies have not applied the large-bank stress-testing requirements, which includes the Dodd-Frank stress testing as well as the Comprehensive Capital Analysis and Review, or CCAR, exercise of the Federal Reserve. They have not applied to community banks or their holding companies.

In addition, we have taken steps to clearly identify when supervisory guidance does and does not apply to smaller institutions. We provide information via newsletter, Web site, and teleconferences targeted to the community bank audience to explain regulatory expectations and provide examples to help them understand new requirements.

As we consider how to best tailor our rules and supervisory activities for community banks, we are keenly interested in better understanding the role that they play in the U.S. economy, the key drivers of their success, and as a result, we have partnered with our colleagues at the Conference of State Bank Supervisors to host two community banking research conferences at the Federal Reserve Bank of St. Louis, the second of which will be taking place next week.

In this regard, I would like to recognize my colleague on this panel Mr. Vice for his personal leadership in that effort, and I expect he will have more to say about the conference and this important initiative in his remarks.

But let me conclude by emphasizing that as we think about addressing regulatory burden at community banks, the Federal Reserve is focused on striking the appropriate balance. On the one hand, we take very seriously our longstanding responsibility for fostering a safe and sound financial system and compliance with relevant consumer protections. On the other hand, we believe that

our supervisory activities and regulations should be calibrated appropriately for the risk profile of smaller institutions.

We are committed to identifying ways to further modify and refine our supervisory programs to not impose undue burden while still ensuring that community banks operate in a safe and sound manner.

Thank you for inviting me to share the Federal Reserve's views on matters affecting community banks, and I would be pleased to answer any questions you may have.

Chairman JOHNSON. Thank you.

Mr. Fazio, please proceed with your testimony.

STATEMENT OF LARRY FAZIO, DIRECTOR, OFFICE OF EXAMINATION AND INSURANCE, NATIONAL CREDIT UNION ADMINISTRATION

Mr. FAZIO. Thank you. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I appreciate the invitation to discuss the status of small credit unions.

With one-third of credit unions having less than $10 million in assets and two-thirds of credit unions having less than $50 million in assets, NCUA is acutely aware of the importance of scaling its regulatory, supervisory, and assistance programs to address the unique circumstances of small credit unions.

Smaller financial institutions, in particular, have fewer resources available to deal with marketplace, technological, legislative, and regulatory changes. Smaller credit unions continue to have lower margins, higher operating expenses, and lower growth rates than larger institutions. As a result, during the last decade the long-term consolidation trend of smaller credit unions has continued.

Ten years ago, credit unions with less than $50 million in assets accounted for 80 percent of all federally insured credit unions. Today that share is 66 percent. While some have grown and are no longer considered small, almost all of the remaining decline in small credit unions is from voluntary mergers.

Our financial system benefits most when there is an effective balance between opportunities for the market to optimize performance and innovate, with prudent regulations to safeguard financial stability and protect consumers. Thus, NCUA's approach to regulating and supervising credit unions has continued to evolve with changes in the marketplace and the credit union system.

NCUA also scales its regulatory and supervisory expectations and seeks to provide regulatory relief when it is appropriate and within the agency's authority to do so. Where regulation is necessary to protect the safety and soundness of credit unions and the Share Insurance Fund, NCUA uses a variety of strategies to ensure that regulations are targeted. These strategies include exempting small credit unions from several rules, using graduated requirements as size and complexity increase for others, and incorporating practical compliance approaches in agency guidance.

We strive to strike a fair balance between maintaining baseline prudential standards for all financial institutions and reducing the burden on those institutions least able to afford it.

NCUA also provides relief for smaller credit unions through the examination process. In 2012, NCUA adopted a streamlined exam-

ination program for smaller credit unions. These examinations now focus on the most pertinent areas of risk in small credit unions: lending, recordkeeping, and internal control functions. The agency has been testing additional streamlining and refinements throughout 2014 with plans for full implementation in 2015.

NCUA appreciates the important role small credit unions play in the lives of their members and local communities, and the significant challenges they face. To help them succeed, NCUA's Office of Small Credit Union Initiatives provides targeted training, one-on-one consulting, and grant, loan, and partnership opportunities. This office demonstrates NCUA's commitment to helping small credit unions not only survive, but to thrive.

NCUA also encourages credit unions to collaborate, both through direct cooperation as well as through credit union service organizations, to achieve economies of scale and expand member service opportunities.

Finally, the Committee has asked for NCUA's views on regulatory relief legislation. Small credit unions face many challenges that require solutions based on size and complexity. Therefore, NCUA would advise Congress to provide regulators with flexibility in writing rules to implement new laws. Such flexibility would allow the agency to scale rules based on size or complexity to effectively limit additional regulatory burdens on smaller credit unions.

NCUA also supports several targeted relief bills like S. 2699, the Credit Union Share Insurance Fund Parity Act, and S. 968, the Small Business Lending Enhancement Act. NCUA further asks the Committee to consider legislation to provide the agency with the authority to examine and enforce corrective actions when needed at third-party vendors, parallel to the powers of the FDIC, OCC, and the Federal Reserve. The draft legislation would provide regulatory relief for credit unions because NCUA would be able to work directly with key infrastructure vendors, like those with a cybersecurity dimension, to obtain necessary information to assess risk and deal with any problems at the source.

In closing, NCUA remains committed to providing regulatory relief, streamlining exams, and offering hands-on assistance to help small credit unions compete in today's marketplace.

I look forward to your questions.

Chairman JOHNSON. Thank you.

Mr. Vice, please proceed with your testimony.

STATEMENT OF CHARLES A. VICE, COMMISSIONER OF FINANCIAL INSTITUTIONS, KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. VICE. Good morning, Chairman Johnson, Ranking Member Crapo, and distinguished Members of the Committee. My name is Charles Vice. I serve as the Commissioner for the Department of Financial Institutions in the Commonwealth of Kentucky. It is my pleasure to testify before you today on behalf of the Conference of State Bank Supervisors.

In my 25 years as a Federal and State bank regulator, it has become very clear to me the vital role community banks play in the economy. I know this because I have seen it firsthand in my State

of Kentucky where a single community bank is the only banking option for four counties. Furthermore, dozens of other counties have no physical banking option except for local community banks. This is not a Kentucky phenomenon. About one-fifth of all U.S. counties depend on community banks as their access point to the financial system.

Because of their importance in these local markets, the continuing trend of consolidation is very concerning. During the past 3 years, the number of banks in the United States with less than $1 billion in total assets has dropped by 924, or 13 percent. This has consequences for communities and for the diversity of the financial services industry. I know this Committee shares my concern on this issue, and I appreciate your efforts to examine the state of our country's community banks and regulatory approaches to smaller institutions.

Community banks should be regulated and supervised in a manner that reflects their relationship-based lending model. Key to this effort is a deeper understanding of community banking and its impact. To that end, CSBS and the Federal Reserve will host the annual Community Bank Research Conference next week in St. Louis. This conference is a unique combination of academic research and industry input, gathered through a nationwide survey and in-person town hall meetings. Here are a few previews.

Our survey included several questions about mortgage lending: 26 percent of respondents indicated that they would not originate non-QM loans; an additional 33 percent will only originate non-QM loans on an exception-only basis.

In addition, one of the research papers to be presented examines a Federal agency's appeals processes. Research such as this helps to identify right-size regulation and solution-oriented approaches to supervision. My written testimony highlights examples where State regulators have been particularly innovative. We have developed and implemented responsive practices to better serve smaller institutions. Some examples are as fundamental as coordinating supervision. Other examples show the States' flexibility in making supervision more effective and efficient. State regulators recognize that our Federal counterparts have made some positive contributions to a right-sized regulatory framework for community banks as well. But right-sizing regulation is not a one-time undertaking. It must be an ongoing effort to identify ways to meet our responsibilities as regulators while supporting growth and health of our community banks and our local economies.

The primary action we can take to right-size regulation is to do away with a one-size-fits-all approach to regulation and supervision, and turn our attention to establishing a policymaking approach that considers the community bank business model. For example, when it comes to applications, agency decisions for smaller institutions should not set precedents for larger banks.

Similarly, in the area of mortgage regulation, there should be greater flexibility tied to the reality of community banks' business model. This includes recognizing the inherently aligned interest between borrowers and creditors in portfolio lending. The CFPB Small Creditor QM does this, but more can be done through the passage of bills, including Senate bill 2641 and House bill 2673,

which grant the QM liability safe harbor to mortgage loans held in portfolio; and Senate bill 1916 and House bill 2672, which create a petition process for responsible balloon loan portfolio lending in rural areas.

To be responsive to diverse institutions, agency leadership itself has to understand these institutions. State regulators support Senator Vitter's proposal that at least one member of the Federal Reserve Board have community banking or community bank supervisory experience. Similarly, the FDI Act's requirement that State bank supervisory experience on the FDIC Board should be clarified to reinforce Congress' intent to have a person who worked in State government supervising banks on the board. I am pleased to say that Senators Coburn and Hirono will be introducing a bill this week to accomplish this goal.

As policymakers, we are capable of right-sizing regulations for these vital institutions, and we must act now to ensure their long-term viability. CSBS will work with Members of Congress and our Federal counterparts to build a new framework for community banks that promotes our common goals of safety and soundness and consumer protection.

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

Chairman JOHNSON. Thank you all for your testimony.

I will now ask the clerk to put 5 minutes on the clock for each Member.

Mr. Fazio, NCUA has received many comment letters on its proposed risk-based capital rule, including a letter that Ranking Member Crapo and I sent earlier this summer. Would you please update us about whether the NCUA Board will reissue the rule for a second comment period? Also, when does the NCUA Board expect to finalize the rule?

Mr. FAZIO. Chairman Johnson, that is an open question at this point, and it is premature for me to give a specific answer to the timing of the final rule and whether or not it would be reproposed for comment.

What I can do in terms of updating you is indicate, as you had mentioned, we received over 2,000 comments as part of the proposed rule process which was out for over 120 days for comment. The NCUA Board has also conducted a series of listening sessions across the country throughout the summer to garner further input on the rule. And we continue at the staff level to consult with industry practitioners on technical aspects of the rule.

So staff is in the process right now of working through all of those comments and analyzing those and conducting additional research and analysis in other areas that we also want to explore.

Once we complete that process, we will then need to work with the NCUA Board to achieve consensus on a direction that we want to take for the final rule. Once we do that, we will be in a position to better speak to the timing and the issue of re-comment. I can say it is the agency's top regulatory priority, so staff is working around the clock on this issue to do it as soon as we can, but we also want to make sure that we get it right and respond fully to the comments.

I know that the commenters expressed significant interest in a second comment process. Also, some have indicated that timing is important because they would like some certainty as it relates to the capital planning and strategic planning they need to do related to the capital standards, contingent, of course, upon NCUA coming out with a sound and responsible rule. And so as we work through these comments and we analyze options for proceeding with the final rule, we will need to look at, and the board will need to make a decision about, whether or not that warrants a second comment period.

Chairman JOHNSON. Ms. Eberley, has the FDIC issued any guidance or placed restrictions on the number of non-QM mortgages an institution can hold in portfolio?

Ms. EBERLEY. So, no, we have not put any restrictions on institutions, but, yes, we have issued guidance on an interagency basis in December discussing our supervisory approach to both QM and non-QM loans, to provide assurance to institutions that there are no changes from a supervisory perspective.

Chairman JOHNSON. Mr. Fazio and Mr. Vice, there is broad support in the Senate for a bill to change how depository institutions provide privacy notifications to their customers. Is this an appropriate change? And how are consumers protected? Mr. Fazio, let us start with you.

Mr. FAZIO. Chairman Johnson, NCUA supports that legislative relief pertaining to the annual privacy notices. We think that that bill provides consumers with adequate protections around the disclosures related to the privacy rights, provided there are no changes. It is posted electronically on their Web site. We think that the bill gives consumers the information they need and allows the institutions to have a cost-effective way of providing those disclosures.

Mr. VICE. In reference to Senate bill 635, CSBS does support this bill. We think it is a common-sense approach to the regulation. The consumer is protected because they can see the privacy notice up front when the account is opened. In addition, they have access to it online, and the only time they would receive notification is if something changes with it. The only thing we would ask is that the bill does not preempt State law relative to privacy notices.

Chairman JOHNSON. This question is for Ms. Hunter and Mr. Bland. What do you consider the biggest risk to the viability of small institutions? And what major step has your agency taken to address that risk? Ms. Hunter, let us begin with you.

Ms. HUNTER. Thank you. Well, Chairman Johnson, to answer your question, the biggest risk facing any particular individual community bank is generally credit risk. That is the largest part of the balance sheet, and so obviously to the extent which smaller banks are taking on credit risk, that is the area where often, if there is new product, for example, being offered, there may not be the expertise in-house to properly address the risk management necessary for that.

In looking at individual banks, it comes down to the issue that I think affects the community banks more broadly across the portfolio, and the concern we often hear is the threat to the community bank business model. And really underlying that I believe is that

the community banks are really concerned and struggling with how to produce revenue. And so the revenue comes in in several forms. One is avoiding costs, which could be associated with the cost of compliance with new regulations. There is also challenge by the low interest rate environment or the current economic environment, and some regions have not rebounded as well as others. But there is also competition for good loans from nonbank lenders. So all of these factors come into play, I think, in creating risk for community banks.

The thing that I would also want to add is that community banks have a comparative advantage *vis-a-vis* larger institutions to the extent they really focus on relationship banking, the special knowledge they have of their customers, of their communities. And to the extent there are regulations or requirements that we place that reduce the discretion that they have in addressing specific and unique needs for their individual customers, I think that is where you will hear the most concern from community banks about their ability to compete, because it is almost in effect reducing the competitive advantage that they have by virtue of this very special local knowledge.

Chairman JOHNSON. Mr. Bland?

Mr. BLAND. Chairman Johnson, in my conversation with community bankers, what I often hear is the amount and the pace of regulation and the impact that is having on the institutions' lending and also servicing their communities. And coupled with that is the changing operating environment where you see institutions now facing the various types of operational risk, including cybersecurity, the impact of technology is placing on them. So it is really getting to what is the right business model for the community bank.

But first and foremost has been the burden of regulations and how that competes with their time and attention to service their communities. And what we really focused on at the OCC is when it relates to regulations that apply to community banks is provide information in a clear format to indicate what regs apply to them and how and why.

In addition to that, we provide information sources, such as on the domestic capital rules a two-pager that clearly states what part of the rules apply to community banks. And, in addition, we also provide a quick reference guide for the CFPB mortgage rules to make sure community bankers understand and to help them as they wade through the various laws and regulations.

And then to the extent that there are opportunities to exempt community banks without compromising safety and soundness and consumer protection standards, we have exempted them from certain rules as well. The heightened standards rule that we issued, the liquidity cover ratio, are some of the things that come to mind.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman. And again, I thank each Member of the panel for being here today and sharing your testimony with us.

Ms. Eberley and Mr. Bland, I was going to direct my first question to you. It was going to be on Operation Choke Point, but I am just going to—I probably will not have time to get to that. I just

wanted to alert you that I will be, either in follow-up or in the hearing, discussing with you the implementation of Operation Choke Point and, frankly, whether it is appropriate for Federal regulatory agencies and the financial world to be utilizing the regulatory system to, in what I view, target business models that are not supported by the Administration. I know that each of you have taken actions to try to correct that issue and perception, and I just want to tell you, from what I am seeing, it is not working yet.

But I am not going to give you a chance to talk with me about that right now. What I want to talk about right now is the bigger question of the EGRPRA review. Each of your agencies has said that you are engaged—I know that you are now engaged in a new review, and the issue that I want to raise with you is whether we can make this real. I am going to back to the 2004–06 review that we did 10 years ago, and at that time Senator Shelby was the Chairman of this Committee, and he assigned me as one of the more junior Members of the Committee the opportunity to be the lead on developing the legislative response to the EGRPRA review. And for those of you who were involved at that time, you will remember we got extensively involved. All of the agencies were reviewing, providing information to us from the input and the analysis they were doing. We engaged with those in the private sector who were also making recommendations and so forth. We were creating lists and charts. I think we had on our list 180 or more items of potential legislative action that was needed to help reduce the regulatory burden on community banks. And then there was another long list of actions that could be taken by the regulators themselves without Congress' activity.

The reason I go through that with you is I was pretty discouraged by the outcome. We did pass some legislation, and we passed some legislation that did some really good things. But in the context of what we could have done, I think we got just mostly low-hanging fruit.

I was reading the response to your current effort from the ICBA which sort of makes the same point. They referred back to the earlier EGRPRA action and said that so little came of it, both at the regulatory and at the congressional level, that many in the industry felt like it was sort of a check-the-box experience where they were going through another regulatory requirement to do a regulatory review, and we will do it and we will have all these issues identified, and we will not have resolution put into place.

I am using up most of my time explaining my question here to you, but my question is: How can we make it real this time? I want to give you one specific example. Last time, in 2004 and 2006, one of the items on our list that we were not able to do was the annual privacy exemption that we are talking about today that everybody seems to be in agreement with. That was on our list. It was one of those we could not get done because there was an objection. And I will not go into where the objection came from, but the point is it was as though unless we had consensus from everyone involved, we could not get the political agreement to move forward on a fix. And somehow, both at the regulatory level and at the congressional level, we need to get by that this time. We do not want another tepid EGRPRA process.

I would just like to ask those of you who can, in the minute that is left out of my question—and we will start with you, Ms. Eberley, to just respond to that generally. Are you committed and will you work on putting together a process that will generate outcomes rather than just lists this time?

Ms. EBERLEY. So, yes, we are very committed and I think that all of the agencies are committed to the process. We are working together through the FFIEC. We just 2 weeks ago closed the comment period on the first round of regulations that we issued for comment. They covered international operations, powers and activities, and applications and reporting. And we did get some comments—not a lot. We hope that we will get more in the future. But we are still open for comments as well. We are going to have outreach sessions around the country. And from a preliminary look at the comments—so we are still early in the process—speaking on the FDIC's behalf, you know, there are some things that are directed directly to us that we may be able to have the control to change.

So to the extent that we have the ability to do that, we are committed to act early, and I think we can get back to you a little further down the road after we have had an opportunity to digest the first round of comments.

Senator CRAPO. Well, thank you. My time is up, but if I could, Mr. Chairman, allow a quick response from Mr. Bland and Ms. Hunter.

Mr. BLAND. Senator Crapo, I echo Ms. Eberley's comments around the spirit of cooperation among the agencies, but also a concerted effort of the current principles to effect change.

With respect to the outreach sessions that Ms. Eberley referred to, Comptroller Curry is personally planning to attend a number of those to really hear directly from the bankers, but also to lay out tangible types of actions. So there is a spirit but also a commitment to effect change this time.

Senator CRAPO. Thank you.

Ms. Hunter?

Ms. HUNTER. And I would just very quickly add that I concur with my colleagues. We also at the Federal Reserve are committed to this process and very hopeful that we will have some very concrete actions that will come out of it in the efforts to reduce regulatory burden for small banks.

Senator CRAPO. Well, thank you.

Mr. VICE. Could I add to that real quickly?

Senator CRAPO. Sure.

Mr. VICE. Thank you. Again, Congress granted the States a seat on the FFIEC, and we really appreciate that. I wanted to update you that the CSBS is taking this seriously. We have had three calls on this already, and we are trying to identify outdated and burdensome regulation. And we completely agree with you. This activity must result in meaningful action and reform.

Senator CRAPO. Well, I thank you all on that. Sorry, Mr. Fazio, I did not give you a chance to respond, but I would just say let us make it right this time. Let us not make it so that the only thing that happens is the narrow band of things that everybody agrees

to. Let us find a consensus of where we need to make fixes, and let us make the changes that we need to make.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Well, thank you, Mr. Chairman. Thank you for holding this hearing. And I really want to take up where Senator Crapo left off, agree with his macro comment on how we approach this, agree with Senator Moran's comments on privacy, support his legislation. But there seems—we have all got individual pieces of legislation. My RELIEVE Act, which is bipartisan, Senator Fisher and others on it, you know, takes the small bank holding company numbers, Ms. Hunter, from 500 million to a billion, which we think makes sense, and I would hope you would concur. It deals, as somebody working, again, with the Chairman and the Ranking Member on QM definitions in terms of rural, takes the number in terms of mortgage origination from 500 to 1,000 per year, again, a step in the right direction; Mr. Fazio, deals with providing credit unions the parity with FDIC-insured institutions when it comes to the interest on lawyers' trust accounts.

But my sense is we are kind of doing this all in a one-off basis, and a more comprehensive approach—and EGRPRA may be the right tool. I just want to publicly say I look forward to working with you and other Members of this Committee to do this kind of at a macro level, because it really needs to be done.

I guess one item I would also want to raise with the regulators is I know when I meet with my credit unions or community banks and I make the defense of we put in the law exemptions for smaller institutions, and, you know, under 10 billion, you are not applied to CFPB, and what happened—and you almost get kind of—you get laughed at by them because while we all pay homage to the role of these small institutions, we all look at this declining number, and, you know, we keep saying these things, and yet if this keeps going, the whole nature of small institutions being able to served particularly rural communities is going to disappear.

One of the things that I constantly hear is that even when you put the exemption in place for a smaller institution, when it comes particularly to the examination process, what ends up being kind of an industry-wide or regulatory-wide best practice that may apply to the larger institution in effect trickles down into the smaller institution. I do not know how you further legislate against that, but I would love to hear from the regulators if you have got any suggestions for us, because I hear your testimony that you value these smaller institutions, want to provide specific relief. We keep trying to do this on a one-off basis. I agree with Senator Crapo that the more macro approach may be better. But, Ms. Eberley and Mr. Bland and Ms. Hunter, how do we guard against this examination creep, which is clearly not the legislative intent, yet still ends up happening under the guise of best practices?

Ms. EBERLEY. So we address that every day, and it is our job to make sure that our examiners are enforcing the rules the way that they are written. So where there is a bright line, it needs to be observed.

We have tried to make it very, very clear when we issue rules or guidance and there is a bright line, what the bright line is. An example that Maryann has raised already is the stress testing.

When we issued the financial institution letters discussing that, we had a whole separate page talking about it not applying to community banks; the $10 billion threshold stood.

So we can do part of it. Part of it is outside of our control and the banking industry, so there are outsiders that talk about the worry of regulatory creep and put a concern really in institutions' minds that this is going to happen to them and they need to be prepared. So we have to combat that as well.

Senator WARNER. But it is happening. I mean, community bank after community bank, when you take—you look at the one place that is expanding is the regulatory staff, which, again, back to Ms. Hunter's comment, makes them in a very competitive market even less competitive. So I am not fully satisfied with your answer.

Ms. EBERLEY. OK. We also have an internal control group that audits our procedures and our adherence to our procedures, so we do reviews of every regional office that covers the examinations that that region has conducted to ensure adherence to policy. So we have other ways of tracking to making sure that our examiners are doing what they are supposed to be. If they are not, we ask bankers to call us and let us know. We can fix it.

Senator WARNER. Can you get me data on how many call and how you respond to that?

Ms. EBERLEY. On how many—oh, bankers, yeah.

Senator WARNER. What your response level is to institutions that say this examination process is going beyond the scope, if you would get me that data, I would appreciate it.

Ms. EBERLEY. [Response from Ms. Eberley:]

The FDIC provides the banks it supervises a robust process for appealing examination results, which includes an informal resolution of issues through the field and regional supervision staffs, informal resolution of issues throughthe FDIC's Ombudsman, and a formal review by the appropriate Division Director, and ultimately, if eligible, a formal appeal to a board-level committee, the Supervisory Appeals Review Committee (SARC).

Informal Supervision Staff Process

As part of the examination process, examiners or field management serve as the first-level of review in an attempt to resolve disputes or unresolved examination issues. Issues that remain unresolved after the conclusion of an on-site examination are elevated to the appropriate regional office for a second-level review. If the regional office and the institution are unable to resolve disputed issues, FDIC staff notifies the institution's management and board of directors of the institution's rights to appeal to the Division Director and the SARC. However, most disputed examination issues are resolved informally between institutions and the field or regional staffs, and the institutions do not pursue formal appeals of the issues in those cases. This informal process has also proven effective at resolving questions about interpretations of our regulations, policies and guidance. If bankers have questions or concerns about whether a particular rule, policy or guidance applies to their bank or about how examiners are reviewing adherence to them, we encourage bankers to raise questions to FDIC field or regional managers, or to the Division Director.

Formal Appeals to the SARC

The first stage of the formal appeals process is to request a review of the disputed finding by the appropriate Division Director in the FDIC's Washington Office. The Division convenes a panel of subject-matter experts who are familiar with the relevant policy issue, but who played no role in the examination in dispute. At the conclusion of the division-level review, the bank receives a comprehensive response to its request that summarizes the bank's position and supporting arguments, the regional office's support for

its findings, a discussion of the applicable policies and examination guidance, and the Division's final decision and rationale. Given the comprehensive nature of the Division's response, often banks choose not to pursue the second-stage appeal to the SARC. Alternatively, some institutions narrow the scope of their appeal to the SARC in light of the divisional response.

Since 2005, the FDIC has received 74 requests for Division level reviews. Of those, 50 were denied, 2 were approved, 4 were partially approved, 8 were deemed ineligible or incomplete, 9 were withdrawn, and 1 bank closed during the process. For the 38 SARC-level appeals since 2005, 20 were denied, 2 were partially approved, 8 were deemed ineligible or incomplete, 3 were withdrawn, and 5 banks closed during the process.

Informal Resolution through FDIC's Ombudsman

Approximately 6,404 industry representatives contacted the FDIC Ombudsman from January 2005 through August 2014 to request assistance. Of this number, 366 complained about the FDIC. The Ombudsman resolved or mitigated these complaints—or referred them to another party for resolution when appropriate. In the majority of these cases, the Ombudsman was able to provide assistance by explaining FDIC policy and procedures and by getting contacts to the right party within the FDIC.

Senator WARNER. If Mr. Bland and Ms. Hunter could comment as well, and also, Ms. Hunter, if you could make some comment on whether you all would have any concern on the small bank holding company level moving from $500 million to $1 billion.

Mr. BLAND. Senator Warner, as the Senior Deputy Comptroller for Midsize and Community Banks, my primary focus is on the community bank supervision. At the OCC we have a separate community bank program, and two-thirds of our examiners are devoted to community bank supervision. So we have established policies and practices that focus exclusively around the community banks and what their needs are and their risk profile.

Your point on trickle-down is a valid one, and so it is very important that we do have a separate focus that we have at the OCC. But in addition to that focus, our practices lend themselves to make sure that what we do applies to a community bank and is not relative to other types of institutions of larger size. But a big part of that is our policies and procedures. We have compliance handbooks. We have training specifically for community bank examinations. And then periodically, as Senior Deputy Comptroller, I hold calls with our examining staff nationwide to have conversations around issues, concerns, and if we do see instances such as laws or regs that should not be applicable but they are, we have opportunities to talk to our staff about that.

Ms. HUNTER. I will just quickly address the trickle-down issue. Our approach at the Federal Reserve is very similar to that described for the FDIC and the OCC. We are really tackling it in two ways.

First, our role in Washington is to provide oversight of the supervision program, so one of the things that the staff here does is we will look at what we call a horizontal review. So if we put in place a practice, especially if we are hearing from bankers that this trickle-down effect is happening, we will look across examinations, across all 12 districts to see how much variation are we seeing in how the standards are being applied. If we are seeing a high level of variation or seeing some outliers, we are then going back and retraining examiners or communicating better with bankers about

expectations, as well as our own staff so that we can narrow that range of variability.

Along with that we are investing in training examiners, and we are actually going through a process right now to look at the curriculum that we use for the commissioning process. We are developing separate curriculums for large institution examiners and small institution examiners so we can take out anything that might confuse where these boundaries are in terms of what is expected for community banks. So we are tackling that on that front.

To speak to the small bank holding company policy statement, this is one I have heard from bankers. Obviously there is a lot of interest in us raising this threshold. Just really as a quick piece of background, this policy statement was developed decades ago in recognition that smaller banks do not have access to as much capital. It is not as easy as for larger institutions. And so they might need to rely on debt financing to accommodate local ownership, to promote local ownership of small institutions. The policy statement in essence says for small institutions you are exempt from consolidated capital guidelines, you do not need to file consolidated financial statements.

We raised that threshold last in 2006, went from 150 million to 500 million, and at that time some of the analysis that we did was to look at what percentage of the industry was covered under this policy statement. So it went from 55 percent under the old standard in 2006 up to about 85 percent of the bank holding companies now are covered under the small statement. Looking at if it were to raise again to the billion dollar threshold, given where we are today and the asset growth of institutions, about 88 percent of the industry would be covered. So it is not a dramatic change from the coverage that we envisioned in 2006 in raising that threshold.

I know there are some proposals to consider a 5-billion threshold. If you applied that threshold, it would go to 91 percent.

The other thing I would just add on this and kind of the factors that we considered in 2006, why we did not raise it higher at that time, so some of the mitigating factors, consolidated capital guidelines are a pretty important component of our supervisory program, and so we want to make sure that we are covering enough of the institutions under that.

The other thing is looking at what you lose by not having the consolidated financial information, and so we want to make sure, for example, do we have enough information that we are able to do the monitoring of financial performance and even the ability to conduct certain work offsite is based on monitoring and using the information that is reported. If we have less information, we might not be able to do as much work offsite as we currently do.

So to the overall question, I think we certainly support raising thresholds over time, and I think the other thing I would suggest is to think about how we might—or just any restrictions on raising that threshold going forward or requiring legislation in order to get a raise of the threshold, that would be something—we do want to be able to raise those over time as it makes sense.

Senator BROWN. [Presiding.] Thank you, Ms. Hunter.

Senator Moran.

Senator MORAN. Mr. Chairman, thank you very much. While you are in the chair, Mr. Brown, let me thank you for the cooperation that you have extended to me and working to get S. 635 accomplished. This is the privacy issue. What we have learned is that 99 percent is not quite sufficient, but we continue to work to see that the Senate might succeed.

Let me start by trying to figure out what role Congress versus the regulators have in addressing and/or solving these issues. I think it was you, Mr. Bland, referenced—one of the things that you said about to the extent that the law allows. I think it was Ms. Hunter that said we seek less burdensome resolution of these issues. We have exempted them from some of them, speaking about banks.

So how much leeway do you have? When my bankers come talk to me about the challenges they face in the compliance and regulatory environment, is this a problem with you? Or is this a problem with Congress?

[Laughter.]

Senator MORAN. It is not a trick question.

Mr. BLAND. Senator Moran, I am trying not to provide a trick answer.

[Laughter.]

Mr. BLAND. I think it is a combination of both, but I think to my comments, where I said to the extent of the law, one of the major fundamentals is safety and soundness and consumer protection. And so when we look at and make determinations of what regulations should or should not apply, that is one of the standards we look at. And what we are finding is, as the industry evolves, there is not a clear demarcation line in all instances anymore, especially the complexity. You look around technology and all, where there may have been years ago the ability to make a cutoff based on asset size, we now have to make a determination about what regulations apply based on the complexity and the operations of the institution. In some instances that is regardless of size.

And so we really try to take that focus on safety and soundness and consumer protection.

Senator MORAN. I think what you are telling me—let me see if I understand you correctly—is that it is not a specific regulation, it is not 101, subparagraph (b), item (I), that necessarily causes the problem. It is the broader phraseology, safety and soundness, that then allows your examiners to make more judgmental decisions based upon policies of the regulation—of the regulator?

Mr. BLAND. Yes.

Senator MORAN. So the ability to address that legislatively becomes difficult. I assume we cannot direct you necessarily to get rid of that subparagraph. And this then requires you to use common sense and good judgment in making the determinations about whether something complies or does not comply.

Mr. BLAND. And ensures that the examiners—we have an overarching process to make sure we are being consistent and we are appropriately applying the law and our established guidance and practices. And so it is ensuring that we are executing the supervision the right way.

When I look at my experience of examining banks of more than 30 years, I am not sure that additional regulation is not necessary. It is very——

Senator MORAN. I did not understand you. Is or is not?

Mr. BLAND. Is not necessary.

Senator MORAN. And so what I think you are telling me, reminding me, is that the people who are in the positions that you are in and those who work for you and those you work for are critical in the outcome of whether or not we have the right regulatory scheme and whether or not the burden is appropriate based upon the risk.

Mr. BLAND. Senator Moran, I believe Congress has the responsibility to determine what laws should be in place, but that has to be in tandem with the regulator's ability to effectively carry that out, and keeping in mind its core mission of safety and soundness and consumer protection.

Senator MORAN. Let me go to a specific piece of legislation that I am interested in. I have introduce Senate bill 727, Financial Institutions Examination Fairness and Reform Act. It is a bipartisan piece of legislation. The bill would create an Ombudsman under FFIEC to ensure consistency in examinations, but perhaps as important to me is it would also require that timely exam reports and providing examined financial institutions the ability to appeal their examination without fear of their examiner coming down on them.

Senator Crapo mentioned Operation Choke Point. I actually think that what happened there sent one more message to those you regulate about needing to be fearful of their examiners. I think this was a mistake, and it set an attitude and atmosphere different than what existed before.

I would tell you, though, that I have had Kansas bankers who bring me complaints or concerns about specific things within, in this case, the FDIC, but the list is longer than that. And I said let us meet with Chairman Gruenberg and let us have a conversation. You as the bankers and me in the room, we will have a conversation and see if we cannot sort this out. And we will hear what their perspective is; you can provide your input.

Not a single banker was willing to sit in a room with the FDIC to present their case and to have that conversation because they were fearful of what the next exam would—how it would occur and what would happen.

That is disturbing to me. This ought to be a cooperative effort in which we are determining the safety and soundness of the bank and trying to make certain that that bank fulfills its mission in their community. The fact that bankers—and so the end result was we had the President of the Kansas Independent Bankers meet with them. We had the President of the Kansas Bankers Association meet. It had to have that level, that distinction, and so no particular bank could encounter what they believed would be retribution for complaining about something that was happening.

How do we get—certainly I am supportive of my legislation, but I would guess that all of you would tell me that is nothing that you want—that fear is nothing you want to have happen. Why does it exist? And how can you get rid of it?

Ms. EBERLEY. Let me start. So we first encourage open communication through the examination process. We invite, by policy,

board members to participate in any conversation during the examination with the examiners. That happens at the beginning of every examination. We have a policy against retribution. We enforce that policy.

Relative to Operation Choke Point, which is a Department of Justice initiative, we do have guidance out on banks' relationships with third-party payment processors. There is BSA guidance out on those relationships. We have clarified how we are supervising that process, and we have asked that if any institution feels that our examiners are not carrying out our policies, that they notify their regional director, myself as the head of the Director of Supervision, our Ombudsman, or our Inspector General.

Senator MORAN. Do any of you oppose this legislation for this FFIEC Ombudsman on behalf of financial institutions? Do you see that as duplication of what you are already doing? Not necessary?

Ms. EBERLEY. We have broad concerns with parts of the proposed legislation, including the Ombudsman, that would be outside of an agency that is accountable for its ratings that it assigns and its supervisory process, that it would take that appeals process to an entity that does not have accountability. We have——

Senator MORAN. Ms. Eberley——

Ms. EBERLEY.——some other concerns as well——

Senator MORAN. Excuse me.

Ms. EBERLEY. I am sorry.

Senator MORAN. No. Pardon me.

Ms. EBERLEY.——with the accounting portions of the rule.

Senator MORAN. Do you think I exaggerate the circumstances I described related to me by bankers, that what I described is not common, it does not exist in any significant way, that it is an aberration that somebody is fearful of their regulator and the consequence of raising a complaint or a concern or disagreeing with an examiner? Is that just overstated?

Ms. EBERLEY. I do not doubt that that is what you have heard and that you are relaying what you have heard. I have to tell you, though, we meet with bankers on a regular basis, and it is not what we hear when we are talking to bankers directly. We ask if anybody has a specific concern to bring it to us, and we get assurances that they would, but they do not have any concerns.

Senator MORAN. Have you ever had the experience of where there was a—that there was a response, an inappropriate response to a bank complaint, and then—you indicated we have policies in place. Examiners cannot cause retribution. Have you corrected retribution in the past?

Ms. EBERLEY. I am not familiar with any acts of retribution, but your first question was whether a policy has been interpreted improperly and whether we have changed that, and we absolutely have. So through our normal appeals process, there have been decisions that go both ways. There have been occasions where a policy has not been interpreted properly, and we overrule the examiner's finding and make a finding in favor of the institution.

Senator MORAN. Let me make sure I understand——

Senator BROWN. And let us wrap it up.

Senator MORAN. Let me make sure I understand the answer to the question. You know of no instance in which a banker has al-

leged that there was retribution, and if there was—and since there was not, there has been no evidence that there has been a response from the agency?

Ms. EBERLEY. I am not aware of any allegations.

Senator MORAN. Thank you, Mr. Chairman.

Senator BROWN. Thank you, Senator Moran. Thank you, Ms. Eberley.

Senator Heitkamp?

Senator HEITKAMP. Thank you, Mr. Chairman.

A couple quick questions first on privacy. How many of you read your privacy notices cover to cover? You know, I was one of the advocates back in the 1990s of the privacy notices. I think now we have had this great experiment. I am pretty sure that if I got a privacy notice and I knew that I was receiving it only because there was an amendment to the privacy, I might actually look at it.

I guess this is a question for anyone. Do you know if there has ever been a study on how many people actually read privacy notices? But yet we incur millions of dollars of expense every year promoting privacy that we have no idea whether it is actually a consumer protection or, you know, in fact, has the opposite result, people become immune to actually looking and preparing the response to their institution.

I also want to just extend what Senator Moran was talking about in terms of examinations. One bad apple spoils the bunch, and I say that because these are institutions who feel under siege, either by regulation or by examination. When one thing happens within one institution, it has a chilling effect across the board on all the institutions, particularly in that State. And so, you know, where you may say, look, we maybe get 1 percent or 2 percent of complaints because of these issues, I will tell you that that 1 or 2 percent may have a much greater impact in the real world, because the chilling effect that you have when people feel like they are up against very high penalties, up against a lot of enforcement and enforcement obligations, their response is let us just not do it because I cannot risk my institution and the penalties. And so I will just say that.

Chairman Gruenberg came to North Dakota at my request. Unlike Senator Moran's experience, our bankers sat down with him and actually had a one-on-one, very candid conversation about concerns about examinations as well as overregulation. I would tell you the follow-up there is why does it take so long to fix this when there was a lot of heading nodding, yes, I get what you are saying.

And it is back to what we said last week, which is that we have got to act sooner rather than later because we are losing the lending lines in these institutions, and in my State, 96 percent of all business is small business. This is the business lender of first resort. It is a rural lender, and we are seeing people retracting from that kind of lending because of concerns about regulation.

Now, my main question is probably a little more esoteric, and it has to do with sub S's, and I know that this is not something that in the broad scheme of things always hits the radar here. But given the current housing situation in North Dakota, many of our community banks are having trouble getting timely appraisals—many of the community banks in North Dakota are sub S's, and I have

heard concerns from many of them about the application of the Basel III capital conservation buffer, and you know that as C corporations, banks with capital deficiency under Basel III can pay their income tax before the dividend restrictions begin. Is the FDIC looking beyond the July guidance to allow S corporation banks to be granted the same flexibility? And this is a critical issue. I guess this goes to you, Ms. Eberley.

Ms. EBERLEY. Thank you. And, Senator, we have—we issued guidance——

Senator HEITKAMP. The July guidance.

Ms. EBERLEY.——in July, discussing how we would use the exemption that is built into the Basel III capital rules about the conservation buffer. So the conservation buffer basically restricts the amount of money that an institution can pay in dividends if they fall below the full amount of the buffer, which is 2.5 percent. It does not go into effect until 2016. It is not fully in effect until 2019.

Nonetheless, we heard concerns about subchapter S banks, that they could fall below the threshold, and they had concerns that that would require their shareholders to pay taxes out of their own income, on the income from the institution.

So what we have done is clarify how we would use the exemption to the extent that we can clarify in kind of a blanket way up front. And so we have said that for well-rated subchapter S institutions that would be paying out no more than 40 percent of their net income to cover the tax obligation of their shareholders, that would remain adequately capitalized after doing so, we would generally expect that we would say yes. So there is a process for the institution to make a request, we would say yes.

So we hear that institutions do not want to ask for things because they think we will say no, so we have signaled ahead we will say yes.

We cannot go beyond that, and that would be the same treatment that we would give to a subchapter C corporation. We do not give blanket approval for an institution to be able to pay dividends or not be subject to dividend restriction if its capital is under pressure, particularly when the capital pressure and diminution of capital could lead to the failure of the institution or the path to failure.

Senator HEITKAMP. But these concerns just add to the weight of overall concerns and I think are resulting in consolidation of our small community banks and reducing the vibrancy and reducing the numbers in a way that I think is not good for the American financial markets and for lenders and borrowers. And so it is really critically important that we understand now one size fits all, that all of this in a cumulative way has a pretty dramatic effect. As we go forward—if I could just ask one more question. He is not paying attention. Anyway——

[Laughter.]

Senator HEITKAMP. Given the current housing situation in North Dakota, many of our community bankers are having trouble getting timely appraisals, and they are frustrated. The appraisals come from out-of-State folks who really do not know the market, and I know I have frequently kind of told the story here that I come from a town of 90 people. We sell a house maybe once every 5 years. Good luck finding comparable sales in Mantador, North Dakota.

The FDIC has taken a look at allowing community banks to conduct—have you taken a look at allowing community banks to conduct valuations for smaller mortgage loans that they will keep on the books? Will you commit to looking at that issue going forward? Because the appraisal issue in rural communities is real.

Ms. EBERLEY. You know, the economic boom in your State has certainly contributed to a high demand for appraisers, and the supply is catching up. It has grown by 20 percent since 2012, since about mid-2012, the number of appraisers. So hopefully that is providing some relief on the supply side.

The second thing I would say is that, you know, we do encourage institutions—and there has been confusion on the institutions' part about when an appraisal is required versus a valuation. We encourage institutions to use valuations when they can, and we issued technical assistance videos this year on both appraisals and valuations to clarify the difference between the two and when they are required. So, yes, we do encourage institutions to use valuations where that is appropriate.

Senator HEITKAMP. If I can just make one last comment, and it is not intended to be a criticism, but, you know, there is a lot of encouraging, and we have sent out this guidance, and I think if we had a greater level of trust between the regulators and the regulated, I think that all of those things would answer the question. But I think there is this sense that there is a "gotcha" world out there, and they are going to get me if I do something that really is coloring outside the lines. And I think we need to be mindful of building back that relationship. I think Senator Crapo made an excellent comment. We have started this process. We somehow cannot seem to finish it, even though we have got great bipartisan support. We all see it. And we have got regulatory support, but yet it does not happen. And that is the frustration here from the community banks and really from Main Street America, you know, going forward.

And so let us kind of renew a commitment to working together, renew a commitment to continuing the process that Senator Crapo initiated many years ago, and actually achieve results, because all the talk that we have here is not going to amount to anything if we actually do not get results out of this process. So thank you all for the hard work.

Senator BROWN. Thank you, Senator Heitkamp.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman. And thank you for your excellent testimony.

Ms. Hunter, the Independent Foreclosure Review has gone through several permutations. In 2013, it was decided to make cash payments directly to those who had been hurt in the foreclosure crisis. But it has been difficult to make the payments. In fact, some of the checks have not been cashed, about $3.9 billion at least, there is a residual. So you have both the opportunity and obligation to get that money out as quickly as possible to the States, and I wonder if you can give us some idea of when you will do this and what you will do.

Ms. HUNTER. Thank you for the question, Senator. Yes, for the Independent Foreclosure Review, one thing I would start with,

about 86 percent of the funds in the pool to be distributed actually have been cashed, or checks have been cashed or deposited. So the percentage is actually pretty high. But that means there is 14 percent of checks that still have not been cashed at this point.

We are continuing to try to locate the affected borrowers, and getting the money into the hands of the affected borrowers is our number one priority. And so that is continuing on.

But I do think you raise a very important point. I know we have been working very closely with the OCC all along the way on this effort. We are working with them to evaluate various options, various alternatives to addressing the resolution of any unclaimed funds. And there are obviously a number of factors we will have to take into account, including any legal restrictions or other information that we get along the way.

But I think you are raising a good point about ultimately the resolution of those funds, and any information that you are providing I am sure will be taken into account with the deliberations that we have and working with the OCC.

Senator REED. Well, I recently wrote to Chairwoman Yellen to urge that she consider getting this money out to funds in the States, in our case, the hardest-hit fund in Rhode Island that has had demonstrable success in preventing foreclosure and helping people, *et cetera.* The worst case would be having these funds sit there for another several years as you all decide what you have to do. So I urge prompt action.

Mr. Fazio, I am a cosponsor of Senator Udall's bill, the Small Business Lending Enhancement Act. In your comments, you look at the bill and say it does contain appropriate safeguards, in your estimate, NCUA, to protect safety and soundness of qualified credit unions. This is a critical issue because no one wants to enable institutions to do things that are beyond their capacity and would in any way even remotely undermine safety and soundness. But that is your conclusion, though, that it would, in fact, not undercut safety and soundness.

Mr. FAZIO. No, we support the legislation. We believe that through the regulatory and examination process we could make sure that that authority was implemented safely and soundly by the credit unions that were willing and able and capable of actually doing that effectively.

Senator REED. And this would provide another source of lending to small businesses particularly, which is the general client to these credit unions.

Mr. FAZIO. Absolutely.

Senator REED. Now let me turn to another issue. You were talking about in your testimony, since 2008, nine third-party vendors, credit union service organizations, have caused more than $300 million in direct losses to the Share Insurance Fund and led to the failure of credit unions worth more than $2 billion in assets. But as you point out, unlike banks, national or State chartered, these vendors are not within the regulatory responsibility of NCUA. Can you elaborate on why this authority is important and vital?

Mr. FAZIO. The authority is particularly important because increasingly credit unions are relying on third-party vendors, including credit union service organizations, to collaborate, cooperate, de-

liver services to members. They are often part of the credit unions' key operational infrastructure, and so they have a significant safety and soundness dimension for individual credit unions, as well as a more widespread or systemic impact if there is a problem.

In fact, we have a few vendors that serve over half the credit union system in key areas, and so a problem with a particular vendor can quickly have a downstream impact on thousands or, if not, hundreds of credit unions. And so it is important for us to be able to have insight into the safety and soundness of that arrangement, including proprietary information that the client credit unions might not even have access to. And, in addition, if there is a problem with that vendor, we need to be able to address it at the source so that it does not end up causing significant problems for thousands of credit unions.

Senator REED. Again, in the spirit of our response to the crisis in 2007 and 2008, we are looking at systemic issues. This seems to be one that is worthy of attention.

Mr. FAZIO. Absolutely, and in particular, as it relates to technology service providers in cybersecurity.

Senator REED. Thank you very much.

Senator BROWN. Thank you, Senator Reed.

Thank you all. I will do a round of questions, and then we will move to the second panel.

The title of the hearing, as you think, is "Examining the State of Small Depository Institutions." Most of you have used the words "community institutions," "community banks," "credit unions." I would just like each of you to give me very briefly—because I have a couple of more substantive questions, if you will, or more focused questions. Each of you, starting with Mr. Vice, if you would just tell me how you define a "community institution." Is it size? Function? Activity? Just give me a short, each of you, definition of how you define in your regulatory sphere and in your mind what that means. Mr. Vice, what is a "community institution" to you?

Mr. VICE. A couple of points that we look at: Where does it operate? Is it operating in the local market? How does it derive its funding? Is it funding from a local market? And what is its primary business lending? Is it taking the deposits that are received from that market and lending in that market? Where is the board and management centered? Are they members of that community? And the lending model of the institution should be not volume drive or automated processes but relationship lending.

So I think instead of a bright-line dollar amount, it would be more of the characteristics of that, and the reason I am saying that is because we have many institutions in Kentucky, about six, that are over $1 billion. I would hate to see the bright line at $1 billion because I view each one of those institutions that meet these characteristics as a community bank in my mind.

Senator BROWN. Fair enough. Good.

Mr. Fazio?

Mr. FAZIO. Senator, we do not use the community definition per se for credit unions. I think that relates to the fact that we have fixed fields of membership, a common bond that credit unions are based around. And we have only one version that is analogous to community charter. Other credit unions have single occupational

sponsors and so forth. So we tend to use a couple of different definitions that are analogous. We also have a definition of "small credit union" that we use in terms of relief and assistance and so forth. We have low-income-designated credit unions, which are credit unions that predominantly serve low-income individuals. We also have new credit unions, newly chartered credit unions that have some special provisions for that.

We do not have a particular single asset size threshold. It tends to be assets as a simplification, $50 million for the smallest institutions, and then another threshold we use for certain rulemaking and supervisory contexts at $250 million.

Senator BROWN. Thank you.

Ms. Hunter?

Ms. HUNTER. Yes, so in looking at community banks for purposes of how we manage our work, we use the $10 billion threshold. We moved to that once it was identified in Dodd-Frank as a dividing line, if you will, and a clear threshold. But I would like to concur with the comments that my colleagues have made. Not every community bank is the same. We certainly recognize that a $150 million bank operating in a small town is very different from maybe an $8 billion bank operating in a suburban neighborhood.

So while we include them all in our community bank program and we think about them collectively, we also recognize that there are differences and that our approach and the issues and the nature of the lending that they do will differ. And so we are certainly attuned to that.

Senator BROWN. Mr. Bland.

Mr. BLAND. Senator Brown, we take a similar approach that you have heard already. Oftentimes it is a general characterization of an institution that is in a generally defined market. They would offer traditional banking services and not an overly complex operation.

The other side of it is that we consider them not to be large banks in terms of what large banks offer. So the community bank model is a general focus on those that are not as complex as other types of institutions, but generally you will see a defined marketplace, really straightforward, plain-vanilla products and services.

Senator BROWN. Thank you.

Ms. Eberley?

Ms. EBERLEY. We use a definition that is based on the characteristics of the institution as opposed to a bright-line asset test. So it is relationship lending as opposed to transactional. It is core deposits versus volatile funding. It is a local geographic community that is fairly tightly defined. And so that ends up including about 300 institutions that are over $1 billion, and it actually excludes some that are less than $1 billion.

Senator BROWN. That is helpful. Thanks.

Ms. Eberley, two quick substantive questions, if you would comment. Some are proposing legislation to remove affiliated title insurance costs from the cap on mortgage points and fees. What are your views on that?

Ms. EBERLEY. I think we do not have an agency position, but have discussed it at the staff level, and I think it is something that you need to study the impact of what it would do. So taking the

fees out from an affiliated company does treat affiliated and unaffiliated companies the same way so it makes it easier for institutions.

But the original consumer protection that was intended in the original statute was to ensure that consumers were not paying a lot of costs in fees and points for a qualified mortgage.

Senator BROWN. And removing caps might do that.

Ms. EBERLEY. It could, and if you have it—yes, it could, and the potential for conflict of interest as well.

Senator BROWN. So there is, if not taking a position on the issue, there is FDIC concern about——

Ms. EBERLEY. Right, I think there are some things you have to consider and flesh out.

Senator BROWN. Thank you. Some are seeking to change the treatment of collateralized loan obligations under the Volcker rule. Any thoughts on that proposal?

Ms. EBERLEY. Sure. I do not think it is actually necessary at this point. I think that the regulatory process has provided the relief, if you will. So new collateralized loan obligations that are being underwritten are conforming to the rule, the exemption that already exists in the rule for a CLO that is composed solely of loans. Existing obligations that are outstanding largely mature before the end of the conformance period, as the Fed has extended it. The Fed has indicated that they would extend the conformance period the maximum amount, which would take it to mid-2017.

And to the extent that a nonconforming CLO would not mature before that time and would not be able to be conformed, they are in the aggregate on call report data right now reporting a net gain, so disposing of such an instrument would not impair an institution's capital.

Senator BROWN. So you said unnecessary or—are you agnostic on the proposal then? Or would you be cautious about it or——

Ms. EBERLEY. I would be cautious. So there are tradeoffs here again in terms of changing the definitions and perhaps some unintended consequences.

Senator BROWN. OK. Thank you. Thank you to all of you on the panel. You were very helpful today to all of us. Thank you very much.

The second panel has six people, so we are going to add a chair. Let me just do bios of the six witnesses as you get settled and as the staff figures out how to squeeze one more person in. Thanks again to Ms. Eberley, Mr. Bland, Ms. Hunter, Mr. Fazio, and Mr. Vice for joining us.

Jeff Plagge is President and CEO of Northwest Financial Corporation, Arnolds Park, Iowa. He served as Chairman of the American Bankers Association.

John Buhrmaster is President of First National Bank of Scotia in Scotia, New York. He serves as Chairman of the Independent Community Bankers of America.

Dennis Pierce is Chief Executive Officer of Community America Credit Union in Kansas City, Missouri. He serves as Chairman of the Board of Directors of the Credit Union National Association.

Linda McFadden is President and CEO of XCEL Federal Credit Union in Bloomfield, New Jersey. She is testifying on behalf of the National Association of Federal Credit Unions.

Marcus Stanley, Policy Director at the Americans for Financial Reform, is a former Case Western Reserve University professor In Cleveland.

And Michael Calhoun is President of the Center for Responsible Lending.

I thank all of you for joining us. We will get settled and begin the testimony.

[Pause.]

Senator BROWN. Thank you all for joining us. Mr. Plagge, we will start with you and your opening statement. Keep it to approximately 5 minutes. If you go over a little while, that is fine, but do not do 10, if it all the same. So, Mr. Plagge, if you would start, and we will work from my left to right. Your microphone, Mr. Plagge.

STATEMENT OF JEFF PLAGGE, PRESIDENT AND CEO, NORTHWEST FINANCIAL CORPORATION, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. PLAGGE. There we go. Thank you very much, Chairman Brown and Ranking Member Moran and Members of the Committee. My name is Jeff Plagge, President and CEO of Northwest Financial Corporation in Arnolds Park, Iowa. I am also the Chairman of the American Bankers Association. I appreciate the opportunity to be here today to represent the ABA and discuss the state of community banking.

Let me begin by saying that the state of our community banks is strong, but the challenges we face are enormous. As I travel the country in the role as Chairman of ABA, I am constantly impressed by how resilient community bankers are and how dedicated they are to serving their communities. Like all small businesses, they have suffered through the Great Recession. Every day these banks work to meet the needs of their customers and their communities, but their ability to do so has been made much more difficult by the avalanche of new rules and regulations.

Banks have had to deal with over 8,000 pages of final rules from the Dodd-Frank Act, with an additional 6,000 pages of proposed rules. This is an enormous challenge for any bank, but nearly impossible for a community bank, which typically has fewer than 40 employees.

The impact goes beyond just dealing with new compliance obligations. It means fewer products are offered to customers. In fact, 58 percent of banks have held off or canceled the launch of new products due to the expected increases in regulatory costs and risks. This means less credit to our communities. Less credit means fewer jobs, lower income for workers, and less economic growth.

If left unchecked, the weight of this cumulative burden could threaten the model of community banking that is so important to strong communities, strong job growth, and a better standard of living. We are already feeling the impact. Over the course of the last decade, over 1,500 community banks have disappeared. Today it is not unusual to hear bankers—from various healthy, strong banks—say they are ready to sell because the regulatory burden

has become too much to manage, a new tipping point in that regard. These are good banks that for decades have been contributing to the economic growth and the vitality of their towns but whose ability to continue to do so is being undermined by the excessive regulation and the Government micromanagement. Each bank that disappears from a community means fewer opportunities in that community.

We must stop treating all banks as if they were the largest and most complex institutions. Financial regulation and exams should not be one-size-fits-all. All too often, the approach seems to be if it is a best practice for the biggest, it might as well be best practice for all banks. This approach layers on unnecessary requirements and does little to improve the safety and soundness, but adds significantly to the cost of providing services—a cost which ultimately is borne by the customer.

Examiners should give credit to well-run banks that know their customers. The one-on-one relationship banking model is the core of community banking. If everything is going to be forced into a standard regulatory box, then we might as well accept the fact that community bank consolidation will accelerate. One-size-fits-all judgments as to whether and how much to reserve against loans, especially when driven solely by numerical analysis, take away the bankers' autonomy and the value of their judgment in contributing to the best allocation of capital to enhance the growth of their communities.

Instead, the ABA has urged for years that a better approach to regulation is to take into account the charter, the business model, and the scope of each bank's operation—in other words, risk-based, regulatory oversight. The time to address these issues is now before it becomes impossible to reverse the negative impacts.

We are appreciative of the efforts of many on this Committee for introducing bills that make a difference. In particular, we would like to thank Senators Brown, Toomey, Manchin, Warner, Moran, and Tester for introducing their bills that have been talked about earlier by the first panel.

While no single piece of legislation can relieve the burden that community bankers face, many of these bills could begin to provide much needed relief. We urge Congress to work together, House and Senate, to get legislation passed and to send to the President that will help community bankers better serve their customers.

Thank you, and I would be happy to answer any questions.

Senator BROWN. Thanks, Mr. Plagge, and thank you for your kind words about our legislation.

Mr. Buhrmaster, welcome.

STATEMENT OF JOHN BUHRMASTER, PRESIDENT AND CEO, FIRST NATIONAL BANK OF SCOTIA, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. BUHRMASTER. Chairman Brown, Ranking Member Moran, Members of the Committee, my name is John Buhrmaster. I am President and CEO of First National Bank of Scotia, a $425 million asset bank in Scotia, New York. We are a closely held bank serving rural and suburban communities in the areas of Albany, Schenec-

tady, and Saratoga since 1923. I am a fourth generation community banker.

I am also Chairman of the Independent Community Bankers of America, and I testify today on behalf of more than 6,500 community banks nationwide. Thank you for convening this hearing.

Based on my discussions with hundreds of community bankers from across the country, I can tell you the state of the industry is resilient and gaining strength in the wake of a historic financial crisis. My personal assessment is confirmed by the most recent FDIC Quarterly Banking Profile. Community banking income is up 3.5 percent from a year ago. More community banks are profitable, asset quality has improved, and there are fewer problem banks.

However, in a historically low interest rate environment, community banks continue to struggle with low margins. Of particular concern is a regulatory burden that is growing both in volume and complexity, suffocating the true potential of community banks to spur economic growth and job creation in their communities. We look to this Committee and the Senate to address these genuine concerns. Even in the short time remaining in this Congress, there is still a real opportunity to provide meaningful relief for community banks. A number of important bills with broad, bipartisan support are positioned for action. ICBA urges the Senate to act before Congress adjourns.

ICBA's legislative and regulatory agenda is built on the principle of tiered regulation, calibrated according to institutional size, business model, and risk profile. Tiered regulation will allow community banks to reach their full potential, without jeopardizing safety and soundness or consumer protection.

The Senate bill that best captures the principle of tiered regulation is the CLEAR Relief Act, S. 1349, sponsored by Senators Moran, Tester, and Kirk. With 40 bipartisan cosponsors, the CLEAR Act is a package of true consensus provisions. We are grateful to the Members of this Committee who have sponsored and cosponsored this bill.

The bill's provisions have been debated and advanced in different forms during this Congress. ICBA strongly encourages this Committee to ensure the CLEAR Relief Act or similar regulatory relief measures pass the Senate expeditiously.

A total of six community bank regulatory relief bills have passed the House. Most passed with broad, bipartisan support and have Senate counterparts awaiting action. If scheduled, all or any one of these bills could pass the Senate with the same broad, bipartisan support. H.R. 3329, for example, would raise the Federal Reserve Small Bank Holding Company Policy Statement threshold to allow additional banks to more easily raise capital. My bank and other banks are bumping up against the current outdated threshold of $500 million. H.R. 3329 passed the House by voice vote.

Another bill, the Privacy Notice Modernization Act, S. 635, sponsored by Senators Brown and Moran, has more than 70 cosponsors, including most Members of this Committee. ICBA strongly urges the Committee's assistance in obtaining swift passage of these and other broadly supported bills.

As important as our legislative agenda is, we also have a great deal at stake in agency rulemaking. I would like to highlight just one of ICBA's current agency initiatives.

Two weeks ago, ICBA delivered a petition to the banking agencies calling for streamlined quarterly call report filings. The petition was signed by nearly 15,000 bankers representing 40 percent of all community banks nationwide. The quarterly call report has grown dramatically. In 2001, my bank filed a 30-page call report. Today the call report comprises 80 pages of forms and 670 pages of instructions. A typical community with $500 million in assets spends close to 300 hours a year of senior-level, highly compensated staff time on the quarterly call report. Now Basel III may add nearly 60 additional pages of instructions.

ICBA is calling on the agencies to allow highly rated community banks to submit a short form call report in the first and third quarters of each year. A full call report would be filed at midyear and at year end. The short form call report would contain essential data as required by regulators to conduct offsite monitoring. This change, together with action on some of the bills I have cited, would allow community banks to dedicate more resources to serving their communities and sustaining a broad-based economic recovery.

Thank you again for the opportunity to testify today, and I sincerely look forward to your questions.

Senator BROWN. Thank you, Mr. Buhrmaster.

Mr. Pierce, welcome.

STATEMENT OF DENNIS PIERCE, CHIEF EXECUTIVE OFFICER, COMMUNITYAMERICA CREDIT UNION, ON BEHALF THE CREDIT UNION NATIONAL ASSOCIATION

Mr. PIERCE. Thank you, Chairman Brown and Ranking Member Moran. We appreciate the opportunity to testify at today's hearing.

Credit unions were established to promote thrift and provide access to credit for provident purposes. We exist to provide consumers and small businesses with an alternative to the for-profit institutions.

The good news is the credit union system remains very sound and has seen historically strong membership growth in the wake of the financial crisis. We recently celebrated 100 million credit union memberships and total assets of $1.1 trillion. The system is very well capitalized. These milestones show that the steps Congress and State legislators took many years ago to authorize credit unions has been successful, and credit unions are increasingly relevant and critical to consumers and small businesses.

Credit unions continue to serve the purpose for which Congress provided the tax exemption. The bad news is that it is becoming increasingly difficult for credit unions to serve their members when the laws and regulations coming out of Washington are blind to the structural and size differences between credit unions and banks. Congress and regulators ask a lot of small, not-for-profit financial institutions when they tell them to comply with the same rules as JPMorgan and Bank of America because the cost of compliance are proportionately higher for smaller-sized credit unions than these huge institutions. Almost half of the credit unions in the United

States operate with five or fewer full-time employees. The largest banks have compliance departments many times that size.

The rules that the CFPB has issued so far have not taken the key distinctions between the large and small institutions into consideration as much as they can or should under the law. Further, what is maddening to credit union managers and volunteers is the abundance of rules to which they have been subjected recently, brought on by actions taken by others in the financial services sector. Credit unions did not engage in the practices that contributed to the financial crisis and prompted these new rules and regulations. We do not understand why our members' service should suffer because someone else treated their customers poorly.

We urge the Senate to be proactive in its oversight of the National Credit Union Administration, which has issued a deeply flawed proposal on risk-based capital. We appreciate the leadership of those on the Committee, including the Chairman and the Ranking Member, who have weighed in with concerns regarding this rule. We appreciate that NCUA has already signaled major changes, and we urge this Committee to help ensure the agency's changes result in a balanced rule that is fully consistent with the Federal Credit Union Act.

While CUNA supports strong but fair safety and soundness efforts, our members continue to raise numerous issues about arbitrary examinations and inadequate appeals processes. We urge the Committee to work with the Federal Financial Institution Examination Council and State regulators to minimize ad hoc examiner decisions that can be extremely difficult to appeal.

We also urge you to take action to require the CFPB to use the exemption authority Congress has already provided to relieve community banks and credit unions from onerous requirements. We were dismayed that the exemption provided in the remittance rule did not go further, and we believe mortgage and mortgage servicing rules should provide more exemptions and relief for credit unions.

This Committee should exercise its oversight responsibility regarding the Federal Housing Finance Agency. The proposal on home loan bank eligibility and the possibility of increased guarantee fees concern us greatly. If adopted, these actions will make it more difficult for credit unions to serve their members and could adversely affect credit availability.

Finally, we hope the Committee will take action on several bills that represent small steps in the right direction.

We ask the Senate to pass Senators Brown and Moran's privacy notification bill so that we have the opportunity to make the privacy notices consumer receive more meaningful and reduce credit unions' cost for mailings that consumers simply disregard.

We ask the Senate to pass Senator King's bill, which is cosponsored by Senators Warner and Tester, so that lawyer trust accounts held at federally insured credit unions have insurance coverage on par with that of FDIC-insured banks.

We ask the Senate to pass Senators Brown and Portman's bill related to the Federal Home Loan Bank eligibility for privately insured credit unions so that this small group of credit unions will have access to the home loan banking system subject to the same

regulations as insurance companies and other financial institutions.

These bills have already passed the House of Representatives, each without a single vote of opposition, so they are simply waiting for the Senate to act.

We also ask that these and similar measures be considered as the first step in a major overhaul of the rising flood of regulations. We understand that appropriate regulation is necessary, but overregulation hurts those it is intended to help. Without meaningful relief, consolidation in the credit union sector will continue, and Americans' access to affordable financial services will be in jeopardy.

Thank you so much for the opportunity to testify. I will be pleased to answer questions.

Senator BROWN. Thank you very much, Mr. Pierce.

Ms. McFadden, welcome. Your microphone, Ms. McFadden.

STATEMENT OF LINDA MCFADDEN, PRESIDENT AND CEO, XCEL FEDERAL CREDIT UNION, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Ms. MCFADDEN. Good morning, Senator Brown and Ranking Member Crapo and Members of the Committee. My name is Linda McFadden. I am testifying today on behalf of NAFCU. I am happy to be appearing before the Committee today to talk about the state of small financial institutions.

I currently serve as the President and CEO of the XCEL Federal Credit Union in Bloomfield, New Jersey. XCEL Federal Credit Union was started in 1964 by the employees of the Port Authority of New York and New Jersey. We now have $155 million in assets and over 18,000 members.

Credit unions, no matter what their size, have always been some of the most highly regulated of all financial institutions, facing restrictions on who we can serve and our ability to raise capital. Many credit unions are saying, "Enough is enough," when it comes to the overregulation.

While NAFCU and its member credit unions take safety and soundness extremely seriously, the regulatory pendulum post crisis has swung too far to the environment of overregulation that threatens to stifle economic growth.

Since the second quarter of 2010, we have lost over 1,000 federally insured credit unions, 96 percent of which were smaller institutions below $1 million in assets. Many smaller institutions simply cannot keep up with the new regulatory tide and have had to merge out of business or be taken over.

At XCEL, we have felt the pain of these burdens as well. There are costs incurred each time a rule is changed, and the costs of compliance do not vary by size of institution. We are required to make updates, to retrain our staff each time there is a change, just as the larger institutions.

The biggest challenge facing XCEL today is NCUA's risk-based capital proposal. The proposal as it is written would negatively impact XCEL, taking us from a well-capitalized credit union to adequately capitalized. This proposal would force us to curtail lending to small businesses such as a recent loan we issued to a ServPro

franchise that was seeking to grow his business and meet the demand of Hurricane Sandy. My written testimony outlines in greater detail the concerns we have for this proposal. Without significant changes to the rule, many credit unions, including mine, will be negatively impacted.

Congress must continue to provide oversight and make sure that the issue is studied and fully vetted for economic impact before NCUA moves forward.

Regulatory burden is also a top challenge facing all credit unions, and that is why in 2013 NAFCU unveiled a "Five Point Plan" for regulatory relief and a "Dirty Dozen" list of regulations to repeal or amend, which are outlined in my written testimony. There are several bills pending in the Senate that we would urge action on to provide the first steps to relief for credit unions.

S. 635, the Privacy Notice Modernization Act of 2013, would remove the requirement that financial institutions send redundant paper notices to the members.

S. 2698, the RELIEVE Act, this legislation, along with S. 2699, would provide important relief to credit unions with interest on lawyers' trust accounts, IOLTAs, ensuring parity between the coverage between the National Credit Union Share Insurance Fund and FDIC on these accounts.

S. 1577, the Mortgage Choice Act of 2013, would make important changes that would exclude affiliated title charges from the points and fees definition and clarify that escrow charges should be excluded from any calculation of points and fees.

We also encourage the Committee to weigh in with regulators to urge them to take steps to provide regulatory relief. A series of steps that regulators such as NCUA, CFPB, the Federal Reserve, and the FHFA can take to help credit unions are outlined in my written testimony.

In conclusion, the growing regulatory burden on credit unions is the top challenge facing the industry today, and credit unions are saying, "Enough is enough," when it comes to the overregulation of our industry. We would urge the Committee to act on credit union relief measures pending before the Senate and to call on NCUA to dramatically change and repropose its risk-based capital rule.

We thank you for the opportunity to share our thoughts with you today, and I welcome any questions.

Senator BROWN. Thank you, Ms. McFadden.

Dr. Stanley, welcome.

STATEMENT OF MARCUS M. STANLEY, PH.D., POLICY DIRECTOR, AMERICANS FOR FINANCIAL REFORM

Mr. STANLEY. Senator, thank you. Senator Brown and Members of the Committee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform.

There is no question that the community banking business model, with its emphasis on local knowledge and relationship-oriented lending, can create unique benefits for local economies, for risk management, and for customer service.

At the same time, community banking is still banking, and the basic principles of banking regulation apply. Thus, in making regulatory decisions, policymakers should seek to preserve the special

benefits of community banking without undermining the core regulatory goals of prudential soundness and consumer protection.

In striking this balance, the first point to consider is size. According to the FDIC's functional definition of "community banking," 99.7 percent of community banks have fewer than $5 billion in assets, and these banks hold 94 percent of community banking assets. Furthermore, the economic problems in the community banking sector appear most concentrated among smaller entities. The entire decline in the number of banks over the last three decades has occurred among banks with fewer than $1 billion in assets, particularly those with less than $100 million.

More recent profit trends show that there is a continuing divergence in the fortunes of smaller banks and the rest of the sector.

During the first 6 months of 2014, not a single bank with more than $10 billion in assets registered a loss, but over 12 percent of banks with less than $100 million in assets did.

Although it is obvious that community banks are small, it is still a point worth making. We often see larger banks seek to benefit from regulatory accommodation when there is little evidence that these larger banks either share the unique characteristics of community banks or face the kinds of economic issues seen among smaller banks.

The data above suggests that measures aimed at assisting community banks should generally be limited to those banks with fewer than $5 billion in assets and have their strongest focus on those with $1 billion in assets or less.

Community banks were obviously not at the center of the 2008 crisis. This suggests that the regulatory response to the crisis should focus on larger entities, and for the most part it has. Most new areas of Dodd-Frank regulation have been tiered, either in statute or through regulatory action, so they have their greatest impact on larger banks. New derivatives rules generally exempt banks with under $10 billion in assets from mandatory clearing and margining. New prudential requirements instituted by the Federal Reserve under Section 165 of the Dodd-Frank Act are limited to bank holding companies with over $50 billion in consolidated assets and are most stringent at advanced approaches' banks with in excess of $250 billion in assets.

Of course, this does not mean that the financial crisis has had no effect on the oversight of community banks. The crisis taught many hard lessons about credit risk, securitization risk, and the significance of consumer protection. These lessons apply in all areas of banking. The risk management failures observed during the crisis affected community banks as well. Over 450 banks failed between 2008 and 2012, more than 90 percent of which were community banks. At one point during this period the Deposit Insurance Fund showed an aggregate deficit of over $20 billion. The potential exposure created by the Deposit Insurance Fund has only been increased by the expansion of the deposit insurance guarantee to a quarter million per depositor in the Dodd-Frank Act.

Regulators have applied the lessons of the crisis in ways that have resulted in stronger prudential oversight of real estate lending as well as securitization holdings and a more stringent definition of capital. While motivated by the financial crisis, these

changes are not mandated by the Dodd-Frank Act. They would likely have occurred anyway as a response to the crisis experience.

I would like to close with a few general suggestions on ways that policymakers can address the needs of community banks.

First, community banks are particularly likely to benefit from technical assistance in reporting and analysis. This will reduce the initial fixed cost of compliance, particularly for the smallest community banks, which might otherwise need to hire consultants or additional employees.

Second, policymakers should be attentive to the ways in which stronger regulation of larger banks is necessary to help level the playing field in financial services. Legislative efforts to mandate higher capital levels for the largest banks, such as the bill introduced by Senators Brown and Vitter, are a valuable corrective to funding costs and balances, as are regulatory rules that scale capital requirements by bank size and funding models.

Finally, any measures to assist community banks should be limited to actual community banks—that is, generally small banks—and should not weaken fundamental regulatory oversight powers that should apply to all types of banks. One example of a proposal that, in my opinion, may not meet this test would be S. 727, the Financial Institutions Examination Fairness and Reform Act. This legislation is not limited in the size of banks it applies to, and it would create so many additional restrictions on the capacity of bank supervisors to make and enforce independent judgments that it could fundamentally alter the nature of regulatory oversight.

Thank you for the opportunity to testify here today. I am glad to respond to questions.

Senator BROWN. Thank you, Dr. Stanley.

Mr. Calhoun, welcome.

STATEMENT OF MICHAEL D. CALHOUN, PRESIDENT, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Thank you, Chairman Brown, Ranking Member Moran. This is, as everyone has noted, a critical hearing about institutions that are critical to the health of the overall economy and particularly underserved markets.

The Center for Responsible Lending is the affiliate of a long-time community development lender. Over more than 30 years, we have provided billions of dollars of home loans, small business loans, and consumer financial services to tens of thousands of families. We are directly familiar with the benefits and challenges of delivering these products and services as a community lender.

Personally, I have been in charge of a number of these lending programs, including home lending and small business lending. I also have served for more than a decade as the general counsel for the lender and have personally drafted and overseen the distribution of the privacy notice, the annual privacy notice, which we have discussed today. So I think I have more invested in that than perhaps anyone else in the room right now on a personal level.

I think everyone here acknowledges the role and value of community banks and credit unions. As noted, there are more than 100 million credit union members in the U.S. Community banks and credit unions provide basic account services for a substantial part

of the overall U.S. population. And it has also been acknowledged that we need flexibility in how we regulate these institutions. This has been acknowledged by the regulators here today and by the CFPB as well.

I want to comment first on the CFPB and recognize some initiatives there that specifically provide flexibility for community banks.

First of all, as this Committee knows and as commented on, the CFPB's most important and visible rule was the qualified/mortgage ability to repay rule, which goes to the heart of the cause of the financial crisis. The CFPB on its own volition created a special small creditor definition under that rule, not required by statute. Pursuant to that, for example, it set a different interest rate standard for loans that could receive a safe harbor. As we know, over 95 percent of loans in the overall market received safe harbor, but for community banks they were given an extra 200 basis points.

So what that means in today's market, for the market overall you can get a safe harbor for a loan up to 5.5 percent interest rate on a first mortgage loan. For community banks, the CFPB raised that to over 7.5 percent. It is a floating margin, but in today's market over 7.5 percent for community banks.

Similarly, the CFPB created small bank exceptions for servicing, and today it is taking comments on how to craft effective protections for community banks for special balloon loans. It created a broad exception for the next 2 years, and it is, as we talk now, taking comments on how to expand what is captured in the rural definition, and we support those efforts to expand that.

At the same time, it is critical to ensure that consumer protection is not lost. A corollary to the community banks playing a key role in the economy is that they are part of that economy in both impact and are impacted by it. The Dodd-Frank reforms protect the economy and community banks in key ways.

First, by providing basic consumer protections in sustainable financial transactions, it creates an avenue and opportunity for confident consumers to invest. Consumer spending is still over 70 percent of our overall economy.

And, second, as we saw in the housing boom, the absence of standards led to a race to the bottom that affected all members of the financial market. If you did not participate in those risky products, you saw your market share plunge. And even when you did not participate, everyone was affected by plunging home values, risky mortgages, foreclosures, and heavy job losses. And so we must not lose sight of maintaining those basic protections that have been created for both consumers and for the whole economy.

A specific issue I want to address is portfolio loans, and there sometimes is an assumption that portfolio loans are by definition safe. I would remind us that two of the largest failing institutions in the crisis—WaMu and Wachovia—were driven down in large part by portfolio loans, and even among some community banks, there have been portfolio loans that have been very unsafe for consumers, particularly with refinances, when the consumer's home equity is what really provides the collateral for the loan, they are in the first-loss position, and that has and can encourage risky lending.

In conclusion, we urge both flexibility for community banks and effective consumer protections. They are both key pillars of a healthy economy. We are committed to continuing to work with community banks, credit unions, their associations and regulators, and this Committee to achieve that goal, and I look forward to your questions. Thank you.

Senator BROWN. Thank you, Mr. Calhoun. Thank you all for your really helpful testimony and for the kind words about a number of pieces of legislation Senator Moran and I are working on.

Mr. Buhrmaster said something as he was testifying, what I was thinking of a couple years ago, Fed Governor Tom Hoenig of Kansas City said—did a back-of-the-envelope calculation that would require 70,000 examiners to examine a $1 trillion bank with the same level of scrutiny as a community bank, something that—I mean, it is slightly debatable, whatever the ratios are, but certainly is, I think, telling.

Let me start with Dr. Stanley. The House counterpart of this Committee, the Financial Services Committee, is moving forward with legislation to amend the application of the Collins amendment to insurance companies, legislation I worked on with Senator Collins and Senator Johanns, sitting on this Committee also. They have in the last few days added extraneous provisions that I believe, unfortunately, are supported by the associations testifying today. Two such provisions deal with—I asked the last panel about—deal with derivatives and collateralize loan obligations.

Do you have views on those two provisions, Dr. Stanley?

Mr. STANLEY. Yes, I do. As you know, we worked closely with your office on the development of this legislation, and I think it was really a model for how we can develop bipartisan initiatives to address genuine technical changes, genuine technical fixes in Dodd-Frank. And I know you put a lot of effort into reaching out to us, to Sheila Bair, to the industry, to create something that could get bipartisan support and move through the Senate on that basis. And it is unfortunate that these provisions, which I do not think show that level of drafting care or work, have been added on in the House.

I think the Volcker rule provision on collateralized loan obligations, we heard from the regulators that that is an unnecessary provision. And it also puts in statute a change in the definition of ownership that would essentially say that if you can fire the manager, fire and replace the manager of a securitization, then you do not own it. I think that could very well turn out to be a problem in the future. To me, if you can hire and fire someone, you know, you have some ownership interest there.

And the derivatives elements in that legislation, I think they do a lot of things the regulators have already done in terms of exempting end users from a derivatives margin, but they also effectively eliminate the CFTC's authority to step in and require a derivatives margin in a case where it might be necessary in the future at a nonbank derivatives dealer. And I think that could be dangerous.

So I just do not think that those pieces of legislation show the care that you showed in creating the insurance capital.

Senator BROWN. Thank you. The original bill—or the second generation of the original bill, if you will, that ultimately went through

the Senate with no dissenting votes, which is not always easy here, as you know. So thank you for your help.

Mr. Calhoun, the same House legislation attached to the Collins amendment would remove affiliated title insurance costs from the cap on mortgage points and fees. Give me your thoughts on that.

Mr. CALHOUN. Well, first of all, Federal law has distinguished between affiliate fees and non-affiliate fees for several decades. It was in the original provisions of the Truth in Lending Act, and it was there because of the concern that affiliates might be charging more for similar products and encourage lenders to require products that may not be necessary. This is a particular risk in title insurance, and we are talking about significant dollars. So in DC today, for a median-priced house, title insurance is $3,000 or more, the bulk of which is paid as a commission actually to the party who secures the title insurance.

There are companies who offer lower prices. They talk about these premiums being set at the State level. That is the maximum premium. That is not the required premium. There is some competition below that. And so, for example, in DC there are title insurers who will save you 25 percent or more off that price. You will not get that discount with an affiliate title. And so you are talking about in DC an extra $750 that that consumer is going to pay. But across the country, you are talking hundreds of extra dollars that consumers will pay for that.

Senator BROWN. So with this provision added to the Collins amendment bill, where Dr. Stanley used to live, in Cleveland, it could cost a home buyer several hundred dollars?

Mr. CALHOUN. Yes. More for the affiliate——

Senator BROWN. Several hundred more——

Mr. CALHOUN.——and you will see pressure for those premiums to keep going up. They are already way out of sync with what title insurance costs in this day of automated title searches.

Senator BROWN. Thank you. Legislation, Mr. Calhoun, was recently introduced that would scale back the Consumer Bureau's examination authority from banks with more than $10 billion in assets to those with more than $50 billion in assets. By my count, that would narrow the examination authority of CFPB from 109 institutions out of 6,000 to 19, so it would be pretty much one-quarter of 1 percent of institutions would be subject to that. What do you think of that?

Mr. CALHOUN. We have deep concerns there. Again, as your numbers show, it reduces it from the current 2 percent of community financial institutions that are subject to examination to about a quarter of 1 percent. But those larger ones, as I mentioned, provide significant levels of financial services, for example, deposit accounts to the American public. We looked at numbers that about a quarter of deposit accounts overall in the aggregate (and particularly from those larger members) are provided by these institutions. And there are a number of issues that have been highlighted in investigations there, for example, overdraft fees on debit cards that are subject to appropriate review, and we would hope that this continues at the current levels.

Senator BROWN. OK. Thank you, Mr. Calhoun.

Senator Moran?

Senator MORAN. Chairman, thank you.

Let me first on a specific issue turn to Mr. Pierce and/or Ms. McFadden. Credit unions are very interested in being allowed to utilize third-party vendors. I want to make sure I understand this issue, if either one or both of you would like a chance to tell me the story.

Mr. PIERCE. Sure. First of all, I think NCUA's concerns are primarily overstretching their reach. We saw very little problems related to these service organizations even during the financial crisis and certainly did not see a large impact on the financials of the Share Insurance Fund as a result of that.

I think they have that opportunity under the existing structure through our institutions to look at the organizations that we choose to do business with. We have certainly had them do that in the course of examinations of our credit union. And we also have and own service organizations that we are more than happy to make sure that they have the ability to ask questions about the operations of those institutions. So while I think there may be a few exceptions that they could speak to, I think in the majority of service organizations and third-party vendors there is not huge risk to credit unions under the current structure.

Senator MORAN. Thank you very much.

Ms. MCFADDEN. I would like to add to that. Just for the Committee's knowledge, a CUSO, or credit union service organization, is an organization that is created and made up by credit unions, and the people who participate in what they offer are also credit unions. So NCUA is already regulating these entities when they regulate my shop. When they come in and look at my vendor due diligence and they run into a CUSO, they can see what other credit unions participate in that CUSO and follow through. They are examining that entity not only once, but they are examining it with every credit union that uses that CUSO.

So why do they need to overstep the bounds and go into that entity and review them again? Is not reviewing them five or six or ten times sufficient? That is my question.

Senator MORAN. Thank you very much.

Let me ask the two of you, Mr. Buhrmaster and Mr. Plagge, you heard the testimony of the previous panel. I wanted to give you the opportunity to respond to anything that you heard that you would like for us to know based upon the testimony that was given. I am particularly interested in knowing about the value of an ombudsman. Is there a willingness for bankers to visit with their regulators, with credit unions to visit with their regulators, to express concerns?

And then, second, help me determine whether or not the problem lies with the law—I guess ultimately it all lies with the law if there is a problem because we give the authority for regulators to do what they do. But it seems to me what I heard today is that it is much more likely as compared to complaining about the particular section and provision of a regulation or legislation, law. It is in the safety and soundness and other broad regulatory arenas that many of the things that our bankers face today are—the challenges that they face today arise.

And then, finally, I would like for you to explain to me why, as Mr. Stanley, Dr. Stanley, indicated, you are different than larger institutions, but also indicated that there was a reason to make certain that the regulations were of a satisfactory nature. What makes you different that we ought to reach a different conclusion or the regulators ought to reach a different conclusion when regulating your institution as compared to something significantly larger or something significantly different than a community financial institution? Mr. Plagge?

Mr. PLAGGE. Very good. Thank you. I will mention one other thing beyond those three things. The discussion earlier about the EGRPRA exercise and the importance of that—and I would echo everything that was talked about on that—is let us make it real. You know, the process of going through that stuff every 10 years is probably never going to have the impact that it would if we would take that issue on every time a new regulation was introduced to say what should go off when something new comes on. So I applaud your comments on that. Let us get serious about it. Let us make it more cohesive and more comprehensive than just individual one-offs.

Senator MORAN. Mr. Plagge, may I interrupt you and say one of the other questions I would like to hear a response to is I think we heard from the regulators with us today, as we do every time they are in front of this Committee, that they have an advisory committee, they understand the special nature of community institutions, they have newsletters and meetings with bankers and work in collaboration to make sure that the regulations are of the appropriate nature for community banks.

I would like to know your reaction to that kind of testimony. Today and every other time that we have had this conversation, those are the answers we get. Is all of that true? And if it is true, why do you or your members continue to come to us or to me and indicate problems?

Mr. PLAGGE. It is true their outreach has improved dramatically. They have gone far above on the advisory boards and everything else to do their outreach. But the problem is all too often we do not see the actions of that outreach. We do not see the changes in the discussions. The ombudsman program, although we have always had personally a great relationship with our regulators, I hear on the road a lot there is a fear factor in tackling that and complaining about an exam or tackling a particular issue. So we are supportive of that, that it should be an independent process and push that forward.

The law versus the regulation side of it, the regulator side of it, I think there are pieces on both sides. The regulators can do things themselves without action on your part to change the law, and we have encouraged that. We have sent specific letters requesting those changes.

Senator MORAN. Have you ever seen it happen?

Mr. PLAGGE. Very few changes have actually happened. Kind of back to the comment before about the EGRPRA exercise, and that is—so I am hopeful this time we will get real about it and actually make some changes.

And the difference side, just the comment I would make there is a lot of the discussion earlier was about the definition of a community bank. It is a relationship business that we are in, and many times when they look at us—you know, in my written testimony I talked about the 12 different kind of exams, reviews, third-party oversight, audits, and everything that our bank—we have a $200 million bank and a $1.3 billion bank has gone through it in any given year. There ought to be some process in that that we get rewarded for those kind of exercises, and it should lower some of the regulatory burden, and as well as understanding that we are focused community banks in our communities, and all the information they already get will help them in their oversight without the continual exercise of more and more exams and more and more questions.

Senator MORAN. Thank you, Mr. Chairman.

Mr. BUHRMASTER. Thank you very much. You have thrown a few things up in the air, and I would like to address at least as many as I can in the time that we have.

As far as EGRPRA, we have a wonderful opportunity here to address changes in our regulatory structure. A lot of work was done last time, but nothing really significant happened. But it is different now than it was then. Tiered regulation is seen in an entirely different way now than it was the last time this exercise was taken. And I think if the EGRPRA process looks at solutions in regard to tiered regulation, I think they are going to have greater success and they will have more changes that will affect us directly and that will help community banks meet the needs of their community.

Now, you mentioned have the regulators said, yes, we hear you but we do not see changes. A great example of that is the small bank policy statement, the small bank holding company policy statement. You know, we have heard the regulators say this is something that probably should change, this is something that is worthwhile. Why hasn't it changed? You know, there is a great need for other sources of capital for community banks now. There are a thousand less banks now than there were in 2006 when this took effect. Where have those assets gone? Well, those assets have merged into larger banks or other community banks, and these community bans have not changed their business model, yet they are larger than they were before. We are larger than we were in 2006, and yet we have not changed our business model. That level needs to keep up with the times and the reality of the consolidation process that is out there.

Finally, you had asked about where community banks differ from their larger brethren. It is business model; it is relationships. It is the fact that—we do not like foreclosures, we do not like repossessions, because we have to see those folks in the community. You know, what we would rather do is we would rather sit at a loan officer's desk, sit at a table with a customer, and talk to them about what is going on in their life and why they need this loan and what they need to make their business grow and what they need to make our community grow. Yet we find our loan officer's time is taken up considerably by checking boxes and signing forms.

I mean, heck, when I started out, you know, we were using carbon notes that were this big. If I tried to use a carbon note with all the disclosures for a car loan right now, it would stretch the length of this table.

You know, these are regulations that have been added that do not give the benefit to the consumer because it is just too much for the consumer to handle.

Senator MORAN. Thank you.

Mr. PIERCE. Well, first of all, credit unions by our nature are cooperative institutions, so we are owned by the people that do business with us. So it is in our best interest to not mess with the boss. So our compliance is focused in on what is best for the people that we work with, with our membership. And so we continue to believe that.

From a regulator's standpoint, all of us up here will tell you we have no problems with the regulator because we do not want to tell you that we do have problems, but somebody else does. And we do a lot of survey work at CUNA, and that continues to be a problem that comes up, that there are issues with regulators. And I think you alluded to this earlier, but in the end a lot of it has to do with communication or the lack of communication. And it is a real challenge to sit down with someone and have a conversation and try to change their opinion, and oftentimes it is changing their opinion about what they believe your institution is about.

I think it is a problem. I think we continue to see that problem show up when we ask credit unions about it. They still show—I think it is better, but I think there is still a lot of room for improvement.

I think another great example of maybe that overreach is the risk-based capital rule that NCUA is proposing. There are many good attributes in there, and I think a comprehensive risk-based product for capital for credit unions would be great. But this is not the one that does it. It leaves out an awful lot of key elements. It does not properly evaluate the risk-based nature of capital. It does not—I think it inappropriately misstates the law and their ability to establish a well-capitalized number beyond the limit that was established in Congress. And it does not include access to supplemental capital or other resources that I think would be a great add for credit union members.

So I think they try. I do not think they get there.

Senator MORAN. Thank you.

Ms. MCFADDEN. Hello, Senator Brown. I would like to answer Senator Moran also. The written testimony that we provided goes into a lot of items in detail on how we can be given regulatory relief. But as far as NCUA and some of their thought processes in regulating us, they have the ability to use a waiver for member business lending. They do not exercise that right. That is just one of the number of things that they have at their disposal that they just fail to use. They have those tools in their toolbox. They do not ever pull them out. Or if they do, the waiver process is so complicated and so long, I have lost that member business loan before I have ever had a chance to book it, because the process took too long.

The other things is I think just in the way they are going about this risk-based capital, they came out with a proposal that was so off the wall that they knew was going to cause a stir within the credit union movement. And instead of saying we will take this back, we will make some adjustments, we will get you involved in the process, and then we will repropose it so you all can look at it, no, they are saying, no, there is not going to be a reproposal. They are going to change the proposal as they gave it to us, they are going to make changes to it, and then Chairman Matz even told us in our listening session there would not be any reproposal for us to comment on, that it was going out how they decided. That is not a collaborative working environment.

So when they draw lines in the sand like that, credit unions are afraid to come forward and take their issues to NCUA because they know that they are very close-minded about it.

Senator MORAN. Thank you. Thank you, Mr. Chairman.

Senator BROWN. Thank you, Senator Moran. I have one more question, and it is for Dr. Stanley. Then we will wrap up.

Several House bills, Dr. Stanley, relating to financial services have been compiled into one bill. These proposals, pretty much sold as job creation proposals, are deregulatory in nature, of course, reducing SEC oversight over market participants, shortening the timeframe for market analysis and agency review and public offerings, limiting certain disclosure requirements. Give me your thoughts on that if you would.

Mr. STANLEY. I have to say that this is—I think there are 13 or 14 different bills in the Fitzpatrick jobs bill. We have not reviewed every single one of those. There are quite a number that the SEC has already taken action on administratively.

I think that some of the moves to put these things in statute are going to restrict the ability of the SEC to protect investors, the ability that they would have if they acted through regulation to protect investors. For example, there is a bill that exempts some mergers and acquisitions brokers from certain kinds of SEC oversight, and I believe that that bill does not say that—it does not say that bad actors would not qualify for the exemption from SEC oversight. And that was a recommendation that was made by the State securities administrators, that you should not let bad actors, people with a history of fraud or abuse, take advantage of this. But I do not think it made it into the House bill. I think a particularly egregious House bill that is coming along later this week is H.R. 1105, which is on the oversight of private equity fund advisors. This is being sold as something that helps small businesses, but, in fact, it would remove even the very minimal reporting and oversight that was required in Dodd-Frank by giant private equity firms. And, you know, we saw as soon as the SEC started to get those reports from private equity firms, we saw evidence of very large scale abuses of investors. And to just remove that oversight for some of the wealthiest entities on Wall Street and sell it as helping small business I just do not think is appropriate.

Senator BROWN. Thank you, Dr. Stanley. Thank you all for participating. We very much appreciate it. The hearing is adjourned.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF DOREEN R. EBERLEY

DIRECTOR, DIVISION OF RISK MANAGEMENT SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

SEPTEMBER 16, 2014

Chairman Johnson, Ranking Member Crapo and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the state of small depository institutions. As the primary Federal regulator for the majority of community banks, the FDIC has a particular interest in understanding the challenges and opportunities they face.

My testimony will highlight some findings from our community bank research efforts and discuss some key performance statistics for community banks. I will describe the FDIC's oversight of community banks and how it differs from our supervision of large banks and will touch on some of our outreach and technical assistance efforts related to community banks. Additionally, I will discuss how the FDIC has taken the characteristics and needs of community banks into consideration in the drafting of regulations. Finally, as you requested in your letter of invitation, I will discuss some important factors for consideration when analyzing regulatory relief proposals.

Community Bank Research Agenda

FDIC Community Banking Study

Since late 2011, the FDIC has been engaged in a data-driven effort to identify and explore issues and questions about community banks—the institutions that provide traditional, relationship-based banking services in their local communities. Our research is based on a definition of community banks that goes beyond asset size alone to account for each institution's lending and deposit gathering activities, as well as the limited geographic scope of operations that is characteristic of community banks.

Our initial findings were presented in a comprehensive Community Banking Study (Study) published in December 2012.[1] The study covered topics such as structural change, geography, financial performance, lending strategies and capital formation, and highlighted the critical importance of community banks to our economy and our banking system.

While community banks account for about 14 percent of the banking assets in the United States, they now account for around 45 percent of all the small loans to businesses and farms made by all banks in the United States. In addition, the Study found that over 600 of the more than 3,100 U.S. counties—including small towns, rural communities and urban neighborhoods—would have no physical banking presence if not for the community banks operating there.

The Study highlighted some of the challenges facing community banks in the present environment. Beyond the high credit losses that were experienced as a result of the recession, community banks have also experienced a squeeze on net interest income during the protracted period of historically low interest rates that has followed. Also, while the available data do not permit a breakdown of regulatory versus nonregulatory expenses, a number of community bankers interviewed as part of the Study stated that the cumulative effect of regulation over time has led to increases in expenses related to complying with the supervisory and regulatory process.

Nonetheless, the Study also showed that the core business model of community banks—defined around well-structured relationship lending, funded by stable core deposits, and focused on the local geographic community that the bank knows well—actually performed comparatively well during the recent banking crisis. Amid the 500 some banks that have failed since 2007, the highest rates of failure were observed among noncommunity banks and among community banks that departed from the traditional model and tried to grow faster with risky assets often funded by volatile brokered deposits.

Our community bank research agenda remains active. Since the beginning of the year, FDIC analysts have published new papers dealing with consolidation among community banks, the effects of long-term rural depopulation on community banks,

[1] *FDIC Community Banking Study,* 2012. *https://www.fdic.gov/regulations/resources/cbi/study.html.*

and on the efforts of Minority Depository Institutions to provide essential banking services in the communities they serve.[2]

Community Bank Performance and the New Community Bank Quarterly Banking Profile

Another important development in our research effort has been the introduction this year of a new section in the *FDIC Quarterly Banking Profile,* or QBP, that focuses specifically on community banks.[3] Although some 93 percent of FDIC-insured institutions met our community bank definition in the first quarter, their relatively small size (encompassing only 14 percent of industry assets) tends to obscure community banking trends amid industry aggregate statistics. This new quarterly report on the structure, activities and performance of community banks should provide a useful barometer by which smaller institutions can compare their own results. This regular quarterly report is an important and ongoing aspect in the FDIC's active program of research and analysis on community banking.

Our most recent QBP shows that community bank loan balances grew by 7.6 percent in the year ending in June, outpacing a 4.9 percent rate of growth for the industry as a whole. All major loan categories increased for community banks. One-to-four family mortgages increased by 4.6 percent over the year. Small loans to businesses—loans to commercial borrowers up to $1 million, and farm loans up to $500,000—totaled $297.9 billion as of June 30, an increase of 3.1 percent from a year ago. Almost three-quarters of the year-over-year increase in small loans to businesses was driven by improvement in commercial and industrial loans and nonfarm nonresidential real estate loans.

Net interest income—which accounts for almost 80 percent of net operating revenue at community banks—was $16.8 billion during the first quarter, up 6.3 percent from a year ago. The average net interest margin at community banks of 3.61 percent was 4 basis points higher than a year ago and 46 basis points above the industry average. However, noninterest income was down 9.5 percent from second quarter 2013, at $4.5 billion in the second quarter 2014, as revenue from the sale of mortgages and other loans declined by 29.1 percent from a year ago. Relative to total assets at community banks, noninterest expense declined to 2.91 percent (annualized) from 2.98 percent a year ago, as assets grew at a faster pace than noninterest expense.

As of second quarter 2014, our analysis shows that community banks reported net income of $4.9 billion, an increase of 3.5 percent from the same quarter a year ago, compared to an earnings increase of 5.3 percent for the industry as a whole. More than half (57.5 percent) of all community banks reported higher earnings than a year ago and the percentage reporting a quarterly loss fell to 7.0 percent from 8.4 percent.

Supervisory Approach for Community Banks

Since the 1990s, the FDIC has tailored its supervisory approach to the size, complexity, and risk profile of each institution. To improve our risk-focused process, in 2013, the FDIC restructured our pre-examination process to better tailor examination activities to the unique risk profile of the individual institution and help community bankers understand examination expectations. As part of this process, we developed and implemented an electronic pre-examination planning tool to ensure consistency nationwide and to ensure that only those items that are necessary for the examination process are requested from each institution.

Examination Cycle

With respect to onsite examinations, the Federal Deposit Insurance Act requires regular safety and soundness examinations of State nonmember banks at least once during each 12-month period. However, examination intervals can be extended to 18 months for institutions with total assets of less than $500 million, provided they are well-managed, well-capitalized, and otherwise operating in a safe and sound condition. Most community banks we supervise have total assets under $500 million and meet the other criteria and, therefore, are subject to extended safety and soundness examination intervals. In contrast, the very largest institutions we supervise

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[2] See: Backup, Benjamin R. and Richard A. Brown, "Community Banks Remain Resilient Amid Industry Consolidation," *FDIC Quarterly,* Volume 8, Number 2, 2014. pp. 33–43; Anderlik, John M. and Richard D. Cofer Jr., "Long-Term Trends in Rural Depopulation and Their Implications for Community Banks," *FDIC Quarterly,* Volume 8, Number 2, 2014, pp. 44–59. Breitenstein, Eric C., Karyen Chu, Kathy R. Kalser, and Eric W. Robbins, "Minority Depository Institutions: Structure, Performance, and Social Impact," *FDIC Quarterly,* Volume 8, Number 3, 2014. *https://www.fdic.gov/bank/analytical/quarterly/.*

[3] *FDIC Quarterly Banking Profile, http://www2.fdic.gov/qbp.*

are subject to continuous safety and soundness supervision during the year rather than a point in time examination.

FDIC policy guides consumer compliance examination schedules, which also vary based on the institution's size, prior examination rating and risk profile. Community Reinvestment Act (CRA) examination schedules conform to the requirements of the Gramm-Leach-Bliley Act, which established the CRA exam cycle for most small institutions. The FDIC also uses different CRA examination procedures based upon the asset size of institutions. Those meeting the small and intermediate small asset-size threshold are not subject to the reporting requirements applicable to large banks and savings associations.

The FDIC utilizes offsite monitoring programs to supplement and guide the onsite examination process. Offsite monitoring programs can provide an early indication that an institution's risk profile may be changing. Offsite monitoring tools using key data from bank's quarterly Reports of Condition and Income, or Call Reports, have been developed to identify institutions that are experiencing rapid loan growth or reporting unusual levels or trends in problem loans, investment activities, funding strategies, earnings structure or capital levels that merit further review. In addition to identifying outliers, offsite monitoring using Call Report information helps us to determine whether it is appropriate to implement the extended examination timeframes.

The Call Report itself is tiered to size and complexity of the filing institution, in that more than one-third of the data items are linked to asset size or activity levels. Based on this tiering alone, community banks never, or rarely, need to fill out a number of pages in the Call Report, not counting the data items and pages that are not applicable to a particular bank based on its business model. For example, a typical $75 million community bank showed reportable amounts in only 14 percent of the data items in the Call Report and provided data on 40 pages. Even a relatively large community bank, at $1.3 billion, showed reportable amounts in only 21 percent of data items and provided data on 47 pages.

Rulemaking

The FDIC also considers size, complexity, and risk profile of institutions during the rulemaking and supervisory guidance development processes, and where possible, we scale our regulations and policies according to these factors. The FDIC has a longstanding policy of implementing its regulations in the least burdensome manner possible. In 1998, the FDIC issued its *Statement of Policy on the Development and Review of FDIC Regulations and Policies.*[4] This policy statement, which was updated and reaffirmed, as recently as 2013, recognizes the FDIC's commitment to minimizing regulatory burdens on the public and the banking industry.

A number of recent FDIC rulemakings implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that were designed to benefit community institutions. For example, the assessment base for deposit insurance was changed from domestic deposits to average total assets minus average tangible equity, which shifted more of the deposit insurance assessment burden from smaller to larger institutions. As a result, aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately one-third in the second quarter of 2011, primarily due to the assessment base change. Under the Dodd-Frank Act, the deposit insurance coverage limit was permanently increased to $250,000, which particularly benefits small businesses and other depositors of community institutions. The Dodd-Frank Act also increased the minimum reserve ratio for the Deposit Insurance Fund (or DIF) from 1.15 percent to 1.35 percent, with the increase in the minimum target to be funded entirely by larger banks.

In addition to issuing rules to implement the provisions of the Dodd-Frank Act that benefit community banks, the FDIC also has taken into account the unique characteristics of community banks in its rulemaking to implement other important reforms to the financial system. For example, in adopting the implementing regulations for the Volcker Rule, the agencies recognized that, while the requirements of the implementing statute apply to all banking entities regardless of size, the activities covered are generally conducted by larger, more complex banks. Accordingly, the agencies designed the Volcker Rule to reduce the burden placed on banks that do not engage in proprietary trading activities or have only limited exposure to fund investments.

Under the Volcker Rule, a bank is exempt from all of the compliance program requirements, and all of the associated costs, if it limits its covered activities to those that are excluded from the definition of proprietary trading. This exemption applies to the vast majority of community banks. For community banks that are less than

[4] *http://www.fdic.gov/regulations/laws/rules/5000-400.html.*

$10 billion in assets but do engage in activities covered by the Volcker Rule, compliance program requirements can be met by simply including references to the relevant portions of the rule within the banks' existing policies and procedures. This should significantly reduce the compliance burden on smaller banks that may engage in a limited amount of covered activities.

The FDIC and other bank regulators also adopted regulatory capital rules for community banks. The FDIC recognizes that a number of the more complex requirements of our capital rules are not necessary or suitable for community banks. As such, many aspects of the revised capital rules do not apply to community banks. For example, the new capital rules introduce a number of provisions aimed only at the large, internationally active banks. These provisions include the supplementary leverage ratio, the countercyclical capital buffer, and capital requirements for credit valuation adjustments and operational risk, to name a few. In addition, the revised capital rules contain large sections that do not apply to community banks. Most notably, the advanced approaches framework only applies to internationally active banks and the market risk rule only applies to banks with material trading operations.

To assist bankers in understanding and complying with the revised capital rules, the FDIC conducted outreach and technical assistance designed specifically for community banks. In addition to the publication of a community bank guide and an informational video on the revised capital rules, FDIC staff conducted face-to-face informational sessions with bankers in each of the FDIC's six supervisory regions to discuss the revised capital rules most applicable to community banks.

Subchapter S

The Basel III capital rules introduce a capital conservation buffer for all banks (separate from the supplementary leverage ratio buffer applicable to the largest and most systemically important bank holding companies (BHCs) and their insured banks). If a bank's risk-based capital ratios fall below specified thresholds, dividends and discretionary bonus payments become subject to limits. The buffer is meant to conserve capital in banks whose capital ratios are close to the minimums and encourage banks to remain well-capitalized.

In July, the FDIC issued guidance clarifying how it will evaluate requests by S corporation banks to make dividend payments that would otherwise be prohibited under the capital conservation buffer. Federal income taxes of S corporation banks are paid by their investors. If an S corporation bank has income but is limited or prohibited from paying dividends, its shareholders may have to pay taxes on their pass-through share of the S-corporation's income from their own resources. Relatively few S corporation banks are likely to be affected by this issue, and in any case not for several years; the buffer is phased-in starting in 2016 and is not fully in place until 2019.

As described in the guidance, when an S corporation bank does face this tax issue, the Basel III capital rules allow it (like any other bank) to request an exception from the dividend restriction that the buffer would otherwise impose. The primary regulator can approve such a request if consistent with safety and soundness. Absent significant safety and soundness concerns about the requesting bank, the FDIC expects to approve on a timely basis exception requests by well-rated S corporations to pay dividends of up to 40 percent of net income to shareholders to cover taxes on their pass-through share of the bank's earnings.

Community Banking Initiative and Technical Assistance

In 2009, the FDIC established its *Advisory Committee on Community Banking* to provide advice and guidance on a broad range of policy issues impacting small community banks and the local communities they serve. In February 2012, the FDIC sponsored a national conference to examine the unique role of community banks in our Nation's economy. Later in 2012, roundtable discussions were conducted in each of the FDIC's regions that focused on the financial and operational challenges and opportunities facing community banks, and the regulatory interaction process.

In discussions with community bankers in these venues and through our routine outreach efforts, it became clear that community banks were concerned about keeping up with changing regulations and policy issues and were interested in assistance from us to stay informed. As a result, in 2013, the FDIC created a regulatory calendar that alerts stakeholders to critical information as well as comment and compliance deadlines relating to new or amended Federal banking laws, regulations and supervisory guidance. The calendar includes notices of proposed, interim and final rulemakings, and provides information about banker teleconferences and other important events related to changes in laws, regulations, and supervisory guidance.

We also instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers. In spring 2013, we issued six videos designed to provide new bank directors with information to prepare them for their fiduciary role in overseeing the bank. This was followed by the release of a virtual version of the FDIC's Directors' College Program that regional offices deliver throughout the year. We have also issued a series of videos, primarily targeted to bank officers and employees, dealing with more in-depth coverage of important supervisory topics with a focus on bank management's responsibilities.[5] We have hosted banker call-ins on topics such as proposed new accounting rules, new mortgage rules, and Call Report changes. The FDIC is also currently offering a series of Deposit Insurance Coverage seminars for banking officers and employees.[6] These free seminars, which are offered nationwide, particularly benefit smaller institutions, which have limited training resources.

These resources can be found on the *Directors' Resource Center,* available through the FDIC's Web site.[7] Additionally, in June 2014, the FDIC mailed an Information Packet[8] to the chief executive officers (CEOs) of FDIC-supervised community banks containing resources and products developed as part of the FDIC's Community Banking Initiative, as well as documents describing our examination processes. In addition to an introductory letter to CEOs, the packet contains brochures highlighting the content of key resources and programs; a copy of the Cyber Challenge, a technical assistance product designed to assist with the assessment of operational readiness capabilities; and other information of interest to community bankers.

EGRPRA Review

The FDIC and other regulators are actively seeking input from the industry and the public on ways to reduce regulatory burden. The *Economic Growth and Regulatory Paperwork Reduction Act of 1996*[9] (EGRPRA) requires the Federal Financial Institutions Examination Council (FFIEC)[10] and the FDIC, the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC) to review their regulations at least once every 10 years to identify any regulations that are outdated, unnecessary, or unduly burdensome. EGRPRA also requires the agencies to eliminate unnecessary regulations to the extent such action is appropriate. The second decennial EGRPRA review is in process with a required report due to Congress in 2016. On June 4, 2014, the Federal banking agencies jointly published in the Federal Register the first of a series of requests for public comment on their regulations.[11] The comment period for this request closed on September 2, 2014. The agencies are currently reviewing the comments received. The agencies also plan to hold regional outreach meetings to get direct input as part of the EGRPRA review process before the end of 2015.

The FDIC has developed a comprehensive plan for conducting its EGRPRA review that includes coordination with the other Federal banking agencies.[12] As the primary Federal regulator for the majority of community banks, the FDIC is keenly aware of the impact that its regulatory requirements can have on smaller institutions, which operate with less staff and other resources than their larger counterparts. Therefore, as part of its EGRPRA review, the FDIC is paying particular attention to the impact its regulations may have on smaller institutions.

Consideration of Regulatory Relief Proposals

As indicated above, the FDIC strives to tailor rules, policies, and supervisory practices to the size, complexity and risk profile of the institutions we supervise, and we welcome suggestions regarding where we can do more. When we review such

[5] *Technical Assistance Video Program: https://www.fdic.gov/regulations/resources/director/video.html.*

[6] *Deposit Insurance Coverage: Free Nationwide Seminars for Bank Officers and Employees* (FIL–17–2014), dated April 18, 2014.

[7] See *https://www.fdic.gov/regulations/resources/director/.*

[8] See *http://www.fdic.gov/regulations/resources/cbi/infopackage.html.*

[9] Public Law 104–208 (1996), codified at 12 U.S.C. § 3311.

[10] The FFIEC is comprised of the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Consumer Financial Protection Bureau (CFPB) and the State Liaison Committee (SLC), which is comprised of representatives from the Conference of State Bank Supervisors (CSBS), the American Council of State Savings Supervisors (ACSSS), and the National Association of State Credit Union Supervisors (NASCUS).

[11] *http://www.gpo.gov/fdsys/pkg/FR-2014-06-04/pdf/2014-12741.pdf.*

[12] *http://www.fdic.gov/EGRPRA/.*

suggestions, our focus is their effect on the fundamental goals of maintaining the safety-and-soundness of the banking industry and protecting consumers.

Strong risk management practices and a strong capital base are fundamental to the long-term health of community banks and their ability to serve their local communities. Most community banks know how to manage the risks in their loan portfolios and have strong capital positions. And of course, community banks have a strong interest in retaining customers by treating them fairly. Serving the credit needs of their local communities, while managing the attendant credit risks, truly is the core expertise of many community banks and what they do best. Reports by the General Accounting Office (GAO) and the FDIC's Office of Inspector General (IG),[13] and our own Community Banking Study have shown that banks—even those with concentrated asset portfolios—with sound risk management practices and strong capital have been able to weather crises and remain strong.

Institutions that did not survive, according to these reports, were those with weaker or more aggressive risk management approaches, including imprudent loan underwriting and rapid growth often financed by wholesale funds or brokered deposits. One of our IG reports also found that banks that heeded supervisory directives regarding risk management practices were more likely to survive.

We believe the evidence strongly supports the idea that the best way to preserve the long-term health and vibrancy of community banks, and their ability to serve their local communities, is to ensure their core strength is preserved: strong capital, strong risk management and fair and appropriate dealings with their customers. We also believe our own supervision plays an important role in obtaining corrective action to address problems where this is needed, and that this also promotes the long-term health of community banks.

This being said, we remain alert to the importance of achieving the fundamental objectives of safety-and-soundness and consumer protection in ways that do not involve needless complexity or expense. As noted elsewhere in this testimony, we have a number of forums for hearing and considering suggestions in this regard, and we stand ready to provide our views and technical assistance to this Committee.

Conclusion

The FDIC's research and community bank operating results both show that the community banking model is doing well. The FDIC tailors its oversight of banks according to size, complexity and risk, and has provided a number of tools to assist community bankers understand regulatory requirements and expectations. Going forward, we continue to look for ways to improve our supervisory processes, and stand ready to provide technical assistance regarding proposals that seek to achieve the fundamental goals of safety-and-soundness and consumer protection in ways that are appropriately tailored for community banks.

PREPARED STATEMENT OF TONEY BLAND

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

SEPTEMBER 16, 2014

I. Introduction

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to discuss the challenges facing community banks and actions that the Office of the Comptroller of the Currency (OCC) is taking to help them meet those challenges and remain a vibrant part of our Nation's financial system. Consistent with the Committee's invitation letter, my testimony provides an overview of the OCC's supervisory program for small national banks and Federal savings associations (hereafter referred to as community banks) and describes initiatives we have implemented to address their specific needs and concerns. These initiatives include offering a broader array of practical resources and tools that are tailored to community banks as well as refinements to our supervisory processes to improve, for example, the clarity and timeliness of supervisory reports and expectations. I also describe actions we have taken to tailor supervisory policies and regula-

[13] *Causes and Consequences of Recent Bank Failures* (January 2013), GAO–13–71 and *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (January 2013), EVAL–13–002.

* Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

tions to recognize the business models of community banks while remaining faithful to safe and sound banking practices, statutory requirements, and legislative intent. These efforts include our ongoing Dodd-Frank Act related rulemakings, our decennial review of regulations to identify where they could be streamlined or eliminated, and our exploration of ways to provide more flexibility for Federal savings associations to respond to the changing economic and business environment as well as to meet the needs of their communities.

Before describing these initiatives and actions, I would like to provide my perspective on community banks. Last month I assumed the role of Senior Deputy Comptroller for Midsize and Community Banks. In this role, I am responsible for the OCC's community bank supervision program that oversees approximately 1,400 institutions with assets under $1 billion. Previously, I served as the OCC's Deputy Comptroller of the Northeastern District where I was responsible for the oversight of more than 300 community banks.

Community banks play a crucial role in providing consumers and small businesses in communities across the Nation with essential financial services and a source of credit that is critical to economic growth and job expansion. Throughout the country, community bankers help small businesses grow and thrive by offering "hands-on" counseling and credit products that are tailored to their specific needs. Community banks and their employees strengthen our communities by helping meet municipal finance needs and through their active participation in the civic life of their towns.

Community banks are important to the OCC. Approximately two-thirds of our examination staff is dedicated to the supervision of these institutions. In my previous role as deputy comptroller, and now as senior deputy comptroller, I regularly meet with community bankers to hear first-hand their successes, their challenges, and their frustrations. I have seen how well-managed community banks were able to weather the financial crisis and provide a steady source of credit to their local communities and businesses. But I've also heard the concerns expressed by many community bankers about the long-term viability of their business models and their frustration that too much of their time and resources are spent on trying to track and comply with an ever expanding array of regulatory requirements rather than meeting with and responding to the needs of their customers and communities.

In my meetings with community bankers, I underscore the advantages they have over larger competitors because of their deep understanding of the unique needs of their local markets and customers and their ability to tailor their products to meet these needs. The willingness and ability of community bankers to work with their customers through good times and bad is one reason why local businesses rely on community banks. Following the recent financial crisis, we took a look at what factors enabled strong community banks to weather that storm, and summarized those findings in our booklet, *"A Common Sense Approach to Community Banking,"* published last year. This booklet shares best practices that have proven useful to boards of directors and management in successfully guiding their community banks through economic cycles and other changes and challenges they might experience.

I am pleased to report that the overall financial condition of community banks has improved considerably since the crisis: the number of troubled institutions has declined significantly, capital has increased, asset quality indicators are improving, and there are signs that lending opportunities are rebounding. Indeed, community banks have experienced growth in most major loan categories and at a higher pace than that of the Federal banking system as a whole. Despite this progress, challenges remain. For example, economic recovery and job creation continues to lag in many regions and communities, and many community bankers face the challenge of finding profitable lending and investment opportunities without taking on undue credit or interest rate risks. Strategic risk is a concern for many community bankers as they search for sustainable ways to generate earnings in the current environment of prolonged low interest rates and increased competition and compliance costs. Moreover, the volume and sophistication of cyber threats continue to challenge banks of all sizes.

The remainder of my testimony describes steps that the OCC is taking to help community bankers meet these challenges, to help them navigate the changing regulatory landscape, and to ensure that the OCC's supervisory policies and regulations are appropriately tailored to community banks. It also provides the OCC's perspectives on factors the Committee may wish to consider as it explores legislative proposals aimed at reducing regulatory burden on community banks.

II. OCC's Approach to Community Bank Supervision

The OCC is committed to supervisory practices that are fair and balanced, and to fostering a regulatory climate that allows well-managed community banks to

grow and thrive. The OCC's community bank supervision program is built around our local field offices, and a portfolio management approach. Our community bank examiners are based in over 60 locations throughout the United States in close proximity to the banks they supervise. They understand the local conditions that affect community banks. The local assistant deputy comptroller (ADC) has delegated responsibility for the supervision of a portfolio of community banks. Each ADC reports up to a district deputy comptroller who reports to me.

Our program 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. Our bank supervision policies and procedures establish a common framework and set of expectations. Each bank's portfolio manager tailors the supervision of each community bank to its individual risk profile, business model, and management strategies. Our ADCs are given considerable decisionmaking 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 in a consistent and balanced manner. For example, every report of examination prepared by an examiner is reviewed and approved by the responsible ADC before it is finalized. In cases where significant issues are identified and an enforcement action is in place, or is being contemplated, we undertake additional levels of review 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. These policies include periodic, randomly selected reviews of the supervisory record, with oversight by our 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 who 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 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 examination staff.

III. Enhancements to the OCC's Community Bank Supervision Program

At the OCC we continuously seek ways to improve our supervisory processes and how we interact with the banks we supervise. A frequent comment I hear from community bankers and their directors is the need for more practical information and tools that can help them identify and respond to emerging risks. I also hear about the challenges community bankers face in trying to absorb and keep track of new or changing regulatory and supervisory requirements, and their desire to have a "one-stop" source where they can go for information. In response to these requests, we have taken a variety of steps to improve and expand upon our suite of tools and resources for community bankers and their directors.

A. Information and Resources

OCC BankNet: Over the last several years, we have enhanced OCC BankNet, our dedicated Web site for national banks and Federal savings associations. The site is designed to provide a "one-stop" source that bankers and their directors can use to obtain up-to-date information on OCC policies and regulations, various educational programs, workshops and Web conferences, as well as resources and analytical tools designed for community banks. We also are expanding its use as a safe and secure means that bankers can use to transmit supervisory data or various forms and applications to the OCC.

To provide community bankers with more practical tools and research, we have expanded the portfolio of stress testing tools available on BankNet to include tools and worksheets for individual and portfolio commercial real estate, acquisition and development and agricultural loans—the types of loan products that are commonly offered by many community banks. To help community bankers keep abreast of emerging economic trends and accounting policies, we have started providing quarterly "snapshots"—brief summaries on topical issues of interest to bankers. The snapshots include recent and pending accounting proposals that may affect banks, and information on national and regional economic and real estate trends, which are especially useful for community bankers.

Quarterly Letters: We have taken a number of initiatives to help community bankers manage the flow of information. A number of years ago, we instituted a quarterly letter that each of our ADCs send to the banks in his or her portfolio. These quarterly letters summarize all of the bulletins and rules that the OCC issued during the previous quarter and highlight any particular supervisory issue or concern that the ADC may be seeing. During the past year, we refined the format and content of our quarterly letters in response to feedback from bankers. In addition, the portfolio manager has a quarterly discussion with the institution's CEO about recent regulatory issuances, significant changes in the bank's strategic plan, and market changes affecting the bank.

Banking Bulletins: We have redesigned our bulletins. Each bulletin includes a "highlights" section that summarizes the key points of the guidance and a box that informs community banks whether and how the guidance may apply to them.

Semiannual Risk Perspective Report: Community bankers also have asked us to be more transparent about the issues and risks that are receiving heightened supervisory attention and our rationale for that attention. To provide this transparency, the OCC publishes a *Semiannual Risk Perspective* report. This report, compiled by our National Risk Committee, summarizes the current operating environment, condition and performance of banks, and key risks across the OCC's lines of businesses. Because the issues and challenges facing community banks can differ from those that larger banks confront, the report provides data and commentary for both large and small banks. Beginning with the most recent report, published in June, the report also outlines our key supervisory priorities for the next 12 months for large, midsize, and community banks.

Outreach: We provide timely information via alerts and joint interagency statements about a range of issues including cyber attacks and vulnerabilities. We also are expanding our use of Web and telephone conferences with bankers to explain our expectations when we issue significant new policies or rules or when we see emerging risks that may be of special interest to community bankers. Recent examples include seminars on cybersecurity, interest rate risk, and compliance issues such as community bank implementation of the Consumer Financial Protection Bureau's (CFPB) ability-to-repay and qualified mortgage standards, and the OCC's guidance on managing third-party relationships. We also have expanded our offerings of director workshops. These hands-on workshops, targeted for community bank directors, are taught by some of our most experienced ADCs and community bank examiners and provide directors with practical tools to help carry out their responsibilities.

B. Improved Internal Supervisory Processes

The above initiatives underscore our commitment to continually look for ways to improve the information and resources we provide to community banks. We are equally committed to improving our internal supervisory processes to ensure that our supervision of individual banks is balanced, timely, and consistent. Specific actions we have taken to respond to concerns raised by community bankers are described below.

Communication on Matters Requiring Attention (MRAs): One of the lessons we learned from the crisis is that when we find deficient practices, we and bank management must have a common understanding of the deficiencies and the actions required by bank management to correct them. To improve the clarity and consistency of our communications, we developed internal guidance used by all of our community bank examiners that establishes clear criteria and a format for the information to be conveyed when citing MRAs. The guidance directs examiners to document and share with bank management: 1) the specific concern that has been identified; 2) the root cause of the concern; 3) the likely consequence or effects on the bank from inaction; 4) the supervisory expectations for corrective actions; and 5) bank management's commitment to corrective action, including applicable timeframes. As part of our transparency efforts, we provide summary data about MRAs in our *Semiannual Risk Perspectives* and on our BankNet Web site.

Timeliness of Examination Reports: We have responded to banker concerns about the timeliness of reports of examination (ROEs) by establishing clear timeframes and benchmarks for completing and sending ROEs to a bank's board of directors. We have incorporated these benchmarks into the performance standards for all the managers within our community bank line of business. I am pleased to report that over 90 percent of the ROEs issued to 1- and 2-rated community banks are mailed within 90 days of the exam start date and within 120 days for 3, 4, or 5-rated banks.

Consistent Application of Policy: Finally, to ensure that our examiners are aware of and applying supervisory policies consistently, we periodically conduct na-

tionwide calls with all of our community bank examiners and managers. We use these calls to explain our expectations for new policies or regulations, and to communicate common issues and areas of emerging risks.

IV. Tiered Regulation

Given the broad array of institutions we oversee, the OCC understands a one-size-fits-all approach to regulation does not work, especially for community banks. We recognize that community banks have different business models and more limited resources than larger banks, and, to the extent underlying statutory requirements allow it, we factor these differences into the rules we write and the guidance we issue.

The OCC seeks to minimize burden on community banks through various means. Explaining and organizing our rulemakings so these institutions can better understand the scope and application of our rules, providing alternatives to satisfy prescriptive requirements, and using exemptions or transition periods are examples of ways in which we tailor our regulations to accommodate community banks, while remaining faithful to statutory requirements and legislative intent.

For example, our final interagency rule to implement the domestic capital requirements illustrates how we seek to tailor our regulatory requirements to reflect the activities of individual banks. The financial crisis made it clear that all banks need a strong capital base, composed of high quality capital that will serve as a buffer in both good times and bad. Consequently, the new capital rule not only raises the minimum capital ratios, but it also emphasizes the need for common equity, the form of capital that has proven to be best at absorbing losses. However, the crisis also showed that there are very important differences between the largest banks and the rest of the industry. It is clear that the largest banks, which were taking on the biggest risks, can have an outsized impact on the entire system. That is why we have differentiated our capital requirements and are imposing higher capital requirements through the supplementary leverage ratio and the countercyclical capital buffers to the largest banks. We also adjusted our final capital rule to address significant concerns raised by community bankers. The final risk-based rules retain the current capital treatment for residential mortgage exposures and allow community banks to elect to treat certain accumulated other comprehensive income (AOCI) components consistently with the current general risk-based capital rules. Treating AOCI in this manner helps community banks avoid introducing substantial volatility into their regulatory capital calculations.

Other recent rulemakings do not apply to community banks. For example, our heightened standards rule recognizes that large banks should be held to higher standards for risk management and corporate governance and require more formal structures in these areas than community banks. That is why the rule generally applies only to those banks with average total consolidated assets of $50 billion or more. Similarly, our recent rule that establishes quantitative standards for short-term liquidity funding does not apply to community banks.

The OCC responded to community bank concerns when finalizing our revised lending limits rule in accordance with section 610 of the Dodd-Frank Act to include counterparty credit exposures arising from derivatives and securities financing transactions. Specifically, the rule now exempts from the lending limits calculations certain securities financing transactions most commonly used by community banks. In addition, the rule permits small institutions to adopt compliance alternatives commensurate with their size and risk profile by providing flexible options for measuring counterparty credit exposures covered by section 610, including an easy-to-use lookup table.

Similarly, our final rule removing references regarding credit ratings from our investment securities regulation, pursuant to section 939A of the Dodd-Frank Act, allowed an extended transition period of almost 6 months for banks to comply with the rule. In response to concerns raised by community bankers about the amount of due diligence the banks would have to conduct, we also published guidance to assist banks in interpreting the new standard and to clarify the steps banks can take to demonstrate that they meet their diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios.

Our final rule implementing the Volcker Rule provisions of the Dodd-Frank Act is another example of how we seek to adapt statutory requirements, where possible, to reflect the nature of activities at different sized institutions. The statute applies to all banking entities, regardless of size; however, not all banking entities engage in activities covered by the prohibitions in the statute. One of the OCC's priorities in the interagency Volcker rulemaking was to make sure that the final regulations

imposed compliance obligations on banking entities in proportion to their involvement in covered activities and investments.[1]

The OCC also is providing more manageable ways for community banks to digest new regulatory and supervisory information and to assist them in quickly and easily understanding whether and how this information applies to them. As I noted previously, each bulletin announcing the issuance of a new regulation or supervisory guidance now includes a box that allows community banks to assess quickly whether the issuance applies to them and a "highlights" section that identifies the key components of the rule or regulation. We have also identified other means to convey plain language descriptions of complex requirements and to assist community bankers in understanding newly issued rules. For example, the OCC produced a streamlined, two-page summary of the final domestic capital rule highlighting aspects of the rule applicable to community banks and key transition dates. We supplemented this summary with an online regulatory capital estimator tool that we developed with the other Federal banking agencies. Likewise, we provided to community banks a quick reference guide to the mortgage rules the CFPB issued in January.

V. Additional Opportunities to Reduce Burden and Improve Competitiveness

The OCC is committed to exploring additional ways to reduce unnecessary regulatory burden on, and promote the competitiveness of, community banks. For example, in response to concerns raised by community banks and our ongoing research, the OCC would be supportive of exempting community banks from the Volcker Rule. We also would suggest a change to current law that would increase the $500 million asset size threshold for community banks so more of them can qualify for an exam every 18 months, rather than every year. As well, we support pending legislative proposals to exempt banks from issuing a mandatory annual privacy notice requirement in certain circumstances.

We believe the foremost factor when evaluating our consideration of proposals to reduce burden on community banks is to ensure that fundamental safety and soundness and consumer protection safeguards are not compromised. We would be concerned, for example, about proposals that would adversely impact or unduly complicate the exam process, mask weaknesses on a bank's balance sheet, or impede our ability to require timely corrective action to address weaknesses.

In addition to these overarching principles, there are other factors that we consider when evaluating proposals. For example, a number of the tools that we make available to bankers to assist them in risk identification and that we use to tailor and streamline our examinations, rely on the detailed data we collect in certain Call Report schedules. We recognize that the decision to include detailed data requires both an analysis of the costs that community banks face in preparing their Call Reports, and an evaluation of the benefits to the agency of being able to do more examination work and monitoring offsite.

Pursuant to the requirements of the Paperwork Reduction Act, the OCC and other Federal banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC) seek comment on Call Report changes and on the agencies' estimates of the burden hours of those proposed changes. In analyzing potential changes to the Call Report, we consider ways that we can tailor reporting requirements to the size of a bank's activities. At the OCC, we have an internal review process for any material changes to the Call Report that OCC staff may want to propose to the FFIEC for consideration. Our internal standard is that Call Report data should directly support long-term supervisory needs to ensure the safety and soundness of banks, and that any additions must be supported by a strong business case that discusses the relative benefits, costs, and alternatives.

Recently, we have received proposals to reduce the burden associated with the preparation of the Call Reports including the feasibility of allowing certain banks to file a short-form Call Report for two quarters of a year. I have discussed the Call Report issue in numerous meetings with bankers, and we are committed to giving careful consideration to their concerns.

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[1] Shortly after the agencies issued the final rule, we learned that certain collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs), which were originally issued as a means to facilitate capital-raising efforts of small banks and mutual holding companies, would have been subject to eventual divestiture and immediate write-downs under the applicable accounting treatment and that the rule was inconsistent with another provision of the Dodd-Frank Act—the Collins Amendment. Given the importance of this issue to affected community banks and to mitigate the unintended consequences, the agencies responded promptly by adopting an interim final rule to address this concern. *See* 79 Fed. Reg. 5223 (Jan. 31, 2014), *available at http://el.occ/news-issuances/Federal-register/79fr5223.pdf.*

Finally, we have heard countless examples of the need for increased resources to operate in today's environment as well as the difficulties in attracting and retaining needed expertise. We are supportive of community banks exploring avenues to collaborate, for example, by sharing resources for compliance or back office processes. We believe opportunities exist for community banks to work together to face today's challenges, and we are prepared to be a resource to assist in these efforts.

Regulatory Review Efforts: Notwithstanding our efforts to ensure that our regulations are appropriately calibrated, we recognize the need to periodically step back and review our regulations to determine if there are ways that we could streamline, simplify, or in some cases, remove, regulations to ease unnecessary burden on banks. The OCC has two concurrent efforts underway that could help identify ways to reduce regulatory burden.

OCC/OTS Rule Integration: The Dodd-Frank Act transferred to the OCC all the functions of the Office of Thrift Supervision (OTS) relating to the examination, supervision, and regulation of Federal savings associations. As part of our integration effort, we are undertaking a comprehensive, multi-phase review of our regulations and those of the former OTS to reduce regulatory burden and duplication, promote fairness in supervision, and create efficiencies for national banks and Federal savings associations. We have already begun this process and, in June of this year, we issued a proposal to integrate national bank and Federal saving association rules relating to corporate activities and transactions. The comment period on this proposal closed a few weeks ago, and we are currently reviewing the comments received.

Economic Growth and Regulatory Paperwork Reduction Act of 1996

(EGRPRA): The OCC and the other Federal banking agencies are currently engaged in a review of the burden imposed on insured depository institutions by existing regulations as part of the decennial review required by the EGRPRA. EGRPRA requires that, at least once every 10 years, the FFIEC, OCC, FDIC, and Federal Reserve review their regulations to identify outdated or otherwise unnecessary regulations for all insured depository institutions. The EGRPRA review provides the FFIEC, the agencies, and the public with an opportunity to consider how to reduce burden and target regulatory changes to reduce burden on all institutions. The OCC, as chair of the FFIEC, is coordinating this joint regulatory review.

In connection with the EGRPRA process, the agencies published a *Federal Register* notice this past June asking for comment on three categories of rules. The comment period on this first notice ended earlier this month, and the agencies are reviewing the comments received. Over the next 2 years, the agencies will issue three more Federal Register notices that will invite public comment on the remaining rules. In each notice, we will specifically ask the public to identify ways to reduce unnecessary burden association with our regulations, with a particular focus on community banks.

Charter Flexibility: One of the strengths of the community bank model is the diversity it provides in the types of charters and missions of institutions that can serve a local community. We see this most prominently in the important roles that minority-owned and mutual savings institutions play in their communities. We have established advisory committees with leading representatives of these banks to help us address the unique challenges facing these institutions. One issue that we hear from Federal savings associations is about their desire to offer a broader range of services to their communities without having to change their charter type. More specifically, any Federal savings association that wants to expand its mortgage lending business model to one that emphasizes a mix of business loans and consumer credit would need to change charters. I believe that the Federal savings association charter should be flexible enough to accommodate either strategy. When the Comptroller was a regulator in Massachusetts, that State made powers and investment authorities, as well as supervisory requirements, the same or comparable regardless of charters, and allowed State thrifts and banks to exercise those powers while retaining their own corporate structure. Congress may wish to consider authorizing a similar system at the Federal level. This flexibility will improve the ability of Federal savings associations to meet the financial needs of their communities.

VI. Conclusion

Community banks are an essential part of our Nation's communities and small businesses. The OCC is committed to providing effective supervision of these banks while minimizing unnecessary regulatory burden. We will continue to carefully consider the potential effect that current and future policies and regulations may have on community banks and will be happy to work with the Committee on any proposed legislative initiatives.

PREPARED STATEMENT OF MARYANN F. HUNTER

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

SEPTEMBER 16, 2014

Introduction

Chairman Johnson, Ranking Member Crapo, and other Members of the Committee, I appreciate the opportunity to testify on the Federal Reserve's approach to regulating and supervising small community banks and their holding companies. Having started my career as a community bank examiner at the Federal Reserve Bank of Kansas City and eventually becoming the officer in charge of bank supervision at the Reserve Bank, I have experienced firsthand how important community banks are to their communities and how critical it is that the Federal Reserve supervises these institutions effectively and efficiently. In my testimony, I will discuss some of the ways the Federal Reserve ensures that regulations, policies, and supervisory activities are tailored to address the risks and activities of community banks without imposing undue burden. The Federal Reserve recognizes the important role that community banks play in providing financial services to their local economies and seeks to supervise these banks in a way that fosters their safe and sound operation without constraining their capacity to support the financial needs of their communities.

Current State of Community Banking Organizations

The Federal Reserve supervises approximately 800 State-chartered community banks, the large majority of which are small community banks with total assets of $1 billion or less, that are members of the Federal Reserve System (referred to as State member banks).[1] In addition, the Federal Reserve supervises over 4,000 bank holding companies and more than 300 savings and loan holding companies, most of which operate small community banks and thrifts.

During the recent financial crisis, most community banks remained in sound condition. But a large number faced challenges as economic conditions weakened, particularly those that had developed large commercial real estate loan concentrations and funded their activities with nontraditional funding sources. In recent years, many of these banks have recovered, and by the second quarter of 2014 the number of banks on the Federal Deposit Insurance Corporation's "Problem List" had fallen to 354, far fewer than the peak of 888 reported at the end of the first quarter of 2011.[2] Despite this decline, the current number of problem banks is still roughly seven times the number of problem banks at the end of 2006, before the crisis began in 2007–08.[3]

However, capital levels and asset quality at small community banks have improved since the financial crisis.[4] At year-end 2013, the aggregate tier 1 risk-based capital ratio for community banks was 15.3 percent, up from a low of 12.7 percent at year-end 2008, and the aggregate leverage ratio was 10.4 percent, up from a low of 9.4 percent at year-end 2009. Noncurrent loans and net charge-offs have decreased over the past 4 years. After several years of declining loan balances at small community banks, we are starting to see a slow increase in loan origination. In addition, earnings have improved in the past couple of years, largely from reductions in provision expenses for loan losses. Yet, despite these promising financial indicators, small community banks continue to experience considerable pressure from low net interest margins, and many report concerns about their prospects for continued growth and profitability.

Supervision of Community Banking Organizations

The Federal Reserve strives to scale its supervisory expectations based on the size, risk profile, condition, and complexity of a banking organization and its activities and recognizes that a one-size-fits-all approach to community banks is often not appropriate. For example, the Federal Reserve has employed a risk-focused ap-

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[1] For supervisory purposes, the Federal Reserve uses the term "community banking organization" to describe a State member bank and/or holding company with $10 billion or less in total consolidated assets.

[2] See Federal Deposit Insurance Corporation, Quarterly Banking Profile, Second Quarter 2014, *available at www2.fdic.gov/qbp/2014jun/qbp.pdf.*

[3] See Federal Deposit Insurance Corporation, Quarterly Banking Profile, Fourth Quarter 2006, *available at www2.fdic.gov/qbp/2006dec/qbp.pdf.*

[4] Figures are based on quarterly Call Report data filed by commercial banks and savings associations. See *www.ffiec.gov/ffiec_report_forms.htm.*

proach to supervision of community banks since the mid-1990s.[5] In the intervening years, we have adjusted this approach to better calibrate the work conducted relative to the complexity and risk of each bank.

If a bank is engaging in nontraditional or higher-risk activities, our supervision program typically requires greater scrutiny and a higher level of review of specific transactions. Conversely, if a bank's activities are lower risk, we adjust our expectations for examiners to a lower level of review. In this way, we alleviate examination burden on community banks with histories of sound performance and modest risk profiles. Last year, we began a process to enhance the ongoing updating of our examination procedures to reflect key lessons of the crisis. Overall, these adjustments should enhance our supervisory efficiency by targeting more intensive examination work at bank activities that proved to be higher risk and reducing some examination testing at community banks that performed well throughout the crisis.

The Federal Reserve adopted a new consumer compliance examination framework for community banks in January 2014.[6] While we have traditionally applied a risk-focused approach to consumer compliance examinations, the new program more explicitly bases examination intensity on the individual community bank's risk profile, weighed against the effectiveness of the bank's compliance controls. As a result, we expect that examiners will spend less time on low-risk compliance issues at community banks, increasing the efficiency of our supervision and reducing regulatory burden on many community banks. In addition, we revised our consumer compliance examination frequency policy to lengthen the timeframe between onsite consumer compliance and Community Reinvestment Act examinations for many community banks with less than $1 billion in total consolidated assets.

In addition to our efforts to refine our risk-focused approach to supervision, we have been increasing the level of offsite supervisory activities, which can tangibly reduce burden on community banking organizations. For example, last year we conducted a pilot program under which we conducted some aspects of the loan review process offsite, relying on the bank's electronic records to evaluate loan quality and underwriting practices. Overall, community bankers that were part of the pilot were very supportive of this approach, which reduced the amount of time examiners needed to spend onsite at bank offices. As a result, we plan to continue using this approach in future examinations at banks that maintain electronic loan records.

While offsite loan review has benefits for both bankers and examiners, some bankers have expressed concerns that increasing offsite supervisory activities could potentially reduce the ability of banks to have face-to-face discussions with examiners regarding asset quality or risk-management issues. In that regard, we will continue to work with community banks that may prefer their loan reviews to be conducted onsite. In short, the Federal Reserve is trying to strike an appropriate balance of offsite and onsite supervisory activities to ensure that resources are used more efficiently while maintaining high-quality supervision of community banking organizations. The Federal Reserve has invested significant resources in developing various technological tools for examiners to improve the efficiency of both offsite and onsite supervisory activities. The expanded use of technological tools has assisted in completing community bank examination work offsite while ensuring the quality of supervision is not compromised. For instance, the Federal Reserve has automated various parts of the community bank examination process, including a set of tools used among all Reserve Banks to assist in the pre-examination planning and scoping. This automation can save examiners and bank management time, as a bank can submit requested pre-examination information electronically rather than mailing paper copies to the Federal Reserve Bank. These tools also assist Federal Reserve Bank examiners in the continuous, offsite monitoring of community banking organizations, enabling examiners to determine whether a particular community banking organization's financial condition has deteriorated and warrants supervisory attention between onsite examinations.

Tailoring Regulations for Community Banking Organizations

As Governor Tarullo testified before this Committee last week, we recognize that the burden community banks encounter when attempting to understand and imple-

[5] Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (1997), *"Risk-Focused Framework for the Supervision of Community Banks,"* Supervision and Regulations Letter SR 97–25 (October 1). In addition, the Board of Governors first approved a risk-focused consumer compliance supervision program on September 18, 1997.

[6] Board of Governors of the Federal Reserve System, Division of Consumer and Community Affairs (2013), *"Community Bank Risk-Focused Consumer Compliance Supervision Program,"* Consumer Affairs Letter CA 13–19 (November 18); and *"Consumer Compliance and Community Reinvestment Act (CRA) Examination Frequency Policy,"* Consumer Affairs Letter CA 13–20 (November 18).

ment a new regulation may be disproportionate to the level of risk to which these institutions are exposed.[7] To address this, we work within the constraints of the relevant statutory mandate to draft rules so as not to subject community banks to requirements that would be unnecessary or unduly burdensome to implement. When a proposed rule is issued to the public for comment, we gather critical information regarding the benefits and costs of the proposal from those we expect to be affected by the rule as well as from the general public.

These feedback channels have been instrumental to our efforts to appropriately scale rules and policies to the activities and risks at community banks. For example, in developing the final capital guidelines that were issued in July 2013, the Federal banking agencies included in their final rules several changes from the proposed rules to respond to comments and reduce the regulatory burden on community banks.[8] As a result, many of the requirements will not apply to community banks. In addition, the Federal Reserve and the other Federal banking agencies developed a streamlined supplemental Community Bank Guide to assist noncomplex community banks and holding companies in understanding the possible impact of the new rules on their operations.[9]

Many recently established rules have been applied only to the largest, most complex banking organizations. For example, the Federal Reserve and the other Federal banking agencies have not applied large-bank stress testing requirements to community banks. The Federal Reserve has continued, through public statements and examiner training, to explain clearly the requirements, expectations, and activities relating to Dodd-Frank Act stress testing (DFAST) and the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) exercise and to reinforce that DFAST and CCAR requirements, expectations, and activities *do not* apply—either explicitly or implicitly—to community banking organizations.[10]

Clarifying Expectations for Community Banks

The Federal Reserve has made a concerted effort to explain to both community bankers and Federal Reserve examiners which entities are subject to new rules and policies. In addition to tailoring regulations, as discussed previously, one significant way we clarify the applicability of guidance to community banks is to provide a statement at the top of each Supervision and Regulation letter and Consumer Affairs letter. These letters are the primary means by which the Federal Reserve issues supervisory and consumer compliance guidance to bankers and examiners. This additional clarity allows community bankers to focus efforts on the supervisory policies that are applicable to their banks. Moreover, it is important to note that we work closely with our colleagues at the State banking agencies and the other Federal regulatory agencies to ensure that our supervisory approaches and methodologies are consistently applied to all community banks.

While it is important that our written guidance and regulations clearly convey supervisory expectations and identify the applicable audience, we know that some of the most important communications are not necessarily those that come out of Washington, DC, but rather the formal and informal conversations that take place between examiners and bankers during onsite examinations. These conversations are fundamental in ensuring that the Federal Reserve's policies are communicated to and correctly interpreted by community bankers. These discussions provide for clear communication of issues identified during the examination process, and community bankers also tell us that they appreciate learning from examiners about where they stand relative to comparable banks. There is a risk that these conversations, however, may inadvertently suggest that practices at larger banks should be adopted by community banks, when that is not actually the Federal Reserve's intent.

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[7] Daniel K. Tarullo (2014), "Dodd-Frank Implementation," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 9, *http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm.*

[8] See Board of Governors of the Federal Reserve System (2013), "Federal Reserve Board Approves Final Rule to Help Ensure Banks Maintain Strong Capital Positions," press release, July 2, *www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm.*

[9] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) (2013), *New Capital Rule: Community Bank Guide* (Washington: Board of Governors, FDIC, and OCC, July), *www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf.*

[10] For more information, see Board of Governors of the Federal Reserve System, FDIC, and OCC (2012), "Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks," May 14, *www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf.*

To ensure that supervisory expectations are communicated appropriately, therefore, the Federal Reserve is making its longstanding program for training examiners more robust. For example, we are currently modernizing our longstanding examiner commissioning program for community bank examiners, and a key part of this effort is reviewing the curriculum to ensure that supervisory expectations for larger banks do not make their way into the curriculum. In addition, when new supervisory policies are issued, we typically arrange a teleconference to explain the new policy to examiners, including whether and to what extent the policy is applicable to community banks. By effectively training our examination staff and providing channels for keeping them informed of newly issued policies in a timely manner, examiners are better equipped to understand the supervisory goals of regulations and guidance for community banks and to provide guidance to community banks.

To help ensure that examiners implement supervisory policies consistently across community banks, Federal Reserve Board staff analysts monitor bank supervision activities and sample recently completed examination reports to assess whether policies are implemented appropriately and whether examiner conclusions are adequately supported. These analysts also conduct periodic reviews of specific examination activities carried out by Reserve Bank examiners to assess their implementation of supervisory policies and standards at community banks. Periodically, we become aware of particular concerns being raised by the industry with regard to community banks being held to inappropriate standards. We take these concerns seriously and focus our reviews of examination activities to confirm that examiners are appropriately implementing supervisory policies and reaffirming policy objectives when necessary.

In addition to the examination process, the Federal Reserve Board has established additional mechanisms to ensure that supervisory policies for community banks are appropriately tailored and to provide other avenues of discussion for community bankers to share their perspectives with the Board and senior Reserve Bank officials. For example, the Federal Reserve established a Community Depository Institution Advisory Council (CDIAC) at each of the 12 Federal Reserve Banks and at the Board.[11] Members are selected from representatives of banks, thrift institutions, and credit unions in each Federal Reserve District, with a representative from each of these 12 local CDIACs serving on a national council that meets with the Federal Reserve Board twice each year. These meetings provide the Federal Reserve Board with valuable insight regarding the concerns of community depository institutions, which often include issues relating to regulatory burden and examination practices.

The Board of Governors also has a community and regional bank subcommittee of its Committee on Bank Supervision.[12] This subcommittee reviews policy proposals to ensure they are appropriately tailored for community banks. The subcommittee also meets with Federal Reserve staff to hear about key supervisory initiatives at community banks and ongoing research in the community banking arena.

On this latter point, one of the great strengths of the Federal Reserve as the central bank of the United States is its role in conducting and fostering economic research. With this in mind, the Board's community bank subcommittee has been encouraging more research about community banking issues to better understand the role of community banks in the U.S. economy and the effects that regulatory initiatives may have on these banks. That initiative to encourage more high-quality research on community banking issues ultimately led to an inaugural community banking research and policy conference: "Community Banking in the 21st Century," jointly hosted by the Federal Reserve System and the Conference of State Bank Supervisors (CSBS) in 2013 at the Federal Reserve Bank of St. Louis.[13] Later this month, the Federal Reserve and the CSBS will host a second community banking research conference, again at the Federal Reserve Bank of St. Louis.[14] Among other topics, the conference will cover community bank formation, behavior, and performance; the effect of government policy on bank lending and risk taking; the effect of government policy on community bank viability; and the future of community banking.

We have also developed several platforms to improve our communication with community bankers and to enhance our industry training efforts. For example, we have developed two programs—Ask the Fed and Outlook Live—that have become

[11] For more information on the CDIAC, see *www.federalreserve.gov/aboutthefed/cdiac.htm.*

[12] For more information on the Board's committees, including membership, see *http://www.federalreserve.gov/aboutthefed/bios/board/default.htm.*

[13] Abstracts of research papers discussed at the 2013 conference are *available at www.stlouisfed.org/banking/community-banking-conference/abstracts.cfm.*

[14] For more information on the 2014 conference, see *www.stlouisfed.org/banking/community-banking-conference-2014/.*

quite popular with community bankers who are interested in learning more about topics of importance to both banks and supervisors. Ask the Fed is a program for officials of State member banks, bank and savings and loan holding companies, and State bank regulators that provides an excellent opportunity for bankers and others to ask Board and Reserve Bank staff policy questions outside of an examination context, primarily on safety-and-soundness and related issues. Outlook Live, which is a companion program to the Federal Reserve's quarterly *Consumer Compliance Outlook* publication, is a Webinar series on consumer compliance issues that is led by Federal Reserve staff.[15]

We are also now using periodic newsletters and other communication tools to highlight information in which community bankers may be interested and to provide information about how examiners will assess compliance with Federal Reserve policies. In addition to *Consumer Compliance Outlook,* in 2012 the Federal Reserve System established the Community Banking Connections Web site and quarterly newsletter to focus on supervisory issues that are of practical interest to community bankers and bank board members.[16] The Federal Reserve also launched a series of special-purpose publications called FedLinks.[17] These publications highlight key elements of specific supervisory topics and discuss how examiners will typically review a particular bank activity and the related risk-management practices. The common goal for all of these outreach efforts is to build and sustain an ongoing dialogue with community bankers through which supervisory expectations are helpfully conveyed and clarified.

Reducing Regulatory Burden for Community Banks

The Federal Reserve continues to explore ways to reduce regulatory burden for community banks. In analyzing regulatory burden on community banks and other institutions, the Federal Reserve tries to strike the appropriate balance between, on the one hand, achieving its longstanding responsibilities of fostering a safe and sound financial system and compliance with relevant consumer regulations and, on the other hand, ensuring that our supervision and regulation are calibrated appropriately for smaller institutions. Whenever the Federal Reserve contemplates possible regulatory changes, we conduct a thorough analysis of the effects of such changes on the ability of institutions to manage their operations in a safe and sound manner as well as the ability of Federal Reserve examiners to identify risks that may pose a threat to individual institutions or to the financial system more broadly.

An example of the how the Federal Reserve and the other Federal banking agencies consider a variety of factors when reviewing regulations for burden is the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) review. The agencies have recently started their second EGRPRA review by requesting public comment to identify potentially outdated, unnecessary, and burdensome regulations imposed on insured depository institutions. The comment period for the EGRPRA review for the first set of regulations ended early in September. The Federal Reserve and the other agencies plan to engage in discussions with bankers and interested parties regarding the EGRPRA review and will post relevant information from these meetings on the EGRPRA Web site once finalized.[18]

Conclusion

Although the financial condition of community banks has been improving, we recognize that many community banks continue to face challenges. The Federal Reserve has a long history of tailoring supervisory practices for community banks, and we will continue to modify and refine our supervisory programs to not impose undue burden while still ensuring that community banks operate in a safe and sound manner. We will continue to solicit the views of smaller institutions in Federal Reserve and interagency rulemaking processes and welcome their feedback on community banking issues more generally.

Thank you for inviting me to share the Federal Reserve's views on these matters affecting community banking organizations. I would be pleased to answer any questions you may have.

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[15] *Consumer Compliance Outlook* is *available at www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/,* and Outlook Live is *available at www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/.*

[16] Community Banking Connections is *available at www.communitybankingconnections.org.*

[17] FedLinks is *available at http://www.cbcfrs.org/fedlinks.cfm.*

[18] For more information on EGRPRA and the regulatory review process, see *http://egrpra.ffiec.gov/index.html.*

NCUA

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September 16, 2014

Congressional Testimony

Larry Fazio
Director, Office of Examination and Insurance
National Credit Union Administration

Senate Banking, Housing and Urban Affairs Committee
Hearing on the State of Small Depository Institutions

NCUA is the independent federal agency created by the U.S. Congress to regulate, charter, and supervise federal credit unions. With the backing of the full faith and credit of the United States, NCUA operates and manages the National Credit Union Share Insurance Fund, insuring the deposits of more than 98 million account holders in all federal credit unions and the overwhelming majority of state-chartered credit unions.

At MyCreditUnion.gov and Pocket Cents, NCUA also educates the public on consumer protection and financial literacy issues.

NCUA

Congressional Testimony

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, the National Credit Union Administration appreciates the invitation to testify about the state of small depository institutions. I am Larry Fazio, Director of NCUA's Office of Examination and Insurance.

With one-third of credit unions having less than $10 million in assets and two-thirds of credit unions having less than $50 million in assets, NCUA is acutely aware of the importance of scaling its regulatory, supervisory, and assistance programs to address the unique circumstances of small credit unions.[1] As a result, the agency has made significant progress in considering the concerns of small credit unions during the last five years. Where the rules that affect small credit unions are within the agency's control and where regulatory exemptions and tailored rules would not significantly affect safety and soundness, NCUA has taken proactive action to ease those burdens.

One way NCUA has eased burdens was to revise the definition of a small credit union under the Regulatory Flexibility Act from less than $10 million in assets to less than $50 million in assets.[2] As a result, the NCUA Board must specifically consider the potential regulatory burden and alternatives for small credit unions in any rule the agency finalizes going forward.

Other examples of NCUA's recent efforts to provide regulatory relief include exempting small credit unions from:

- NCUA's risk-based net worth rule;
- the agency's interest rate risk rule;
- advanced provisions of NCUA's liquidity and contingency funding rule; and
- the posting of creditor notices during voluntary liquidations.

In the process of updating the Regulatory Flexibility Act threshold for defining a small entity, the NCUA Board also committed the agency to revisiting the threshold by January 2015 and every three years thereafter. This review process will ensure NCUA's definition of a small credit union remains current with the credit union system's evolution.

[1] For purposes of this testimony, the use of the term "small credit unions" refers to federally insured credit unions with less than $50 million in assets, unless otherwise indicated.
[2] See http://www.gpo.gov/fdsys/pkg/FR-2013-01-18/pdf/2013-00864.pdf.

In recent years, NCUA has additionally implemented a streamlined supervisory program to minimize examination burdens for the smallest of federal credit unions that are financially and operationally sound, cutting annual examination times at institutions with less than $30 million in assets from as much as 100 hours to 40 hours. Finally, NCUA provides high-quality training, individualized consulting, grants, loans, and other services to small credit unions and other qualified institutions through our Office of Small Credit Union Initiatives.

My testimony today will begin by reviewing NCUA's mission. As the Committee requested, I will then describe the current state of small credit unions, their performance, and the challenges they face. My testimony will also cover the agency's current and prospective efforts to calibrate regulation and supervision based on a credit union's size and complexity of activities, as well as NCUA's many proactive programs providing assistance to small credit unions. Finally, I will offer ideas for the Senate Banking Committee to consider when deliberating on regulatory relief proposals.

NCUA's Mission

NCUA's primary mission is to provide, through regulation and supervision, a safe and sound credit union system. NCUA performs this important public function by:

- Examining all federal credit unions;
- Participating in the supervision of federally insured, state-chartered credit unions in coordination with state regulators; and
- Insuring individual accounts at federally insured credit unions up to $250,000 and joint accounts up to $250,000 per member.

As required by the Federal Credit Union Act, NCUA also serves as the administrator of the $11.6 billion National Credit Union Share Insurance Fund.[3] In this role, NCUA provides oversight and supervision to 6,429 federally insured credit unions. Of these credit unions, NCUA directly supervises the 4,029 federal credit unions chartered by the agency.

Currently, federally insured credit unions represent 98 percent of all credit unions in the United States and serve more than 98 million credit union members.[4]

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[3] Congress established the National Credit Union Share Insurance Fund in 1970 as part of the Federal Credit Union Act (P.L. 91-468) and amended the Share Insurance Fund's operations in 1984 (P.L. 98-369). The fund operates as a revolving fund in the U.S. Treasury under the administration of the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state-chartered credit unions that request federal insurance. Funded by federally insured credit unions, the Share Insurance Fund is backed by the full faith and credit of the United States.

[4] The term "credit union" is used throughout this testimony to refer to federally insured credit unions. NCUA does not oversee approximately 132 state-chartered, privately insured credit unions. As a policy matter, in 2007 NCUA issued a report to Congress concluding that the federal government should be the sole provider of primary deposit insurance. Federal deposit insurance has played an important role in maintaining confidence in the financial system and the stability

State of Small Credit Unions

As shown in Chart 1, the number of credit unions has been declining consistently for more than two decades even as membership in the system has grown steadily. Between 1990 and 2013, credit union membership rose by 66.3 percent, while the number of credit unions fell 49.7 percent. This consolidation among credit unions is consistent with larger trends within the entire financial services marketplace, but credit unions are still unique with their smaller size and exclusive focus on serving their members.

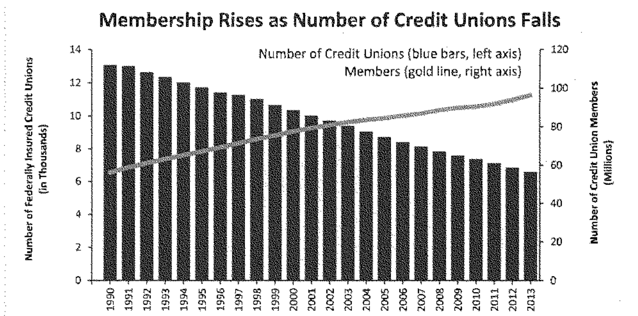

Chart 1

One factor contributing to the decline in the number of credit unions is that many generally cannot take advantage of economies of scale given their small size. Other factors include a single-sponsor credit union that loses its sponsor, lack of succession planning within the credit union before a long-term CEO retires, and technological changes. Bad management decisions, insufficient internal controls, and employee fraud also have played a role in the system's consolidation. In all, employee fraud led to $311.4 million in losses for the Share Insurance Fund between 2010 and 2013 at liquidated credit unions.

Additionally, some credit unions lack the resources and capabilities to provide the financial services and products that today's consumer considers essential. This situation is particularly apparent in small credit unions. Today, checking accounts, real estate loans, ATM and debit cards, and home banking services (including mobile banking) are available at roughly 60 percent of credit unions with less than $50 million in assets. But essentially

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of our economy, and the lessons learned from failures of private deposit insurance schemes should not be forgotten. See http://www.ncua.gov/Legal/Documents/DepositInsuranceStudyReporttoCongress-Ver6-4.pdf for more details.

all credit unions with assets of greater than $50 million provide each of these services. These differences have persisted over the past ten years, underscoring the competitive challenges that small credit unions must confront.[5]

Between 2003 and 2013, the credit unions that ceased operations tended to be small credit unions. Out of 9,369 credit unions active at the end of 2003, there were 7,472 small credit unions. In all, 2,850 credit unions left the system by the end of 2013, of which 2,636 (92.5 percent) were small credit unions. However, more than 90 percent of the small credit unions that left the system during the decade voluntarily merged with another credit union. Of the 4,836 credit unions that were small in 2003 and were still active in 2013, nearly 90 percent still had assets less than $50 million at the end of 2013.[6]

While many small credit unions closed or merged during the last decade, some successfully grew beyond the small credit union threshold. In all, 538 small credit unions at the end of 2003 grew above $50 million by 2013.[7] This statistic demonstrates that, given the right circumstances, small credit unions have the ability to survive and thrive.

Small credit unions also account for a smaller share of total system assets than they did ten years ago. At the end of 2003, small credit unions accounted for 14 percent of assets in federally insured credit unions. That share declined to 6 percent by the end of 2013.[8]

Finally, membership at small credit unions fell as a share of total system memhership in the ten years starting at the end of 2003. The number of members in small credit unions declined from 22 percent of total membership in federally insured credit unions at the end of 2003 to 10 percent by the end of 2013.[9]

Performance Metrics by Asset Class

The challenges small credit unions confront are also reflected in their financial performance. To put the operational pressures and compliance burdens faced by small credit unions in perspective, one only needs to look at the number of employees in different asset classes. At the end of 2013, the median number of full-time equivalents at the credit unions with less than $10 million in assets was two, while credit unions between $10 million and $50 million in assets had seven.[10] These numbers have remained static for more than a decade.

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[5] See Appendix I for more details.
[6] See Appendix II for more details.
[7] Ibid.
[8] See Appendix III for more details.
[9] Ibid.
[10] See Appendix IV for more details.

Additionally, while they tend to have higher net worth ratios, small credit unions generally underperform larger credit unions in most financial measures.[11] This may occur, in part, because these small credit unions have made business decisions to pay their members higher interest rates on share deposits and share certificates, charge lower rates on loans, and offer more services rather than further increasing retained earnings and net worth. Other factors contributing to lower returns at small credit unions include higher proportional costs to deliver services effectively to their members and higher charge-off rates.

During the past ten years, median annual average loan, asset, and membership growth rates at the smallest credit unions, those with less than $10 million in assets, have all been negative.[12] Although credit unions with $10 million to $50 million in assets performed somewhat better in loan and asset growth, at the median, they, too, have experienced annual declines in median average membership over the past ten years. In contrast, median average membership, loans, and assets have grown over the past decade at credit unions above $50 million in assets.

The data for the most recent year confirm these trends.[13] Over the year ending in the fourth quarter of 2013, median loan growth fell 0.8 percent at credit unions with less than $10 million in assets, and grew 1.0 percent in credit unions between $10 million and $50 million in assets. By contrast, median loan growth was 4.1 percent in credit unions with $50 million to $250 million in assets, and 8.4 percent in credit unions with over $250 million in assets.[14] Median asset growth and membership growth show similar trends, with rates increasing with the size of the asset class.

Finally, averaged over the past 10 years, the median return on average assets in credit unions with less than $10 million in assets was just 7 basis points, compared with 29 basis points at credit unions with $10 million to $50 million in assets, 43 basis points at credit unions with $50 million to $250 million in assets, and 64 basis points at credit unions with over $250 million in assets.[15] The low median returns on average assets among the smallest credit unions indicate that many are losing money each year. Even with the smallest credit unions' high net worth ratios, the negative earnings at many of them highlight the need for policymakers to examine options for providing regulatory relief.

Regulatory Flexibility Act

In recognition of the operational and financial challenges faced by small credit unions, the NCUA Board in January 2013 reviewed the threshold used to identify which credit unions qualify as small entities under the Regulatory Flexibility Act. Under this law, NCUA must

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[11] Ibid.
[12] Ibid.
[13] Ibid.
[14] Ibid.
[15] Ibid.

give special consideration of regulatory burden and alternatives of small credit unions every time the agency issues a new regulation. Based on system percentages carried forward from the last update in 2003 and corresponding risks to the Share Insurance Fund, the Board determined that credit unions with less than $50 million in assets, up from the prior $10 million threshold, were small entities for purposes of the Regulatory Flexibility Act.

As noted earlier, the Board committed the agency to revisiting the Regulatory Flexibility Act threshold by January 2015 and every three years thereafter. This triennial review of the small credit union definition under the Regulatory Flexibility Act is in addition to NCUA's rolling three-year review of all regulations.[16]

Since 1987, NCUA has followed a well-delineated and deliberate process to continually review its regulations and seek comment from stakeholders, such as credit unions and trade associations representing the credit union system. Through this agency-initiated process, NCUA conducts a rolling review of one-third of all its regulations each year, meaning that the agency reviews all of its regulations at least once every three years. Each year, NCUA publishes the list on its website of the applicable regulations up for review that year and invites public comment.

The change in the definition of a small credit union is also consistent with Chairman Debbie Matz's ongoing Regulatory Modernization Initiative. The initiative balances two principles:

- Safety and soundness—strengthening regulations necessary to protect credit union members and the Share Insurance Fund.
- Regulatory relief—revising and removing regulations that limit flexibility and growth, without jeopardizing safety and soundness.

At the time of the adjustment of the definition of a small credit union under the Regulatory Flexibility Act, the number of small credit unions nearly doubled. Approximately 2,270 additional credit unions became eligible for regulatory relief, bringing the total of small credit unions to over 4,670 or 68 percent of all credit unions. The growth in the number of small credit unions is illustrated in Chart 2 on the next page.

For consistency and to provide immediate regulatory relief, the NCUA Board extended the $50 million Regulatory Flexibility Act threshold to two preexisting regulatory exemptions. First, the Board increased from $10 million to $50 million the threshold that defines what credit unions are complex, narrowing the category of credit unions that could be subject to risk-based net worth requirements and the associated prompt corrective action mandates. Second, the Board increased from $10 million to $50 million the threshold used to exempt credit unions from the requirements of our interest rate risk rule.

[16] See http://www.ncua.gov/Legal/Regs/Pages/Regulations.aspx.

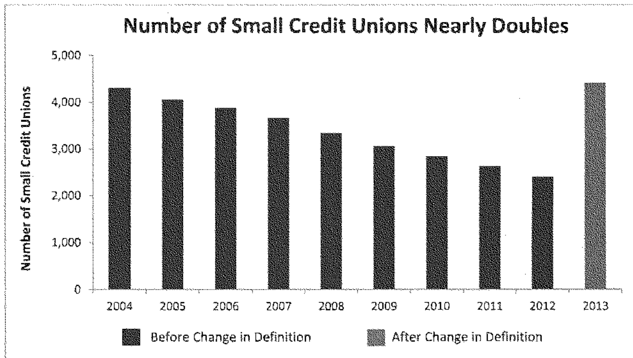

Chart 2

Subsequently, the Board extended relief at the same levels in new rules requiring certain liquidity contingencies and creditor notices in voluntary liquidations. Additionally, in a coordinated policy change, the NCUA Board nearly doubled the number of credit unions able to apply for the Office of Small Credit Union Initiatives' individualized consulting services by increasing the eligibility threshold to $50 million.

Regulatory Costs and Benefits

In developing any regulation, NCUA strives to ensure the agency's rulemakings are reasonable and cost-effective. Under the leadership of Chairman Matz, the NCUA Board has recently used asset-size exemptions as a tool to limit regulatory burdens for smaller institutions.

When promulgating new rules, the NCUA Board considers the potential benefits, as well as the direct and indirect potential costs. Direct costs include any expenses credit unions are likely to incur in complying with the rule. These costs might include the additional time spent collecting data, reporting, and training staff, as well as the need to acquire new software or services. Indirect costs might include higher lending rates or fees, lower rates on share deposits, or other constraints on a credit union's activities.

Many of NCUA's regulations strengthen the safety and soundness of credit unions the agency supervises. The benefit of these safety and soundness regulations is that they reduce the likelihood of credit union failures and, in doing so, promote stability and protect the Share Insurance Fund. Any loss to the Share Insurance Fund is ultimately borne by

surviving credit unions, which can be required to pay increased premiums. As member-owned cooperatives, this means the members, who are the owners and customers of the credit unions, may ultimately have to repay these costs. As the developments of the last decade have demonstrated, the cost of regulatory inaction can result in failures that impose a greater cost to credit unions and society than the cost of action.[17]

Through the public comment process, the NCUA Board gains insight on potential costs and unintended consequences directly from the credit unions the agency supervises and insures. The Board then uses this information to make adjustments to the final rule. A good example of this process is NCUA's final rule on emergency liquidity and contingency funding, adopted by the Board in October 2013. The proposed rule applied to all federally insured credit unions with more than $50 million in assets, but the public comment period yielded a number of important observations about the compliance requirements associated with establishing emergency lines of credit.

Based on this information, the NCUA Board reconsidered the balance between costs and benefits specifically for credit unions between $50 million and $250 million in assets. The final rule exempted these credit unions from establishing emergency lines of credit with the Federal Reserve's Discount Window, NCUA's Central Liquidity Facility, or both. Instead, the NCUA Board only required credit unions of this size to develop contingency funding plans that clearly set out strategies for meeting emergency liquidity needs.

Examples of Scaled Regulation

In addition to calibrating the liquidity and contingency funding rule to provide the least possible burden for small credit unions, NCUA has scaled many of its other regulations based on the asset size of the credit union. Examples of such tailored regulation include the agency's interest rate risk rule and the proposed risk-based capital rule issued earlier this year. A brief discussion of each of these matters follows.[18]

Interest Rate Risk Rule

NCUA's focus on interest rate risk management has been constant and pronounced for more than 15 years, as evidenced by a steady issuance of guidance to examiners and credit unions on asset-liability management. Since 2010, interest rate risk management has been a heightened focus for NCUA, and it is a primary supervisory focus for the agency in 2014.

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[17] The collapse of five corporate credit unions during the recent financial crisis best illustrates this point. To date, credit unions have paid $4.8 billion in assessments and experienced $5.6 billion in losses in the form of contributed capital. These costs reduced credit union earnings and assets and, as a result, may have decreased interest paid on share deposits, increased loan rates, and constrained credit union services for their members.
[18] See Appendix V for a more complete listing of NCUA's efforts to scale regulations, calibrate examinations, and provide assistance designed to address the unique circumstances of smaller credit unions.

NCUA's focus on interest rate risk exposure has increased due to the extraordinary low level of rates and the overall lengthening of asset durations in the credit union system. NCUA is mindful that a period of rapidly rising rates could be a particularly challenging scenario for some credit unions. To stay ahead of the curve and maintain stable earnings, all credit unions need to put in place policies to survive adverse rate environments.

These concerns led the NCUA Board to issue a final rule on managing interest rate risk in January 2012. Generally, the rule categorizes credit unions based on size, which is correlated to risk exposure, to determine the need to adopt a written policy on interest rate risk. Consistent with the Board's policy to exempt small credit unions from regulations when prudent, the size and exposure criteria in the interest rate risk rule exempt small credit unions with less than $50 million in assets, while protecting the Share Insurance Fund through coverage of most of the system's assets.

The NCUA Board took this action based on several factors. First, most small credit unions use short-term liabilities like regular share deposit accounts and share certificates to fund medium-term assets such as new and used auto loans, and unsecured personal loans and lines of credit. This strategy typically increases earnings and net worth. Second, small credit unions are not as active in the residential mortgage lending as larger credit unions, primarily due to resource issues.[19] Finally, smaller credit unions hold relatively more cash and short-term investments on their balance sheets.[20] While holding earnings down in the current low rate environment, holding more cash and short-term investments favorably positions small credit unions to take advantage of rising interest rates in the future.

Proposed Risk-Based Capital Rule

Most recently, NCUA has sought to provide regulatory relief for small credit unions in its proposed rule on risk-based capital. In January 2014, the NCUA Board issued a proposed rule to revise the risk-based capital framework for federally insured credit unions tailored to protect the system and consumers from losses. The rule modernizes the existing risk-based net worth rule and is required by the Federal Credit Union Act. Generally, the proposed rule would require credit unions that take greater risks to hold more capital against those risks to protect the Share Insurance Fund from losses.

While seeking to enhance the safety and soundness of the credit union system, the proposed rule would only apply to credit unions with assets of $50 million or more. As a result, two-thirds of all credit unions are not affected by the proposed rule. These credit unions pose minimal risk to the Share Insurance Fund and have more limited exposure to interest rate risk, as noted above.

[19] As of June 30, 2014, real estate loans at large credit unions accounted for 32.6 percent of total assets, compared to 15.6 percent at small credit unions.
[20] As of June 30, 2014, small credit unions maintained cash and short-term investment balances at 23.4 percent of total assets, compared to 13.2 percent for large credit unions.

The exemption of credit unions with less than $50 million in assets is consistent with the NCUA Board's efforts to exempt small credit unions from regulation when prudent, as well as the Federal Credit Union Act. Chairman Matz has also publicly indicated that the NCUA Board will explore whether to further increase the asset threshold for complex credit unions in order to exempt more credit unions from the final risk-based capital rule.

Small Credit Union Examination Program

Beyond providing targeted relief for smaller credit unions when possible through the issuance of regulatory exemptions and the adoption of tailored rules, NCUA provides relief to smaller credit unions through the examination process.

Since 2002, NCUA has followed a risk-focused exam program which is designed to allocate agency resources to the credit unions and areas of operation that exhibit the greatest risk to the Share Insurance Fund. The program relies on examiner judgment to determine what areas need review. Over time, NCUA has fine-tuned this approach by adding minimum scope requirements and establishing the National Supervision Policy Manual.

While the risk-based examination program has worked generally well, NCUA recognized the distribution of examination resources was out of balance with the credit union system's risks. NCUA was spending more exam hours on the smallest credit unions rather than the largest credit unions that have the concentration of assets in the system. With the continuing changes in the credit union system, NCUA shifted its focus on the size, scale, and scope of credit union examinations.

NCUA has since moved to concentrate supervision on credit union activities that pose the most risk. Larger risks have wider consequences. In recognition that larger, more complex credit unions require more attention, NCUA began streamlining exams for the smallest credit unions and putting examiners where their work will be most effective in protecting the Share Insurance Fund.

In September 2012, NCUA adopted a streamlined examination program for financially and operationally sound credit unions with less than $10 million in assets. As part of the Small Credit Union Examination Program, NCUA aims to spend only 40 exam hours on average per small, well-managed credit union. Before the new program, NCUA had spent as much as 100 exam hours in credit unions of this asset size. This decreased examination burden reflects a reduced scope aimed at focusing on the most pertinent areas of risk in small credit unions—lending, recordkeeping, and internal control functions.

In 2014, NCUA expanded the Small Credit Union Examination Program to include federal credit unions with $30 million or less in total assets that receive a composite CAMEL rating

of 1, 2, or 3 at their last examination.[21] Under the recalibrated program, the target examination time is 65 hours on average for eligible federal credit unions with assets from $10 million to $30 million.

NCUA is currently testing additional improvements for this program. NCUA anticipates fully implementing the new procedures for the Small Credit Union Examination Program in 2015.[22] Prior to implementation, NCUA will train staff and provide information about the changes to affected federal credit unions.

NCUA's Office of Small Credit Union Initiatives

In addition to the agency's concerted efforts to reduce the regulatory and supervisory burdens for small credit unions, NCUA makes available, through the agency's Office of Small Credit Union Initiatives, a wide variety of programs to assist small credit unions. Created in 2004, the office fosters credit union development and the effective delivery of financial services for small, new, and low-income credit unions,[23] as well as minority depository institutions. To help viable small credit unions thrive, 28 NCUA staff offer individualized consulting, loan and grant opportunities, targeted training, and valuable partnership and outreach.

Through this office, NCUA provides enrolled credit unions one-on-one consulting on strategic management and operational issues. Many small and developing credit unions have immediate needs for operational assistance such as chartering, field of membership expansion, and internal controls. The 474 consulting service contacts provided by the office during 2013 well surpassed those of the past two years, 325 and 245 provided during 2012 and 2011, respectively. Credit unions using NCUA's consulting services are better able to plan for the future by thinking strategically and developing a business plan that supports the credit union's field of membership.

Congress also established the Community Development Revolving Loan Fund to provide grants and reduced-rate loans to low-income credit unions, many of which are small credit unions.[24] This program enables the low-income credit unions to provide financial services

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[21] The CAMEL rating system is based upon an evaluation of five critical elements of a credit union's operations: Capital adequacy, Asset quality, Management, Earnings and Liquidity. The CAMEL rating system is designed to take into account and reflect all significant financial, operational and management factors that examiners assess in their evaluation of a credit union's performance and risk profile. CAMEL ratings range from 1 to 5, with 1 being the highest rating.
[22] For larger, more complex credit unions, NCUA will continue to perform risk-focused exams.
[23] A low-income credit union is one in which a majority of its membership (50.01 percent) qualifies as low-income members. Low-income members are those members who earn 80 percent or less than the median family income for the metropolitan area where they live, or the national metropolitan area, whichever is greater. During the last two years, NCUA has nearly doubled the number of low-income credit unions through a streamlined designation process. Under the Federal Credit Union Act, the low-income designation offers certain benefits and regulatory relief.
[24] Small credit unions are slightly more likely to be low-income credit unions. Overall, 70 percent of low-income credit unions are small credit unions compared to small credit unions making up two-thirds of the system.

and stimulate economic activities in underserved communities, as well as reach members who have limited access to basic financial services. The program is funded by congressional appropriations and managed by the Office of Small Credit Union Initiatives. In 2014, NCUA has awarded more than $1.5 million to 331 low-income credit unions through two grant rounds. Demand for these funds has consistently and significantly exceeded available appropriations.

Grant initiatives focus on innovation, collaboration, and development of credit unions to increase and improve financial services to their members. Specific uses for the grants in the last two fiscal years have included:

- Developing and implementing new products and services to benefit the community;
- Supporting financial literacy and school branching efforts;
- Training credit union staff, officials, and managers;
- Shaping future leaders by providing an opportunity for students to work in the credit union system; and
- Encouraging collaboration among credit unions to reduce expenses.

NCUA also provides reduced-rate loans to low-income credit unions through the Community Development Revolving Loan Fund. The goal is to help credit unions provide basic financial services to low-wealth, unbanked, and under-banked consumers. Additionally, such support enables the credit unions to improve their operations.

In October 2011 the NCUA Board approved a comprehensive rewrite of the regulations governing the Community Development Revolving Loan Fund's loan functions. The change cut regulatory burdens, eliminated red tape, and streamlined program administration. Most significantly, the rule removed the requirement that NCUA charge an interest rate between 1 and 3 percent. The Board made this change to provide flexibility to charge below-market rates no matter how low or how high the prevailing rates move in the future. The modified rule also better detailed the application and award processes, and post-award reporting requirements.

The revised rule has resulted in increased demand for loans by low-income credit unions. As of June 2014, NCUA had a total of $7.6 million in outstanding loans to low-income credit unions, including $570,000 in loans made to four credit unions in 2013. During the first six months of 2014, NCUA funded nine loans totaling $4.25 million. The majority of these loans were for credit unions to implement loan products in low-income communities.

NCUA's Office of Small Credit Union Initiatives also uses technology to effectively and efficiently deliver timely training to a broad range of audiences in the credit union system.

In 2013, NCUA introduced new videos, a monthly webinar series, and specialized full-day "CEO Boot Camps" to its mix of training events. This was in addition to its traditional in-person workshop format. During 2013, NCUA trained 26,134 credit union officials, board members, and volunteers. As of June 30 this year, NCUA had trained 17,540 more individuals.

A final service provided by NCUA's Office of Small Credit Union Initiatives is partnerships and outreach. Achieving a successful partnership requires the right mix of timing, commitment, and resources. By working with other government agencies and non-profit organizations, NCUA expands credit union access to products and services that may benefit their memberships.

During 2013, NCUA began work with two non-profits, Net Impact and SCORE. Net Impact uses a network of more than 40,000 graduate students and young professionals who seek to make a positive change in their communities socially or environmentally through their work. SCORE is supported by the U.S. Small Business Administration and assists small businesses, such as credit unions, through a network of over 11,000 volunteers experienced in many facets of business. NCUA maintains partnerships with other federal agencies including, the Assets for Independence Program of the U.S. Department of Health and Human Services and the U.S. Department of the Treasury's Community Development Financial Institutions Fund.

Regulatory Relief Legislation

The Committee's invitation additionally asked NCUA to comment about ways to provide regulatory relief through legislation.

Today, there is considerable diversity in scale and business models in the financial services marketplace. As noted earlier, many credit unions are very small and operate on extremely thin margins. They are challenged by unregulated or less-regulated competitors, as well as limited economies of scale. They often provide services to their members at a loss out of commitment to offer a specific product or service.

To that end, NCUA would advise Congress to provide regulators with flexibility in writing rules to implement new laws. Such flexibility would allow the agency to effectively limit additional regulatory burdens on smaller institutions by appropriately scaling the regulatory requirements. As previously noted, NCUA continues to modernize existing regulations with an eye toward balancing requirements appropriately with the risk small credit unions pose to the credit union system. By allowing NCUA discretion on scale and timing to implement new laws, we can more flexibly mitigate the cost and administrative burdens of these smaller institutions while balancing consumer and financial system risk priorities.

Another way Congress could help small credit unions that have a federal charter is to modify the Federal Credit Union Act to give NCUA the authority to streamline field of

membership changes and permit them to grow their membership by adding underserved areas. The Federal Credit Union Act currently only permits federal credit unions with multiple common-bond charters to add underserved areas to their fields of membership.

Allowing federal credit unions that do not have a multiple common-bond charter the opportunity to add underserved areas would open up access for many more unbanked and underbanked households to credit union membership. This legislative change could also eventually enable more credit unions to participate in the programs of the Community Development Financial Institutions Fund,[25] thus increasing the availability of credit and savings options in the distressed areas where the small credit unions operate.

Additionally, NCUA supports targeted regulatory relief bills now pending in Congress. One such bill is H.R. 3468, the Credit Union Share Insurance Fund Parity Act, which the U.S. House of Representatives passed in May. The bill is virtually identical to S. 2699, which Senator Angus King and Senator Mark Warner introduced in late July. NCUA has no safety and soundness concerns with either of these proposals.

Currently, federally insured credit unions cannot offer the same level of insurance on deposits as banks and thrifts for lawyers' trust accounts. Deposit insurance at banks and thrifts for these accounts is $250,000 per owner of the funds (client), per financial institution, assuming the account is properly designated as a trust account and proper accounting of each client's funds is maintained. Because not all clients of a lawyer are credit union members, credit unions cannot offer the same level of insurance for lawyers' trust accounts. The bills pending in the Senate are narrowly scoped to achieve the desired result of providing parity between federal share and federal deposit insurance coverage.

NCUA also reiterates the agency's support for S. 968, the Small Business Lending Enhancement Act, sponsored by Senator Mark Udall and Senator Rand Paul.[26] This bill modifies the current cap on members business lending. It also contains appropriate safeguards to ensure NCUA can protect safety and soundness as a qualified credit union gradually increases its member business lending program.

In federally insured credit unions, member business loans are limited to the lesser of 12.25 percent of assets or 1.75 times net worth. For smaller institutions with the membership demand and the desire to serve the business segments of their field of membership, the low limit makes it very difficult or impossible to successfully build a qualified member business lending service. Many smaller institutions are unable to deliver commercial lending services cost effectively, which denies small businesses in their communities access to credit and working capital.

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[25] Located within the U.S. Department of the Treasury, the Community Development Financial Institutions Fund's mission is to expand the capacity of financial institutions to provide credit, capital, and financial services to underserved populations and communities in the United States.
[26] http://www.ncua.gov/News/Press/CT20110616Matz.pdf

These institutions miss an opportunity to support the small business community and to provide a better service alternative to the small business borrower. Small businesses are an important contributor to the local economy as a provider of employment and as a user and producer of goods and services. NCUA believes members that are small business owners should have full access to financial resources in the community, including credit unions, but this may be inhibited by the cap on member business loans.

Additionally, NCUA supports H.R. 719, the Capital Access for Small Businesses and Jobs Act, pending in the House. Most federal credit unions only have one way to raise capital—through retained earnings. Without access to other ways to raise capital, credit unions are exposed to risk when the economy falters. Financially strong and well-capitalized credit unions also may be discouraged from allowing healthy growth out of concern it will dilute net worth and trigger prompt corrective action under the Federal Credit Union Act.

A credit union's inability to raise capital outside of retained earnings limits its ability to expand into fields of membership more effectively and to offer greater options to eligible consumers. NCUA has therefore previously encouraged Congress in letters and testimony to consider authorizing healthy and well-managed credit unions, as determined by the NCUA Board, to issue supplemental capital that will count as net worth.

Finally, NCUA requests that the Senate Banking Committee consider legislation to provide the agency with examination and enforcement authority over third-party vendors, including credit union service organizations. Although NCUA may examine vendors with their permission, NCUA cannot enforce any corrective actions. NCUA can merely make recommendations and present findings to each vendor's credit union clients.

NCUA's lack of authority over third-party vendors poses a regulatory burden for credit unions, as the agency must rely upon credit unions to report certain information on the vendors with which they do business. This situation particularly affects small credit unions that must rely on vendors for many products and services that larger credit unions could provide in-house. A legislative fix would provide some regulatory relief for credit unions in that NCUA would be able to work directly with key infrastructure vendors, like those with a cyber-security dimension, to obtain necessary information to assess risk and deal with any problems at the source. Obtaining this authority is the agency's top legislative priority.[27]

While providing important services and helping small credit unions to achieve economies of scale, there are inherent risks in credit union service organizations, or CUSOs for short. Since 2008, NCUA estimates that nine CUSOs have caused more than $300 million in

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[27] NCUA has two other legislative priorities. The first priority would enhance access to emergency liquidity for the credit union system by making targeted changes to the Central Liquidity Facility and expanding the agency's access to the U.S. Treasury. The second priority would permit NCUA to charge risk-based premiums for the Share Insurance Fund much like the Federal Deposit Insurance Corporation charges for the Deposit Insurance Fund. Risk-based premiums would lessen the funding burden on small credit unions, which generally pose less risk to the Share Insurance Fund.

direct losses to the Share Insurance Fund and led to the failures of credit unions with more than $2 billion in assets. In one such example, a CUSO caused losses in 24 credit unions, some of which failed, and more than half of the affected institutions were small credit unions.

For federally insured credit unions of all sizes, CUSOs provide products and services that can significantly affect financial well-being, and, in the case of technology service providers, the security posture of credit unions and the members they serve. At year-end 2013, credit unions using the services of a CUSO accounted for $920 billion in assets or 87 percent of system assets. This is up from 79 percent of assets at year-end 2009.

Third-party vendors provide important services that allow small credit unions to achieve better economies of scale and access to necessary expertise and infrastructure to provide member services that would otherwise be out of reach for them. As a result, small credit unions in particular rely on vendors to provide many important services to members.

The challenge is that third-party vendors, including CUSOs, are not within NCUA's regulatory authority. This limits the agency's ability to assess risk to credit unions and, ultimately the Share Insurance Fund, and respond to any problems. NCUA addressed the need for this authority in testimony before Congress several times in recent years by asking that the agency have the same authority as the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Federal Reserve.[28]

NCUA has developed a legislative proposal which we believe would afford the agency the appropriate statutory authority. NCUA stands ready to work with the Committee on legislation to effectuate the necessary changes so that all credit unions can responsibly and effectively utilize the services of CUSOs and technology service providers.

Conclusion

In closing, NCUA recognizes the need to address the particular circumstances of small credit unions. We do this by tailoring our rules and exempting small credit unions when possible. We also calibrate our examinations of credit unions based on the size, scope, and risk of the institution. Further, NCUA provides direct assistance to small credit unions so they can develop the strategic plans and undertake the required activities to provide needed services to their members. Finally, NCUA is supportive of several targeted legislative proposals, like those to provide parity in insurance coverage for lawyers' trust accounts and raising the cap on member business lending, and we ask that the Committee consider providing regulators with appropriate flexibility in any future legislation.

Thank you again for the invitation to testify. I am happy to answer any questions.

[28] For example, see http://www.ncua.gov/News/Press/CT20101209Matz.pdf.

NCUA

APPENDIX I

Provision of Services by Asset Class

	Less than $50 million	Less than $10 million	$10 million to $50 million	$50 million to $250 million	Over $250 million	Credit Union System
2003, Fourth Quarter						
Number of Credit Unions	7,472	4,576	2,896	1,410	487	9,369
Provision of Services:						
Checking Accounts	60.0%	39.4%	92.5%	98.3%	99.0%	67.8%
Auto Loans	94.8%	91.7%	99.9%	99.9%	100.0%	95.9%
Real Estate Loans	57.9%	36.3%	92.1%	98.9%	99.4%	66.3%
ATM/Debit Card	N/A	N/A	N/A	N/A	N/A	N/A
Home Banking	32.5%	12.4%	64.2%	93.5%	98.4%	45.1%
2008, Fourth Quarter						
Number of Credit Unions	5,770	3,275	2,495	1,406	630	7,806
Provision of Services:						
Checking Accounts	64.3%	41.6%	94.2%	99.3%	99.5%	73.5%
Auto Loans	95.1%	91.5%	99.8%	100.0%	99.8%	96.4%
Real Estate Loans	60.8%	37.0%	92.1%	99.8%	100.0%	71.0%
ATM/Debit Card	57.5%	32.9%	89.8%	97.9%	99.5%	68.2%
Home Banking	51.8%	24.9%	86.9%	98.6%	99.5%	64.1%
2010, Fourth Quarter						
Number of Credit Unions	5,176	2,782	2,394	1,472	691	7,339
Provision of Services:						
Checking Accounts	64.7%	40.4%	92.9%	99.3%	99.6%	74.9%
Auto Loans	94.9%	90.6%	99.9%	99.9%	99.9%	96.4%
Real Estate Loans	60.6%	35.0%	90.4%	99.8%	100.0%	72.2%
ATM/Debit Card	58.8%	33.1%	88.6%	98.0%	99.6%	70.5%
Home Banking	53.2%	24.9%	86.1%	98.6%	99.4%	66.7%
2013, Fourth Quarter						
Number of Credit Unions	4,332	2,181	2,151	1,452	770	6,554
Provision of Services:						
Checking Accounts	65.4%	39.0%	92.2%	99.2%	99.6%	76.9%
Auto Loans	95.0%	90.3%	99.7%	99.9%	99.7%	96.6%
Real Estate Loans	60.6%	32.6%	89.0%	99.7%	100.0%	73.9%
ATM/Debit Card	62.0%	33.3%	91.2%	99.1%	99.9%	74.7%
Home Banking	59.0%	29.1%	89.4%	99.0%	99.9%	72.7%

APPENDIX II

Small Credit Unions at 2003 Year End and Status at 2013 Year End[29]

2003, Fourth Quarter	
Filed a Call Report as a Federally Insured Credit Union	7,472
2013, Fourth Quarter	
Did not file Call Report	**2,636**
Merger	2,452
Other	184
Filed a Call Report as a Federally Insured Credit Union	**4,836**
with Assets Less than $50 Million	4,298
with Assets More than $50 Million	538

[29] This table uses NCUA's current definition of small credit union—that is, less than $50 million—for all data points regardless of timeframe. The NCUA Board raised the threshold for the definition of a small credit union in January 2013 from less than $10 million in assets to less than $50 million in assets.

APPENDIX III

Historical Composition of Credit Unions by Asset Class

	Less than $10 million	$10 million to $50 million	$50 million to $250 million	Over $250 million	Total
2003, Fourth Quarter					
Number of Credit Unions	4,576	2,896	1,410	487	9,369
Share of all Credit Unions	48.8%	30.9%	15.0%	5.2%	100.0%
Total Assets (millions)	16,894	68,361	153,668	371,202	610,125
Share of all Credit Unions	2.8%	11.2%	25.2%	60.8%	100.0%
Members	4,677,125	13,225,427	23,772,874	40,753,535	82,428,961
Share of all Credit Unions	5.7%	16.0%	28.8%	49.4%	100.0%
2008, Fourth Quarter					
Number of Credit Unions	3,275	2,495	1,406	630	7,806
Share of all Credit Unions	42.0%	32.0%	18.0%	8.1%	100.0%
Total Assets (millions)	12,371	59,764	154,144	584,768	811,047
Share of all Credit Unions	1.5%	7.4%	19.0%	72.1%	100.0%
Members	3,218,399	10,294,574	20,781,626	54,283,725	88,578,324
Share of all Credit Unions	3.6%	11.6%	23.5%	61.3%	100.0%
2010, Fourth Quarter					
Number of Credit Unions	2,782	2,394	1,472	691	7,339
Share of all Credit Unions	37.9%	32.6%	20.1%	9.4%	100.0%
Total Assets (millions)	10,789	57,625	162,003	683,924	914,341
Share of all Credit Unions	1.2%	6.3%	17.7%	74.8%	100.0%
Members	2,557,179	8,891,451	19,797,070	59,238,258	90,483,958
Share of all Credit Unions	2.8%	9.8%	21.9%	65.5%	100.0%
2013, Fourth Quarter					
Number of Credit Unions	2,181	2,151	1,452	770	6,554
Share of all Credit Unions	33.3%	32.8%	22.2%	11.7%	100.0%
Total Assets (millions)	8,750	52,933	162,058	838,208	1,061,949
Share of all Credit Unions	0.8%	5.0%	15.3%	78.9%	100.0%
Members	1,883,008	7,394,223	18,287,607	68,713,870	96,278,708
Share of all Credit Unions	2.0%	7.7%	19.0%	71.4%	100.0%

APPENDIX IV

Historical Performance by Asset Class

	2013, Fourth Quarter Median			
	Less than $10 million	$10 million to $50 million	$50 million to $250 million	Over $250 million
Loan Growth (annual)	-0.77	0.98	4.14	8.36
Asset Growth (annual)	-0.29	1.35	2.40	3.87
Membership Growth (annual)	-1.43	-0.90	0.44	2.88
Loan-to-Share Ratio	55.61	54.41	63.93	71.71
Net Worth Ratio	14.12	11.39	10.38	10.32
Return on Average Assets	0.04	0.17	0.41	0.72
Delinquency Rate	1.50	0.95	0.91	0.83
Noninterest Expenses-to-Total Assets	3.65	3.59	3.73	3.41
Full-Time Equivalent Employees	2	7	30	144

	5-Year Median			
	Less than $10 million	$10 million to $50 million	$50 million to $250 million	Over $250 million
Loan Growth (annual)	-1.50	0.15	2.06	3.95
Asset Growth (annual)	1.62	4.16	5.47	6.77
Membership Growth (annual)	-1.48	-0.67	0.55	2.6
Loan-to-Share Ratio	58.05	58.29	67.13	71.88
Net Worth Ratio	14.36	11.44	10.09	9.77
Return on Average Assets	-0.23	0.07	0.28	0.60
Delinquency Rate	2.18	1.29	1.16	1.14
Noninterest Expenses-to-Total Assets	4.09	3.99	4.02	3.57
Full-Time Equivalent Employees	2	7	29	137

	10-Year Median			
	Less than $10 million	$10 million to $50 million	$50 million to $250 million	Over $250 million
Loan Growth (annual)	-0.63	1.8	4.31	6.63
Asset Growth (annual)	-0.39	2.77	4.94	6.76
Membership Growth (annual)	-1.66	-0.56	0.79	2.75
Loan-to-Share Ratio	65.59	65.23	72.26	77.70
Net Worth Ratio	14.82	12.24	10.74	10.29
Return on Average Assets	0.07	0.29	0.43	0.64
Delinquency Rate	2.41	1.29	1.07	0.95
Noninterest Expenses-to-Total Assets	4.01	4.01	4.05	3.58
Full-Time Equivalent Employees	2	7	28	128

APPENDIX V

Examples of NCUA's Efforts to Scale Regulation and Support Small Credit Unions

Rule/Program	Description
Small Credit Union Definition	• A credit union with less than \$50 million in assets is excluded from certain NCUA rules. • NCUA also must consider the specifically consider the potential regulatory burden and alternatives for small credit union in any rulemaking. • NCUA will review the small credit union definition by January 2015 and then every three years. The review will keep the definition up-to-date as the system evolves.
Interest Rate Risk	• Credit unions with \$50 million or less in assets are excluded.
Liquidity and Contingency Funding	• Credit unions with less than \$50 million in assets must maintain a basic written liquidity policy. • Credit unions \$50 million and over in assets must establish and document a contingency funding plan. • Credit unions \$250 million and over in assets also must establish and document access to at least one contingent federal liquidity source.
Voluntary Liquidations Creditor Notices	• Federal credit unions with less than \$1 million in assets are exempt. • Federal credit unions with less than \$50 million in assets but more than \$1 million in assets are required to place just one creditor notice.
Risk-Based Capital	• Credit unions with less than \$50 million in assets are excluded under the existing risk-based net worth rule and the proposed risk-based capital rule. NCUA is considering raising the threshold for exemptions before finalizing the revised rule.
One-on-One Consulting Services	• Credit unions with less than \$50 million in assets are eligible to apply for customized consulting from NCUA.
Net Worth Restoration Plans	• Credit unions with less than \$10 million in assets must receive NCUA assistance in developing Net Worth Restoration Plans, if requested.
New Credit Union Support	• Federal credit unions with less than \$10 million in assets and less than 10 years in operation are eligible for NCUA consulting assistance. • Federal credit unions with less than \$10 million in assets must receive NCUA assistance with business plan revisions, if requested.
Generally Accepted Accounting Principles	• Credit unions with assets under \$10 million are exempted from complying with the reporting requirements of Generally Accepted Accounting Principles.
Audits	• Credit unions between \$10 million to \$500 million in assets may choose one of three lower-cost alternatives for their annual financial statement audits: a balance sheet audit, a report on examination of internal control over Call Reporting, or an Audit per the Supervisory Committee Guide.
Truth in Savings Act	• Non-automated credit unions with \$2 million or less in assets after subtracting any non-member deposits are exempted from the Truth in Savings Act.
Operating Fees	• Federal credit unions with less than \$1 million in assets are exempted from the annual operating fee that funds federal credit union regulation. • Federal credit unions with more than \$1 million in assets pay annual operating fees scaled to size.
Small Credit Union Examination Program	• Operationally sound federal credit unions with less than \$10 million in assets received streamlined exams averaging 40 hours. • Operationally sound federal credit unions with assets between \$10 million and \$30 million receive streamlined examinations averaging 65 hours.
Federally Insured, State-Chartered Credit Union Examinations	• Federally insured, state-chartered with less than \$250 million in assets are generally not subject to an annual onsite NCUA examination.
Electronic Filing	• To assist in the migration to electronic filing of quarterly Call Reports, NCUA helped manual filers obtain computers and assigned an Economic Development Specialist to work with small credit unions identified as filing manually each quarter.

PREPARED STATEMENT OF CHARLES A. VICE

COMMISSIONER OF FINANCIAL INSTITUTIONS
KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS
ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

SEPTEMBER 16, 2014

INTRODUCTION

Good morning, Chairman Johnson, Ranking Member Crapo, and distinguished Members of the Committee. My name is Charles Vice, and I serve as the Commissioner of Financial Institutions for the Commonwealth of Kentucky and I am the Immediate Past 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 U.S. Virgin Islands. State banking regulators charter and supervise more than 5,000 insured depository institutions. Additionally, most State banking departments also regulate a variety of nonbank financial service providers, including mortgage lenders, mortgage servicers, and money services businesses. 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.[1]

In my 25 years as both a Federal and State bank regulator, it has become abundantly clear to me that community banks are vital to economic development, job creation, and financial stability. I know this Committee shares my convictions, and I appreciate your efforts to examine the state of our country's community banks and regulatory approaches to smaller institutions.

My testimony today will highlight the importance of community banks and their relationship-based business model, State regulators' vision of a right-sized community bank regulatory framework, and the States' efforts to produce new and enhanced research to promote a better understanding among policymakers about the role of community banks and the impact they have upon our local, State, and national economies and communities. I will also expand upon State and Federal regulators' efforts at right-sizing regulation and supervision, and highlight specific ways in which Congress and the Federal banking agencies can adopt right-sized policy solutions for community banks.

COMMUNITY BANKS & RELATIONSHIP LENDING ARE ESSENTIAL

The U.S. banking system is incredibly diverse, ranging from small community banks to global financial conglomerates. This diversity is not a mistake, but rather a product of our unique dual-banking system. The dual-banking system, comprised of State and national banks chartered by State and Federal regulators, has encouraged financial innovation and institutional diversity for more than 150 years.

Community banks are essential to the U.S. financial system and economy. The Federal Deposit Insurance Corporation (FDIC) classifies nearly 93 percent of all U.S. banks as community banks, meaning there are 6,163 community banks embedded in local communities throughout the country.[2] The defining characteristic of a community bank is its relationship-based business model—a business model that relies on the bank's knowledge of its local market, citizens, and economic conditions. Community banks are able to leverage this personal, soft data in a way that large, model-driven banks cannot. This is why community banks have an outsized role in lending to America's small businesses, holding 46 percent of the banking industry's small loans to farms and businesses while only making up 14 percent of the banking industry's assets.[3] A community banker knows the entrepreneur opening a new business around the corner. A community banker also knows the local real estate market and the home buyer seeking a mortgage loan. These relationships allow community bankers to offer personalized solutions designed to meet the specific needs of the borrower.

Community banks engage in relationship lending in the largest U.S. cities and the smallest rural markets. Their role in providing credit and banking services is just as vital as the largest financial institutions. Their relationship-based lending busi-

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[1] *www.csbs.org.*

[2] "Quarterly Banking Profile: Second Quarter 2014." FDIC. Available at: *https://www2.fdic.gov/qbp/2014jun/qbp.pdf.*

[3] "FDIC Community Banking Study." FDIC, pp. 3–4 (December 2012). Available at: *http://www.fdic.gov/regulations/resources/cbi/study.html.*

ness model is a complement to the largest banks' model-driven, economies-of-scale business model. In fact, many consumers, businesses, and farms are not served particularly well by standardized, model-driven lending. This is especially the case in rural areas, where the FDIC has found that community banks are three times more likely to operate a banking office outside of a metro area than their large bank counterparts.[4]

Simply put, community banks are a vital part of a very diverse financial services marketplace and help ensure credit flows throughout the Nation's diverse markets. They provide credit and banking services in a flexible, innovative, and problem-solving manner, characteristics that are inherent in the community bank relationship-based business model.

STATE REGULATORS' VISION FOR COMMUNITY BANK REGULATION

State regulators charter and supervise banks of all sizes, and we support and encourage banking industry diversity as a central goal of the dual banking system. Just as community banks have a first-hand knowledge of their local communities, we State regulators have an in-depth knowledge of our State-chartered banks and the communities in which they operate. Our local focus and authority provide us with flexibility. The 50+ different State banking agencies are able to serve as laboratories of regulatory and supervisory innovation, developing practical solutions and approaches that fit the needs of their particular States.

We are concerned that one-size-fits-all banking regulations are not differentiating enough between types of banks and are preventing community banks from delivering innovative, flexible services and products to their customers and the markets in our States. Recent regulatory reform efforts have centered on addressing the problems posed by the largest, most systemically important banks, and rightfully so. However, a global megabank and a small community bank are simply not the same.

Statistics on the U.S. banking industry illustrate the immense differences between a typical community bank and global megabank. Nearly 90 percent of the 6,656 U.S. depository institutions have less than $1 billion in total assets. The 5,983 banks falling below this threshold hold less than 9 percent of the banking industry's total assets. On the other hand, there are four U.S. banks with more than $1 trillion each in total assets—J.P. Morgan Chase, Bank of America, Wells Fargo, and Citigroup. These four institutions hold approximately 41 percent of the banking industry's total assets. The average size of a community bank's assets in the United States is $225 million, and employs 54 people on average. The four largest banks, all exceeding $1 trillion in total assets, average 188,100 employees. You can quickly see that a global megabank and a community bank have very little in common, and regulations designed for the former simply should not be applied to the latter. While there are examples in which laws and regulations have established certain applicability thresholds, this needs to occur more often and the differentiation in approach more meaningful.

Design dictates outcome, and State regulators believe that rules that treat all banks the same, regardless of size and business model, promote further consolidation and will lead to a banking system with very little diversity and innovation. Indeed, I continue to hear from my community banks in Kentucky that regulations are driving flexibility and local problem-solving out of their banking decisions and forcing them into standardized banking products and practices. Community banks rightfully fear that this standardization hurts their communities and customers and runs counter to their time-proven relationship-based lending business model.

Regulators have the responsibility to regulate and supervise our community banks in a manner that recognizes their relationship-based business model. My testimony outlines a regulatory approach that counters one-size-fits-all, an approach that State regulators call right-sized regulation, and how it is particularly well-suited for community banks. This search for right-sized regulation and supervision is a matter that State regulators take very seriously and, as my testimony illustrates, have taken considerable measures to achieve. Based on this Committee's work and the measures taken by both Federal and State regulators, I am confident that we as policymakers can undertake this effort to recognize the community bank business model.

Right-sized regulation does not mean less regulation, but rather regulations and supervisory processes that are appropriately designed to accommodate an institution's underlying business model. In the context of community banks, right-sizing requires understanding the business of community banking, tailoring regulations to meet this business model, and utilizing risk-based supervision. Congress and Federal regulators have undertaken measures to aid community institutions using each

[4] *Ibid.*

of these elements. These efforts are positive, but must be built upon in a purposeful, comprehensive manner to form an appropriate regulatory framework for community banks that allows them to thrive.

THE NEED FOR ROBUST COMMUNITY BANK RESEARCH

State regulators recognize that designing a right-sized regulatory framework requires us to truly understand the state of community banking, the issues community banks face, and the nuances within the community banking industry. Data-driven and independently developed research on community banks is sorely lacking when compared to the breadth of research dedicated to the largest financial institutions and their impact upon the financial system and the Nation. To address the need for research focused on community banks, State regulators, through CSBS, have partnered with the Federal Reserve to conduct the annual Community Banking in the 21st Century research conference.[5] Bringing together State and Federal regulators, industry experts, community bankers, and academics, the research conference provides valuable data, statistics, and analyses about community banking. Our hope is that community bank research will inform legislative and regulatory proposals and appropriate supervisory practices, and will add a new dimension to the dialogue between the industry and regulators.

The research conference represents an innovative approach to research. The industry informs many of the themes studied, providing their perspective on issues through a national survey and local town hall meetings. At the same time, academics explore issues raised by the industry in a neutral, empirical manner, while also contributing their own independent research topics. This approach ensures that three research elements—quantitative survey data, qualitative town hall findings, and independent academic research—all enhance and refine one another, year after year. The research conference's early success underscores the interest and need for community bank research: this year, more than 1,000 community bankers participated in the national survey, more than 1,300 bankers attended local town hall meetings, and more than 37 research papers were submitted by academics for consideration, a considerable increase from the number of papers submitted for the 2013 conference.

Last year's inaugural conference has already provided us with valuable data and research findings on the importance of community banks and the centrality of their relationship-based lending model. For example, a study presented last year found that community bank failures lead to measurable economic underperformance in local markets.[6] Research also shows that the closer a business customer is to a community bank, the more likely the startup borrower is to receive a loan.[7] Community banks also have a key advantage through "social capital," which supports well-informed financial transactions. This so called "social capital" is the basis for relationship lending and exists because community bankers live and work in the same communities that their banks do business. The success of the community bank is tied directly to the success of consumers and businesses in those communities. This is especially true in rural areas, where the community bank relationship-based lending model results in lower default rates on U.S. Small Business Administration loans than their urban counterparts.[8]

These highlights provide examples of the value this type of research can provide. Policymakers can have better understanding of the role and value that community banks play in our economy. This should inform and inspire us to not establish broad asset thresholds out of political pressure, but craft meaningful approaches that are consistent with a banking model that we want to exist because of the value community banks bring to the economy and the limited risk they present to the financial system.

The second annual Community Banking in the 21st Century research conference is next week, September 23–24, at the Federal Reserve Bank of St. Louis. While this year's survey results are not yet public, I want to share a few key findings with you today.

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[5] "Community Banking in the 21st Century." Federal Reserve System/CSBS. Available at: *https://www.stlouisfed.org/banking/community-banking-conference-2014/*.

[6] Kandrac, J. "Bank Failure, Relationship Lending, and Local Economic Performance." Available at: *https://www.stlouisfed.org/banking/community-banking-conference/PDF/Kandrac_BankFailure_CBRC2013.pdf.*

[7] Lee, Y., and S. Williams. "Do Community Banks Play a Role in New Firms' Access to Credit?" Available at: *https://www.stlouisfed.org/banking/community-banking-conference/PDF/Lee_williams.pdf.*

[8] DeYoung, R., *et. al.* "Small Business Lending and Social Capital: Are Rural Relationship Different?" Available at: *https://www.stlouisfed.org/banking/community-banking-conference/PDF/DGNS_2012_SBA_lending.pdf.*

Bankers have been very vocal about the compliance burdens associated with the new Ability-to-Repay (ATR) and Qualified Mortgage (QM) rules. Our research finds that community banks continue to see opportunity in residential mortgage lending, but have a mixed view of making non-QM loans, with 26 percent of respondents indicating that they would not originate non-QM loans and an additional 33 percent only originating non-QM on an exception basis. Assessing the new ATR and QM mortgage standards against existing loans, 67 percent of bankers identified a low level of nonconformance, suggesting the two rules generally align with existing bank practices.

However, bankers in the town hall meetings were quite clear: the ATR and QM mortgage rules have required banks to make significant operational changes in order to comply. These changes have increased the cost of origination, the cost to the consumer, and have reduced the number of loans a bank can make. If a new requirement is generally consistent with most community banks' practices, why does implementation produce increased cost and a reduction in credit availability? This is not an outcome that any of us should want.

It will come as no surprise to hear that community banks have voiced concerns about increasing regulatory compliance costs, but these costs have been difficult to quantify historically. To encourage additional data and research in this area, the survey seeks to identify how increased compliance costs are realized in the bank's operations. Survey data show that rising compliance costs primarily take the shape of spending additional time on compliance, hiring additional compliance personnel, and increasing reliance on third-party vendors.

The survey shows less than a quarter of respondents looking to add new products and services in the next 3 years. This was confirmed in the town hall meetings, where bankers indicated that the compliance burdens and security concerns are significant headwinds to new products and innovation. Similarly, bankers expressed that new regulations have changed how they approach serving their customers, shifting their mentality away from creating flexible products for customers and toward what regulations allow them to do. We must take this as an important red flag. Any industry that is not in a position to innovate while the world around it is innovating has questionable long-term viability.

In addition to the qualitative feedback from the town hall meetings and the survey results, a dozen research papers will be presented next week. This year's lineup of research papers and speakers will buildupon last year's research, and provide some interesting perspectives.[9] For example, one paper set to be discussed looks at the current regulatory burden surrounding community banks, and finds that more than 80 percent of responding banks report a greater than 5 percent increase in compliance costs. Another paper examines the Federal banking agencies' appeals processes, finding the processes seldom used, inconsistent across agencies, and at times dysfunctional. The paper recommends establishing an independent authority for appeals that could apply a more rigorous standard of review. Still another paper provides new research on *de novo* banks. State regulators are concerned by the lack of *de novo* banks during the economic recovery, and we believe more research is needed to appreciate the role new bank formations play in a vibrant, healthy banking system and to see if there are any regulatory impediments to *de novo* banking activity. Findings like these are just what policymakers need to inform their work toward designing a right-sized policy framework for community banks.

STATE EFFORTS TO RIGHT-SIZE COMMUNITY BANK REGULATION & SUPERVISION

State regulators have a long history of innovating to improve our regulatory and supervisory processes to better meet the needs of our banks, their customers, and our States. Because of our roles and where we fit in the regulatory framework, State banking departments are able to pilot programs at the local level based on our particular needs. This often leads to innovative practices bubbling up from individual States and expanding into other States. At the same time, each State has the authority to choose what works best in their local context. This regulatory flexibility is a strength of the State banking system. After all, community banks in Kentucky might face localized issues that my department should address in one manner, while another State's banking regulator might have a different set of supervisory challenges to address.

I would like to highlight just a few cases in which State regulators have proven to be particularly adept at developing and implementing flexible practices to better serve our smaller institutions. Some of these examples are broad, historic initiatives

[9] The full line-up of papers presented and the conference Web cast will be *available at https://www.stlouisfed.org/banking/community-banking-conference-2014/*.

that have significantly shaped the trajectory of U.S. banking regulation and supervision, such as the joint and coordinated bank examination framework. Other examples provide local snapshots highlighting the flexibility that individual States exercise on a regular basis. The significance that these are State-based solutions cannot be understated. States have the dexterity to experiment with supervisory processes in ways that the Federal Government cannot without applying sweeping changes to the entire industry. This is by design and a trademark of our dual-banking system. As States develop these practices, CSBS has developed several vehicles for States to share techniques and best practices with one another, allowing for the speedy deployment of successful models nationwide and maximizing regulatory efficiency.

Joint Examinations of Multi-Charter Holding Companies

Joint bank examinations trace their roots back more than two decades, when due to interstate branching restrictions, bank holding companies would often own independently chartered banks in different States. To improve regulatory efficiency, State banking agencies began conducting joint examinations of multi-charter holding companies with other State regulators.

Before the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal), States like Iowa and Indiana were already coordinating with other State banking regulators to conduct joint State examinations for multi-charter holding companies. This approach eliminated regulatory duplication, reduced the regulatory burden on the individual banks and the holding company, and helped the regulators develop a holistic view of the entire holding company. Once Riegle-Neal was passed, States built upon their existing practices in order to coordinate with Federal supervisors, crafting examination plans across State and agency lines. In 1996, the States formalized cooperative and coordination agreements, the Nationwide Cooperative Agreement[10] and Nationwide State-Federal Supervisory Agreement,[11] to facilitate the supervision of multi-State banks and to define the nature of State-Federal supervision. These agreements set up a model centered on the examination team of the holding company or lead institution and, while close to 20-years old, still form the basis for State-Federal supervisory interaction. These agreements foster effective coordination and communication among regulators and have led to a supervisory model that reduces burden and enhances responsiveness to local needs and interests in an interstate banking and branching environment.

This process ultimately leads to a more consistent examination experience for these community institutions. Rather than the holding company having to handle numerous examinations throughout the year, regulators conduct coordinated examinations of all the holding company's institutions at the same time, satisfying State and Federal supervisory requirements in a streamlined manner.

This is just one of many illustrations of how State regulatory agencies have shown great flexibility and willingness to reduce burden for their State-chartered institutions, all while maintaining the same level of effective oversight.

Central Point of Contact

Many State banking departments follow the practice of assigning a single individual as a central point of contact to specific institutions to conduct ongoing offsite surveillance and monitoring. The offsite portion of this process promotes efficient and effective State supervision, allowing examiners to carry out their work away from the bank, freeing up bankers' time and office space. At the same time, central points of contact also provide banks with a single person to turn to when they have supervisory questions and issues, ensuring a more direct, faster response to their needs.

Arkansas Self-Examination Program

A State-specific example of regulatory innovation can be found in the Arkansas Self-Examination Program. The program serves both as an offsite monitoring program and an effective loan review report for bank management. Since its introduction in 1986, the program has created significant regulatory efficiencies and benefits to participating community banks.

When an Arkansas bank volunteers to participate in the Self-Examination Program, it provides the Arkansas State Bank Department with roughly three pages of financial information each month. Arkansas regulators use this information to spot problem areas and trends that may threaten the bank's safety and soundness.

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[10] Nationwide Cooperative Agreement (Revised 1997). Available at: *http://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide__coop__agrmnt.pdf.*

[11] Nationwide State/Federal Supervisory Agreement (1996). Available at: *http://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide__state__fed__supervisory__agrmnt.pdf.*

In exchange for this data, the Department provides participating institutions with reports that reflect the bank's month-by-month performance, a performance comparison with peer institutions, and early warnings that flag issues of concern. Both the information provided by the banks and reports generated by the Arkansas State Bank Department remain confidential. While the program is not a replacement for examinations, it is an excellent supplement that benefits the regulator and the bank.

Although the program is optional, the participation rate of Arkansas banks typically exceeds 90 percent. By creating a simple, direct, and valuable tool for community banks, Arkansas regulators can better protect consumers and the marketplace and ensure the continuing success of their financial institutions.

New Examiner Job Aid

In addition to coordination with the industry to make supervision more efficient, State regulators are increasingly turning to technology to enhance and streamline supervision. In 2012, CSBS published a Loan Scoping Job Aid (job aid) for examiners that encourages State regulators to consider institution-specific criteria that may lead to a smaller, yet more effective, loan review methodology.[12] Loan review is the cornerstone of safety and soundness examinations, providing examiners the best avenue for determining a bank's health. The CSBS job aid provides methods for examiners to improve their loan scope by reviewing a different sample of loans than would otherwise be the case. This more thoughtful, risk-focused, yet surgical approach will help regulators identify new risks and provide community banks with more meaningful and useful examination results.

These examples demonstrate the willingness of State regulators to seek innovative solutions and methods to provide comprehensive and effective supervision, while tailoring our efforts to the business models of banks. Banks should be in the business of supporting their communities. We are working to enact supervision that ensures safety and soundness and consumer protection, while allowing State-chartered banks to serve their customers most effectively and contribute to the success of our local communities, our States, and our Nation.

RIGHT-SIZED REGULATION IN THE FEDERAL CONTEXT

While some see the industry's regulatory challenges as being about the volume of regulation, State regulators see the issue as the type of regulation and the compatibility between a given regulation and the business model of the regulated entity. State regulators are concerned that regulations seem aimed at removing all risk from community banking. The tendency is to focus on the 489 banks that have failed since the crisis as justification for a more conservative approach overall. However, when you approach regulation and supervision from the perspective of the over 5,000 community banks that did not fail, I believe you come to a more balanced and accommodative approach. The many smaller banks that successfully navigated the financial crisis and continue to operate today have shown their ability to manage the risks of their business. Laws and regulations should recognize this, and regulators, in implementing policies and regulations, need to focus on whether institutions are properly managing and mitigating—not necessarily eliminating—the risks of their business.

FEDERAL EFFORTS AT REGULATORY RIGHT-SIZING

State regulators recognize that our Federal counterparts have made some positive and constructive contributions to a right-sized regulatory framework for community banks. However, we must recognize that in some cases, these efforts would not have been necessary had statutes or rules been appropriately designed or applied to community banks in the first place. By and large, the efforts outlined below prove that Federal policymakers, both in Congress and at the Federal banking agencies, have the commitment to promote right-sized regulations in additional areas.

The CFPB's Small Creditor QM

The Consumer Financial Protection Bureau's (CFPB) ATR mortgage regulations represent an effort at regulatory right-sizing. Portfolio lending—originating loans with the intent of holding them in portfolio—is an important part of many community banks' mortgage business. Portfolio lenders have an aligned economic interest with the borrower. These banks bear the full risk of default, which incentivizes them to ensure the consumer can afford the loan in the first place.

The CFPB recognized this inherent alignment of interests in creating the Small Creditor QM, a part of the ATR rule which provides smaller lenders with greater

[12] Available at: *http://www.csbs.org/regulatory/resources/Pages/JobAids.aspx.*

flexibility for mortgages made and held in portfolio. This regulatory right-sizing provides benefits to the communities served by these small creditors, as community bank portfolio lenders can continue making loans designed for borrowers who might not fit standardized credit profiles such as small business owners, seasonal workers, the self-employed, and young graduates with short credit histories but otherwise sound financial management.

Tailoring Regulatory Communication to Smaller Institutions

The Federal regulatory agencies have made efforts to produce useful and accessible guides for smaller institutions on complex rules. While State regulators question whether overly complex rules should apply to community banks, we acknowledge the agencies have taken important steps in communicating the requirements of such rules.

For example, the ATR and QM statutes in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) resulted in a thorough and complex final rule.[13] To ensure the industry was better informed about this complex final rule, the CFPB undertook a communications campaign designed to ease compliance with the rule for institutions of all sizes. Similarly, the FDIC sought to tailor communications and outreach regarding new Basel III capital rules to community banks, hosting community bank-focused outreach sessions, an on-demand video, a national conference call, and capital estimation tool to solicit meaningful input from community banks.

The Federal Financial Institutions Examination Council

A key ingredient to making regulation responsive is effective regulatory coordination. Congress has created a Federal body tasked with doing the type of agency coordination necessary for right-sizing regulation and supervision across the banking industry. The Federal Financial Institutions Examination Council (FFIEC) was established in 1978 "to promote consistency" and "ensure progressive and vigilant supervision."[14] The FFIEC provides all community institution regulators with a forum for right-sizing regulation. Congress originally encouraged State interaction at the FFIEC by mandating that the States participate in FFIEC meetings at least twice a year. Congress subsequently cemented the importance of the State perspective in bank regulation by giving the States a voting seat on the FFIEC in 2006.[15] State regulator involvement in the FFIEC is conducted through the State Liaison Committee (SLC). Currently, Massachusetts Banking Commissioner David Cotney chairs the SLC. I have also served as a member of the SLC, representing the States on the FFIEC's Task Force on Supervision.

One of the FFIEC's current major projects is the review of banking regulations mandated by the Economic Growth and Regulatory Paperwork Reduction Act.[16] State regulators, through our presence on the FFIEC, are committed to using this review as an opportunity to pinpoint regulations that may not be properly suited to the business model of community banks. We are eager to participate in this process with our Federal colleagues and look forward to a productive result for right-sized regulations.

Another area of focus for the FFIEC is cybersecurity. State regulators are active participants in the cybersecurity work being done through the FFIEC, and encourage fellow FFIEC members to continue the commitment to raise awareness and strengthen the oversight of cybersecurity readiness for community institutions. States are furthering this effort through a cybersecurity outreach program. The Executive Leadership of Cybersecurity initiative is designed to create awareness and provide tools to bank executives as they navigate the complex security issues facing financial institutions.[17] With the FFIEC as a coordination forum, the States are confident that the collective action between States and Federal regulators will be a reliable resource for all parties looking to minimize & mitigate the risks facing financial institutions today.

Automated Exam Tools

State regulators' ability to tailor loan review to the risks facing an institution, as discussed above, is possible because of technology developed by the FDIC. The Examination Tools Suite Automated Loan Examination Review Tool (ETS–ALERT) has been an excellent resource for automated loan examination and review, serving as the backbone for risk scoping that takes a community bank's business model into

[13] Dodd-Frank Act Sections 1411 and 1412.
[14] 12 U.S.C. § 3301.
[15] P.L. 109–351, Title VII, § 714(a).
[16] 12 U.S.C. § 3311.
[17] *http://www.csbs.org/cybersecurity.*

account. The FDIC, Federal Reserve, and States use this program to review loans during the course of an examination. This program serves as a standardized platform that greatly improves the efficiency of the examination process across the country and reduces regulatory burden.

Dodd-Frank and the Role of State Regulators

State regulators are best positioned to recognize risks building up in their local markets, and they can quickly address these local risks at the State and local level. Congress recognized the importance of State regulators and local intervention in the Dodd-Frank Act by reaffirming the importance of the States in the financial regulatory fabric. Through measures including recalibrating the relationship between the National Bank Act and applicable State law, the intentional requirements for the CFPB to coordinate with State regulators, and the role of State regulators in the Financial Stability Oversight Council, Congress has affirmed the importance of the State regulatory perspective and the local focus and greater flexibility that perspective provides.

Money Remittance Improvement Act

Recognizing the unique approach of State supervisory agencies and the value such an approach can bring to Federal partners, the recently enacted Money Remittances Improvement Act improves the Financial Crimes Enforcement Network's ability to coordinate with State regulators and leverage State anti-money laundering compliance examinations. We applaud Congress for this simple, direct act that simultaneously allows State regulators to add value to the work of Federal regulators as well as reduce the overall regulatory burden on institutions engaging in money remittances.

OPPORTUNITIES FOR POLICYMAKERS TO RIGHT–SIZE COMMUNITY BANK REGULATIONS

Right-sizing regulation is not a one and done undertaking; for State regulators, this concept is in our regulatory DNA and part of our regulatory mission, and we urge our fellow regulators and Congress to pursue this approach at every opportunity. State regulators—individually and collectively, through CSBS—have devoted a great deal of energy to identifying ways to ensure that our financial regulatory system reflects and supports the diversity of the banking system. Through groups such as the CSBS Community Bank Steering Group, we have an ongoing effort to identify ways to meet our responsibilities as regulators in a manner that supports the growth and health of our State and local economies and the community institutions that serve those economies. Accomplishing this requires a focus on right-sizing regulation, throughout the entire policymaking process, from legislation, to regulation, to supervision, and to Congress's ongoing oversight role.

The following represent specific actions that Congress and/or the Federal banking agencies can undertake to promote right-sized regulations for community banks.

Study Risk-Based Capital for Smaller Institutions

The Basel Committee on Banking Supervision designed risk-based capital standards for internationally active banks. These standards are overly complex and inappropriate for community banks and their business model. Indeed, research has shown that a simple leverage requirement would be equally, if not more, effective than risk-based capital requirements for community banks, and would be much less burdensome.[18]

Congress should mandate the U.S. Government Accountability Office (GAO) investigate the value and utility of risk-based capital for smaller institutions. The resulting GAO study should seek to understand how risk weights drive behavior in the volume and type of credit a bank originates, as well as the burden of providing the necessary data for calculating capital ratios.

Mortgage Rules Should Better Reflect the Realities of Community Bank Portfolio Lending

Community banks that hold the full risk of default of a loan are fully incented to determine the borrower's repayment ability. Laws and regulations regarding mortgage lending should reflect this reality.

[18] Moore, R., and M. Seamans. "Capital Regulation at Community Banks: Lessons from 400 Failures." Available at: *https://www.stlouisfed.org/banking/community-banking-conference/PDF/Capital_Regulation_at_Community_Banks.pdf.*

QM for Mortgages Held in Portfolio

When a community bank makes a mortgage and holds that loan in portfolio, the interests of the bank and the borrower are inherently aligned. Yet, the survey and town halls conducted in conjunction with our upcoming Community Bank Research Conference point to a problem: while much of community banks' existing mortgages businesses are consistent with the Ability-to-Repay and Qualified Mortgage requirements, complying with the regulations is not only creating an outsized regulatory burden but also curtailing lending. One solution that would tailor the requirement to the nature of community bank mortgage lending is to grant the QM liability safe harbor to all mortgage loans held in portfolio by a community bank. To accomplish this, CSBS supports passage of S. 2641 and a similar House measure, H.R. 2673, as an appropriate means of facilitating portfolio lending.

Improving the CFPB's Rural Designation Process

The Dodd-Frank Act's ATR requirement's restrictions on balloon loans and the CFPB's efforts to provide limited relief for balloon loans made by smaller institutions in rural areas illustrate the need for regulatory right-sizing and a conscious effort to understand and adapt regulation to the community bank business model. When used responsibly, balloon loans are a useful source of credit for borrowers in all areas. Properly underwritten balloon loans are tailored to the needs and circumstances of the borrower, including situations where the borrower or property is otherwise ineligible for standard mortgage products. Because banks can restructure the terms of a balloon loan more easily than an adjustable rate mortgage, they are able to offer the borrower more options for affordable monthly payments, especially in a rising interest rate environment. As a regulator, I prefer that lenders and borrowers in my State have flexibility and options when selecting consumer products and mortgages. Since the mortgage is held in portfolio, community banks must work to ensure that the product is tailored to take into consideration all risks associated with the credit in order to avoid default.

Community banks retain balloon mortgages in portfolio as a means of offering credit to individuals that do not fit a standard product but nonetheless can meet the monthly mortgage obligation. That is the logic behind the Dodd-Frank Act provision providing balloon loans with QM status if those loans are originated in rural or underserved areas by a small creditor.

However, the CFPB's approach to implementing this provision relies on one analytical framework, the Department of Agriculture's Urban Influence Codes. Unfortunately, this approach produces many illogical outcomes. For example, Nye County, Nevada, is the third-largest county in the United States. Despite containing only 2.42 persons per square mile and its Yucca Mountain once being considered for a nuclear waste repository due to its remoteness, Nye County is not considered rural because it neighbors Clark County, the home of Las Vegas. This is the difficulty of applying one framework to something as inherently localized and granular as evaluating whether an area is "rural."

CSBS has suggested that the CFPB adopt a petition process for interested parties to seek rural designation for counties that do not fit the Urban Influence Code definition—a step that is within the CFPB's current authorities. My fellow State regulators and I were pleased to see Congress take up this issue, with the introduction and House passage of H.R. 2672. We urge the Senate to act on S. 1916, the Senate companion to H.R. 2672. More fundamentally, portfolio lending is not a "rural" issue or an "underserved" issue, it is a relationship-based lending issue for all community banks. Eliminating the rural or underserved balloon loan limitations for qualified mortgages would effectively expand the CFPB's Small Creditor QM framework to include all loans held in portfolio by community banks. Similarly, removing the rural or underserved requirements from the exception to mandatory escrow requirements for higher-priced loans would make right-sized regulations business model focused, not geographically focused.

Tailor Appraiser Qualifications for 1–4 Family Loans Held in Portfolio

Current appraisal regulations can curtail mortgage lending in markets that lack qualified appraisers or comparable sales. Congress should require regulations to accommodate portfolio loans for owner-occupied 1–4 family loans, recognizing the lender's proximity to the market and the inherent challenge in securing an accurate appraisal by a qualified appraiser.

Community Bank Fair Lending Supervision Must Acknowledge the Business Model and Be Applied Consistently

State regulators take the difficulties that many underserved borrowers have had in obtaining access to fair credit very seriously, especially in regards to mortgage

lending and homeownership. State regulators are committed to enforcing institutions' compliance with the letter and spirit of our fair lending laws, but we are concerned about regulators' over reliance on opaque statistical models that use small samples to judge fair lending performance and inconsistencies in Federal regulators' approach to fair lending supervision. Many times it is not the statute that creates the problem, but the interpretation, guidance, and the examination techniques utilized. Federal agency leadership must commit to a more pragmatic and transparent approach to fair lending supervision.

Federal regulators should not use one-size-fits-all techniques and tools on community banks in fair lending examinations. A smaller institution makes case-by-case lending decisions based on local knowledge and local relationships. While statistical analysis plays a role in fair lending supervision, it is not the beginning and end of the analysis. Supervisors must utilize their flexibility to look beyond statistical models to take a more holistic view of the lending decision.

Despite assurances of consistent approaches from "headquarters" to "the field" and of continued collaboration to ensure consistency, State regulators have observed meaningful differences in how the three Federal banking agencies treat community banks on fair lending issues and as well as a disconnect within the individual agencies. Federal agency leadership has the responsibility to make sure this is not the case, and they must be accountable for ensuring transparency and consistency.

The current approach to fair lending for community banks is having a chilling effect on credit availability, as banks, frustrated by the examination process, are curtailing or exiting many consumer credit products. From a public policy perspective, we should want community banks doing this business. If there were only 66 banks that had compliance or Community Reinvestment Act problems in 2013,[19] and referrals to the Department of Justice are minimal, why are banks experiencing such in-depth and extensive reviews?

The Application Process for Community Banks Must Reflect the Business Model

Community bank applications submitted to Federal banking agencies for transactions such as mergers and capital investments can take an extended time to process because the agencies have to ensure the decision will not establish a precedent that could be exploited by larger institutions. The approval of a merger, acquisition, or expansion of activities should be related to the overall size and complexity of the transaction, and community banks should not be unnecessarily penalized for the potential action of larger financial institutions. Federal law, an agency rule, or a clause in an approval letter could provide the necessary protection by stating that application decisions for banks below a specified size (perhaps $10 billion) do not establish a precedent for institutions above a certain size threshold.

To further address the length of time the agencies take to review community bank applications, the application review and approval process for institutions below a certain size should be de-centralized with more final decisionmaking authority given to FDIC Regional Offices and the regional Federal Reserve Banks.

Additionally, the Federal agencies need to be open-minded when faced with circumstances that do not fit within predetermined parameters. Most recently in my State of Kentucky, two banks took over 2 years to gain regulatory approval for a merger despite being affiliates that would clearly benefit from becoming one institution. In this particular situation, I saw that the strengths in one institution addressed the other's weaknesses. Had the Federal agency focused on the actual circumstances of each institution and on the merger's positive impact for each institution and the organization as a whole, both institutions—particularly the smaller of the two—could have avoided prolonged burden and the expense that resulted from redundant processes and management.

Federal Regulatory Agencies Leadership Should Include State Supervisory Representation

Meaningful coordination in regulation and supervision means diversity at the highest governance levels at the Federal regulatory agencies. The current FDIC Board does not include an individual with State regulatory experience as required by law.[20] The Federal Deposit Insurance (FDI) Act and Congressional intent clearly require that the FDIC Board must include an individual who has worked as a State official responsible for bank supervision. As the chartering authority for more than 76 percent of all banks in the United States, State regulators bring an important regulatory perspective that reflects the realities of local economies and credit mar-

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[19] "FDIC Annual Report 2013." FDIC. Available at: *https://www.fdic.gov/about/strategic/report/2013annualreport/AR13section1.pdf.*

[20] 12 U.S.C. § 1812(a)(1)(C).

kets. Congress should refine the language of the FDI Act to ensure that Congress's intent is met and that the FDIC Board includes an individual who has worked in State government as a banking regulator.

Similarly, to ensure the Federal Reserve's Board of Governors (the Board) properly exercises its supervisory and regulatory responsibilities, Congress should require that at least one Governor on the Board has demonstrated experience working with or supervising community banks. Last fall, CSBS released a White Paper [21] on the composition of the Board of Governors and an infographic [22] that illustrates the background and experience of the members of the Board of Governors throughout the Board's history. The White Paper highlights two key trends: Congress' continuing efforts to ensure the Board's composition is representative of the country's economic diversity, and the Board's expanding supervisory role. The infographic illustrates the growing trend of naming academics to the Board. In addition to adhering to Congressional intent, ensuring that at least one Governor has demonstrated experience working with or supervising community banks will also help the Federal Reserve as it exercises its monetary policy and lender of last resort functions. Governors with practical community banking and regulatory experience have a unique and tangible perspective on the operation of local economies that will assist the Federal Reserve as it performs these vital functions.

CSBS was pleased to see that the Senate endorsed this concept by adopting Senator Vitter's amendment to the Terrorism Risk Insurance Act requiring that at least one member of the Board of Governors have community bank supervisory or community banking experience.

MOVING FORWARD

Congress, Federal regulators, and State regulators must focus on establishing a new policymaking approach for community banks. We must embrace creativity, innovation, and customized solutions to the problems facing small banks today. Community banks need a broad, principles-based regulatory framework that effectively complements and supervises their unique relationship-based lending model. Such a framework acknowledges community banks' distinct contribution to thousands of local markets, ensures banking industry diversity, and ultimately promotes economic growth.

Policymakers are capable of right-sizing regulations for these indispensable institutions, but we must act now to ensure their long-term viability. CSBS remains prepared to work with Members of Congress and our Federal counterparts to build a new right-sized framework for community banks that promotes our common goals of safety and soundness and consumer protection.

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

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[21] "The Composition of the Federal Reserve Board of Governors." CSBS. Available at: *http://www.csbs.org/news/csbswhitepapers/Documents/Final%20CSBS%20White%20Paper%20on%20Federal%20Reserve%20Board%20Composition%20(Oct%2023%202013).pdf.*

[22] Available at: *http://goo.gl/eCKVrS.*

September 16, 2014

Testimony of

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On behalf of the

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before the

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United States Senate

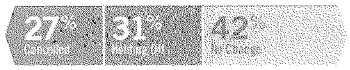
September 16, 2014

Chairman Johnson, Ranking Member Crapo, and members of the Committee, my name is Jeff Plagge. I am president and CEO of Northwest Financial Corp of Arnolds Park, Iowa, and Chairman of the American Bankers Association. Northwest Financial Corp is a privately owned, two bank holding company with approximately $1.6 billion in assets. One of our banks is a $230 million rural community bank and the other one is a $1.4 billion bank with rural and metro branches. Overall, we are true community bank organization with 27 branches, serving communities throughout Western Iowa and Omaha, Nebraska.

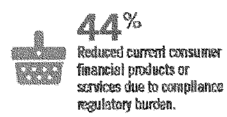
I appreciate the opportunity to be here to represent the ABA and discuss the state of community banking. The ABA is the voice of the nation's $15 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $11 trillion in deposits and extend over $8 trillion in loans. Our median member has just $190 million in assets and over 85 percent of our members hold under $1 billion in assets.

The state of our community banks is strong, but the challenges we face are enormous. As I travel the country in my role as Chairman of the ABA, I am constantly impressed by how resilient community bankers are and how dedicated they are to serving their communities. Like all small businesses, they have suffered through the great recession. Every day these banks work to meet the needs of their customers, but their ability to do so has been made much more difficult by the avalanche of new rules and regulations. For example, banks have had to deal with 8,040 pages of final rules from the Dodd-Frank Act alone, with an additional 6,112 pages of proposed rules. This is

an enormous challenge for any bank, but is nearly impossible for community banks, which typically employ fewer than 40 employees.



The impact goes beyond just dealing with new compliance obligations—it means fewer products are offered to customers. For example 58 percent of banks have held off or canceled the launch of new products—designed to meet consumer demand—due to expected increases in regulatory costs or risks. Additionally, 44 percent of banks have been forced to reduce existing consumer products or services due to compliance or regulatory burden. This means less credit in our communities. Less credit means fewer jobs, lower income for workers, and less economic growth.



If left unchecked, the weight of this cumulative burden could threaten the model of community banking that is so important to strong communities, strong job growth and a better standard of living. It is already having an impact. The sad fact is that over the course of the last decade, over 1,500 community banks have disappeared. Today, it is not unusual to hear bankers—from strong, healthy banks—say they are ready to sell because the regulatory burden has become too much to manage. These are good banks that for decades have been contributing to the economic growth and vitality of their towns but whose ability to continue to do so is being undermined by excessive regulation and government micro-management. Each bank that disappears from the community makes for fewer opportunities in that community.

The key to changing this trend is stop treating all banks as if they were the largest and most complex institutions. Financial regulation and examination should not be one-size-fits-all. All too often, regulation intended for the largest institutions become the standard that is applied to every bank. Such an approach only layers on unnecessary requirements that add little to improve safety and soundness, but add much to the cost of providing services—a cost which customers ultimately bear. Instead, the ABA has urged for years that a better approach to regulation is to take into account the charter, business model, and scope of each bank's operations. Regulators challenge community banks to consider Enterprise Risk Management assessments and programs to better identify and manage our risk. This same model should be used by Regulators to assign risk categories to banks and then to regulate accordingly. This would ensure that regulations and the exam process add value for banks of all sizes and types.

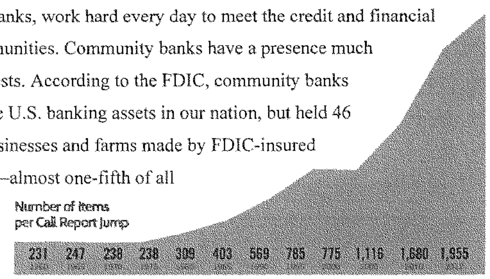
The time to address these issues is now before it becomes impossible to reverse the negative impacts. ABA believes that the regulators can take action under their own authority, without any new laws, to help community banks. There are also actions that Congress can take. We are appreciative of the efforts of many on this committee for introducing bills that can make a difference, including Senators Brown, Toomey, Manchin, Warner, Moran, and Tester (S. 635, S. 727, S.1349, S. 1916, and S. 2698). While no single piece of legislation can relieve the burden that community banks face, many of these bills could begin to provide much needed relief. We urge Congress to work together—House and Senate—to get legislation passed and sent to the President that will help community bankers better serve our customers.

In my testimony today I would like to make the following four points:

- Community banks face an avalanche of regulation that limits their ability to serve their communities;
- Regulation cannot be "one size fits all," and must be tailored to fit a bank's individual model;
- Congress should act to enact key bills that will provide relief for community banking; and
- More can and must be done to address tax-favored competitors and liquidity access for community banks.

I. Community Banks Face an Avalanche of Regulation that Limits Their Ability to Serve Their Communities

Community banks, as do all banks, work hard every day to meet the credit and financial needs of their customers and communities. Community banks have a presence much greater than their total assets suggests. According to the FDIC, community banks accounted for just 14 percent of the U.S. banking assets in our nation, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions.[1] In 629 U.S. counties—almost one-fifth of all U.S. counties—the only banking offices are operated by



[1] FDIC Community Banking Study - https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf

community banks. Without community banks, many rural areas, small towns, and urban neighborhoods would have little or no physical access to mainstream banking services

The ability to meet local needs has not been easy with the increased regulatory costs and the staff workload from new the regulatory requirements. During the last decade, the regulatory burden for community banks has multiplied tenfold and it is no surprise that ***nearly one of every 5 community banks disappeared*** in that period.

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

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

Furthermore, research by the Federal Reserve over the years has confirmed that the burden of regulations falls disproportionately on smaller banks. The Federal Reserve Bank of Minneapolis has estimated that hiring one additional employee to respond to the increased regulatory requirements would reduce the return on assets by 23 basis points for the median bank with total assets of $50 million or less. To put this estimate in perspective, such a decline could cause about 13 percent of the banks of that size to go from being profitable to unprofitable.

At my institution, we have always had a good relationship with our regulators, making sure they know and understand what we do and how we do it. We proactively reach out to our regulators to discuss the implementation of new regulations so we increase our chances of getting it right the first time. But to illustrate the cumulative impact that excessive oversight can have on a community bank, consider what our two bank, privately owned holding company has had to deal with. ***In the last 12 months alone, we have had a dozen separate exams***:

1. Full safety & soundness and compliance OCC exam at First National Bank of Creston (FNBC)
2. Full OCC IT Exam at FNBC
3. Full FDIC Compliance exam at Northwest Bank (NWB)
4. Full State & FDIC Safety & Soundness exam at Northwest Bank
5. Third-party loan review at both banks
6. Third-party intrusion exam at our IT center
7. Third-party compliance reviews
8. FDICIA testing
9. FDICIA Audit
10. Full Financial Audit
11. FDIC HMDA exam at NWB
12. Offsite Federal Reserve exam (holding company) of all of our ongoing internal compliance, FDICIA and Audit reviews and processes

All of the above (external only and does not include our internal audit and compliance reviews) turned into approximately 125 pages of requests with 967 direct questions and/or copies of documents. The 967 direct questions and requests for copies of documents do not include the sub-items under those 967 items and direct questions. To be clear, these are not "yes/no" questions. These are requests for piles and piles of paper or electronic filings. The list of requests with all of the sub-requests under the core questions probably doubles the number of direct items I have already listed.

Our employees and our third party consultants have over 1,000 hours of work on Financial Deposit Insurance Corporation Improvement Act (FDICIA) requirements alone during this 12 month period of time. These FDICIA requirements are in place because we are over $1 billion in assets. All of this adds up to an enormous expense but my bigger concern is the burden it puts on my staff and ultimately our customers. As a $1.6 billion bank, we are better able to spread out some of the compliance costs than our smaller brethren. For the median-sized bank in this country with $174 million in assets and 41 employees, the burden is magnified tremendously. As I have traveled

the country and spoken with bankers, I have been shocked to learn the challenges they face. Here are a few stories I have heard and some results from our surveys:

- A $70 million bank in Kansas has dedicated 3.5 of 25 full-time employees to compliance-related tasks. This means 15 percent of the bank's employees focus solely on regulatory compliance.
- A Texas community bank originated over 1,200 mortgages with a total mortgage staff of 18. In 2012, that same bank originated just over 1,000 loans with a mortgage staff of 25—due entirely to increased compliance burden.
- 18 percent of banks subject to the remittance rule plan to stop offering remittance services altogether, while 42 percent plan on increasing fees to cover additional compliance costs.
- Of community banks, 6 percent report having discontinued residential lending following DFA, with an additional 9 percent anticipating exiting the mortgage business. This does not include an even higher percentage of banks that now limit their mortgage activities to QM mortgages only, due to the ongoing liability and legal risks of making non-QM loans.

Ultimately, this excessive burden leaves banks less able to meet the needs of their communities and support growth on main streets across America. Every dollar spent on compliance is a dollar that cannot be lent. This means less credit in our communities to support economic growth, job creation and income growth.

II. Regulation Cannot be "One Size Fits All," and Must be Tailored to Fit a Bank's Individual Model

Time and again, I hear from bankers wondering why the complex set of rules, reporting requirements, and testing that are imposed upon the largest most diverse and global institutions become the standard applied to the smaller community banks in the country. The approach seems to be: "If it's the "best practice" for the biggest banks it must be the best practice for all banks." Such an approach makes no sense in our diverse banking system with different business models and strategies.

Of course, the supervisory process should assure risk is identified and managed prudently, that bank officials and directors are aware of and understand risk, and that sufficient capital and reserves are available to absorb losses. This risk assessment must be appropriate to the type of institution. In

the aftermath of the financial crisis, the pendulum of bank examination has swung to the extreme—affecting every sized bank. Overbroad, complicated restrictions supplant prudent oversight. Inconsistent examinations hinder lending, increase costs, and create procedural roadblocks that undermine the development of new products and services to bank customers.

The banking agencies should move towards customized examinations that consider the nature of a bank's business model, charter type, and perhaps most important, bank management's success at managing credits, including a borrower's character, prior repayment history and strength of personal guarantees. Regulators' traditional focus on a bank's asset size is misplaced. In today's complex banking environment, an array of risk factors have a far greater impact on a banks' ability to serve its customers—as well as its likelihood to get in trouble—than asset size.

In this regard, examiners should give credit to well-run banks that know their customers and local communities, and have far more experience in identifying which borrowers are creditworthy and which are not, than examiners themselves, especially if examiners are new to a region. This one-on-one relationship banking model is at the core and culture of community banking. If everything is going to be forced into a standard regulatory box or run through automated credit approval models, then we might as well accept the fact that community bank consolidation will accelerate. One-size-fits-all judgments about such standards as to whether and how much to reserve against loans, especially when driven solely by numerical analysis, effectively take away bankers' autonomy and the value of their judgment in contributing to the best allocation of capital to enhance growth.

Banks, like other private enterprises, should be allowed and encouraged to run their businesses to meet the needs of their community, their customers and their business model, provided they have sufficient capital and reserves to absorb losses and have demonstrated a record of good management. Auditors consider the myriad of differences among their clients when making a determination of performance; bank examinations should not be any different.

To be fair, the regulators have made improvements and they have their own challenges in meeting all of the new requirements associated with Dodd-Frank and other new regulations. The introduction of the Financial Institutions Examination Accountability Act (H.R. 1553) was instrumental in facilitating the current regulatory changes. But more can be done. The starting place for that is for Congress to enact legislation that creates a balanced and transparent approach to bank examinations and establishes a way for banks to appeal those examination decisions without fear of

retaliation. Everyone involved in this process has a vested interest in making the process more efficient and more effective.

The Financial Institutions Examination Fairness and Reform Act (S.727) introduced by Senators Moran (R-KS) and Manchin (D-WV) is an excellent starting point. Although no single piece of legislation could remedy all concerns about the current supervisory environment, the following provisions are critical to improving the examination process:

- **Require timely exam reports** by the regulators (including the CFPB) and more information about the facts upon which the agency relied in making examination decisions.
- **Ensure consistent treatment and clarity** regarding how the regulatory agencies and their examiners treat loans with respect to nonaccrual, appraisal, classification, and capital issues.
- **Create an interagency examination ombudsman** within the Federal Financial Institutions Examination Council (FFIEC) to ensure the consistency and quality of all examinations, which create an avenue of accountability to assure that the examination process is applied in a manner appropriate to the charter, business model, and size and scale of each bank's operations, rather than in a one-size-fits-all way. The Ombudsman should have clear authority to take corrective action to remedy examination errors. Moreover, the Ombudsman can conduct confidential outreach to measure whether actions to address community bank concerns are actually achieving their intent.
- **Provide for expedited appeals of examinations without fear of reprisals.**
- **Prohibit any Regulatory Retaliation** against the bank, their service providers, and any institution-affiliated party as defined in the Federal Deposit Insurance Act. An agency cannot delay or deny action that would benefit a bank or institution-affiliated party that is appealing an agency decision.

III. Congress Should Act to Enact Key Bills that Will Provide Relief for Community Banking

ABA applauds members of this committee for taking the issue of regulatory burden seriously and holding hearings such as todays. Members on and off of this committee have also introduced a number of bills to address specific issues and address the problem. I have already touched on the

Financial Institutions Examination Fairness and Reform Act (S.727) introduced in this committee, which would help reform the financial services examination process. We would like to thank Senators Brown, King, Manchin, McConnell, Moran, Toomey, Tester and Warner for introducing some of the legislation we will discuss below.

➢S. 1349 – Community Lending Enhancement and Regulatory Relief Act

The Community Lending Enhancement and Regulatory Relief Act would reduce the number of notice requirements banks have to send, prompt the SEC to conduct a cost-benefit analysis of any new accounting principle, limit attestation requirements for small banks, and expand the QM safe harbor.

➢S. 2698 – RELIEVE Act

The RELIEVE Act contains helpful provisions that ABA supports to ease regulatory burdens. It would help small bank and thrift holding companies raise more capital by raising the threshold for the Federal Reserve's Small Bank Holding Company Policy Statement from $500 million to small bank and savings and loan holding companies with less than $1 billion in consolidated assets. Additionally, it would increase the availability of credit in rural communities by defining "rural" more broadly for purposes of the qualified mortgage rules and increase the annual mortgage origination limit from 500 to 1,000 per year.

➢S. 635 – Privacy Notice Modernization Act

The Privacy Notice Modernization Act would eliminate redundant mailings of annual privacy notices when a financial institution's privacy policy has not changed.

➢S. 1916 – HELP Rural Communities Act

The Helping Expand Lending Practices (HELP) in Rural Communities Act, would direct the Consumer Financial Protection Bureau (CFPB) to establish an application process under which a person who lives or does business in a state may apply to have an area designated as a rural area if it has not already been designated as such by the Bureau.

IV. More Can and Must be Done to Address Tax-Favored Competitors and Liquidity Access for Community Banks.

The bills that have been introduced by this committee are important first steps to addressing the problem of regulatory burden, but more can and must be done. Community banks face tremendous additional pressure as they struggle to address this growing regulatory burden. Concerns with losing access to the Federal Home Loan Bank System as well as competition from tax favored entities place additional burdens on community banks.

➢ The FHFA's recent proposal could hurt access to this important system

The Federal Housing Finance Agency's (FHFA) recent proposal – issued September 2nd – would dramatically change the qualifications for membership in the Federal Home Loan Bank System. Because so many banks of all sizes rely on the Federal Home Loan Banks for liquidity to make loans, this rule could have profound implications for the banking.

The FHFA proposal would impose an ongoing asset test on FHLB members, requiring that they track and report on the mortgage related assets they hold on their books. This would replace the current system which requires applicants to show that they have ten percent of their assets in long term mortgages to be approved for entry in to the System. Members who fail the ongoing test can be forced out of the System, destabilizing the System's capital base. The new proposal will reduce liquidity, make borrowing from the System less certain and more expensive.

The proposal would also redefine captive insurance companies as no longer eligible for System membership. The types of entities eligible for membership in the System are delineated in statute, including insurance companies. The proposed rule, therefore, runs counter to the plain meaning of the statute, and declare captive insurance companies ineligible.

Access to liquidity, particularly for community banks, is critical. This rule is unnecessary, runs counter to the authorizing statue, and would potentially put at risk an important source of liquidity for banks at a time when such liquidity is vitally necessary.

➢ Tax-favored credit unions and the farm credit system GSE are hurting community-based lenders

Not only do banks face incredible pressure from new regulations placed on them, but they must also compete with a number of tax-favored entities such as the credit union industry and the Farm Credit System (FCS). Both the credit union industry and the FCS have outgrown their charters and no longer deserve the tax advantage that they are given. Both were established with the goal of helping extend credit to those who had little access to it, but both have grown far beyond this and use their tax advantage to compete in virtually all aspects of community banking.

Credit unions were founded to serve those of modest means, and were given special tax treatment to support this goal. Many credit unions, however, have outgrown their special tax treatment and compete directly with banks. In fact, there are over 200 credit unions with more than $1 billion in assets, larger than 90 percent of the banks in our country. These institutions have morphed into full banks in disguise and no longer serve their mission, if they want to be full service banks, they should pay the same taxes as the banks they compete with.

The Farm Credit System has veered significantly from its charter to serve young, beginning, and small farmers and ranchers, and now primarily serves large established farms, who could easily obtain credit from the private sector. It has grown into a $261 billion behemoth offering complex financial services. To put this in perspective, if the Farm Credit System were a bank it would be the ninth largest in the United States, and larger than 99 percent of the banks in the country. The Farm Credit System no longer serves its intended charter, and thus does not deserve its special tax treatment.

Conclusion

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

Congress has the opportunity to act on legislation—championed by members of this committee—to help turn the tide of community bank consolidation and protect communities from

losing a key partner supporting economic growth. We urge action on S. 635,S. 727, S.1349, S. 1916, and S. 2698.

An Avalanche of Regulation

"As battle-scarred survivors of a financial crisis and deep recession, community bankers today confront a frustratingly slow recovery, stiff competition...and the responsibility of complying with new and existing regulations. Some observers have worried that these obstacles—particularly complying with regulations—may prove insurmountable."

– Ben Bernanke, October 2, 2013

A majority of small banks tend to have just **one compliance officer** who must understand and implement all the new regulations.

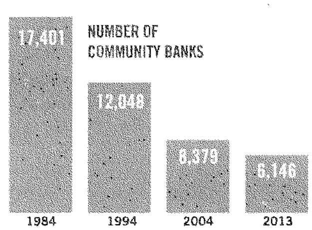
Source: ABA 2013 Bank Compliance Officer Survey

Each new regulation is hundreds of single-spaced, 3 column, 9-point font pages.

456 pages	Servicing Rules
408 pages	ATR/QM
313 pages	2013 HOEPA Rule
275 pages	Basel III
272 pages	Volcker Rule
248 pages	Remittance Rule
225 pages	Loan Originator Rules

Source: Number of Federal Register Pages

Heavy regulatory burden has helped fuel consolidation of community banks.



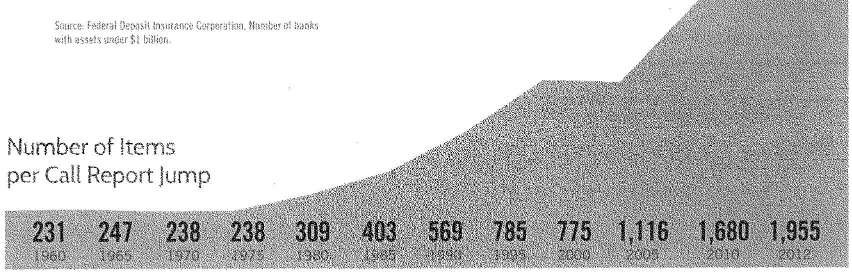
Source: Federal Deposit Insurance Corporation. Number of banks with assets under $1 billion.

1 in 5

"Almost one out of every five U.S. counties...have no other physical banking offices except those operated by community banks."

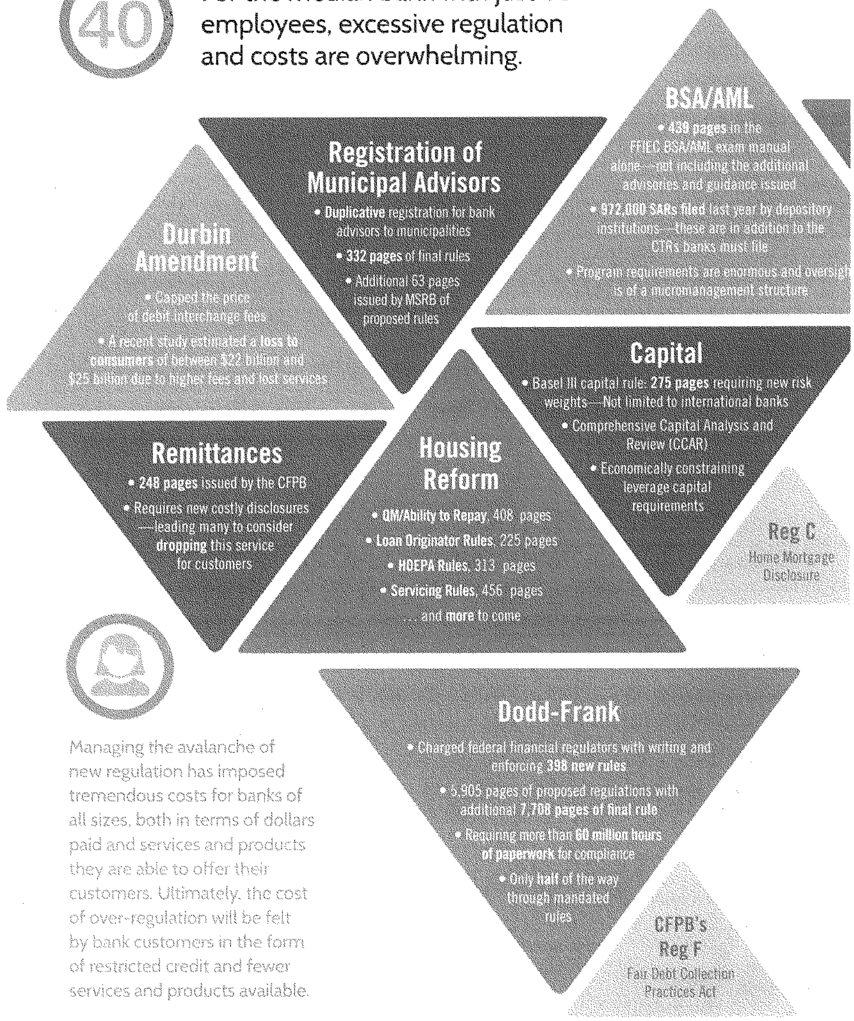
– FDIC Community Banking Study

Number of Items per Call Report Jump

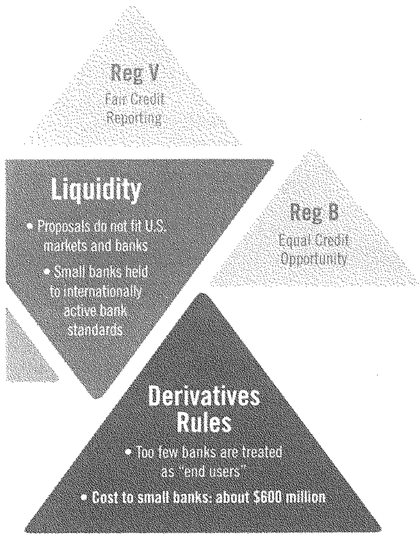


Source: Call Report, Federal Financial Institutions Examination Council

For the median bank with just 40 employees, excessive regulation and costs are overwhelming.



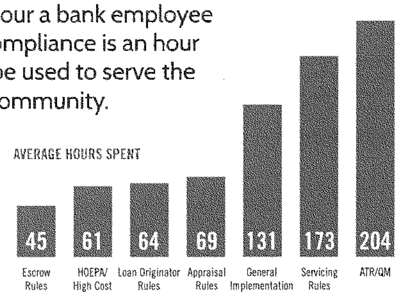
Managing the avalanche of new regulation has imposed tremendous costs for banks of all sizes, both in terms of dollars paid and services and products they are able to offer their customers. Ultimately, the cost of over-regulation will be felt by bank customers in the form of restricted credit and fewer services and products available.



What's Being Said:

- A $70 million bank in Kansas has dedicated 3.5 of 25 employees to compliance-related tasks. This means **15% of the bank's employees focus just on red tape.**
- Of community banks, 6% report having **discontinued residential lending** following DFA, with an additional 9% **anticipating exiting** the mortgage business.
- Federal Reserve Governor Elizabeth Duke noted that "hiring one additional employee would **reduce the return on assets by 23 basis points** for the median bank in the group of smallest banks, those with total assets of $50 million or less. To put this estimate in perspective, such a decline could cause about **13 percent of the banks of that size to go from profitable to unprofitable.**"
- A Texas community bank originated 1,296 mortgages in 2009 with a total mortgage staff of 18. In 2012, the bank originated 1,080 mortgage loans with a total mortgage staff of 25—due to **increased compliance burden.**
- 18% of banks subject to the remittance rule **plan to stop offering remittance services altogether** while 42% plan on increasing fees to cover additional compliance costs.
- A regional bank operating in the Midwest spent **$20 million** on FinCEN's BSA/AML regulation alone.

Every extra hour a bank employee spends on compliance is an hour that cannot be used to serve the bank's local community.

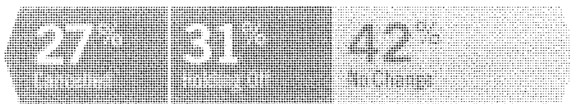


Source: Average results of 10 ABA member banks for the year 2013

More Regulation = Fewer Products

new
products

Many banks have **decided not to launch** a new product, delivery channel, or enter a new market due to expected increased regulatory costs/risks, while nearly an additional third are **holding off** on these decisions to determine the regulatory impact.



44%
Reduced current consumer financial products or services due to compliance regulatory burden.

78%

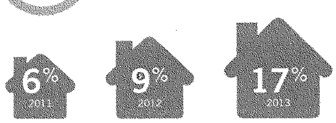
In addition, 78% of banks have said they will or may need to change their nature, mix and volume of mortgage products in response to regulatory changes.

Source: ABA 2013 Bank Compliance Officer Survey

Excessive Rules on Banks Push Business to Less Regulated Shadow System

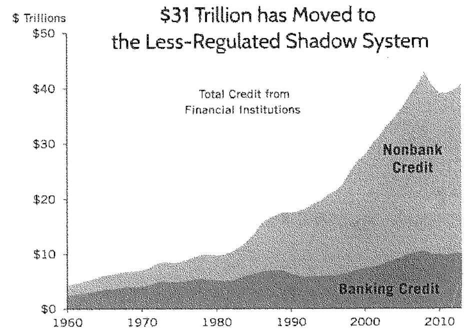
3x

Market share of non-bank mortgage servicers has nearly tripled in 3 years



Source: "Mortgage Market Gets Reshuffled," *The Wall Street Journal*, March 9, 2014. Includes the 30 largest servicers in data.

$31 Trillion has Moved to the Less-Regulated Shadow System



Source: Federal Reserve and Bureau of Labor Statistics. Inflation Adjusted, Base = 2013.

take
action
now

The Avalanche of Regulations has Become Overwhelming

"Policymakers should take action to promote the strength and resurgence of America's banks—large, medium, and small—for the benefit of the customers and communities that rely upon them."
– Frank Keating, ABA President and CEO

INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

John Buhrmaster
President & CEO
Of
First National Bank of Scotia
Scotia, NY

On behalf of the
Independent Community Bankers of America

Before the

United States Senate
Committee on Banking, Housing, and Urban Affairs

Hearing on

"Examining the State of Small Depository Institutions"

September 16, 2014
Washington, D.C.

Chairman Johnson, Ranking Member Crapo, and members of the Committee, my name is John H. Buhrmaster, and I am President and CEO of First National Bank of Scotia, a $425 million asset bank in Scotia, New York. I am also Chairman of the Independent Community Bankers of America and testify today on behalf of more than 6,500 community banks nationwide. Thank you for convening this hearing on "Examining the State of Small Depository Institutions."

From my vantage point as Chairman of ICBA, based on discussions with hundreds of community bankers from across the country, the state of the industry is resilient and gaining strength in the wake of an historic financial crisis. My personal assessment is confirmed by the most recent FDIC Quarterly Banking Profile. Community bank net income is up 3.5 percent from a year ago. Loan growth, at 7.6 percent over the past year, outpaced the industry as a whole. More community banks are profitable, asset quality has improved, and there are fewer problem banks.[1]

However, in a historically low interest rate environment, community banks continue to struggle with low margins, and the pace of consolidation and dearth of new charters has the potential to reshape the industry to the detriment of rural areas and smaller communities. Of particular concern is an onerous regulatory burden that is growing both in volume and complexity, suffocating the true potential of community banks to spur economic growth and job creation in their communities. We look to this Committee and the Senate to address these genuine concerns. Even in the short time remaining in the 113th Congress, there is a real opportunity to provide meaningful relief for community banks. As addressed in this testimony, a number of important financial services bills with broad, bipartisan support are poised for final action. ICBA urges the Senate Banking Committee to act with all due haste before this opportunity is lost.

America's community banks are critical to the prosperity of the U.S. economy, particularly in small and rural communities. As the FDIC Community Banking Study showed, in one out of every five counties in the United States, the only physical banking offices are those operated by community banks.[2] Providing 60 percent of all small business loans under $1 million, as well as customized mortgage and consumer loans suited to the unique characteristics of their local communities, community banks are playing a vital role in ensuring the economic recovery is robust and broad-based, reaching communities of all sizes and in every region of the country. First National Bank of Scotia serves rural and suburban communities in the area of Albany, Schenectady, and Saratoga in upstate New York. We are a closely-held bank, employing 140 people and offering a full range of traditional banking services. First National Bank of Scotia has served these communities since 1923 and I'm a fourth generation community banker. On a personal note, I'm committed to spreading financial literacy through our schools and at all levels. I hope to inspire other community bankers to do so as well. Our story, our culture of relationship banking, and the role we play in our communities are typical of thousands of community banks.

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[1] FDIC Quarterly Banking Profile. Second Quarter 2014.
[2] FDIC Community Banking Study. December 2012.

Tiered Regulation is Needed

ICBA's legislative and regulatory agenda is built on the principle of tiered regulation. Regulation should be calibrated according to institutional size, business model, and risk profile. Appropriate tiering will allow community banks to reach their full potential as catalysts for entrepreneurship, economic growth, and job creation, without jeopardizing safety and soundness or consumer protection. ICBA fully endorses comments made by Federal Reserve Governor Daniel Tarullo before this Committee just last week. With regard to small and mid-sized banks, Governor Tarullo said: "It may be time to consider raising some thresholds or eliminating altogether the application of some Dodd-Frank provisions for them."[3]

Working with community bankers from across the nation, ICBA developed its Plan for Prosperity, a platform of legislative recommendations designed to provide meaningful relief for community banks and allow them to thrive by doing what they do best – serving and growing their communities. By rebalancing unsustainable regulatory burden, the Plan will ensure scarce capital and labor resources are used productively, not sunk into unnecessary compliance costs, allowing community banks to better focus on lending and investing to directly improve the quality of life in our communities. The Plan for Prosperity is attached to this testimony.

The CLEAR Relief Act (S. 1349)

The current Senate bill that best captures the scope of the Plan for Prosperity and does the most to advance the principle of tiered regulation is the Community Lending Enhancement and Regulatory Relief Act of 2013 (the "CLEAR Relief Act" (S. 1349)), sponsored by Sens. Jerry Moran (R-KS), Jon Tester (D-MT), and Mark Kirk (R-IL). We are very pleased S. 1349 has attracted the support of 40 cosponsors to date. The bipartisan mix and political range of the cosponsors – spanning the full width of the political spectrum – is testimony the provisions of the bill represent a set of genuinely consensus solutions to ensure continued access to consumer credit and other banking services. The House counterpart bill, H.R. 1750, has more than 170 cosponsors with a similar bipartisan composition. We are grateful to the members of this committee that have sponsored and cosponsored S. 1349.

S. 1349 contains four provisions. The bill would:

- Provide "qualified mortgage" status under the CFPB's ability-to-repay rules for any mortgage originated and held in portfolio for at least three years by a lender with less than $10 billion in assets.
- Exempt from any escrow requirements any first lien mortgage held in portfolio by a lender with less than $10 billion in assets.
- Exempt community banks with assets of less than $1 billion from the Sarbanes-Oxley 404(b) internal-controls assessment mandates. The exemption

[3] The Wall Street Journal. Money Beat Blog. September 9, 2014.

threshold would be adjusted annually to account for any growth in banking assets.

- Require the Federal Reserve to revise the Small Bank Holding Company Policy Statement by increasing the qualifying asset threshold from $500 million to $5 billion.

Each of these provisions was crafted to provide meaningful, targeted regulatory relief while preserving and strengthening consumer protections and safety and soundness.

Mortgage Lending

The first two provisions relate to mortgage lending. The principal rationale for both of these provisions, and the reason they can be safely enacted, is they apply only to loans originated and held in portfolio by community banks. QM defines mortgages that are either "conclusively" or "presumptively" deemed to comply with the Dodd-Frank Act "ability-to-repay" requirements. As relationship lenders, community bankers are in the business of knowing their borrowers and assessing their ability to repay a loan. What's more, when a community bank holds a loan in portfolio it holds 100 percent of the credit risk and has an overriding incentive to ensure the loan is well underwritten and affordable to the borrower. In a typical community bank portfolio, even a small number of defaults can put a bank at risk. Community bank portfolio lenders ensure they understand the borrower's financial condition and structure the loan accordingly. If the borrower has trouble making payments due to job loss or other unforeseen circumstances, a community bank portfolio lender will work with the borrower to restructure the loan and keep the borrower in their home. By the same token, portfolio lenders will protect their collateral by ensuring borrowers remain current on tax and insurance payments. For this reason, the escrow requirement, which must be outsourced at a relatively high cost by community banks with a low volume of mortgages, is an unnecessary burden when a loan is held in portfolio.

Compelling anecdotal evidence, confirmed by a recent empirical survey of community bankers conducted by the Mercatus Center demonstrates that mortgage rules that became effective in 2014, including the ability-to-repay and escrow rules, will have a significant impact on community bank mortgage availability.[4] According to the Mercatus Center survey, 56% of respondents reported that the QM rule will have a significant negative impact on mortgage lending. An additional 29% report that these factors will have a slight negative impact. The two mortgage provisions of S. 1349 noted above will help to keep community banks in the business of mortgage lending.

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[4] "How are Small Banks Faring Under Dodd-Frank?" Hester Peirce, Ian Robinson, and Thomas Stratmann. Mercatus Center Working Paper. February 2014.

Relief from Accounting and Auditing Expenses for Publicly Traded Community Banks and Thrifts

The third provision of S. 1349 would provide relief for community banks under $1 billion in asset size from the internal control attestation requirements of Section 404(b) of the Sarbanes-Oxley Act. Since community bank internal control systems are monitored continually by bank examiners, they should not have to incur the unnecessary annual expense of paying an outside audit firm for attestation work. This provision will substantially lower the regulatory burden and expense for small, publicly traded community banks without creating more risk for investors.

Modernize the Federal Reserve's Small Bank Holding Company Policy Statement

The fourth and last provision of S. 1349 would require the Federal Reserve to revise the Small Bank Holding Company Policy Statement – a set of capital guidelines that have the force of law. The Policy Statement, which eases the terms under which small bank holding companies may raise additional capital by issuing debt, would be revised to apply to both bank and thrift holding companies and to increase the qualifying asset threshold from $500 million to $5 billion. Under the Policy Statement, qualifying bank and thrift holding companies must not have significant outstanding debt or be engaged in nonbanking activities that involve significant leverage. This will help ease capital requirements for small bank and thrift holding companies. First National Bank of Scotia is bumping up against the current threshold, as are a number of other New York banks. Raising that threshold will ensure that as we grow we continue to have access to the capital we need to serve our communities.

These reasonable regulatory reforms of the CLEAR Relief Act have been debated and advanced in different forms throughout the 113th Congress. ICBA strongly encourages this Committee to ensure CLEAR Relief Act measures pass the Senate expeditiously.

The Senate Can Provide Immediate, Targeted Relief

As much as ICBA would like to see S. 1349 enacted into law this year, we are of course prepared to renew our efforts in the next Congress to advance this or a similar bill, if the sponsors choose to reintroduce a similar package. Until then, we appeal to the Senate Banking Committee for immediate relief, albeit more targeted in scope. A total of six community bank regulatory relief bills have passed the House. Most of those bills passed with broad bipartisan support and have Senate counterparts awaiting action. We are confident that, if scheduled, all or any one of these bills could pass the Senate with broad support. They could be enacted into law before Congress adjourns, and they would provide tangible relief to community banks and their customers. One of those House bills, H.R. 3329, would raise the Federal Reserve Small Bank Holding Company Policy Statement threshold from $500 million to $1 billion, similar to the CLEAR Relief Act provision I noted above. H.R. 3329 passed the House by voice vote. Another bill backed

by broad consensus is the Privacy Notice Modernization Act (S. 635), sponsored by Senators Sherrod Brown (D-OH) and Jerry Moran (R-KS), which currently has more than 70 cosponsors. (A complete list of House-passed bills and their Senate counterparts is attached to this statement.) S. 635 would provide relief from annual privacy notice mailings when a bank has not changed its privacy policies. Community banks simply do not have the scale to automate the annual privacy notice mailings, making them a manual and fairly labor intensive process. S. 635 will save even the smallest banks tens of thousands of dollars a year, real money for a community bank. And importantly, it will do so without putting consumers at risk or reducing their control over the use of their personal data. ICBA strongly urges the Committee's assistance in obtaining swift passage of S. 635.

Agency Rulemaking

As important as the legislative agenda is to community banks, we also have a great deal at stake in agency rulemaking. This is why it is critically important we have representation on the Federal Reserve Board and at the other agencies. The overwhelming majority of banks in this country are community banks. They deserve adequate attention and representation on policymaking bodies. ICBA thanks the Banking Committee for its support of Senator Vitter's amendment to the Terrorism Risk Insurance Act reauthorization to require that at least one Federal Reserve Board Governor have community banking experience. We urge your continued backing to ensure the amendment is included in the final version of this bill.

The Vitter amendment will help improve the quality of rulemaking at the Federal Reserve Board. However, community banks will no doubt continue to rely on this Committee's support for relief from agency rules. Congressional interest was a decisive factor in several favorable rule changes in recent years. The best examples are significant improvement to the Basel III final rule, new community bank exemptions under the CFPB's ability-to-repay/QM rule, a reversal of the Volcker Rule prohibition on bank ownership of collateralized debt obligations backed by trust preferred securities (TruPS CDOs), and a favorable SEC rule on registration of municipal advisors. ICBA sincerely thanks all of the members of this Committee who wrote or signed letters, asked tough questions of regulators in hearings, or otherwise communicated their support for community banks. Your influence with the regulators cannot be understated. With that in mind, I would like to highlight additional, much-needed regulatory relief and encourage your support for current ICBA agency initiatives, as discussed below.

Call Reports

Last week, ICBA delivered a petition to the regulatory agencies calling for more streamlined quarterly call report filings. The petition was signed by nearly 15,000 community bankers representing 40 percent of all community banks nationwide. The strong level of interest in this petition is testament to the growing burden and expense of the quarterly call report both in page volume and complexity. The quarterly call report now comprises 80 pages of forms and 670 pages of instructions. Implementation of the new Basel III capital standards may add nearly 60 additional pages to the already burgeoning call report.

ICBA's recent Community Bank Call Report Burden Survey empirically demonstrates this problem. Eighty-six percent of survey respondents said the total cost of preparing the quarterly call report has increased over the last 10 years.[5] Thirty percent said it had increased significantly. A typical $500 million asset community bank, such as First National Bank of Scotia, spends close to 300 hours a year of senior level, highly-compensated staff time on the quarterly call report. By contrast, in 2001 my bank filed a 31 page call report. The growth of this burden has been dramatic.

Only a fraction of the information collected is actually useful to regulators in monitoring safety and soundness and conducting monetary policy. The 80 pages of forms contain extremely granular data such as the quarterly change in loan balances on owner-occupied commercial real estate. Whatever negligible value there is for the regulators in obtaining this type of detail is dwarfed by the expense and the staff hours dedicated to collecting it. To put things in perspective, consider this contrast: some large credit unions filed a less than 30 page call report in the first quarter of 2014. Surely, regulators can supervise community banks with significantly less paperwork burden than they currently demand.

For this reason, ICBA is calling on the agencies to allow highly-rated community banks to submit a short form call report in the first and third quarters of each year. A full call report would be filed at mid-year and at year-end. The short form would contain essential data required by regulators to conduct offsite monitoring, including income, loan growth, changes in loan loss reserves, and capital position. In the recent survey noted above, community bank respondents overwhelmingly agreed that instituting a short-form call report in certain quarters would provide a great deal of regulatory relief. Seventy-two percent of respondents indicated the relief would be substantial. ICBA views this as a reasonable and moderate request that will provide significant burden relief to community banks and hopes you will support it.

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[5] 2104 ICBA Community Bank Call Report Burden Survey. http://www.icba.org/files/ICBASites/PDFs/2014CallReportSurveyResults.pdf

Federal Housing Finance Agency Membership Test Proposal

On September 2, the Federal Housing Finance Agency (FHFA) released a Notice of Proposed Rulemaking which would impose an ongoing test to retain membership in the Federal Home Loan Bank (FHLB) system. The FHLB system is a critical source of stable, low-cost funding for community banks used for home mortgage lending, loans for land purchases, and affordable housing. As a result of an ongoing eligibility test, some community banks with a long history of using the FHLB system may be cut off from a vital source of funding, resulting in reduced access to credit in some markets. ICBA is very concerned about the unintended consequences of this rule change and opposed a similar proposal four years ago. We will continue to work with the FHFA on this issue and ask for the Committee's support.

The Economic Growth and Regulatory Paperwork Reduction Act Review

Another opportunity for agency regulatory relief is the 10-year review required under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). The OCC, the Federal Reserve Board, and the FDIC are required to identify outdated, unnecessary or unduly burdensome regulation on insured depository institutions. This review will be conducted over a two-year period and will proceed by soliciting comment on twelve categories of regulation. This process holds real promise, if the agencies commit themselves to carrying it out in earnest and according to the terms of the statute.

Community bankers were significantly engaged in the last EGRPRA review, completed in 2006. More than 500 community bankers attended meetings around the country and many more submitted comment letters. Their input was substantive and detailed and should have formed the basis of significant regulatory relief. Unfortunately, the process was a lost opportunity and community bankers were deeply disappointed and disillusioned with the results. Though the process fully demonstrated the urgent need for relief, only minimal regulatory changes were made.

John Reich, then-Director of the Office of Thrift Supervision and leader of the interagency EGRPRA program, wrote:

> Financial institutions of all sizes suffer under the weight of unnecessary regulatory burden, but small community banks unquestionably bear a disproportionate share of the burden due to their more limited resources. While it is difficult to accurately measure the impact regulatory burden has played in industry consolidation, numerous anecdotal comments from bankers across the country as well as from investment bankers who arrange merger and acquisition

> transactions indicate it has become a significant factor. Accordingly, I am deeply concerned about the future of our local communities and the approximately 8,000 community banks under $1 billion in assets...[6]

Unfortunately, the process did not produce the results participants had hoped for and, unfortunately, Reich's assessment turned out to be accurate. Since he made that statement in 2007, the number of community banks has dropped to about 6,500 due mainly to consolidation, and the amount of regulation has grown exponentially.

For this reason, ICBA is making specific recommendations with regard to the process to increase the chances the results match what was intended by Congress. ICBA's recommendations include:

- The agencies should conduct at least six outreach meetings to receive direct input from community bankers.
- The agencies should establish a more comprehensive website, as they did during the last review, to publish notices and post comment letters. The website should feature a "top ten list" of the most burdensome regulations as identified in comment letters and at outreach meetings.
- The agencies should appoint a high level, overall director of the process, an "EGRPRA Czar," to lead the process and, importantly, resolve disputes among the agencies and overrule the objections of any single agency that is obstructing a significant reform.
- The agencies should conduct an independent, empirical study to quantify the regulatory burden facing community banks.

ICBA believes these recommendations are critical to the success of the EGRPRA process as originally intended by Congress. We urge this Committee to support our recommendations and to actively ensure the process results in significant regulatory relief. Community banks cannot afford another missed opportunity.

Closing

Thank you again for the opportunity to testify today. ICBA hopes this testimony, while not exhaustive, gives the Committee a sense of the sharply increasing resource demands placed on community banks by regulation and examination and what's at stake for the future of community banking.

Left unaddressed, the increasing burden of regulation will continue to discourage the chartering of new community banks and lead to further industry consolidation. Consolidation will lead to higher loan interest rates for borrowers, lower rates paid on

[6] **Federal Register** /Vol. 72, No. 211 /Thursday, November 1, 2007 /Notices. P. **62037**

deposits, and fewer product choices – especially in the rural areas and small towns currently served by community banks. A more concentrated industry, dominated by a small number of too-big-to-fail banks, will jeopardize the safety and soundness of the financial system and expose taxpayers to the risk of additional costly bailouts. That is why it is so important to enact sensible regulatory reforms, including but not limited to the bills and regulatory initiatives discussed here.

ICBA encourages you to reach out to the community bankers in your states. Ask them about the current regulatory environment and needed reforms.

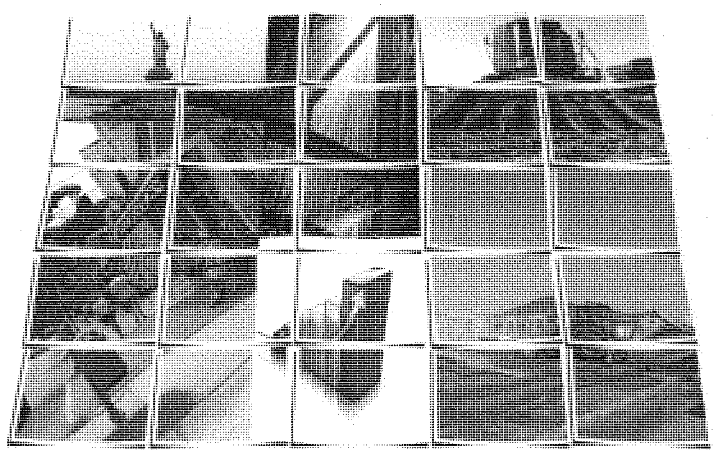
Thank you again for the opportunity to testify today. ICBA looks forward to working with this committee to craft urgently needed legislative solutions.

ATTACHMENTS

- ICBA Plan for Prosperity
- List of House-Passed Community Bank Regulatory Relief Bills

ICBA

Plan for Prosperity



A Regulatory Relief Agenda to Empower Local Communities

2013

Plan for Prosperity: A Regulatory Relief Agenda to Empower Local Communities

America's 7,000 community banks are vital to the prosperity of the U.S. economy, particularly in micropolitan and rural communities. Providing 60 percent of all small business loans under $1 million, as well as customized mortgage and consumer loans suited to the unique characteristics of their local communities, community banks are playing a vital role in ensuring the economic recovery is robust and broad based, reaching communities of all sizes and in every region of the country.

In order to reach their full potential as catalysts for entrepreneurship, economic growth, and job creation, community banks must be able to attract capital in a highly competitive environment. Regulation calibrated to the size, lower-risk profile, and traditional business model of community banks is critical to this objective. ICBA's Plan for Prosperity provides targeted regulatory relief that will allow community banks to thrive by doing what they do best – serving and growing their communities. By rebalancing unsustainable regulatory burden, the Plan will ensure that scarce capital and labor resources are used productively, not sunk into unnecessary compliance costs, allowing community banks to better focus on lending and investing that will directly improve the quality of life in our communities. Each provision of the Plan was selected with input from community bankers nationwide and crafted to preserve and strengthen consumer protections and safety and soundness.

The Plan is not a bill; it is a platform and set of legislative priorities positioned for advancement in Congress. The provisions could be introduced in Congress individually, collectively or configured in whatever fashion suits interested members of Congress. The Plan is a flexible, living document that can be adapted to a rapidly changing regulatory and legislative environment to maximize its influence and likelihood of enactment. Provisions of the Plan include:

Support for the Housing Recovery: Mortgage Reform For Community Banks. Provide community banks relief from certain mortgage regulations, especially for loans held in portfolio. When a community bank holds a loan in portfolio, it has a direct stake in the loan's performance and every incentive to ensure it is affordable and responsibly serviced. Relief would include: Providing "qualified mortgage" safe harbor status for loans originated and held in portfolio for the life of the loan by banks with less than $10 billion in assets, including balloon mortgages; exempting banks with assets below $10 billion from escrow requirements for loans held in portfolio; increasing the "small servicer" exemption threshold to 20,000 loans (up from 5,000); and reinstating the FIRREA exemption for independent appraisals for portfolio loans of $250,000 or less made by banks with assets below $10 billion.

Strengthening Accountability in Bank Exams: A Workable Appeals Process. The trend toward oppressive, micromanaged regulatory exams is a concern to community bankers nationwide. An independent body would be created to receive, investigate, and resolve material complaints from banks in a timely and confidential manner. The goal is to hold examiners accountable and to prevent retribution against banks that file complaints.

Redundant Privacy Notices: Eliminate Annual Requirement. Eliminate the requirement that financial institutions mail annual privacy notices even when no change in policy has occurred. Financial institutions would still be required to notify their customers when they change their privacy policies, but when no change in policy has occurred, the annual notice provides no useful information to customers and is a needless expense.

Serving Local Governments: Community Bank Exemption from Municipal Advisor Registration. Exempt community bank employees from having to register as municipal advisors with the SEC and the Municipal Securities Rulemaking Board. Community banks provide traditional banking services to small municipal governments such as demand deposits, certificates of deposit, cash management services, loans and letters of credit. These activities are closely supervised by state and federal bank regulators. Municipal advisor registration and examination would pose a significant expense and regulatory burden for community banks without enhancing financial protections for municipal governments.

Creating a Voice for Community Banks: Treasury Assistant Secretary for Community Banks. Economic and banking policies have too often been made without the benefit of community bank input. An approach that takes into account the diversity and breadth of the financial services sector would significantly improve policy making. Creating an Assistant Secretary for Community Banks within the U.S. Treasury Department would ensure that the 7,000 + community banks across the country, including minority banks that lend in underserved markets, are given appropriate and balanced consideration in the policy making process.

Balanced Consumer Regulation: More Inclusive and Accountable CFPB Governance. Change the governance structure of the CFBP to a five-member commission rather than a single Director. Commissioners would be confirmed by the Senate to staggered five-year terms with no more than three commissioners affiliated with any one political party. This change will strengthen accountability and bring a diversity of views and professional backgrounds to decision-making at the CFPB. In addition, FSOC's review of CFPB rules should be strengthened by changing the vote required to veto a rule from an unreasonably high two-thirds vote to a simple majority, excluding the CFPB Director.

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Relief from Accounting and Auditing Expenses: Publicly Traded Community Banks and Thrifts. Increase from $75 million in market capitalization to $350 million the exemption from internal control attestation requirements. Because community bank internal control systems are monitored continually by bank examiners, they should not have to sustain the unnecessary annual expense of paying an outside audit firm for attestation work. This provision will substantially lower the regulatory burden and expense for small, publicly traded community banks without creating more risk for investors. Separately, due to an inadvertent oversight in the recently-passed JOBS Act, thrift holding companies cannot take advantage of the increased shareholder threshold below which a bank or bank holding company may deregister with the SEC. Congress should correct this oversight by allowing thrift holding companies to use the new 1200 shareholder deregistration threshold.

Ensuring the Viability of Mutual Banks: New Charter Option and Relief from Dividend Restrictions. The OCC should be allowed to charter mutual national banks to provide flexibility for institutions to choose the charter that best suits their needs and the communities they serve. In addition, certain mutual holding companies – those that have public shareholders—should be allowed to pay dividends to their public shareholders without having to comply with numerous "dividend waiver" restrictions as required under a recent Federal Reserve rule. The Federal Reserve rule makes it difficult for mutual holding companies to attract investors to support their capital levels. Easier payment of dividends will ensure the viability of the mutual holding company form of organization.

Rigorous and Quantitative Justification of New Rules: Cost-Benefit Analysis. Provide that financial regulatory agencies cannot issue notices of proposed rulemakings unless they first determine that quantified costs are less than quantified benefits. The analysis must take into account the impact on the smallest banks which are disproportionately burdened by regulation because they lack the scale and the resources to absorb the associated compliance costs.
In addition, the agencies would be required to identify and assess available alternatives including modifications to existing regulations. They would also be required to ensure that proposed regulations are consistent with existing regulations, written in plain English, and easy to interpret.

Additional Capital for Small Bank Holding Companies: Modernizing the Federal Reserve's Policy Statement. Require the Federal Reserve to revise the Small Bank Holding Company Policy Statement – a set of capital guidelines that have the force of law. The Policy Statement, makes it easier for small bank holding companies to raise additional capital by issuing debt, would be revised to apply to both bank and thrift holding companies and to increase the qualifying asset threshold from $500 million to $5 billion. Qualifying bank and thrift holding companies must not have significant outstanding debt or be engaged in nonbanking activities that involve significant leverage. This will help ease capital requirements for small bank and thrift holding companies.

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Cutting the Red Tape in Small Business Lending: Eliminate Data Collection. Exclude banks with assets below $10 billion from new small business data collection requirements. This provision, which requires the reporting of information regarding every small business loan application, falls disproportionately upon community banks that lack scale and compliance resources.

Facilitating Capital Formation: Modernize Subchapter S Constraints and Extend Loss Carryback. Subchapter S of the tax code should be updated to facilitate capital formation for community banks, particularly in light of higher capital requirements under the proposed Basel III capital standards. The limit on Subchapter S shareholders should be increased from 100 to 200; Subchapter S corporations should be allowed to issue preferred shares; and Subchapter S shares, both common and preferred, should be permitted to be held in individual retirement accounts (IRAs). These changes would better allow the nation's 2300 Subchapter S banks to raise capital and increase the flow of credit. In addition, banks with $15 billion or less in assets should be allowed to use a five-year net operating loss (NOL) carryback through 2014. This extension of the five-year NOL carryback is countercyclical and will support community bank capital and lending during economic downturns.

The Independent Community Bankers of America®, the nation's voice for nearly 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. For more information, visit www.icba.org.

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House-Passed Community Bank Regulatory Relief Bills

House Bill (date of passage)	Description	Senate Companion Bill
The Eliminate Privacy Notice Confusion Act (H.R. 749) (March 12, 2013)	Eliminates privacy notice mailings when no change in policy has occurred.	The Privacy Notice Modernization Act (S. 635)
The Holding Company Registration Threshold Equalization Act (H.R. 801)(January 14, 2014)	Allows thrift holding companies to use the new shareholder registration/deregistration thresholds of the 2012 JOBS Act. These thresholds are currently available to banks.	The Holding Company Registration Threshold Equalization Act (S. 872)
Helping Expand Lending Practices in Rural Communities Act (H.R. 2672) (May 6, 2014)	Creates a petition process with regard to the CFPB's designation of an area as "rural."	HELP Rural Communities Act of 2014 (S. 1916)
H.R. 3329 (May 6, 2014)	Raises the Federal Reserve Small Bank Holding Company Policy Statement asset threshold from $500 million to $1 billion.	No companion bill. Similar provision included in the CLEAR Relief Act (S. 1349).
The SEC Regulatory Accountability Act (H.R. 1062)(May 17, 2013)	Requires the Chief Economist of the SEC to determine that the benefits of any proposed regulation justify the costs.	No companion bill. Similar to the Financial Regulatory Responsibility Act (S. 450).
The Consumer Financial Protection Commission Act (H.R. 3193) (February 27, 2014)	Replaces the single CFPB Director with a five-person Commission, strengthens FSOC review of CFPB rules, among other provisions.	N/A

Testimony
of
Dennis Pierce
Chief Executive Officer
CommunityAmerica Credit Union
On Behalf of the
Credit Union National Association
Before the
Committee on Banking, Housing & Urban Affairs
United States Senate
Hearing Entitled
"Examining the State of Small Depository Institutions"
September 16, 2014

Chairman Johnson, Ranking Member Crapo and Members of the Committee:

Thank you very much for the opportunity to testify at today's hearing. My name is Dennis Pierce, and I am Chief Executive Officer of CommunityAmerica Credit Union in Kansas City, Missouri. I am also Chairman of the Board of Directors of the Credit Union National Association (CUNA), on whose behalf I am testifying today. CommunityAmerica Credit Union is the second largest credit union in Missouri with $1.9 billion in assets and over 180,000 members. CUNA is the largest credit union trade association in the United States representing over 6,600 federally and state chartered credit unions and their 100 million members.

As you know, credit unions are member-owned, not-for-profit financial cooperatives, which exist to promote thrift and provide access to credit for provident purposes to their members. This is the express purpose of credit unions – nothing more and nothing less. Credit unions are not in business to make money for outside stockholders. The users of credit unions are not a means to an end; for the credit union, its members are the end. This

characteristic is the key differential between not-for-profit credit unions and for-profit banks. The credit union structural difference helped cooperative financial institutions come through the Great Recession nearly unscathed while the banking industry teetered on near-complete collapse. When considering regulatory burden, particularly as it relates to consumer financial protection, it is critical that policymakers understand that the incentive structure for credit unions and banks is quite different, and the regulatory structure should reflect those differences. In short, credit union members really don't need that much protection from the credit unions they own.

As financial institutions, credit unions are subject to a number of regulations imposed on them by Federal and state regulators. With respect to both safety and soundness regulation and consumer protection regulation, the regulatory regime to which credit unions are subject has increased significantly in recent years, largely in response to a financial crisis that natural person credit unions neither caused nor to which they contributed. These regulatory changes have made it more difficult for credit unions to serve their members and have provided credit union members with little, if any, benefit. And, in some cases, the regulations that have been imposed since the financial crisis have made things worse for credit union members.

My testimony today will describe the current state of credit unions' regulatory burden, our concern with proposed regulations under consideration by the National Credit Union Administration (NCUA) and the Federal Housing Finance Agency (FHFA) and our views on pending regulatory relief legislation.

Credit Unions' Regulatory Burden

Credit unions face a crisis of creeping complexity with respect to regulatory burden. It is not that any particular regulation presents an

unmanageable situation for credit unions, but the accumulation of regulatory requirements and the frequency with which these requirements change that contributes to a degradation of member service because it diverts finite resources away from our purpose and mission. Since the beginning of the financial crisis, credit unions have been subject to more than 180 regulatory changes from at least 15 different Federal regulatory agencies.

The Ever-Increasing Regulatory Burden Impacts Small Financial Institutions Disproportionately

The impact of these regulations hits smaller institutions particularly hard. The credit union system is growing, but it remains significantly smaller than the banking sector. My credit union is a large credit union, but would be considered a small bank. To put the question of size in perspective, consider that each of the four largest banks in the United States has total assets greater than the combined assets of the entire credit union system. Congress and regulators ask a lot of small, not-for-profit, financial institutions when they tell them to comply with the same rules as J.P. Morgan, Bank of America and Citibank, because the cost of compliance is proportionately higher for smaller-sized credit unions than these behemoth institutions. Almost half of the credit unions in the United States operate with five or fewer full-time equivalent employees; the largest banks likely have compliance departments that exceed that number by multiples of a hundred or more. The rules that the Consumer Financial Protection Bureau (CFPB) has promulgated so far have not taken this disparity– and disproportionate burden – into consideration as much as we feel they can or should under the law.

When a regulation is changed or a new rule is released, there are certain upfront costs that must be incurred no matter the institution: staff time and credit union resources must be applied to assess what is necessary to comply;

disclosures must be changed; data processing systems must be reprogrammed; and staff have to be retrained. Credit union members must be told how the new rule or change will affect them, and at times members get frustrated because of the change. None of these changes are of a minimal undertaking, and when they have to be done simultaneously, the burden to conform to the new rule or law can be overwhelming, especially for a smaller institution.

Moreover, the cumulative effect of current compliance responsibilities and ever increasing new ones is staggering. This is a key reason that more than 300 small credit unions each year merge with larger institutions.

Every dollar that a credit union spends on complying with a regulation is a dollar that is not spent to the benefit of its membership. And, because credit unions sustain their operations through retained earnings, the money that is spent on compliance directly impacts credit union members, affecting rates, dividends and even the services that may be offered. What is maddening to credit union managers and volunteers is the abundance of rules and regulations to which they have been subjected recently, promulgated in response to actions taken by others in the financial services sector. Credit unions feel as if they are being made to pay for the sins of others. The losers in this situation are the 100 million credit union members who turn to their financial cooperatives, their credit unions, as an alternative to for-profit banks.

Allow me to provide you with some examples of how recent regulations have affected the way that CommunityAmerica Credit Union serves their members.

The CFPB's recently finalized a new "Ability to Repay" Rule. This rule has resulted in a longer turnaround time for credit union members to close a loan. The regulation requires us to do additional verification on our borrower's

ability to repay. In our case, this additional verification includes calling an employer directly and confirming pay information rather than just getting stated income or a paystub. These members have often been members for a number of years – we know their financial situation, and can trust the information and documentation that they are providing. While we feel we need to do this to comply, this additional verification step has slowed down the lending process, required more administrative work on our staff and has so far not led to any ability to repay issues that we were not already catching before. I can see why this process was created for larger financial institutions who do not have such a tight relationship with their borrowers, but in institutions of our size, it is superfluous and over-reactive.

Another requirement has also wreaked administrative havoc in our credit union. Financial institutions are now required to give a list of ten homeownership counseling agencies to all home loan applicants. This has led to questions by members concerned that we are already concluding that they are going to have a hard time making their mortgage payments. It may make sense to send this information with the first collection letter, but putting it at the front of the loan application process is confusing and disconcerting to members, and, frankly, quickly forgotten once they move on with their loan. If they do have financial trouble down the way, they are not going to look back at opening documents to seek help.

A new proposal by the CFPB regarding debt collection would align the debt practices rule to the debt collection practices. This rule is meant for debt collectors, but will impact credit unions. Aligning these two rules will make it much harder for credit unions to collect debt and could force institutions to simply outsource the function.

When regulatory burden slows down the member-credit union interaction, confuses the member or forces a credit union to outsource a function, member service is degraded. This should be a concern for the Committee and Congress, and we urge you to address it through changes to the relevant statutes and oversight of the relevant regulatory agencies.

Credit Unions Continue to Have Concerns Regarding Examination Conduct and Consistency

We also encourage the Committee to continue to exercise its oversight responsibilities with respect to the conduct and consistency of credit union examinations. This is an ongoing concern for many credit unions.

Preliminary results from CUNA's 2014 Examination Survey continue to show that most credit unions view heavier regulatory/exam requirements as putting increasing pressure on credit union resources. Overall 76% of recently-surveyed respondents mention this concern.

A substantial percentage of credit union CEOs are just plain dissatisfied with their exams. Overall, 28% of credit union executives indicate they are dissatisfied, with 17% indicating they are "somewhat dissatisfied" and 11% indicating they are "very dissatisfied". These percentages have not changed appreciably over the three years CUNA has conducted the survey.

Credit union CEOs generally give exam teams positive ratings on a number of items, such as giving credit unions the opportunity to comment, being open to discussion, and knowledge of rules and regulations and the credit union. However, exam teams receive especially negative ratings on in a number of very important areas. For example, over half (51%) say that their examiner or exam team applied "guidance" as if it was enforceable regulation and a similar percentage (52%) indicated that examiners were "covering themselves". Beyond this, roughly 40% say that examiners, at times, make recommendations

then later provide contradictory guidance and a similar percentage (39%) said that examiners inappropriately tell institutions how to run their businesses.

More than one-third of respondents (35%) indicate that examiners make excessive use of Documents of Resolution (DORs). Fully 40% of responding credit unions are currently under a DOR. And 43% say that items are appearing in DORs that used to be handled more routinely.

We have seen little improvement in these concerns - each of these metrics mirrors results seen in surveys over the past two years. This is why we support legislative efforts to address examination issues, including S. 727, the Financial Institution Examination Fairness and Reform Act, which has been introduced by Senators Jerry Moran (R-KS) and Joe Manchin (D-WV), and its House companion, H.R. 1553, which has been introduced by Representative Shelley Moore Capito (R-WV) and Carolyn Maloney (D-NY). We encourage the Committee to address these concerns.

The remainder of my written testimony discusses concerns that credit unions have with pending regulatory matters at the National Credit Union Administration and the Federal Housing Finance Agency, as well as pending legislation that would reduce credit unions' regulatory burden. These bills are but a small step toward regulatory relief; there is much more that needs to be done. Failure to take even small steps in the direction of reducing credit unions' regulatory burden will result in the continued trend of consolidation in the credit union sector – fewer credit unions serving America's consumers and small businesses. That is a public policy outcome only the banking trade associations would applaud.

Credit Unions Have Significant Concerns with the National Credit Union Administration's Proposed Rule on Risk-Based Capital

In January 2014, NCUA issued a proposed rule related to risk-based capital standards for credit unions.[1] The agency has indicated that it was prompted to update its standards following a 2012 GAO study, a report from its Office of Inspector General and lessons learned from the financial crisis. CUNA is a strong, historic supporter of risk-based capital for credit unions, but we strongly oppose this proposal because we believe it is a solution in search of a problem; it exceeds NCUA's statutory authority; and it would adversely impact credit unions' ability to serve their members without providing meaningful benefit to the protection of the National Credit Union Share Insurance Fund (NCUSIF).

The Proposal Is a Solution In Search of a Problem

There were 8,100 federally-insured credit unions at the start of the worst financial crisis in this nation's history. In total, only 25 of those deemed "complex" by the proposal failed. If in place at that time, the proposal would not have prevented any of those failures nor would it have significantly reduced losses to the NCUSIF. It would have caused substantial overcapitalization of thousands of other healthy credit unions thus substantially reducing service and capital to members when many needed it the most.

The proposal does not reflect credit unions' robust historical financial performance including during times of severe financial market distress. NCUA has not – and cannot – justify the proposal as issued for comments in light of the vigorous health of federally insured credit unions in general. If finalized as proposed, the overall negative impact of the proposal would be far greater than

[1] Proposed rule on prompt corrective action; risk based capital (12 CFR Parts 700, 701, 702, 703, 713, 723 and 747) issued by NCUA on January 23, 2014.
http://www.ncua.gov/Legal/Documents/Regulations/PR20140123PCA.pdf

the agency has anticipated and would result in a much smaller credit union system over the long term.

The Proposed Rule Exceeds NCUA's Statutory Authority

The proposed rule would impose a risk-based capital standard for the purposes of determining whether a credit union is well-capitalized. However, the *Federal Credit Union Act* directs the NCUA to establish risk-based net worth requirements for which the adequately capitalized level does not provide adequate protection.[2] In his comment letter to NCUA, former Senate Banking Committee Chairman Alfonse D'Amato clearly expressed the intent of this provision of the *Federal Credit Union Act*, which was added under his leadership in 1998:

> *"When we crafted the credit union version of PCA, we modeled it after the bank version already in place, but we incorporated some very important differences to reflect the different nature of banks and credit unions.... we instructed NCUA to construct only a risk-based net worth floor, to take account of situations where the 6% requirement to be adequately capitalized was not sufficient... If we had intended there should also be a separate risk-based requirement to be well capitalized (in addition to the 7% net worth ratio), we would have said so."*[3]

We strongly believe that if NCUA feels it needs to establish a higher risk-based capital standard for the purposes of determining whether a credit union is well-capitalized, compared to an adequately capitalized credit union, then it should seek such authority from Congress.

Furthermore, the proposed rule would permit NCUA examiners to establish individual capital standards for credit unions on a case-by-case basis; our reading of the *Federal Credit Union Act* suggests that this is an authority that

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[2] 12 U.S.C. § 1790d(d).

[3] Letter from the Honorable Alfonse D'Amato to the National Credit Union Administration. May 7, 2014. http://www.ncua.gov/Legal/CommentLetters/CLRisk20140507AD'Amato.pdf

Congress has not conveyed to the agency, and it would be inconsistent with the recommendations of the Department of Treasury and the Governmental Accountability Office.[4,5] Credit unions face too many uncertainties already without having to contend with whether NCUA will impose additional capital beyond what is indicated in the rule in order to meet well-capitalized requirements.

The Proposed Rule Would Adversely Impact Credit Unions' Ability to Serve Their Members and Would Not Substantially Improve the Protection of the Share Insurance Fund

Given its major weaknesses—which would seriously constrict credit union growth and financial performance—we believe major changes are needed in the final rule. The agency has indicated a number of such changes are under consideration. However, if implemented without change, the proposed rule would doom credit unions to a marginal role in the financial marketplace without effectively achieving the objectives NCUA has identified. It would clumsily identify credit unions in need of additional capital at the expense of overcapitalizing many other well-managed credit unions. Member service and credit availability from credit unions would suffer, because credit unions will move away from decision making based on the best interest of the members and communities that they serve and toward operating as if they were for-profit banking institutions. Short of withdrawing the proposal, we have urged NCUA to issue a revised proposal for comment.

As we discuss in our comment letter, we have many other issues with the proposed rule.[6] We object to the proposal's interest rate risk scheme, because

[4] U.S. Treasury Report to Congress, Credit Unions, at 8 (December 1, 1997)
[5] GAO-12-247.
[6] Letter from Bill Cheney, President and Chief Executive Officer, Credit Union National Association to the National Credit Union Administration. May 28, 2014.
http://www.ncua.gov/Legal/CommentLetters/CLRisk20140528BCheney.pdf

it completely ignores liabilities. We also have expressed concern that the proposed rule discounts the 1% deposit credit unions place in the NCUSIF; and with the proposed rule's one-dimensional, asset-based definition of a "complex" credit union.

In addition, we believe the risk-weights in the proposed rule are misaligned given the *Federal Credit Union Act's* mandate that NCUA develop a system that takes into consideration the unique characteristics of the credit union system, and would have unnecessarily harsh consequences on credit unions, their members and communities. In many cases, the proposed risk-weights, which attempt to account for interest rate and for concentration risk among other factors, are substantially more stringent than similar risk-weights in the Basel III rules for small banks, even though credit union performance on these assets is generally stronger. If implemented as proposed, it would lead to a contraction in credit union lending, particularly mortgage lending and small business lending, at a time when the economy is recovering from a very significant financial crisis.

For example, the traditional small agricultural credit union serving farmers and ranchers in rural America would be required to dramatically change the way it serves its members. In summary, the regulator's proposed risk weights would make it more difficult for credit unions to lend to their members as they have historically done in a safe and sound manner.

This concern was eloquently articulated by the Midwest Agricultural Credit Union Coalition. In their May 22, 2014, comment letter, 21 credit unions from seven states joined together to tell the NCUA the devastating impact the risk-based capital proposal would have on their service to member farmers and ranchers:

"This proposed rule will inhibit the future of member business lending in the American Midwest. The proposed rule improperly treats all [member business loans (MBL)] the same, grouping agricultural loans with construction loans. There are many credit unions in the Midwest that have an extremely long history in agricultural lending, with the expertise, operational processes and managerial oversight in place, and has been in place, to be very successful in making low-risk loans to their members. The proposed rule does nothing to take into account of how MBL risk is mitigated through the experience that these credit unions have. Furthermore, if the rule were to be finalized as proposed, many of these credit unions would have to cease or significantly modify their agricultural lending practices, thus removing another lender from the marketplace. In some rural locations in the Midwest, the credit union is the only agricultural lender. This proposed rule will hurt the consumer and the American farmer."[7]

The last thing we need during this fragile recovery is for regulators to make it more difficult for credit unions to lend to their members, but that would be an impact of the proposal.

In fact, the commentary accompanying the proposed rule significantly underestimates the impact of the proposal on credit unions, their members and the communities that they serve. NCUA indicates that less than 10% of covered credit unions would be affected by the proposal – only 189 would be reclassified from well-capitalized to adequately capitalized and only 10 would be reclassified to undercapitalized – and that these credit unions would be required to raise a total of $63 million of additional capital to become adequately capitalized, given no changes in their balance sheets.[8] This estimate ignores several operational realities. First, very few credit unions seek to maintain capital levels precisely at the required minimum amount. They generally want to maintain a buffer

[7] Letter from the Midwest Agricultural Credit Union Coalition to the National Credit Union Administration. May 22, 2014.
http://www.ncua.gov/Legal/CommentLetters/CLRisk2014MACUC.pdf
[8] 79 Fed. Reg. 11, 188.

above those minimums so that they can manage unexpected changes in their balance sheets; and, their examiners generally prefer that they maintain the buffer. The NCUA estimate calculates only the amount that the ten credit unions reclassified as undercapitalized would need to achieve an adequately-capitalized classification; it does not take into consideration the capital required for those ten credit unions to achieve a well-capitalized classification nor does it take into consideration the buffer that those credit unions would seek to maintain above the minimum threshold to be considered well capitalized.

Further, the $63 million completely ignores the 189 credit unions that would be reclassified from well to adequately capitalized. These credit unions also would certainly find it necessarily prudent to attempt to raise sufficient capital quickly to restore their well-capitalized status. Doing so would require $480 million in additional capital.

Finally, many other credit unions that would come perilously close to having their capital classifications reduced from well- to adequately-capitalized would face similar pressures.

On net, across all potentially affected credit unions (those with more than $40 million in assets), we conservatively estimate that the rule would compel credit unions to add an additional $3.0 - $4.5 billion in capital in an effort to maintain or manage buffers above the higher requirements.[9]

In our comment letter, we urged NCUA to pursue risk-based capital standards as part of a multi-faceted capital reform strategy, which would include statutory capital reform. Representatives Peter King (R-NY) and Brad

[9] The actual increase in the amount of capital required to be well capitalized would rise by about twice that much, but for many credit unions existing capital buffers are sufficiently high that a reduction in those buffers would likely not lead to the need for additional capital.

Sherman (D-CA) have introduced a bill, H.R. 719, the *Capital Access for Small Businesses and Jobs Act*. This legislation has the support of the NCUA Chairman and enjoys cosponsorship by an additional 49 bipartisan members of the House of Representatives. [10] It would be a good place to start the conversation regarding credit union capital reform.

For these reasons and others, the proposed rule has received a historic amount of interest from stakeholders. As noted above, CUNA expressed concerns to the agency in a comprehensive comment letter filed in May, as did CommunityAmerica Credit Union.[11,12] These letters were among the more than 2,200 comment letters the agency received. We appreciate the leadership of Chairman Johnson and Ranking Member Crapo who recently sent a letter to the NCUA on this matter, as well as that of the other 25 Senators who have weighed in on this proposal. The proposed rule has generated similar interest in the House of Representatives where more than 324 Members signed a letter to the agency organized by Representatives Peter King (R-NY) and Gregory Meeks (D-NY).[13,14] The level of continuing interest and concern regarding this proposed rule can be clearly appreciated through the stream of letters going from Capitol

[10] Letter from NCUA Chairman Debbie Matz to Representative Peter King. May 30, 2014.
[11] Letter from Bill Cheney, CUNA, to NCUA regarding the proposed rule on prompt corrective action; risk based capital issued January 23, 2014.
http://www.ncua.gov/Legal/CommentLetters/CLRisk20140528BCheney.pdf
[12] Letter from Dennis Pierce, Chief Executive Officer, Community America Credit Union, to the National Credit Union Administration. May 16, 2014.
http://www.ncua.gov/Legal/CommentLetters/CLRisk20140516DPierce.pdf
[13] Comment letters received by NCUA regarding the proposed rule on prompt corrective action; risk based capital issued January 23, 2014.
http://www.ncua.gov/Legal/Regs/Pages/PR20140123RiskBasedCapital.aspx
[14] Letter from Representatives Peter King, Gregory Meeks and 322 Members of the House of Representative to NCUA regarding the proposed rule on prompt corrective action; risk based capital issued January 23, 2014.
http://www.ncua.gov/Legal/CommentLetters/CLRisk20140515Congress.pdf

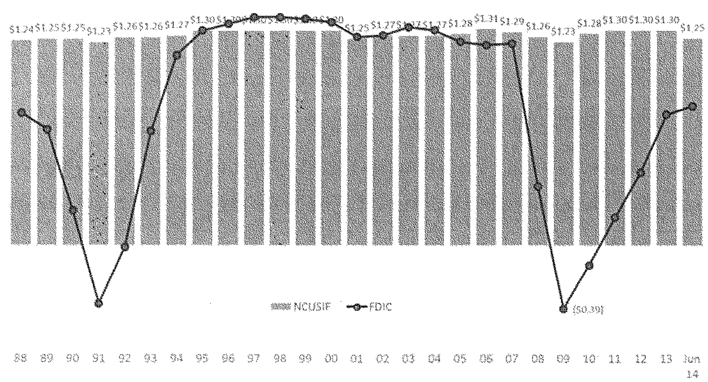
Hill to the NCUA urging them to take the concerns credit unions have with this proposal into consideration as the rule is finalized.

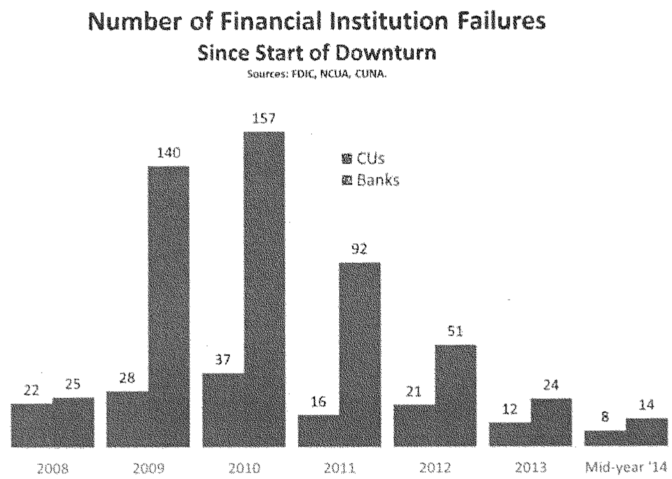
America's credit unions – since their inception – have been the model of risk management in the U.S. financial system, as the following two charts demonstrate. No other class of financial institution has been as resilient to risk as credit unions. The absence of a profit motive, a mission of service and a cooperative ownership structure, are all reasons for this performance. That fewer credit unions have failed throughout their history than any other types of financial institution is no accident – it is because credit unions are different.

Insurance Fund Ratios

Fund Balances per $100 in Insured Deposits

Sources: FDIC, NCUA, CUNA.





NCUA should be encouraging credit unions to do more of what they do now to serve their members and communities—not limiting them so they can only do less. Credit unions appreciate the oversight role that the Committee has with respect to NCUA, and we encourage the Committee to exercise that responsibility to ensure that the risk-based capital rule that is finally implemented is consistent with the law, balances the best interests of credit union members with the safety of the money they entrust to their credit union and recognizes that credit unions are cooperative institutions formed to serve their members on a not-for-profit basis.

Credit Unions Have Significant Concerns with the Federal Housing Finance Agency Proposed Revisions to Federal Home Loan Bank Eligibility Requirements

We are very concerned about the September 2, 2014 proposal from FHFA to revise the agency's rules regarding membership in a Federal Home Loan Bank (FHLB). FHLBs are critical sources of liquidity for many credit unions, and

based on a very preliminary assessment, the proposed regulation would make it much more difficult for credit unions to maintain access to the FHLB system. CUNA questions the need for the proposal at all.

This proposed rule, which is based on an advance notice of proposed rulemaking (ANPR) issued almost four years ago, creates two core requirements for financial institutions. First, the rule would require all financial institutions who are FHLB members to hold one percent of their assets in "home mortgage loans" on an ongoing basis. The proposed regulation suggests that FHFA is considering raising this requirement to as high as five percent in the future. While financial institutions currently must meet the one percent-of-assets threshold to become FHLB members, there is no requirement at this time that the member maintain it to remain a member.

Second, all FHLB-member credit unions—but, because of a statutory limitation in the *Federal Home Loan Bank Act*, only certain banks—would also be required to hold 10% of assets in "residential mortgage loans" on an ongoing basis. As with the one percent test, the 10%-of-assets threshold must be met by the institution in order to become a FHLB member, but there is no current requirement that the member maintain it to remain a member. Credit unions are not treated equally with banks in this regard because the Federal Home Loan Bank Act exempts from the "10 percent" requirement any "community financial institution," defined as FDIC-insured banks with less than $1 billion in average total assets (adjusted annually for inflation) over the preceding three years. Federally insured credit unions are not given parity with banks in this regard. The *Federal Home Loan Bank Act* should be amended to ensure credit unions are given parity and considered "community financial institutions."

Beyond correcting this statutory deficiency, we urge Congress to ask tough questions of FHFA regarding the need for this proposal as well as the details. Although we recognize FHFA has an interest in ensuring that FHLB members maintain a commitment to housing finance, we believe this is a regulation in search of a problem. We are unaware of any financial institutions who can jump through the substantial regulatory hoops to become FHLB members, who are willing to buy stock in the FHLBs, and who meet the 10% requirement at the time of membership who are not committed to housing. This regulation will create another compliance task for credit unions, who will be forced to maintain a close watch over their balance sheet to ensure they meet an arbitrary requirement on an ongoing basis. FHFA acknowledges that the proposed regulation will put the existing FHLB membership for some credit unions in jeopardy. Loss of FHLB membership will limit access to the low-cost sources of funding provided by the FHLBs, restricting credit at a time when our nation's housing recovery remains fragile.

We are also troubled by the 60-day comment period, which is simply not enough time given the important policy issues involved. If implemented as proposed, this rule may require credit unions to restructure their balance sheets to ensure compliance. Additional time is important to digest what the consequences of this proposal will be in the real world. In any event, it is unclear to us that there is an immediate need for FHFA to finalize this proposal on an accelerated basis, especially given the ANPR was initially issued almost four years ago. We have urged the agency to extend the comment period for a minimum of 60 additional days (for at least 120 total).

FHLB liquidity was a critical resource during the last financial crisis and the proposed regulation would limit its utility in a future crisis. We hope FHFA

will reconsider this proposal and look forward to working with the agency to make it work for credit unions.

Credit Union Ask the Senate to Approve House-Passed Regulatory Relief Legislation

As Congress approaches the conclusion of its session, we encourage the Senate to take action on the following measures which have already passed the House of Representatives.

H.R. 749 / S. 635 – the Privacy Notice Modernization Act

The *Privacy Notice Modernization Act* (H.R. 749 / S. 635) is an example of legislation that both reduces regulatory burden and improves consumer protection. The legislation would require financial institutions to send their customers privacy policy notifications when the privacy policy is changed. Under current law, financial institutions must send these notices on an annual basis regardless of whether the policy changes. This imposes a significant cost on credit unions and results in very little consumer benefit. Since 2001, credit unions have sent over 1 billion privacy notices to their members, averaging over 87,000,000 notices a year.

A voter survey conducted in 2013 showed that fewer than one-quarter of consumers read the privacy notifications they receive, and over three-quarters of consumers would be more likely to read them if they were only sent when the financial institution changed its policy. This suggests that the public policy goal of privacy notifications would be better achieved if the notices had more meaning to consumers. We believe that this legislation achieves this goal.

The legislation passed the House of Representatives in March 2013. A companion bill has been introduced in the Senate by Senators Brown (D-OH) and Moran (R-KS), enjoying cosponsorship by 72 Senators. We encourage the

Senate to pass this legislation and send it to the President's desk as soon as possible.

H.R. 3468 / S. 2698 / S. 2699 - Credit Union Share Insurance Fund Parity Act

We encourage the Senate to consider legislation providing parity in insurance coverage for lawyer trust accounts and other similar trust accounts held at a federally insured credit union. Senators King (I-ME), Warner (D-VA), Tester (D-MT) and Fischer (R-NE) have introduced regulatory relief legislation that includes a provision to address this issue: S. 2698, the Regulatory Easement for Lending Institutions that Enable a Vibrant Economy Act (RELIEVE Act); and S. 2699, a standalone measure that would address this issue.

The *Federal Credit Union Act* directs NCUA, which administers the NCUSIF, to provide insurance coverage that is on par with the Federal Deposit Insurance Corporation. However, the NCUSIF does not provide equal insurance treatment for certain types of accounts that are similar to accounts held by bank customers and insured by the FDIC, including Interest on Lawyer Trusts Accounts (IOLTAs) and other similar trust accounts.

An IOLTA is set up by an attorney as an escrow account containing pooled client funds, with interest generated by the funds going to support legal services for the poor. NCUA has stated that the client continues to own the money and that the attorney is only serving as a custodial agent; therefore, membership status (in the credit union) of the client(s), as the owner(s) of the funds, and not that of the attorney or IOLTA administrator, determines whether the IOLTA account can be maintained by the credit union and whether it is insurable.[15] As a result, in order for the attorney to maintain an IOLTA account

[15] NCUA legal opinion letter 96-0841

at most credit unions, all of the clients whose funds would be deposited must be members of the credit union.[16]

In May, the House of Representatives passed by voice vote H.R. 3468, a bill that would clarify that NCUSIF insurance coverage can be extended to IOLTA accounts, and other similar trust accounts. We encourage the Senate to resolve the disparity in treatment of IOLTA accounts by considering the House bill, S. 2698 or S. 2699 as soon as possible.

S. 1806 / H.R. 3584 - Capital Access for Small Community Financial Institutions Act

S. 1806 and its House companion, H.R. 3584, would correct a drafting oversight in the *Federal Home Loan Bank Act* which has resulted in a small number of privately insured credit unions ineligibility to join a Federal Home Loan Bank.

In 1989, in the wake of the savings and loan crisis, the Federal Home Loan Bank System was opened up for the first time to commercial banks and credit unions. Unfortunately, the bill was drafted in such a way to apply only to an "insured credit union" as defined under the *Federal Credit Union Act*. If the legislation had used a broader term – such as "state credit union" or "state-chartered credit union" terms that are clearly defined in the 12 USC 1752 of the *Federal Credit Union Act*, this would not be an issue. This is why, for many years, we have suggested that this was likely an oversight in drafting. Unfortunately, it has meant that this small group of credit unions has been denied the right to even apply for membership in the Federal Home Loan Bank System for over two decades.

[16] Federal credit unions that are designated as "low income" face fewer restrictions in setting up IOLTA accounts since they are allowed to accept non-member funds.

The House of Representatives has recognized this as a problem. In 2004 and 2006, the full House passed legislation to correct this. In 2008, as part of the *Housing and Economic Recovery Act of 2008*, Congress made a small change that permits privately-insured, state-chartered credit unions which are designated as CDFIs to apply for membership to the Federal Home Loan Banks; however, of the 132 privately insured credit unions, only two hold CDFI status.

We understand some policymakers have concerns with respect to the existence of a private insurance option for certain state chartered credit unions; however, this legislation would not expand that option for credit unions nor would it present an increased risk to the Federal Home Loan Bank System.

If this legislation were enacted, privately insured credit unions would not be the only non-federally insured institutions eligible for membership in the Federal Home Loan Bank System. Insurance companies, which are not federally insured, were original members of the System and they remain so today. In fact, 119 insurance companies presently borrow from the Federal Home Loan Bank System and report borrowings of nearly twice that of the 427 federally insured credit unions that also currently have advances outstanding, according to the *Combined Financial Report of the Federal Home Loan Bank System for the Quarter ending on September 30, 2013.*

It has never seemed fair to our small institutions that some of the largest banks in the world, or insurance companies (which are not federally insured) or a foreign bank's U.S. subsidiary can borrow billions of dollars from the Federal Home Loan Bank System, but credit unions serving teachers in Ohio and Texas, firefighters in California, postal and county workers in Illinois and farmers in Indiana cannot.

In May, the House of Representatives passed H.R. 3468 by a vote of 395-0. This bi-partisan piece of legislation would allow state-chartered, privately insured credit unions, to apply for membership in the Federal Home Loan Bank System. The Senate companion bill has been introduced in the Senate by Senators Brown (D-OH) and Portman (R-OH). We encourage the Senate to pass this bill as soon as possible.

S. 1916 / H.R. 2672 – Helping Expand Lending Practices in Rural Communities Act

S. 1916, and its House companion, H.R. 2672, would direct the CFPB to establish an application process to determine whether an area should be designated as a rural area if the CFPB has not designated it as one. Designation of "rural" by the CFPB has many implications for credit unions, particularly with respect to the type of products credit unions may offer their members in these areas. For instance, the Escrow Requirement under the *Truth in Lending Act* Rule requires certain lenders to create an escrow account for at least five years for higher-priced mortgage loans. If those loans are made by small lenders that operate predominately in rural or underserved counties, they are exempt from this requirement. Another example incudes the Ability to Repay and Qualified Mortgage (QM) Standards under the *Truth in Lending Act* Rule by which mortgage loans with balloon payments do not meet the QM definition. Like the Escrow Rule, small lenders that operate predominately in rural areas are eligible to originate balloon-payment QMs. The CFPB has defined "rural" by using the U.S. Department of Agriculture Economic Research Services' urban influence codes.

H.R. 2672 passed the House of Representatives by voice vote in May. We urge the Senate to pass this legislation prior to adjournment.

S. 1511 / H.R. 3211 - The Mortgage Choice Act

CUNA supports Senate passage of S. 1511, the *Mortgage Choice Act of 2013*. S. 1511 is bipartisan legislation that would give mortgage lenders much needed relief from the CFPB's "Ability to Repay/Qualified Mortgage (QM)" rule that was implemented due to provisions within the *Dodd-Frank Wall Street Reform and Consumer Protection Act.*

The current QM rule prohibits "Points & Fees" from exceeding three percent of the total loan amount. Due largely to the loose interpretation of what constitutes a "point" or a "fee", otherwise qualified borrowers will experience the inability to pass the QM test, consequently failing to have their loan approved.

The legislation would exclude from the calculation of points and fees, compensation paid to affiliated businesses, such as land title companies. Defining points and fees in this way will maintain a competitive marketplace, prevent over-pricing or limiting choice in low-moderate income areas and allow consumers to enjoy the existing benefit of working through one mortgage provider. The House of Representatives recently passed companion legislation (H.R. 3211) by voice vote.

Credit Unions Encourage the Senate to Consider Other Measures and Issues

S. 1927 – The Data Security Act

Credit unions take the security of member data seriously. Recent reports indicate that financial institutions discovered consumer data available for sale on the black market, and the data was traced to a breach at Home Depot. The reports also suggest the Home Depot breach may be larger in scope than the Target breach. While the investigation continues, this latest data security

breach demonstrates yet again the need for data security requirements for merchants.

Merchant data breaches have become a chronic issue, because data security standards are inconsistent across the board. Simply put, credit unions and other financial institutions are subject to high data protection standards under the Gramm-Leach-Bliley Act and merchants are not subject to federal data protection standards. Under today's federal law, there is no merchant accountability.

As today's hearing focuses on the unique challenges facing small financial institutions, it is important to recognize that the costs of a merchant data breach scenario for a small financial institution will be relatively greater than those of large financial intuitions. For example, a small credit union does not enjoy the economies of scale as a national megabank. Therefore, the costs of everything from replacing a debit card to monitoring suspicious activities, will be greater. Merchant data breaches are a continuing challenge for smaller financial institutions.

CUNA supports S. 1927, the *Data Security Act of 2014*, introduced by Senators Carper (D-DE) and Blunt (R-MO), would provide a national standard for businesses to protect sensitive consumer information, rather than a myriad of differing state laws and regulations. Importantly, this legislation recognizes the high data security protection standards that financial institutions must follow. Under this legislation, breached entities would be responsible for investigating the source of the breach and reporting the breach to appropriate authorities and the consumer(s) affected. Congress should act quickly to enact this legislation.

H.R. 3240 – The Regulation D Study Act

H.R. 3240, bipartisan legislation introduced by Representatives Pittenger (R-NC) and Maloney (D-NY), directs the Government Accountability Office (GAO) to study the impact of the Federal Reserve Board's monetary reserve requirements, implemented through Regulation D, on depository institutions, consumers and monetary policy. Credit unions became subject to monetary reserves in 1980.

Regulation D impacts credit union members by limiting the number of automatic withdrawals from a member's savings account to six transactions per month. The impact of this limit is to unnecessarily cause credit union members to overdraft their checking accounts when a debit draws the checking account balance below zero and the member has already had six automatic transfers during the month. When this happens, members who may have the funds in a savings account to cover the debit are hit with nonsufficient fund fees (NSF) from their financial institution and, when a check is involved, a returned check fee from the merchant. This is not a result of an overdraft protection program – this happens because of a regulatory cap on automatic transfers. It is difficult for credit union members affected by the cap to understand that this is out of the control of the credit union when the funds to cover the debit are sitting in their savings account at the credit union.

We would like to see this cap increased or eliminated altogether, but we understand that one of the reasons the regulation is in place is because the Federal Reserve uses it as a tool to conduct monetary policy. So, as a first step toward the possible change in this cap, the legislation directs the Government Accountability Office (GAO) to study the issue so that more information will be available for Congress to determine whether an increase in or the elimination of this cap would substantially affect their ability to conduct monetary policy.

Specifically, H.R. 3240 directs the GAO to examine and report within one year of enactment on the following topics: an historic overview of how the Federal Reserve has used reserve requirements to conduct monetary policy; the impact of the maintenance of reserves on depository institutions, including the operations requirements and associated costs; the impact on consumers in managing their accounts, including the costs and benefits of the reserving system; and, alternatives to required reserves the Federal Reserve may have to effect monetary policy. The bill also directs the GAO to consult with credit unions and community banks.

This bill is timely. According to former Federal Reserve Chairman Ben Bernanke, "...reserve balances far exceed the level of reserve requirements and the level of reserve requirements thus plays only a minor role in the daily implementation of monetary policy."[17] A GAO study will allow an objective assessment of whether the rarely changed monetary reserves imposed on depository institutions and consumers are necessary in order for the Fed to implement monetary policy in the 21st century. CUNA strongly supports this bill, which recently passed the House Financial Services Committee by voice vote.

H.R. 4466 – The Financial Regulatory Clarity Act

Credit unions support H.R. 4466, the *Financial Regulatory Clarity Act.* This commonsense bipartisan legislation would require financial regulators to determine whether new regulations are duplicative or inconsistent with existing Federal regulations. Requiring a regulator to consider whether its new rule or regulation is consistent with or duplicative of existing regulations would only contribute to stronger rule making and reduce regulatory burden.

[17] Letter from Federal Reserve Chairman Ben Bernanke to Representative Robert Pittenger, September 20, 2013.

H.R. 4226 – The Credit Union Residential Loan Parity Act

We support H.R. 4226, the *Credit Union Residential Loan Parity Act.* This legislation, introduced by Representatives Royce (R-CA) and Huffman (D-CA), addresses a disparity in the treatment of certain residential loans made by banks and credit unions. When a bank makes a loan to purchase a 1-4 unit non-owner occupied residential dwelling, the loan is classified as a residential real estate loan; however, if a credit union were to make the same loan, it would be classified as a business loan and therefore would be subject to the cap on member business lending under the *Federal Credit Union Act.*

H.R. 4226 would amend the *Federal Credit Union Act* to provide an exclusion from the cap for these loans. In addition, H.R. 4226 would authorize NCUA to apply strict underwriting and servicing requirements for the loans.

Enactment of this legislation would not only correct this disparity but it would also enable credit unions to provide additional credit to borrowers seeking to purchase residential units, including low-income rental units. Credit unions would be better able to meet the needs of their members, if this bill was enacted, and it would also contribute to the availability of affordable rental housing.

H.R. 4383 - Bureau of Consumer Financial Protection Small Business Advisory Board

Shortly after the CFPB was established, the Bureau leadership announced the creation of a credit union advisory council (CUAC). This group, the creation of which CUNA strongly urged, advises the agency on the impact of the Bureau's proposals on credit unions, sharing information, analyses, recommendations and the unique perspective of not-for-profit financial institutions with the agency director and staff. However, since the CUAC is not required by law, it could be abolished at any time. We believe the CUAC is an important resource for the agency and also provides a forum for credit union officials to provide

direct feedback to the agency on how proposals and final rules will affect credit unions' operations.

H.R. 4383, as amended by the House Financial Services Committee, codifies the CFPB Credit Union Advisory Council as a legal requirement. Working with the bill's sponsor, and the Chairman and Ranking Member of the House Financial Services Committee, language was inserted that would codify the CUAC and establish permanency for its needed existence. H.R. 4383 was passed by voice vote in the House Financial Services Committee. The full House of Representatives could consider the legislation before adjournment of the Congress; CUNA strongly supports its consideration and passage in the Senate.

S. 2641 / H.R. 2673 – The Portfolio and Mortgage Lending Access Act

CUNA supports S. 2641, the *Portfolio and Mortgage Lending Access Act*, introduced by Senator Landrieu (D-LA). This legislation allows for mortgages held in a credit union's portfolio to be automatically designated as a Qualified Mortgage, per the CFPB's mortgage lending rules. The House Financial Services Committee approved the companion bill (H.R. 2673) earlier this year.

Designating a mortgage held on a financial intuitions' balance sheet as a QM loan is appropriate, because the lender retains all of the risk involved with these mortgages and is subject to significant safety and soundness supervision from its prudential regulator. Historically, credit unions are portfolio lenders. This bill would allow them to continue in that fashion, extending mortgage credit to their credit worthy members, even if they do not fit the cookie cutter QM box.

S. 2732 – Consumer Financial Protection Bureau Examination and Reporting Threshold Act

In July, Senators Toomey (R-PA) and Donnelly (D-IN) introduced S. 2732, the *Consumer Financial Protection Bureau Examination and Reporting Threshold*

Act of 2014. This legislation would increase the threshold for examination of banks and credit unions by the CFPB from $10 billion to $50 billion.

Raising this threshold would provide significant regulatory relief to the affected institutions and direct Bureau resources to the examination of the institutions that serve the greatest number of consumers. While this change would not significantly change the number of institutions and percentage of assets presently subject to examination by the Bureau, it would allow the Bureau to more efficiently use its examination resources in the coming years. The number of financial institutions approaching $10 billion in total assets is increasing. As these institutions cross the threshold, the Bureau will be required to spend more of its resources examining these newly covered institutions at the expense of other activities.

Institutions affected by this change would continue to be subject to the Bureau's rules and regulations, and they would be examined for compliance with these rules by their prudential regulator. In addition, Section 1026 of the *Dodd-Frank Act* provides the Bureau authority to examine on a sampling basis credit unions, thrifts and banks for which it does not have examination authority and includes language directing coordination between the prudential regulators and the Bureau.

While we support the legislation that has been introduced, we would encourage the Committee to consider adding language to index the threshold for inflation.

CFPB's Exemption Authority

As the Committee considers additional ways to address the regulatory burden facing credit unions, we urge the Committee to ask the CFPB to conduct a review of its regulations to identify and address outdated and unnecessary

regulations with an eye toward reducing unwarranted regulatory burden, as directed by Section 1021(b)(3) of the *Dodd-Frank Act*.

Further, we ask the Committee to encourage the CFPB to use the exemption authority Congress conveyed to it under Section 1022(b)(3) of the *Dodd-Frank Act* with alacrity. We believe the CFPB has more authority than it has been exercising to extend relief to credit unions and others from certain compliance responsibilities. We are very concerned that the CFPB seems to be picking and choosing when to use the statutory flexibility Congress provided under the *Dodd-Frank Act*. It is important that Congress aggressively urges the CFPB to utilize the exemption clause so that the weight of compounding regulations that are intended for abusers and the largest financial institutions do not overburden credit unions and other smaller financial institutions. The CFPB's failure to use this authority as Congress intended may ultimately drive good actors out of markets, forcing consumers to do business with those entities that remain – we have seen this already in the remittance transfer market.

We encourage Congress to urge the CFPB to exercise its exemption authority as broadly as possible to protect credit unions from burdensome overregulation, which ultimately impacts consumers. Further, CUNA has urged the CFPB to include an analysis of its exemption authority with every proposal and final rule so that every time the CFPB considers a new regulation, it will also consider whether institutions such as credit unions that are already heavily regulated should be exempted. The default should be exclusion unless an actual need is demonstrated.

Along these lines, we strongly encourage the Committee as it considers additional regulatory relief legislation to consider ways to more directly exempt credit unions and small banks from the CFPB's rulemaking.

Conclusion

Credit unions were established to promote thrift and provide access to credit for provident purposes, but their ability to fulfill this mission is complicated by the ever increasing, never decreasing regulatory burden imposed on them by Congress and regulators. Without meaningful relief, the trend of consolidation in the credit union sector will continue, jeopardizing American's access to affordable financial services from cooperatively run not-for-profit financial institutions. The 100 million members of America's credit unions need Congress to act.

On behalf of the 6,600 credit unions and their 100 million members, thank you very much for holding today's hearing and providing me the opportunity to express my views. I am happy to answer any questions the Members of the Committee may have.

NAFCU

Testimony of

Linda McFadden

President and CEO of XCEL Federal Credit Union

On behalf of

The National Association of Federal Credit Unions

"Examining the State of Small Depository Institutions"

Before the

United States Senate Banking Committee

September 16, 2014

Introduction

Good morning Chairman Johnson, Ranking Member Crapo and Members of the Committee. My name is Linda McFadden and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I am happy to be appearing before the Committee today to talk about the state of small financial institutions. I look forward to giving a general overview of the current regulatory environment and the most timely issues credit unions, including smaller credit unions like mine, face today.

XCEL Federal Credit Union is headquartered in Bloomfield, New Jersey. We were started in 1964 by the employees of the Port Authority of New York and New Jersey and are celebrating our 50th Anniversary this year. Over the past 50 Years, XCEL's field of membership has grown to include other agencies in the New York and New Jersey area along with many other smaller groups. Today we have over $155 million in assets and over 18,000 members. Until the tragic events of September 11th, we were headquartered in the World Trade Center (Tower 1 – 39th Floor), but now we call North Jersey our home. For four years in a row we have been named one of the best places to work in New Jersey by NJBIZ and we were recognized as NAFCU's Credit Union of the Year for 2014, in the small asset class.

I have 40 years of experience in the financial services sector and have been with XCEL since the beginning of 2001, first as Vice President of Operations, where I helped implement our disaster recovery operations post-9/11, and then as President and CEO from 2006 until today.

As you are aware, NAFCU is the only national organization exclusively representing the interests of the nation's federally-chartered credit unions. NAFCU-member credit unions collectively account for approximately 69 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in today's hearing regarding the state of our nation's smaller financial institutions, such as credit unions.

Historically, credit unions have served a unique function in the delivery of essential financial services to American consumers. Established by an Act of Congress in 1934, the federal credit

union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom may otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need – a niche that credit unions still fill today.

Every credit union, regardless of size, is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While over 80 years have passed since the Federal Credit Union Act (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain wholly committed to providing their members with efficient, low-cost, personal financial service; and,

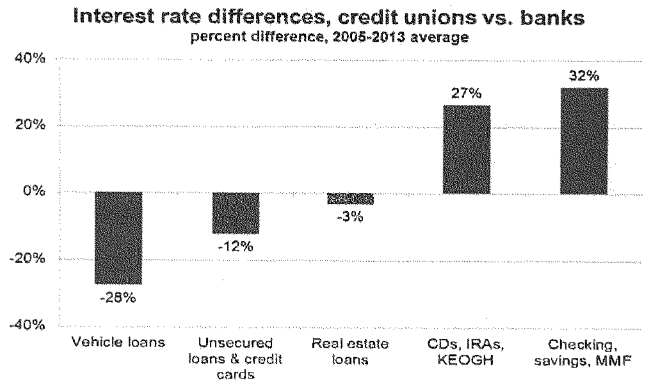
- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

These principles apply for all credit unions, regardless of their size. When compared with the nation's "Too Big To Fail" financial institutions, all credit unions are "small" institutions. It is with this fact in mind that NAFCU believes that there should not be artificial or arbitrary asset thresholds established for which size credit unions should receive regulatory relief. The challenges facing the industry impact, or stand to impact, all credit unions and all ultimately need relief.

I. Increased Regulatory Burden has Impacted Credit Unions

Credit unions have a long track record of helping the economy and making loans when other lenders often have left various markets. This was evidenced during the recent financial crisis when credit unions kept making auto loans, home loans, and small business loans when other lenders cut back. Still, credit unions have always been some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital.

Credit unions continue to play a crucial role in the recovery of our nation's economy. Credit unions remain a relatively small part of the marketplace when compared to the banking industry. They are oftentimes a lender of last resort for consumers that have been denied credit via other financial institutions. As detailed in the chart below, on average from 2005-2013, credit unions consistently outperformed banks with lower interest rates on loans and higher returns on savings and deposits.



Today, credit union lending continues to grow at a solid pace, up about 18% in June compared to 2009. In short, credit unions didn't cause the financial crisis, helped blunt the crisis by continuing to lend during difficult times, and perhaps most importantly, continue to play a key role in the still fragile economic recovery. Although credit unions continue to focus on their members, the increasing complexity of the regulatory environment is taking a toll on the credit union industry. While NAFCU and its member credit unions take safety and soundness extremely seriously, the regulatory pendulum post-crisis has swung too far towards an environment of overregulation that threatens to stifle economic growth. As the National Credit Union Administration (NCUA) and the Consumer Financial Protection Bureau (CFPB) work to prevent the next financial crisis, even the most well intended regulations have the potential to regulate our industry out of business.

During the consideration of financial reform, NAFCU was concerned about the possibility of overregulation of good actors such as credit unions, and this was why NAFCU was the only credit union trade association to oppose the CFPB having rulemaking authority over credit unions.

Unfortunately, many of our concerns about the increased regulatory burdens that credit unions would face under the CFPB have proven true. While there are credible arguments to be made for the existence of a CFPB, its primary focus should be on regulating the unregulated bad actors, not adding new regulatory burdens to good actors like credit unions that already fall under a functional regulator. As expected, the breadth and pace of CFPB rulemaking is troublesome, and the unprecedented new compliance burden placed on credit unions has been immense. While it is true that credit unions under $10 billion are exempt from the examination and enforcement from the CFPB, all credit unions are subject to the rulemakings of the agency and they are feeling this burden. While the CFPB has the authority to exempt certain institutions, such as credit unions, from agency rules, they have been lax to use this authority to provide relief.

The impact of this growing compliance burden is evident as the number of financial institutions continues to decline, dropping by 21% (more than 1,600) institutions since 2007. This trend rings true for credit unions as well, and a main reason for the decline is the increasing cost and complexity of complying with the ever-increasing onslaught of regulations. Since the 2^{nd} quarter of 2010, we have lost 1,025 federally-insured credit unions, 96% of which were smaller institutions below $100 million in assets. Many smaller institutions simply cannot keep up with the new regulatory tide and have had to merge out of business or be taken over. Credit unions need regulatory relief, both from Congress and their regulators.

This growing demand on credit unions is demonstrated by a 2011 NAFCU survey of our membership that found that nearly 97% of respondents were spending more time on regulatory compliance issues than they did in 2009. A 2012 NAFCU survey of our membership found that 94% of respondents had seen their compliance burdens increase since the passage of the *Dodd-Frank Act* in 2010. Furthermore, a March 2013 survey of NAFCU members found that nearly 27% had increased their full-time equivalents (FTEs) for compliance personnel in 2013, as compared to 2012. That same survey found that over 70% of respondents have had non-compliance staff members take on compliance-related duties due to the increasing regulatory burden. This highlights the fact that many non-compliance staff are being forced to take time away from serving members to spend time on compliance issues. Furthermore, a number of credit unions have also

turned to outside vendors to help them with compliance issues – a survey of NAFCU members, conducted in June of 2014, found that nearly 80% of respondents are using third-party vendors to help comply with the new CFPB TILA-RESPA requirements.

At XCEL FCU we have felt the pain of these burdens as well. There are costs incurred each time a rule is changed and most costs of compliance do not vary by size, therefore it is a greater burden on smaller credit unions like mine when compared to larger financial institutions. We are required to update our forms and disclosures, to reprogram our data processing systems and to retrain our staff each time there is a change, just as large institutions are. Unfortunately, lending regulation revisions never seem to occur all at once. In recent years, XCEL FCU has spent over $13,000 just to update our loan documents and train our staff on these new documents. If all of the changes were coordinated and were implemented at one time, these costs would have been significantly reduced and a considerable amount of XCEL FCU's resources that were utilized to comply could have been used to benefit our members instead.

In some cases, our ability to provide service to our members has been hindered. For example, XCEL FCU eliminated processing outgoing international wires and ACHs due to the complexity of the revised remittance regulations that were implemented. We felt the risk and compliance requirements involved with providing these services were excessive.

In 2013, the CFPB implemented eight new mortgage rules, seven of which were finalized in October 2013 and were effective by January 2014. A majority of credit unions are small financial institutions like mine which operate with a limited staff. It is a struggle to keep abreast with the constantly changing regulations. Tracking the proposals and the changes made to them as they work through the regulatory process began to monopolize my senior management's time. Timeframes between when the rules are being finalized and are effective are often becoming shorter and shorter. These shorter periods do not provide ample time to read through these rules and implement and update systems and procedures to ensure that we stay in compliance. This is one of the reasons that I found it necessary to hire an additional staff person to work as a

Compliance Officer, so that my senior management staff can concentrate on other responsibilities that they have. This cost is an additional $50,000 in salary and benefits, which is a considerable amount for a small institution like mine.

NAFCU continues to hear from its member credit unions that "enough is enough" when it comes to the overregulation of credit unions. Small credit unions are going away and larger credit unions are even having a hard time keeping up. If Congress and the regulators do not act to provide regulatory relief to credit unions, the industry may look vastly different a decade from now..

II. NCUA's Risk-Based Capital Proposal: Regulating Credit Unions Out of Existence

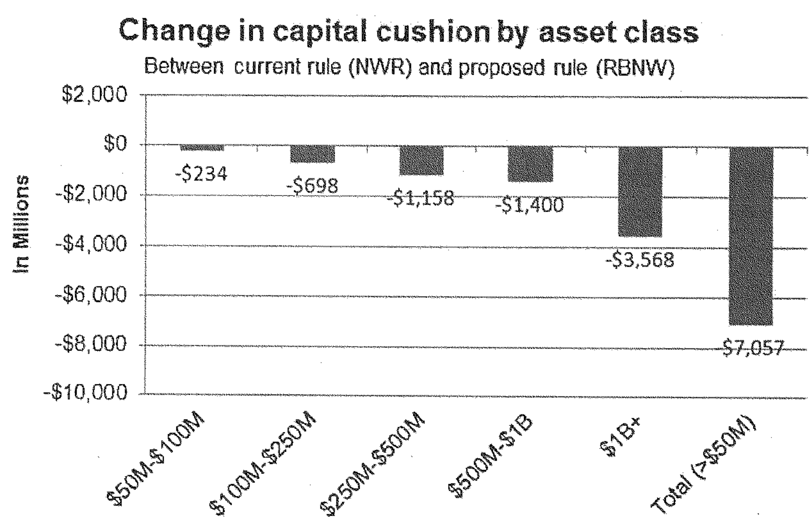
The biggest challenge facing XCEL FCU today is NCUA's risk-based capital proposal. Capital requirements should not be a substitute for proper credit union management or appropriate examinations. The proposal, as it is written, would negatively impact XCEL FCU, taking us from a well-capitalized credit union to adequately-capitalized. This proposal will be putting restraints on the growth of credit unions and will restrict XCEL from implementing products and programs which are needed to compete in the financial industry. While the NCUA has stated that one of the primary purposes of this rule is to protect the National Credit Union Share Insurance Fund (NCUSIF), we believe that reducing assets and cutting expenses to gain capital is not the solution for safety and soundness of the insurance fund. Running a fundamentally sound financial institution, while providing our members with the best products and services, and the latest technology is a necessity to keep us viable in this industry for generations to come.

This ongoing issue is of the utmost importance to credit unions of all sizes and the one-size-fits-all approach currently being taken by NCUA will stifle growth, innovation and diversification, not only at XCEL, but at credit unions in general.

The proposed rule will force XCEL's board and management to change our business model even though we have had steady balanced growth with good solid returns over the past few years. We have developed a sound concentration risk policy and set limits on our diversified loan and

investment portfolio. This proves that our credit union has been managing this portion of the business well for years. If the NCUA continues forward without heeding current concerns on the proposal, XCEL would need to curtail certain aspects of our lending, ultimately hurting our members and the local economy.

NAFCU's Economics and Research department prepared the impact analysis graph found below that outline the impact the proposal would have on credit unions based on their asset size. NAFCU's analysis of the proposed rule determined that credit unions with more than $50 million in assets will have to hold $7.1 billion more in additional reserves to achieve the same capital cushion levels that they currently maintain.



While NCUA contends that a lower amount of capital is actually needed to maintain current capital levels, the agency ignores the fact that most credit unions maintain a capital cushion above the minimum needed for their level – often because NCUA's own examiners have encouraged them

to do so. Because credit unions cannot raise capital from the open market like other financial institutions, this cost will undoubtedly be passed on to the 98 million credit union members across the country. A survey of NAFCU's membership taken found that nearly 60% of respondents believe the proposed rule would force their credit union to hold more capital, while nearly 65% believe this proposal would force them to realign their balance sheet. Simply put, if the NCUA implements this rule as proposed, credit unions will have less capital to loan to credit-worthy borrowers, whether for a mortgage, auto, or business loan.

Additionally, it is also worth drawing the Committee's attention to the chart below breaking-down risk-weighting at the FDIC (under Basel III) compared to the proposed risk-weighting by NCUA highlighting the areas that will be especially problematic for our nation's credit unions.

	Category	Sub-Category	NCUA proposal	FDIC weights
Numerator	Liabilities		1	1
	Equity		1	1
	Contra Assets		1	1
	Other Assets	Goodwill	-1	-1
		Identifiable intangible assets	-1	-1
		NCUSIF	-1	**
Denominator	Cash		0	0
	Investments*	0-1 Year	0.2	0.2
		1-3 Years	0.5	0.2
		3-5 Years	0.75	0.2
		5-10 Years	1.5	0.2
		>10 Years	2	0.2
		Corporate CU Member Capital	1	**
		Corporate Paid-in Capital	2	**
	Real Estate Loans	Nondelinquent 1st mort R/E loans (excl. MBLs)		
		<25% of assets	0.5	0.5
		25-35% of Assets	0.75	0.5
		>35% of Assets	1	0.5
		Other R/E and delinquent R/E		
		<10% of Assets	1	1
		10-20% of Assets	1.25	1
		>20% of Assets	1.5	1
	Other Loans	Nondelinquent student loans	1	1
		Nondelinquent other loans	0.75	1
		Delinquent other loans	1.5	1.5
		SBA	-0.8	-0.8
		Member business loans		
		<15% of Assets	1	1
		15-25% of Assets	1.5	1
		>25% of Assets	2	1
	Other Assets	Goodwill	-1	-1
		Identifiable intangible assets	-1	-1
		NCUSIF	-1	**
		Invt in CUSO	2.5	**
		Mort servicing rights	2.5	2.5
		All other assets	1	1
	Off Bal Sheet	Loans with recourse	0.75	**
		Unfunded commitments bus loans (75% conversion)	1	**
		Unfunded commitments non-bus loans (10% conversion)	0.75	**
	Capitalization thresholds			
		Well Capitalized	10.5%	10.0%
		Adequately Capitalized	8.0%	8.0%

* U.S. Treasuries and other direct and unconditional claims on the U.S. government are weighted at zero by both NCUA and FDIC. Most other credit union investments are weighted from 0.2 to 2 according to their maturity. They would generally be rated at a constant 0.2 under the FDIC rule.

** No direct comparison with FDIC

Widespread concern about this proposal is also highlighted by the over 2,000 comment letters NCUA has received to date about the content of the proposal and the process used to fast track the

rule despite credit unions not contributing to the financial crisis. In NAFCU's own comment letter submitted on May 27, 2014 (attachment A) signed by the NAFCU Board of Directors and Regulatory Committee members, significant concerns about the proposal included:

- Several issues related to NCUA's legal authority to issue the rule as proposed, such as:
    - Comparability with banking regulatory requirements;
    - Substitution of statutorily defined legal terms;
    - Individual minimum capital requirements;
    - Definition of a "complex" credit union;
- The need for a legislative solution in order to achieve a fair and balanced risk-based capital system;
- NCUA's treatment of the regulatory process including the refusal to extend the comment period, form an industry working group prior to releasing a proposed rule, and the need for an additional notice of proposed rulemaking with public comment period;
- NCUA's drastic understatement of credit unions that will be affected by this rule and whose balance sheets and business plans will need adjustment;
- NCUA's proposed risk-based capital ratio for well capitalized credit unions set at 10.5 percent;
- NCUA's treatment of risk-weighted assets and the lack of explanation for deviation from similar banking risk-weights;
- NCUA's incorporation of interest rate and concentration risk into risk-weighting for real estate, investments, and member business loans (MBL's);
- Individual minimum capital requirements for credit unions including issues with the subjectivity of their imposition;
- Components not included in the numerator portion of the risk-based capital ratio, such as goodwill;
- The 1.25 percent cap on Allowance for Loan and Lease Losses (ALLL) especially considering the Financial Accounting Standards Board's (FASB) most recent proposal on ALLL;

- Supplemental capital authority is needed now more than ever considering the restrictions brought on by this rule; and
- The proposed 18-month implementation timetable is not long enough for a rule as complex and impactful as this proposed rule.

Many of these concerns were also expressed by XCEL FCU in our own comment letters (attachment B) and by the numerous Members of Congress who have also weighed in with NCUA. On behalf of NAFCU member credit unions and the entire credit union community, we want to thank all of you for your steadfast support. The outpouring of concern from Congress has been significant and NAFCU remains hopeful that a final rule will address many of the issues raised.

Despite NCUA's refusal to extend the official comment period, this summer's listening sessions on the proposal in Los Angeles, Chicago, and Alexandria, Virginia, reinforce the need for significant changes to the proposal and additional time for credit unions to digest the proposal and come into compliance. During these listening sessions, credit unions repeatedly stated that they believe that, given the magnitude of this rule and its potentially devastating effects on our member credit unions, it is imperative that NCUA re-propose the rule and put it out for additional comment.

As many of you are aware, the *Administrative Procedure Act* (APA) not only mandates consideration of all submitted comments, but it also requires an agency to engage in a subsequent comment period when the agency makes such substantive changes to a rule that it is no longer a logical outgrowth of the proposal. If NCUA implements changes to the proposed rule in accordance with even some of the 2,000 comments received, the changes will be substantive, and more than mere adjustments or clarifications to the initial proposal. In fact, both Chairman Matz and Board Member Metsger have publically supported changing the treatment of risk-weighted assets. NAFCU believes that this change alone would be substantive under the APA and warrant reissuing the proposal for public comment.

Furthermore, NAFCU encourages NCUA to allow credit unions the opportunity to voice their thoughts and concerns. The 2,000 comments submitted for the proposal clearly exemplify that credit unions around the country have a vested interested in this issue and they deserve the

opportunity to comment given the magnitude of the potential negative impact of this proposal. Credit unions believe it is critical that NCUA effectively consider and incorporate industry input to ensure that an appropriate risk-based capital regime is adopted for the credit union industry. In the best interests of all stakeholders, therefore, credit unions urge the NCUA Board to operate in a collaborative manner with the credit union industry and reissue the risk-based capital proposal for comment so that we may have the necessary opportunity to raise concerns and suggestions. Doing so, even if not required by the APA, would be good policy for the agency.

Should NCUA's proposal go forward with little or no changes, the new rule would precipitate the need for Congressional action on proposals to bring about capital changes for credit unions such as allowing credit unions to have access to supplemental capital sources. In addition this would prompt the need for statutory changes necessary to design a true risk-based capital system for credit unions. Lastly, a final rule mirroring the proposal in terms of an individual credit union's risk-based capital requirements being changed through the exam process only reinforces the need for action on S. 727, the *Financial Institutions Examination Fairness and Reform Act*. In such a circumstance, it would also be important for Congress to be ready to enact a "stop and study" requirement on NCUA to allow further examination of the issues surrounding the proposal while providing time for action on the legislative fixes that would be necessary. NAFCU looks forward to continuing to work with Congress on this timely issue.

III. NAFCU's Legislative and Regulatory Approaches for Relief

Regulatory burden is also a top challenge facing all credit unions. While smaller credit unions continue to disappear from the growing burden, all credit unions are finding the current environment challenging. Finding ways to cut-down on burdensome and unnecessary regulatory compliance costs is the only way for credit unions to thrive and continue to provide their member-owners with basic financial services and the exemplary service they need and deserve. It is also a top goal of NAFCU.

Ongoing discussions with NAFCU member credit unions led to the unveiling of NAFCU's "Five Point Plan for Regulatory Relief" [attachment C] in February 2013, and a call for Congress to

enact meaningful legislative reforms that would provide much needed assistance to our nation's credit unions. The "Five Point Plan" covers key areas for credit unions including: Administrative Improvements for the Powers of NCUA; Capital Reforms for Credit Unions; Structural Improvements for Credit Unions; Operational Improvements for Credit Unions; and, 21st Century Standards for Data Security.

Recognizing that there are a number of outdated regulations and requirements that no longer make sense and need to be modernized or eliminated, NAFCU also compiled and released a document entitled "NAFCU'S Dirty Dozen" [attachment D] in December 2013, that outlines twelve key regulatory issues credit unions face that should be eliminated or amended. The "Dirty Dozen" includes expanding credit union investment authority; updating NCUA's fixed assets rules; improving the process for credit unions seeking changes to their field of membership; increasing the number of transactions allowed to be made per month from savings accounts per the Federal Reserve Regulation D; providing flexibility for credit unions that offer member business loans; updating requirements to disclose account numbers to protect privacy of credit union members; updating advertisement requirements for loans products and share accounts; modernizing NCUA advertising requirements; making improvements to the Central Liquidity Fund; providing flexibility for federal credit unions to operate under state law in certain circumstances; simplifying regulations governing check processing and funds availability; and, eliminating redundant NCUA requirements to provide copies of appraisals upon request.

Our "Five Point Plan" and "Dirty Dozen" outline a number of areas where credit unions need action on both the legislative and regulatory fronts. We urge the Committee to review these documents. In our statement today, we highlight a number of key issues where regulatory burdens and proposals are posing immediate threats to the ability of credit unions to serve their members and give them the financial products that they want.

IV. Pending Bills Before the Senate to Provide Relief

There are several measures awaiting action in the Senate that would take small steps to provide relief to credit unions, and we would encourage the Senate to act on them this year.

S. 635, *The Privacy Notice Modernization Act of 2013*

We applaud Senators Brown and Moran for their leadership on this issue. This bipartisan legislation would remove the requirement that financial institutions send redundant paper annual privacy notices if they do not share information and their policies have not changed, provided that they remain accessible elsewhere. These duplicative notices are costly for the financial institution and often confusing for the consumer as well. Similar legislation has passed the House by voice vote and this legislation has over 70 cosponsors in the Senate. We strongly encourage the Senate to pass this small measure of relief this year.

S. 2698, *The RELIEVE Act*

We applaud Senators King, Warner, Tester and Fischer for their leadership in introducing this legislation, a key element of which would provide important relief to credit unions with Interest on Lawyers Trust Accounts (IOLTAs). Maintaining parity between the coverage provided by the National Credit Union Share Insurance Fund (NCUSIF) and the Federal Deposit Insurance Corporation (FDIC) on all types of deposits and accounts is imperative and a longstanding goal of NAFCU member credit unions. Consumers often do not distinguish between the government backing on accounts at financial institutions. It is important that the law dictate that there is no difference in coverage, so as not to favor one type of institution over another in the marketplace. NAFCU is pleased that the legislation, along with S. 2699, will provide NCUSIF parity with the FDIC for certain accounts, including IOLTAs. This issue passed the House by voice vote earlier this year and we urge the Senate to act on this issue.

S. 1577, *The Mortgage Choice Act of 2013*

We applaud Senators Manchin, Johanns, Toomey, Kirk, Stabenow and Levin for their leadership in introducing this measure. The *Mortgage Choice Act of 2013* would make important changes that would exclude affiliated title charges from the "points and fees" definition, and clarify that escrow charges should be excluded from any calculation of "points and fees." These changes would greatly improve the definition of "points and fees" used to determine whether a loan meets the QM test, and would ensure that those with low and moderate means would continue to be able

to obtain their mortgages from their credit union at a reasonable price. We urge the Senate to advance this issue.

S.2732, *The CFPB Examination and Reporting Threshold Act of 2014*

We applaud Senators Toomey and Donnelly for introducing this legislation to address the arbitrary $10 billion threshold for examination of depository institutions by the CFPB. As I noted earlier in my statement, NAFCU believes that all credit unions, as good actors during the financial crisis, should be exempt from being subject to the CFPB and would support adding language to the legislation exempting all credit unions in place of the proposed $50 billion threshold.

Relief from the Credit Union MBL Cap

NAFCU supports and urges action on S. 968, the *Small Business Lending Enhancement Act of 2013,* introduced by Senators Mark Udall and Rand Paul, to raise the arbitrary cap on credit union member business loans. This issue is of particular concern to XCEL FCU, as we found ourselves approaching the cap in 2012, but ultimately had to change our business practices when Congress did not act to change the cap.

We would also urge Congressional action on legislation to exclude loans made non-owner occupied 1- to 4-family dwelling from the definition of a member business loan. We would urge Congressional action on legislation to exempt loans made to our nation's veterans from the definition of a member business loan. Such a measure can not only help our nation's returning heroes, but also the American economy.

Examination Fairness

Credit unions now face more examiner scrutiny than ever, as the examination cycles for credit unions have gone from 18 months to 12 months since the onset of the financial crisis even though credit union financial conditions continue to improve. Additional exams mean additional staff time and resources to prepare and respond to examiner needs. NAFCU has concerns about the continued use of Documents of Resolution (DOR) when they are not necessary or are used in place of open and honest conversations about examiner concerns. A survey of NAFCU members earlier this year found that nearly 40% of credit unions who received DORs during their last exam felt it was

unjustified and nearly 15% of credit unions said their examiners appeared less competent than in the past. NAFCU supports effective exams that are focused on safety and soundness and flow out of clear regulatory directives

New examination fairness provisions should be enacted to help ensure timeliness, clear guidance and an independent appeal process free of examiner retaliation. As outlined earlier, NAFCU supports the bipartisan S. 727, the *Financial Institutions Examination Fairness and Reform Act* which was introduced on April 15, 2013, by Senators Manchin and Moran. Credit unions must have adequate notice of and proper guidance for exams, the right to appeal to an independent administrative law judge during the appeal process, and be assured that they are protected from examiner retaliation.

V. Areas Where Regulators Can Provide Relief to Credit Unions

While my testimony has outlined important issues impacting credit unions and highlighted steps that Congress can take to help, there are additional steps that the NCUA, CFPB and the Federal Reserve can currently take to provide relief without Congressional action and we would encourage them to do so.

NCUA

We are pleased that the National Credit Union Administration has been willing to take some small steps recently to provide credit unions relief. A prime example of this is the agency's new fixed-asset rule this summer. This is a topic that is on NAFCU's "Dirty Dozen" and the agency deserves credit for taking steps to address it.

We are also glad to see NCUA's voluntary participation in review of its regulations pursuant to the *Economic Growth and Regulatory Paperwork Reduction Act of 1996* (EGRPRA). This review provides an important opportunity for credit unions to voice their concerns about outdated, unnecessary or unduly burdensome requirements of NCUA's Rules and Regulations.

Member Business Lending

A major area where we think NCUA can use its authority to provide relief is with member business lending. The Member Business Lending (MBL) regulation, as NAFCU and our members have consistently maintained, is far too restrictive and cumbersome.

As NAFCU outlined in both its March 5, 2014, letter to NCUA Board and its "Dirty Dozen" list of regulations to eliminate or amend, there are several aspects of the MBL requirements which should be improved, including: changes to the waiver requirements and waiver process to make it more efficient and easier to obtain individual and blanket waivers; expanding opportunities to obtain waivers; and removing the five year relationship requirement to obtain a personal guarantee waiver. Additionally, NCUA should use its authority granted in the *Federal Credit Union Act* (FCU Act) to provide an exception to the limitations on member business loans (the MBL cap) for those credit unions that have a history of making MBLs to their members for a period of time.

Section 1757a of the FCU Act contains the limitations on MBLs. Under Part 723 of NCUA's Rules and Regulations, the aggregate MBL limit for a credit union is limited to the lesser of 1.75 times the credit union's net worth or 12.25% of the credit union's total assets. However, the FCU Act also contains exceptions to the MBL cap. In particular, it provides exception authority from the MBL cap for "an insured credit union chartered for the purpose of making, **or that has a history of primarily making, member business loans to its members** (emphasis added), as determined by the Board." *See*, 12 U.S.C. § 1757a(b)(1).

Traditionally, this provision in § 1757a has been construed narrowly by NCUA. Section 723.17(c) of NCUA's Rules and Regulations currently defines credit unions that have a history of primarily making member business loans as credit unions that have either 25 percent of their outstanding loans in member business loans or member business loans comprise the largest portion of their loan portfolios, as evidenced by any Call Report or other document filed between 1995 and 1998. NAFCU continues to hear from our members that this definition is overly restrictive and often prevents them from extending sound loans to their small business members, many of whom have been abandoned by other financial institutions due to their smaller size.

NAFCU has urged NCUA to take a broader interpretation of the history of primarily making MBLs provision of the FCU Act. This can be done by NCUA utilizing its statutory authority to create an exception from the MBL cap for all credit unions that have a history of making MBLs for an extended period of time. NAFCU and our members believe that a credit union that has had a successful MBL program in place for a period of five years or greater would be a reasonable basis to satisfy this statutory authority.

NCUA has explained that the current definition "focuses on a credit union's historical behavior during the years leading up to the enactment of the *Credit Union Membership Access Act* (CUMAA)." NAFCU and our members believe this focus is unnecessarily restrictive, and we have urged the agency to expand the scope of the definition. NAFCU contends that it would be more appropriate for NCUA to consider a credit union's history of making MBLs in general, rather than restricting its focus solely to a credit union's behavior from 1995 through 1998. In particular, we believe the agency should define credit unions that have had a successful MBL program in place for at least five years as having a "history of primarily making MBLs." NAFCU has encouraged the NCUA Board to set this standard and make the exception available to all credit unions.

NCUA expanding the opportunities for credit unions to obtain waivers is another area where they could help. In February 2013, NCUA issued supervisory letter 13-01 to credit unions attempting to shed light on the criteria and processes for obtaining MBL waivers. While this guidance was useful to credit unions, NAFCU continues to hear from its members that the waiver process is complicated, slow moving, and inefficient. As a result, many credit unions have been unable to extend sound loans to their small business members, loans which may have been lost to competitors, or worse, never extended at all.

While waivers should not be used so frequently that they are the norm, the process to obtain one should not be so excessively difficult as to prevent credit unions from serving their membership effectively. Healthy, well-run credit unions with risk focused MBL programs that maintain appropriate policies and procedures and that perform adequate due diligence on their member

borrowers should be able to apply for and obtain blanket waivers which would help their membership.

Furthermore, the MBL regulations should be amended to expand a credit union's ability to obtain an individual or blanket waiver. Credit unions, because of their fundamental nature, are in a great position to extend credit to small businesses which will help fuel our nation's economic recovery. Expansion of the waiver capabilities would enable well run credit unions to extend loans to their small business members.

As noted above, the FCU Act contains the limitations on and exceptions to MBLs. However, the FCU Act does not prescribe limitations on the waivers that NCUA can put in place with regard to the regulations it imposes for MBLs that are not statutory requirements.

Section 723.10 of NCUA's Rules and Regulations contains an enumerated list of MBL related requirements for which a credit union can apply for a waiver. NAFCU believes that this enumerated list of available waivers should be replaced with a more flexible waiver provision that would allow a credit union to apply for, and obtain, a waiver from a non-statutorily required MBL regulatory requirement. The use of an enumerated list necessarily restricts a credit union from obtaining a waiver of a requirement which is not listed, even where such a waiver would not pose a safety and soundness concern to the credit union. NAFCU encourages NCUA to amend Section 723.10 to provide a more flexible waiver provision.

NCUA could issue appropriate guidance for the types of waivers that a credit union could obtain using a more flexible standard, which could include enumerated lists and appropriate examples. Section 723.11 of NCUA's Rules and Regulations contains the procedural requirements for a credit union to obtain a waiver, and it requires a credit union to submit a waiver request accompanied by a great deal of information related to the credit union's member business loan program. Under a more flexible provision, and taking into account safety and soundness considerations, NCUA should be able to determine from the information required to be provided pursuant to Section 723.11 whether a waiver is appropriate for a credit union. This approach would

enhance a credit union's ability to provide MBLs to its members without compromising the safety and soundness of the credit union.

Advertising

Another area where NCUA could provide relief would be to amend its Rules and Regulations to accommodate for the rise of social media and mobile banking. Regulations governing advertising, such as 12 CFR 740.5, for example, contain requirements that are impossible to apply to social media and mobile banking, especially medias that are interactive. These rules should be amended with the use of social media and mobile banking in mind to include more flexibility as opposed to the rigidity of the current rules. Credit unions have fared very well in safely adopting the use of such technology, and they take actions necessary to ensure their policies and procedures provide oversight and controls with regard to the risk associated by social media activities. A modernization of these rules by NCUA would clear up ambiguity and help credit unions use new technologies to better meet the needs of their members.

Budget Transparency

NCUA is funded by the credit unions it supervises. Each year, credit unions are assessed a different operating fee based on asset size. NCUA then pools the monies it receives from credit unions and uses those funds to create and manage an examination program. The monies that NCUA collects, however, have significantly increased over the past six years to cover a $109.7 million increase in the agency's budget during that period.

NAFCU supports the agency's efforts to accurately calculate the appropriate overhead transfer rate and urges NCUA to maintain a rate that is equitable to FCUs given they are funding the remaining agency expenses through operating fees. NAFCU encourages NCUA to continue to look for ways to decrease costs in order to reduce fees FCUs pay to the agency. In connection with this, NAFCU believes that credit unions deserve clearer disclosures of how the fees they pay the agency are managed.

As NAFCU has stated in previous communications to the agency, NCUA is charged by Congress to oversee and manage the National Credit Union Share Insurance Fund (NCUSIF), the Temporary

Corporate Credit Union Stabilization Fund, the Central Liquidity Fund, and its annual operating budget. These funds are comprised of monies paid by credit unions. NCUA is charged with protecting these funds and using its operating budget to advance the safety and soundness of credit unions.

Because these funds are fully supported by credit union assets, NAFCU and our members strongly believe that credit unions are entitled to know how each fund is being managed. Currently, NCUA publicly releases general financial statements and aggregated balance sheets for each fund. However, the agency does not provide non-aggregated breakdowns of the components that go into the expenditures from the funds. Although NCUA releases a plethora of public information on the general financial condition of the funds, NAFCU urges the agency to fully disclose the amounts disbursed and allocated for each fund. For example, NAFCU and our members believe that NCUA should be transparent about how the monies transferred from the NCUSIF through the overhead transfer rate are allocated to the NCUA Operating Budget.

CFPB

We would also like to acknowledge efforts by the CFPB to provide relief, such as seeking to act on the privacy notice issue in the absence of any final Congressional action and efforts to revisit some of the concerns raised about points and fees under the new QM rule. While we believe that legislative action is still necessary in both regards, the Bureau deserves credit for taking steps in the absence of Congressional action.

Exemption Authority

One area where the CFPB could be the most helpful to credit unions would be to use its legal authority to exempt credit unions from various rulemakings. Given the unique member-owner nature of credit unions and the fact that credit unions did not participate in many of the questionable practices that led to the financial crisis and the creation of the CFPB, subjecting credit unions to rules aimed at large bad actors only hampers their ability to serve their members. While the rules of the CFPB may be well-intentioned, many credit unions do not have the economies of scale that large for-profit institutions have and may opt to end a product line or service rather than face the hurdles of complying with new regulation. This happened with us at XCEL when it came to the

new remittance requirements. As a small credit union, the new compliance burden was just too high and we ultimately had to drop this service for our members.

Reg E

As NAFCU outlined in its "Dirty Dozen" list of regulations to eliminate or amend in order to better serve credit union customers, the requirement to disclose account numbers on periodic statements should be amended in order to protect the privacy and security of consumers.

Under Regulation E, credit unions are currently required to list a member's full account number on every periodic statement sent to the member for their share accounts. Placing both the consumer's full name and full account number on the same document puts a consumer at great risk for possible fraud or identity theft. We strongly urge you to update the language of Regulation E to allow for truncated account numbers to be used on member's periodic statements.

NAFCU encourages the CFPB to amend Regulation E §205.9(b)(2) to allow financial institutions to truncate account numbers on periodic statements. This modification is consistent with 12 C.F.R. § 205.9(a)(4), which allows for truncated account numbers to be used on a receipt for an electronic fund transfer at an electronic terminal. This change is also consistent with § 605(g) of the Fair Credit Reporting Act that states, "no person that accepts credit cards or debit cards for the transaction of business shall print more than the last 5 digits of the card number or the expiration date upon any receipt." NAFCU believes that by adopting this change, the CFPB will allow financial institutions to better protect the security and confidentiality of consumer information.

Compromised accounts are not only dangerous for consumers, but can be extremely costly for credit unions. In the past year alone data breaches have cost the credit union industry millions of dollars. According to feedback from our member credit unions, in 2013 each credit union on average experienced $152,000 in loses related to data breaches. The majority of these costs were related to fraud losses, investigations, reissuing cards, and monitoring member accounts.

As the recent high-profile data breaches at some of our nation's largest retailers have highlighted, criminals are willing to go to great extremes to obtain consumer's sensitive financial information.

Credit unions understand the importance of steadfastly protecting their member's confidential account information, which is why we strongly suggest this regulatory update.

Until Congress passes new legislation to ensure other third parties, such as merchants, who have access to consumer's financial information, have effective safeguards in place to protect consumer information, the CFPB should consider this minor modification to Regulation E. This change would go a long way in keeping sensitive financial information out of the hands of criminals and reduce the increasing fraud costs borne by credit unions and other financial institutions.

Federal Reserve Board

NAFCU has long encouraged the Federal Reserve to update Regulation D. This issue is also on NAFCU's "Dirty Dozen" list. Regulation D generally imposes reserve requirements on depository institutions with transaction accounts or nonpersonal time deposits, and requires reporting to the Federal Reserve. The regulation aims to facilitate monetary policy and ensure sufficient liquidity in the financial system. It requires credit unions to reserve against transaction accounts, but not against savings accounts and time deposits.

NAFCU believes the Federal Reserve Board should revisit the transaction limitation requirements for savings deposits. The six-transaction limit imposes a significant burden on both credit union members in attempting to access and manage their deposits and credit unions in monitoring such activity. Member use of electronic methods to remotely access, review and manage their accounts, as well as the contemporary transfer needs of members and consumers at all types of financial institutions, make a monthly transaction limit an obsolete and archaic measure. Should the Board decide not to outright remove the transaction limitation requirement for savings deposits, NAFCU has urged the Board to raise the current limitation from six to twelve transactions. If the Board fails to act in this area, we believe Congress should be ready to address this issue.

FHFA

On September 2, 2014, the Federal Housing Finance Agency (FHFA) released a proposed rule that would require institutions to hold 10% of assets in residential mortgage loans, not only to become a member, but also to maintain that 10% on a constant basis to remain a member. The current rule

only requires the 10% be held at the time membership is approved. FDIC-insured banks with under $1 billion in assets currently have a statutory exemption from this 10% requirement in the *Federal Home Loan Bank Act*, but credit unions do not.

Credit union membership in federal home loan banks (FHLBs) has been increasing, and, as of June 2014, 19% of credit unions had membership in a federal home loan bank. FHLBs can also be an important source of liquidity for credit unions. This proposed rule change threatens to hamper credit union access to, and membership in, FHLBs. We would urge Congress to express concerns to the FHFA about this proposal. Furthermore, we would urge legislative action to grant credit unions parity in the exemptions enjoyed by banks under the *Federal Home Loan Bank Act*.

VI. Regulatory Coordination is also Needed

With numerous new rulemakings coming from regulators, coordination between the agencies is more important than ever. Congress should use its oversight authority to make sure that regulators are coordinating their efforts and not duplicating burdens on credit unions by working independently on changes to regulations that impact the same areas of service. There are a number of areas where opportunities for coordination exist and can be beneficial. I outline two of them below.

Financial Stability Oversight Council (FSOC)

NAFCU has been on the forefront encouraging the FSOC regulators to fulfill their Dodd-Frank mandated duty to facilitate rule coordination. This duty includes facilitating information sharing and coordination among the member agencies of domestic financial services policy development, rulemaking, examinations, reporting requirements and enforcement actions. Through this role, the FSOC is effectively charged with ameliorating weaknesses within the regulatory structure and promoting a safer and more stable system. It is extremely important to credit unions for our industry's copious regulators to coordinate with each other to help mitigate regulatory burden. We urge Congress to exercise oversight in this regard and consider putting into statute parameters that would encourage the FSOC to fulfill this duty in a thorough and timely manner.

Data Security

Outside of advocating for federal legislation with regard to the safekeeping of information and breach notification requirements for our nation's retailers, NAFCU has also urged regulatory coordination for credit unions already in compliance with the stringent standards in the *Gramm-Leach-Bliley Act*. In the wake of the massive Target data breach in December 2013 the Federal Trade Commission began exploring a range of regulatory options to assist consumers, businesses, and financial institutions. Moving forward, it is imperative that NCUA ensure that credit unions are protected from any unnecessary regulatory burden and continue to allow them to provide quality services to their members.

VII. Conclusion: All Credit Unions Need Regulatory Relief

The growing regulatory burden on credit unions is the top challenge facing the industry today and credit unions are saying "enough is enough" when it comes to the overregulation of the industry. All credit unions are being impacted regardless of asset size.. This burden has been especially damaging to smaller institutions that are disappearing at an alarming rate. The number of credit unions continues to decline, as the compliance requirements in a post Dodd-Frank environment have grown to a tipping point where it is hard for many smaller institutions to survive. Those that do are forced to cut back their service to members due to increased compliance costs.

Credit unions want to continue to aid in the economic recovery, but are being stymied by this overregulation. NAFCU appreciates the Committee holding this hearing today. Moving forward, we would urge the Committee to act on credit union relief measures pending before the Senate and the additional issues outlined in NAFCU's Five-Point Plan for Credit Union Regulatory Relief and NAFCU's "Dirty Dozen" of regulations to review and amend. Additionally, Congress needs to provide vigorous oversight to the NCUA's proposed risk-based capital rule and be ready to step in and stop the process so that the impacts can be studied further. Finally, the Committee should also encourage regulators to act to provide relief where they can without additional Congressional action.

We thank you for the opportunity to share our thoughts with you today. I welcome any questions you might have.

Attachment A: NAFCU's May 27, 2014 comment letter on the NCUA's Prompt Corrective Action/ Risk-Based Capital proposal

Attachment B: XCEL FCU's comment letters on the NCUA's Prompt Corrective Action/ Risk-Based Capital proposal

Attachment C: NAFCU's "Five Point Plan for Regulatory Relief" released in February 2013

Attachment D: NAFCU's "Dirty Dozen" – Twelve Regulations to Eliminate or Amend

Attachment A: NAFCU's May 27, 2014 comment letter on the NCUA's Prompt Corrective Action/ Risk-Based Capital proposal

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NAFCU | Your Direct Connection to Education, Advocacy & Advancement

May 27, 2014

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: Comments on NCUA Prompt Corrective Action – Risk-Based Capital Proposed Rule

Dear Mr. Poliquin:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents federal credit unions, I am writing to you regarding the proposed rule on prompt corrective action and risk-based capital. As the credit union community comments on this rule, NAFCU is hopeful that the National Credit Union Administration (NCUA or Agency) Board will realize the devastating effect that this proposal will have on the credit union industry, the American consumer, and our nation's small businesses. While we are supportive of the idea of a risk-based capital regime for credit unions, the current NCUA proposal is not appropriate for credit unions or the credit union industry. If it were to be implemented as proposed, credit unions would find themselves at a significant competitive disadvantage to banks. As proposed, the rule is one-size-fits-all and would serve to stifle growth, innovation, and diversification within credit unions. We ask that the NCUA Board withdraw the rule or alternatively make major modifications to the proposal before any rule is finalized.

NAFCU has many concerns with the proposed rule which we explain in detail below; however, our major concerns include:

- Several issues related to NCUA's legal authority to issue the rule as proposed, such as:
  - Comparability with banking regulatory requirements;
  - Substitution of statutorily defined legal terms;
  - Individual minimum capital requirements;
  - Definition of a "complex" credit union;
- The need for a legislative solution in order to achieve a fair and balanced risk-based capital system;
- NCUA's treatment of the regulatory process including the refusal to extend the comment period and form an industry working group prior to releasing a

proposed rule, and the need for an additional notice of proposed rulemaking with public comment period;

- NCUA's drastic understatement of credit unions that will be affected by this rule and whose balance sheets and business plans will need adjustment;
- NCUA's proposed risk-based capital ratio for well capitalized credit unions set at 10.5 percent;
- NCUA's treatment of risk-weighted assets and the lack of explanation for deviation from similar banking risk-weights;
- NCUA's incorporation of interest rate and concentration risk into risk-weighting for real estate, investments, and member business loans (MBL's);
- Individual minimum capital requirements for credit unions including issues with the subjectivity of their imposition;
- Components not included in the numerator portion of the risk-based capital ratio, such as goodwill;
- The 1.25 percent cap on Allowance for Loan and Lease Losses (ALLL) especially considering the Financial Accounting Standards Board's (FASB) most recent proposal on ALLL;
- Supplemental capital authority is needed now more than ever considering the restrictions brought on by this rule; and
- The proposed 18-month implementation timetable is not long enough for a rule as complex and impactful as this proposed rule.

Legal Authority

NAFCU does not believe that NCUA has the legal authority to issue the rule as proposed. There are several areas of the proposed rule where NAFCU questions whether the rule is consistent with the requirements of the Federal Credit Union Act (FCU Act.)

The FCU Act Requirements

The FCU Act 12 U.S.C. §1790d contains the requirements for Prompt Corrective Action (PCA), including the required regulations and the risk-based net worth requirement. These provisions were added to the FCU Act by the Credit Union Membership Access Act of 1998 (CUMAA).

NCUA acknowledges in the proposed rule that it derives its legal authority for promulgating the proposed risk-based capital rule from sections 1766[1] and 1790d of the FCU Act, and maintains that the proposed rule achieves the purposes that the FCU Act requires.

NCUA states in the proposed rule that "Congress set forth a basic structure for PCA in section 216 that consists of three principal components: (1) A framework combining mandatory actions prescribed by statute with discretionary actions developed by NCUA; (2) an alternative system of PCA to be developed by NCUA for credit unions defined as

[1] This section refers to powers of the NCUA Board.

'new'; and (3) a risk-based net worth requirement to apply to credit unions that NCUA defines as 'complex.'"[2]

Comparability

The FCU Act requires that the NCUA Board "shall, by regulation, prescribe a system of prompt corrective action for insured credit unions that is—(i) consistent with this section; and (ii) **comparable** to section 1831o of this title."[3] (Emphasis added.) This reference to 12 U.S.C. §1831o is to the PCA requirements of the Federal Deposit Insurance Act, as implemented through the Federal Deposit Insurance Corporation (FDIC) regulations.

During the deliberations on CUMAA, Congress also stated on the record that "'Comparable' here means parallel in substance (though not necessarily identical in detail) and equivalent in rigor."[4] This proposed rule goes far beyond this interpretation of comparable in a number of instances that are highlighted throughout this letter.

Risk-Based Net Worth vs. Risk-Based Capital Terminology

NCUA's proposed amendments to 12 C.F.R. §702.102 would replace statutorily defined terms with what it considers to be "functionally equivalent" terms.[5] NAFCU questions whether NCUA has the legal authority to deviate from these statutory terms. The FCU Act also requires a "risk based net worth requirement for complex credit unions;" the statutory requirement reads:

> *"Risk-based net worth requirement for complex credit unions.—*
>
> *(1) In general.—The regulations required under subsection (b)(1) of this section shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.*
>
> *(2) Standard.—The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."[6] (Emphasis added.)*

The FCU Act also provides specific definitions for "net worth"[7] and "net worth ratio."[8] These terms are specifically defined in the FCU Act as follows:

> "(2) *Net worth.—The term "net worth"*
> *(A) with respect to any insured credit union, means the retained earnings balance of the credit union, as determined under generally accepted accounting principles, together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined;*

[2] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11185.
[3] 12 U.S.C. § 1790d(b)(1)(A).
[4] S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).
[5] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11191.
[6] 12 U.S.C. § 1790d(d).
[7] 12 U.S.C. § 1790d(o)(2).
[8] 12 U.S.C. § 1790d(o)(3).

(B) with respect to any insured credit union, includes, at the Board's discretion and subject to rules and regulations established by the Board, assistance provided under section 208 to facilitate a least-cost resolution consistent with the best interests of the credit union system; and
(C) with respect to a low-income credit union, includes secondary capital accounts that are—
(i) uninsured; and
(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund.[9]

(3) Net worth ratio.
The term "net worth ratio" means, with respect to a credit union, the ratio of the net worth of the credit union to the total assets of the credit union."[10] *(Emphasis added.)*

The preamble to the proposed rule discusses NCUA's proposed amendments to § 702.102, including changes to the terminology used. NCUA acknowledges that the FCU Act specifically uses the term "risk-based net worth requirement" but proposes to replace that terminology with "risk-based capital," which it contends is "functionally equivalent."[11]

The proposed rule also replaces the term "net worth" with the term "capital categories" to describe the combined "net worth ratio" and "risk-based net worth" measurements, as well as several other modifications to the terminology currently used.

NCUA contends that "no substantive changes to the requirements of section 216(c) are intended by these changes in terminology."[12] These changes are not only substantive, but redefine statutorily defined terms including "net worth" and "net worth ratio" with terms that do not encompass the same things.

These statutorily defined terms may not be redefined by NCUA through regulation in order to place an ill-fitting risk-based capital system on top of the current PCA system. NAFCU believes that if NCUA really wants to institute a working risk-based capital system that would be comparable to what banks have, then NCUA would need Congress to change the FCU Act to give it the authority to do so.

Individual Minimum Capital Requirements

NAFCU questions whether NCUA has the statutory authority to institute individual minimum capital requirements. Under the proposed rule, NCUA introduces a new power to raise individual minimum capital requirements for credit unions "that varies from any of the risk-based capital requirement (s) that would otherwise apply to the credit union..."[13] The proposed rule contains a list of circumstances where NCUA could raise a credit union's individual minimum capital requirements that includes, among others, a credit union receiving special supervisory attention or a portfolio that reflects weak credit quality or significant likelihood of financial loss. The FCU Act 12 U.S.C. § 1790d(h) states:

[9] 12 U.S.C. § 1790d(o)(2).
[10] 12 U.S.C. § 1790d(o)(3).
[11] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11191.
[12] *Id.*
[13] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11216 (to be codified at 12 C.F.R. § 702.105(a)).

"(h) More stringent treatment based on other supervisory criteria

With respect to the exercise of authority by the Board under regulations comparable to section 1831o(g) of this title—

(1) the Board may not reclassify an insured credit union into a lower net worth category, or treat an insured credit union as if it were in a lower net worth category, for reasons not pertaining to the safety and soundness of that credit union; and

(2) the Board may not delegate its authority to reclassify an insured credit union into a lower net worth category or to treat an insured credit union as if it were in a lower net worth category." (Emphasis added.)

A broad interpretation of the statute[14] would allow for NCUA to use issues of safety and soundness to reclassify an insured credit union or treat it as though it were in a lower net-worth category. By doing so, the NCUA Board could subject those individual credit unions that did not meet the individual minimum capital requirements to the same restrictions as those credit unions that are less than well capitalized. The statute, if read broadly, could allow for the NCUA Board to downgrade a credit union in cases pertaining to safety and soundness.

Taking a more narrow interpretation of the statute, one could argue that having the authority to treat an insured credit union as if it were in a lower net worth category is not the same as having the authority to arbitrarily subject individual credit unions to different individual minimum capital requirements. While the effects of lowering a credit union's net worth category could be similar for a credit union under the proposed individual minimum capital requirement, it is not the same as being authorized to be able to pick the point at which a credit union would not be safe and sound.

Finally, a strict reading of the statute would not provide the authority necessary for the NCUA Board to promulgate a rule that includes proposed § 702.105. Nowhere in the statute does Congress specifically authorize the NCUA Board to provide different minimum capital requirements for individual credit unions.

There is a second major issue regarding individual minimum capital requirements. Assuming the NCUA Board is deemed to have the authority to institute a system that would allow for individual minimum capital requirements because of its interpretation of 12 U.S.C. § 1790d(h)(1), at issue is whether the NCUA Board can delegate that authority to anyone other than itself, such as an examiner or regional director. Congress was clear in its intent that this authority is not to be delegated to anyone other than the NCUA Board.[15]

The proposed rule uses phrases such as "The decision is necessarily based, in part, on subjective judgment grounded in agency expertise..."[16] and "NCUA may establish

[14] 12 U.S.C. § 1790d(h).
[15] 12 U.S.C. § 1790d(h)(2).
[16] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11217 (to be codified at 12 C.F.R. § 702.105(c)).

increased individual minimum capital requirements..."[17] The proposed § 702.105 uses the term NCUA, not NCUA Board, as is used in other parts of the proposed rule.[18] The proposed rule also specifically sets out in the summary that the initials "NCUA" are meant to mean the National Credit Union Administration as a whole agency and "Board" to mean the NCUA Board.[19] NAFCU believes this proposed rule intends to delegate the power to raise individual minimum capital requirements from the NCUA Board to other individuals or departments within the NCUA. This would fall directly outside the power authorized by Congress in 12 U.S.C. § 1790d. These discrepancies must be addressed in any final rule that is issued.

Definition of Complex

The proposed rule seeks to establish new more stringent risk-based capital standards for all credit unions with more than $50 million in assets, which NCUA has defined as "complex." NCUA's re-definition of a "complex" credit union is outside of the scope of the authority designated to it by Congress. The proposed rule arbitrarily sets the threshold at $50 million in assets with no additional tests to actually determine if the credit union itself is "complex."

The FCU Act[20] directs NCUA to develop a risk-based net worth system for complex credit unions that is based on the "portfolios of assets and liabilities of credit unions."[21] Congress could have directed NCUA to focus only on asset size in defining "complex." Instead, the FCU Act[22] requires NCUA to consider the complexity of a credit union's book of assets such as types of investments and loans, as well as liabilities. The definition of "complex" must be based on whether the credit union's financial activities and operations are sufficiently elaborate to warrant that credit union be designated as "complex" rather than just on its asset size.

As NAFCU has previously stated, the size of an institution does not determine the complexity of the assets and liabilities of a given credit union. There are many credit unions with well over $50 million in assets that are run out of one branch with only a handful of employees that often engage in only the most basic of transactions for members. Furthermore, there are many large credit unions that have very simple portfolios and are not involved in "risky" activities. There are also some smaller credit unions that engage in more risky activities that would require them to hold more capital. Limiting the definition of "complex" for credit unions to only those credit unions over $50 million is completely arbitrary and contrary to Congressional mandate.

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[17] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11216 (to be codified at 12 C.F.R. § 702.105(b)).
[18] See Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184 (to be codified at 12 C.F.R. §§ 702.110, 702.111, 702.112).
[19] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184.
[20] 12 U.S.C. 1790d(d).
[21] *Id.*
[22] As modified by The Credit Union Membership Access Act of 1998 (CUMAA).

Legislative Solution

NAFCU supports a risk-based capital system for credit unions. We support less capital for lower-risk credit unions and more capital for higher-risk credit unions. However, we continue to believe that we need Congress to make statutory changes to the FCU Act to achieve a fair system.

Ongoing discussions with NAFCU member credit unions led to the unveiling of NAFCU's "Five Point Plan for Regulatory Relief" in February 2013, and a call for Congress to enact meaningful legislative reforms that would provide much needed assistance to our nation's credit unions. In NAFCU's "Five Point Plan for Regulatory Relief," NAFCU calls on Congress to direct NCUA and industry representatives to conduct a study on PCA and recommend changes. It also calls on Congress to modernize capital standards by directing the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks and allows the NCUA Board to authorize supplemental capital. Finally, it asks Congress to establish special capital requirements for newly chartered federal credit unions that recognizes the unique nature and challenges of starting a new credit union.

NCUA's proposed rule on risk-based capital does not achieve a truly risk-based capital system for credit unions. NAFCU believes that the proposal is conceptually flawed, deviates from statutory requirements for PCA, and tries to establish an ill-fitting risk-based capital system without the necessary legislative solution. This results in a one-size-fits-all rule that will ultimately hurt credit unions while disregarding Congressional intent, and will require credit unions to hold additional unnecessary capital.

The FCU Act also prescribes that credit unions have net worth ratios of six percent to be considered adequately capitalized and seven percent for well capitalized,[23] while banks have leverage ratios of four percent to be adequately capitalized and five percent for well capitalized.[24] Credit unions are already at a competitive disadvantage to banks in this regard, and this proposed rule only serves to multiply that competitive disadvantage by requiring credit unions to hold even more capital as compared to banks.

These additional requirements are increasing the capital that credit unions cannot use to help members by providing loans. Furthermore, credit unions also have to account for a one percent contribution to the NCUSIF which constructively limits the amount of funds available for credit unions to extend credit, placing additional capital burdens on credit unions. NAFCU believes that NCUA should work with Congress to change PCA requirements such that credit unions are put on equal footing with and better able to compete with banks.

Should NCUA's current proposed rule go forward with little or no changes, the new rule would precipitate the need for other Congressional action to bring about capital changes for credit unions such as H.R. 719, the Capital Access for Small Businesses and Jobs Act,

[23] 12 U.S.C. § 1790d(c).
[24] 12 U.S.C. § 1831o.

which would allow credit unions to have access to supplemental capital sources. Additionally, the inclusion of an individual minimum capital requirement that starts with the examiner in any final rule only reinforces the need for action on H.R. 1553, the Financial Institutions Examination Fairness and Reform Act.

The Regulatory Process

Capital touches every part of a credit union's operations and decision-making. NAFCU believes that this proposed rule is one of the most important rulemakings to come out of the Agency in recent history. It is troubling that NCUA has refused to work with credit unions throughout the rulemaking process.

On May 8, 2013, NAFCU sent a letter to the NCUA Board requesting it to consider creating a working group on reforming current regulatory capital requirements for credit unions. That request specifically sought a working group made up of industry stakeholders to be formed and convened prior to any rulemaking by NCUA. NAFCU continued to stress to NCUA the need for a capital working group to perform an analysis prior to the issuance of a proposed rule on risk-based capital. Unfortunately, a working group was not convened prior to the release of this proposed rule.

Furthermore, NAFCU believes that for complex and important rules it is appropriate to issue an Advanced Notice of Proposed Rulemaking (ANPR) to collect public input on key issues. NCUA did not issue an ANPR prior to the release of the risk-based capital proposed rule. A risk-based capital rule is one such issue that is complex and important enough that an ANPR made sense for both the Agency and the credit union industry. It would also have given NCUA an opportunity to gather data from credit unions about the true effects of any changes in the capital regime. NAFCU believes that NCUA should have issued an ANPR to solicit comments from the public instead of releasing a proposed rule without credit union input either by formal comment period or working group.

Additionally, NCUA released a "Risk-Based Capital Calculator" when the NCUA Board approved the proposed rule in January 2014, and made this calculator available to the public. The calculator uses the most recent 5300 Call Report data and generates a credit union's current net worth ratio, net worth classification, and most importantly what the credit union's risk-based capital ratio would be pursuant to the proposed rule.

NAFCU believes that this calculator should not have been made available to the public. While this may be a useful tool for a credit union to understand what its capital position would be under the proposed rule, its public disclosure could have unintended consequences such as damage to a credit union's reputation. The proposed rule is complex and an uninformed viewer of this information could draw the wrong conclusions about the strength of the credit union, particularly as the rule is still in the proposal stage and subject to change. A better alternative would have been to provide credit unions with access to the calculator through a secure portal on NCUA's website.

On February 28, 2014, NAFCU sent a joint letter along with the Credit Union National Association (CUNA) to Chairman Matz to request an extension of the comment period by

90 days to give credit unions more time to understand this complex rule and to provide valuable feedback to NCUA about the possible effects of the rule on their credit union. Chairman Matz denied this request and in doing so, stated that the comment period provided enough time for credit unions to understand the rule and provide constructive comments to the Agency.

After Chairman Matz denied the request, credit unions continued to ask for more time and NAFCU, along with CUNA, wrote another letter to all members of the NCUA Board to again request that the comment period for the rule be extended for 90 days. That request was also denied. This rule is too important to rush the rulemaking process. Giving credit unions extra time to realize the full effects of the rule on present and future portfolios and business decisions easily outweighs any possible negatives in delaying its implementation.

Given the recent comments from NCUA Board members regarding the significant changes that will be made to the rule before it is finalized, NAFCU believes that NCUA should re-issue the proposed rule with any changes made using the input received from this comment period and the scheduled listening sessions through a notice of proposed rulemaking. This would give credit unions an opportunity to see those significant changes and contribute comments. If NCUA intends the final rule to include as many changes as the NCUA Board members have indicated, then NCUA will need to re-issue a proposed rule with another public comment period as required by the Administrative Procedure Act.

Affected Credit Unions

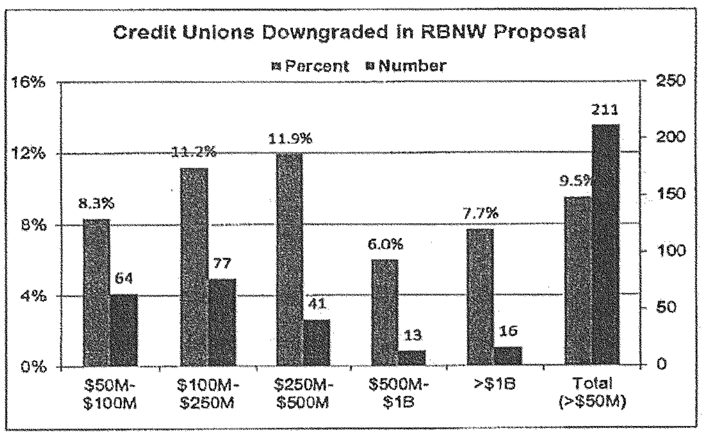
NCUA has stated publicly that this proposed rule would only affect around 200 credit unions.[25] That number simply includes those credit unions whose net worth classification will be downgraded. While there may only be around 200 credit unions whose net worth categories will be downgraded, there are many more credit unions that will be affected by this proposed rule. There are 1,404 federally-insured credit unions (FICUs)[26] that currently have more than $50 million in assets but are not currently defined as complex pursuant to PCA requirements. These credit unions would be defined as complex by the proposed rule. This means that 1,404 additional FICUs would be subject to a risk-based capital standard that would otherwise not be affected, based solely on the change in definition of "complex." All credit unions subject to the requirements of this proposed rule will need to carefully examine their balance sheets and potentially make substantial portfolio changes.

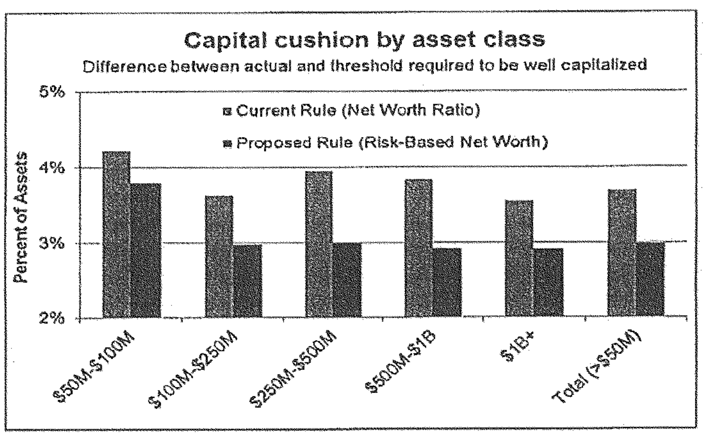
A survey of NAFCU's membership taken in April 2014 found that nearly 60 percent of respondents believe the proposed rule would force their credit union to hold more capital, while nearly 65 percent believe this proposal would force them to realign their balance sheet. If the NCUA implements this rule as proposed, most credit unions will have to hold more capital. This additional capital requirement is not commensurate with the actual risks

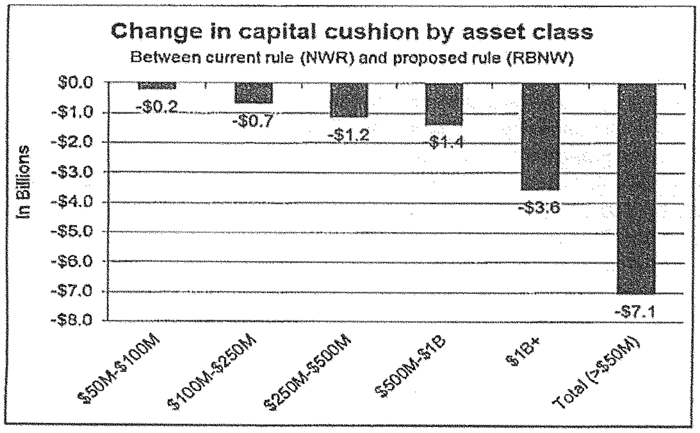
[25] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11188.
[26] As of December 31, 2013, there are 2,222 FICUs with assets over $50 million. 818 FICU's have a risk-based net worth over 6% and are currently rated as complex. 1,404 FICU's have a risk-based net worth less than or equal to 6% and are therefore not considered complex by the current definition, but would be under the proposed rule.

of a credit union's portfolio, nor will it serve the intended purpose of protecting the National Credit Union Share Insurance Fund (NCUSIF).

NAFCU's Economics and Research department prepared the impact analysis graphs found below that outline the impact the proposal would have on credit unions based on asset size. Our analysis of the proposed rule determined that credit unions with more than $50 million in assets will have to hold $7.1 billion more in additional reserves to achieve the same currently maintained capital cushion. Because credit unions cannot raise capital from the open market like other financial institutions, this cost will undoubtedly be passed on to the 97 million credit union members across the country in the form of higher loan rates and lower rates on share accounts.







NAFCU questions whether it is appropriate to finalize a rule that would require credit unions to hold so much more capital as compared with the actual costs to the NCUSIF. Below is a chart that details the number of, and cost to, the NCUSIF of liquidated or assisted merger credit unions by asset class and year for credit unions under $250 million in assets. The total cost to the share insurance fund for all credit unions between $50 million and $250 million in assets from 2003 through 2012 was less than $285 million. This stands out as disproportionate when compared to the $898 million more in additional capital that would be required under the proposed rule for credit unions between $50 million and $250 million in assets to maintain the same capital cushion as in the current rule. Essentially, credit unions would be required to hold $898 million more in capital to maintain the same capital cushion as currently held in order to prevent what was less than $285 million in losses over the past 10 years.

The Number of and Cost to Insurance Fund of Liquidated or Assisted Merger Credit Unions by Asset Class and Year						
	Assets < $250M		Assets < $100M		Assets < $50M	
Year	Number	Cost to Ins Fund	Number	Cost to Ins Fund	Number	Cost to Ins Fund
2003	13	$ 10,158,257	13	$ 10,158,257	13	$ 10,158,257
2004	21	$ 11,892,786	21	$ 11,892,786	21	$ 11,892,786
2005	15	$ 15,088,257	15	$ 15,088,257	15	$ 15,088,257
2006	16	$ 6,717,182	16	$ 6,717,182	16	$ 6,717,182
2007	11	$ 9,470,960	10	$ 7,539,629	10	$ 7,539,629
2008	17	$ 32,989,171	16	$ 32,989,171	14	$ 31,334,427
2009	26	$ 156,497,713	24	$ 137,520,215	18	$ 36,954,777
2010	27	$ 60,346,866	23	$ 26,803,469	23	$ 26,803,469
2011	16	$ 52,876,674	14	$ 31,100,299	13	$ 18,259,280
2012	21	$ 138,544,436	19	$ 58,687,421	17	$ 48,865,808
Total	183	$ 494,582,303	171	$ 338,496,687	160	$ 213,613,873
Source: NCUA FOIA response 13-FOI-00097						

Between the years 2003-2012 there were 190 total credit union failures, but only 7 of these failures were credit unions above $250 million in assets. During this time period, the total number of credit unions under $250 million in assets that failed was 183. However, 160 of those failed credit unions were under $50 million in assets. There were only 23 failed credit unions between $50 million and $250 million in assets during that time period.

Additionally, almost half of the losses to the NCUSIF from 2003-2012 for those credit unions under $250 million in assets were incurred because of failures of credit unions with under $50 million in assets.

This rule will not cover those credit unions with under $50 million in assets. Meaning, if this proposed rule had been implemented prior to those failures, it would not have helped to prevent the losses to the NCUSIF. While holding additional capital for assets that do carry higher risk makes sense in a true risk-based system, holding more capital for the sake of holding more capital is not the solution, and will not prevent failures.

10.5% Risk-Based Capital Ratio

The proposed rule introduces a 10.5 percent risk-based capital ratio requirement in order for a credit union to be categorized as well capitalized. This ratio will make credit unions less competitive than their banking counterparts. NCUA reasons that the proposed "10.5 percent risk-based capital ratio target is comparable to the [o]ther [f]ederal [b]anking [r]egulatory [a]gencies' 8 percent plus the 2.5 percent capital conservation buffer..."[27] The Agency states this was done in order to "avoid the complexity of implementing a capital

[27] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11192.

conservation buffer."[28] In its efforts to avoid complexity, NCUA is proposing an ill-fitting risk-based capital ratio for credit unions.

The impact of the 2.5 percent capital conservation buffer was designed specifically for banks and does not work for credit unions, and will result in an unnecessary additional increase to credit union capital requirements. The banking regulators developed the capital conservation buffer in order to ensure that banks retained capital in times when it was needed most. During the crisis, distressed banks were distributing capital to shareholders and employees even though it was negatively affecting their capital ratios. This led the banking regulators to include a capital conservation buffer of 2.5 percent on top of the Tier 1 risk-based capital ratio minimum level of 8 percent as part of the FDIC rules that become effective over the next five years.

The specific purpose of the capital conservation buffer is to ensure that banks are only able to pay stock dividends and share buybacks if they meet their 2.5 percent capital conservation buffer and not just the 8 percent Tier 1 risk-based capital minimum. This approach to capital distribution does fit the credit union business model.

NCUA failed to include any rationale or data for why it chose to have a 10.5 percent minimum capital requirement to be well capitalized other than to "avoid the complexity of implementing a capital conservation buffer."[29] NAFCU believes that the FDIC Tier 1 ratios are more consistent to the types of capital that credit unions are allowed to hold, as opposed to the FDIC's other risk-based capital ratios, as indicated in the chart below.

Net Worth Classification	Proposed Risk-Based Capital Ratio	FDIC Tier 1 Capital Requirements	NAFCU's Alternative
Well Capitalized	10.5% or above	8% or above	8% or above
Adequately Capitalized	8% to 10.49%	6% to 7.99%	6% to 7.99%
Undercapitalized	Less than 8%	Under 6%	Under 6%

NAFCU believes that unless NCUA provide compelling rationale and/or data to differ from the FDIC rule, NCUA should remove the 2.5 percent capital buffer component of the minimum risk-based capital ratios and make capital categories mirror the FDIC Tier 1 capital requirements.

Risk Weights

The proposed rule revises the risk-weights for many of NCUA's current asset classifications and requires higher minimum levels of capital for credit unions that are perceived as having riskier portfolios. NAFCU and its member credit unions have identified several key areas where risk-weighting in the proposal does not accurately capture the risks associated with the asset in question. In particular, a number of the NCUA proposed risk-weights require credit unions to hold much more capital as compared with the FDIC and Basel III requirements for community banks — often without solid justification for the deviations.

[28] *Id.*
[29] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11192.

Concentration Risk and Interest Rate Risk

As discussed above, the FCU Act requires that the system of prompt corrective action that the NCUA prescribes by regulation be comparable to those that the banking regulators institute.[30] In the many iterations of Basel and most recent rules that the FDIC has finalized, banking regulators have chosen not to incorporate interest rate risk and concentration risk into their risk-weights. However, NCUA's proposed rule incorporates concentration risk and interest rate risk into many of its proposed risk-weights. NAFCU acknowledges that interest rate and concentration risk are risks that every credit union needs to manage and plan for, but this rule is not the way to avoid losses due to those risks in the future.

NAFCU urges NCUA to eliminate the interest rate and concentration risk components of the risk-weighting for non-delinquent first mortgage real estate loans, other real estate secured loans, member business loans (MBLs), and investments. Rather, NCUA should change those risk-weights to be consistent with the risk-weighting given to those assets by the FDIC.

A risk-based capital rule is a poor tool for managing these additional risks, and simply requiring credit unions to hold more capital does not address or solve any issues that individual credit unions have when trying to manage those risks. Both Basel III and the FDIC interim final rule are constructed in such a way that authorities would employ other mechanisms to measure and control for risk other than credit risk. In order to comply with the comparability mandate of The FCU Act,[31] NCUA should follow the other federal banking regulatory agencies in this regard.

To better control for interest rate risk, NAFCU believes that a more sensible alternative to the proposed rule would be to continue to apply industry-accepted methods as part of a competent supervision and examination process.[32] Banking regulators have prescribed this as well and by holding credit unions to significantly different standards, NAFCU is concerned that NCUA may be running afoul of the will of Congress regarding the requirement that the rule be comparable to what banks have to follow.

This rule will also constrict capital availability that would otherwise be used for loans to members because credit unions will be required to hold more capital for interest rate and concentration risk. This is harmful to credit unions and to their members. During the financial crisis credit unions continued to lend when banks and other financial institutions pulled back. This rule would constrict the ability of credit unions to lend to members because so much more of their capital would have to be held for interest rate and

[30] 12 U.S.C. §1790d(b)(1)(A)(ii).
[31] *Id.*
[32] NCUA already has a number of requirements and guidance regarding interest rate risk that credit unions must comply with, such as the interest-rate risk final rule, a letter to credit unions on the subject (12-CU-05), and it is the top subject in the most recent NCUA supervisory focus (13-CU-01). Instead of making credit unions hold more capital, NCUA should first look to its existing requirements and regulations.

concentration risk. This is another reason this rule puts credit unions at a disadvantage to banks.

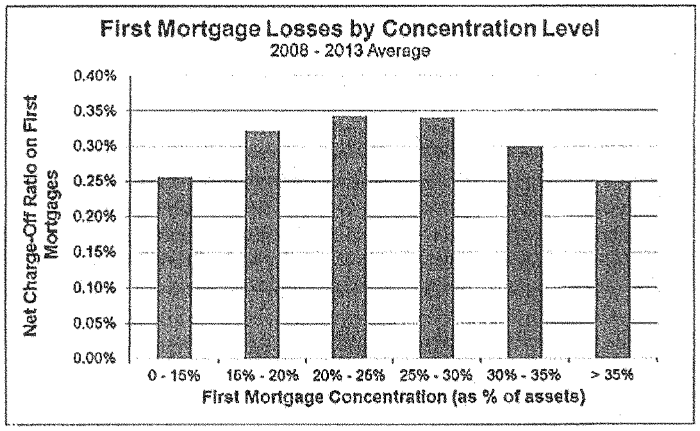
Non-Delinquent First Mortgage Real Estate Loans

NCUA's proposed rule uses the non-delinquent first mortgage real estate loans risk-weights to compensate for concentration risk by increasing the risk-weights to correspond with the percentage of those assets held by the credit union in its portfolio. The FDIC on the other hand, does not take into consideration concentration risk through its capital standards and assigns risk-weights for non-delinquent first mortgage real estate loans at 50 percent regardless of the concentration in the portfolio.

NAFCU believes that in any final rule, NCUA should set all non-delinquent first mortgage real estate loan risk-weights at 50 percent so as to align with FDIC weights as seen in the chart below.

Non-delinquent 1st Lien Real Estate Loans	**NCUA Proposed Risk-Weights**	**FDIC Risk-Weights**
<25% percent of assets	50 percent	50 percent
25 to 35% of assets	75 percent	50 percent
>35% of assets	100 percent	50 percent

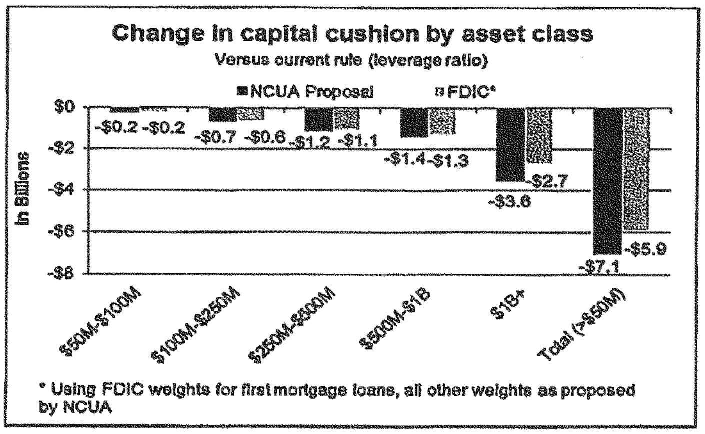
The risk-weights for each asset should also be rooted in the loss histories associated with that asset. When considering whether variable weights to account for concentration risk are warranted, it makes sense to look at the loss history for different levels of concentration for a given asset. Only in the case where higher asset concentrations are shown to result in higher loss histories would there be justification for increased risk-weights. In the case of non-delinquent first lien mortgage loans, the data shows that for different concentration levels, there has been no significant difference in average charge-offs since the onset of the financial crisis. Therefore, NCUA should do away with the risk-weights associated with higher concentrations of non-delinquent first mortgage loans and simply use a single risk-weight – 50 percent – for all outstanding loans.



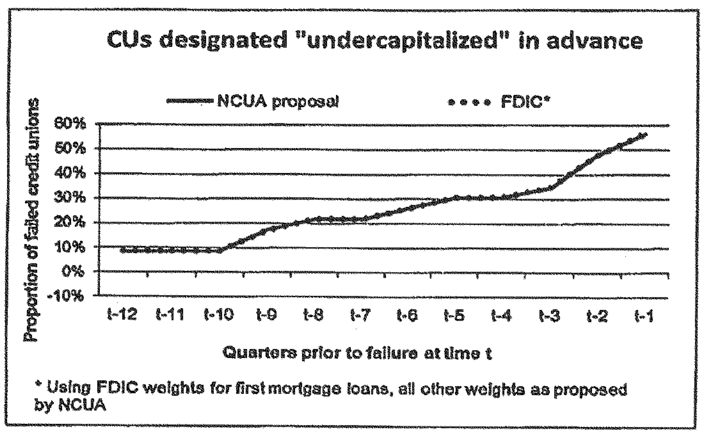
The graph above shows that aggregate losses for the highest concentrated credit unions (the "> 35%" group on the right) are equal to or lower than the losses for any other concentration group. NCUA argues that high concentrations of real estate and MBL loans led to numerous failures during recent years. This one-size fits all approach is not appropriate. Credit unions with high concentrations of mortgage loans on their books do not experience a higher loss rate on those loans than other credit unions, on average.

NAFCU also believes that concentration risk should be controlled through the supervision and examination process and not a one-size fits all capital regime that requires credit unions to hold more capital without allowing those credit unions with less risk to hold less capital.

The next chart shows that the capital cushion for credit unions would still shrink from current levels using FDIC risk-weights for non-delinquent first mortgage real estate loans, but the impact would not be as severe as under the NCUA proposal. The FDIC weights would result in a benefit to the capital cushion for credit unions at every asset group above $100 million in assets as compared to the NCUA proposal.



The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for non-delinquent first mortgage real estate loans. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is no difference between when the NCUA or FDIC weights would have designated a credit union as "undercapitalized" prior to its failure. This is significant because it means that changing the risk-weighting to the FDIC risk-weights for other real estate loans will not detract at all from NCUA's intention that the proposed rule would act as an early warning system for troubled credit unions.



There are a number of other concerns regarding the logical inconsistencies with this one-size-fits-all capital rule. For example, the proposed rule's treatment of real estate presents issues where a credit union may take steps to remove credit and liquidity risk from its portfolio by selling a 30-year mortgage that is currently risk-weighted at 50 percent. If that same credit union were to sell these mortgages to Fannie Mae and take back a Fannie Mae security with an average life of seven years, that mortgage-backed security would be risk-weighted at 150 percent. By doing so, the credit union has minimized its liquidity and credit risk while not providing any more interest rate risk. The result is that the credit union will be required to hold three times as much capital while having a less risky asset. This represents just one of many examples of the proposed risk-weights in this rule that do not match the actual risks posed to the credit union.

Other Real Estate Loans

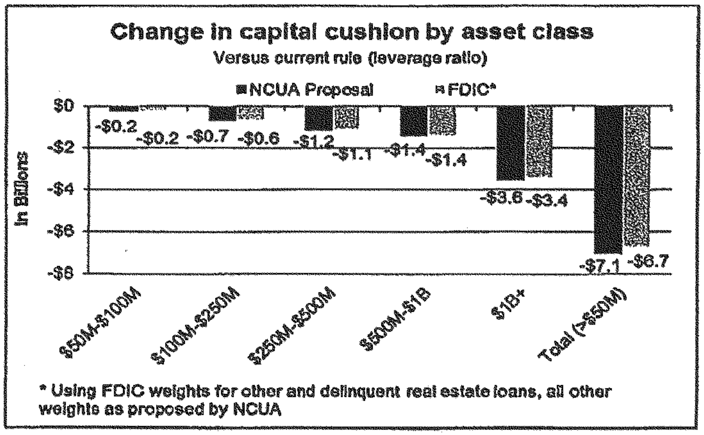
According to the proposed rule, "real estate-secured loans not meeting the definition of first mortgage real estate loans would be referred to as 'other real estate loans.'"[33] In the proposed rule, the risk-weights for these other real estate loans would incorporate concentration risk and increase as the percentage of these assets held by the credit union in its portfolio increases. The FDIC weights for these types of loans are 100 percent regardless of concentration.

NAFCU believes that in any final rule, NCUA should align other real estate loans risk-weights with FDIC weights as seen in the next table.

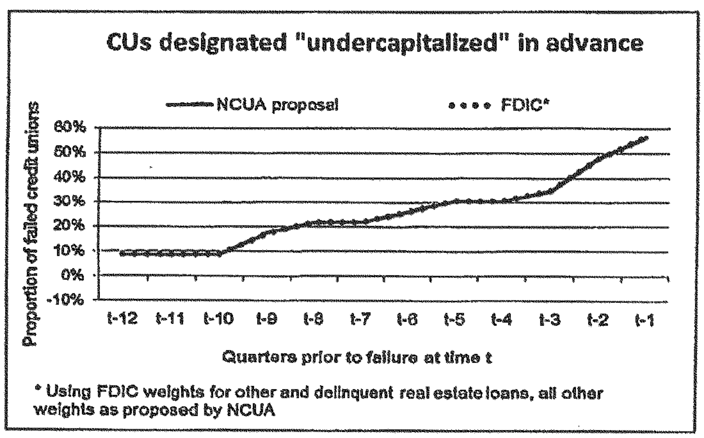
Other Real Estate Loans	NCUA Proposed Risk-Weights	FDIC Risk-Weights
0-10% percent of assets	100 percent	100 percent
>10 to 20% of assets	125 percent	100 percent
>20% of assets	150 percent	100 percent

The next chart shows that the capital cushion for credit unions would still shrink from current levels using the FDIC weights for other real estate loans, but the impact would not be as severe as under the NCUA proposal. The FDIC weights would result in a benefit to the capital cushion for credit unions at every asset level size except $500 million — $1 billion (no change) as compared to the proposed rule as seen in the next graph.

[33] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11197.



The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for other real estate loans. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is no difference between when the NCUA or NAFCU weights would have designated a credit union as "undercapitalized" prior to its failure. This is significant because it means that changing the risk-weighting to the FDIC risk-weights for other real estate loans will not detract at all from NCUA's intention that the proposed rule would act as an early warning system for troubled credit unions.



Investments

The proposed rule uses the investment risk-weights to compensate for interest rate risk. This is apparent in the differences in proposed risk-weights for investments based on the Weighted-Average Life of Investments (WAL).

NAFCU has a number of issues with the proposed rule's risk-weights for investments. First, any final rule should eliminate the interest risk component from the capital requirements to align itself with FDIC risk-weights for investments. As noted above, credit unions already monitor and control for interest rate risk through internal policies and in accordance with NCUA examination and supervision policies. It is unnecessary and redundant for a risk-based capital regime to perform this function. This proposed rule is a one-size-fits-all requirement to hold more capital for almost all types of investments as a means to control for interest rate risk. Requiring more capital only serves as a disincentive to invest in longer-term investments, it does not provide the in-depth analysis to evaluate investments that is needed and brought about through the current supervision and examination process. [34]

As NAFCU compares the NCUA proposal to the FDIC requirements for risk-based capital, we note that for those investments that credit unions are permitted to make, the FDIC does not incorporate interest rate risk into the investment risk-weights for community banks. Instead, it generally weights the investments that credit unions can make with a single risk-weight regardless of maturity. FDIC weights most types of investments that credit unions are able to make at a 20 percent risk-weight regardless of the WAL. This is another example of how this rule would put credit unions at a competitive disadvantage to banks. NCUA's proposal also does not account for any mitigation efforts, such as variable-rate assets or derivatives, which would offset some exposure for credit unions to interest rate risk.

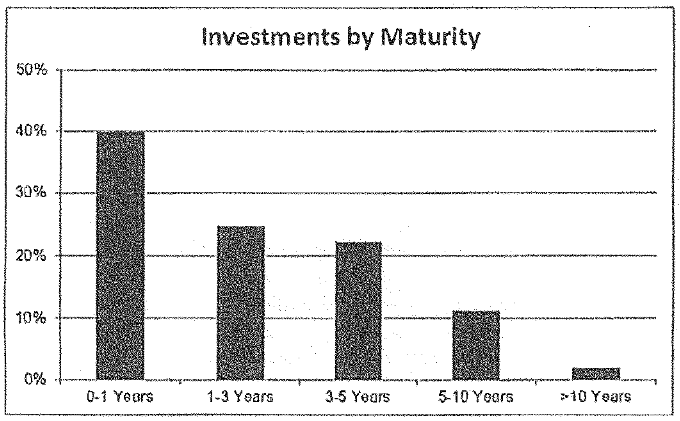
According to the proposed rule, the specific risk-weights are based primarily upon the 300 basis point interest rate shock used to prepare for a worst-case scenario of interest rate fluctuation. This means the NCUA has selected the increments for the investment weight scale to match the loss that would take place due to a 300 basis point interest rate shock. NAFCU believes that this methodology is flawed and does not result in the appropriate risk-weights for investments.

NAFCU strongly believes that NCUA should stay within their statutorily mandate and use the 20 percent FDIC risk-weights for investments regardless of WAL, as illustrated in the next chart.

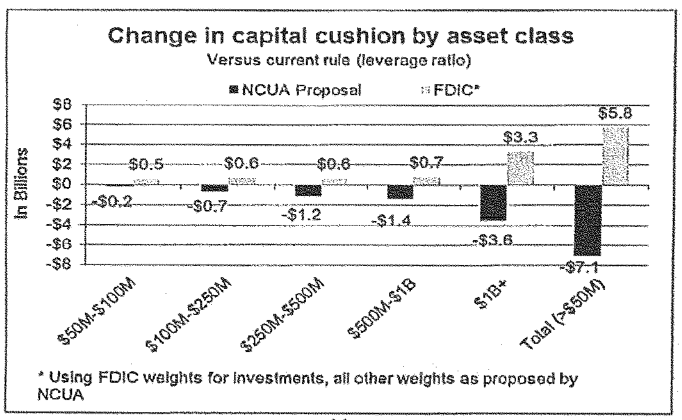
[34] NCUA already has a number of requirements and guidance that credit unions must comply with such as the interest-rate risk final rule, a letter to credit unions on the subject (12-CU-05), and it is the top subject in the most recent NCUA supervisory focus (13-CU-01). Instead of making credit unions hold more capital, NCUA should first look to its existing requirements and regulations.

Investments By WAL	NCUA Proposed Risk-Weights	FDIC Risk-Weights
0-1 year	20 percent	20 percent
1-3 years	50 percent	20 percent
3-5 years	75 percent	20 percent
5-10 years	150 percent	20 percent
>10 years	200 percent	20 percent

NCUA should also be mindful of the cooling effects of the final rule on short- and medium-term investments. The chart below shows the distribution of total credit union investments by maturity bucket. Note that only about 13 percent of credit union investments have an average life of over five years.

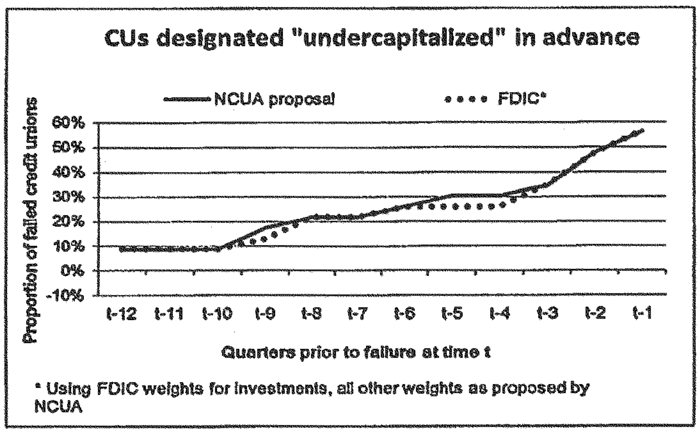


The FDIC risk-weights would benefit the capital cushion for credit unions at every asset level size as compared to the proposed rule. This is illustrated in the next graph.



Changing the risk-weighting to the FDIC risk-weights does not significantly affect the warning available prior to a failure of a troubled credit union. The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights. This proportion is tracked over the twelve quarters prior to a credit union's failure, serving as an early warning sign to NCUA that capital issues were on the horizon.

As the graph on the next page shows, using the FDIC risk-weights for investments would result in negligible changes in the early warning signs for troubled credit unions as compared to the proposed rule. As illustrated, the alternative investment risk-weights deviate only slightly in the t-6 through t-3 and t-10 through t-8 timeframes prior to failure.



To summarize, NAFCU strongly urges NCUA to remove the interest rate risk component from any final rule. Interest rate risk should continue to be controlled for and monitored through the supervision and examination process, continuing to incorporate industry standard methods. Finally, NCUA should use the FDIC risk-weights of 20 percent for investments regardless of the WAL of the investment.

Federal Reserve Deposits

The proposed rule does not specifically identify how cash held at the Federal Reserve is to be treated. The rule does address how cash on deposit (which is normally interpreted as cash on deposit at other insured financial institutions), cash equivalents, and cash on hand are to be treated, but does not propose a specific risk-weight for cash held at the Federal Reserve. Credit unions often have balances at the Federal Reserve as a repository for excess cash or to satisfy their minimum reserve requirement.

NAFCU believes that cash held at the Federal Reserve should have a risk-weight of zero percent. A zero percent risk-weight would take into account the Federal Reserve's unique relationship with the U.S. Government. NCUA should risk-weight all balances held at the Federal Reserve at zero percent.

Federal Home Loan Banks

The proposed rule also does not specifically address Federal Home Loan Banks (FHLB). NAFCU believes that the proposed rule could risk-rate FHLB consolidated obligations and stock from 20 percent to 200 percent creating a distinct disadvantage when compared to other insured depository institutions and potentially restricting credit extensions to the communities served by credit unions.

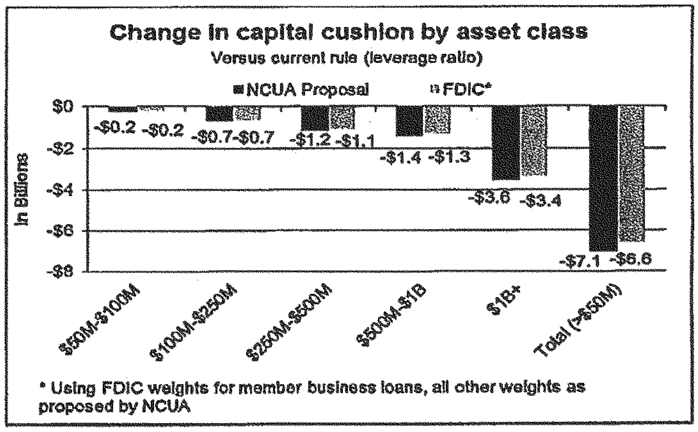
NAFCU notes that the risk weighting for FHLB consolidated obligations (highly liquid and safe – generally rated AAA and track treasuries) and FHLB stock (statutorily mandated to be redeemed at par and no member has ever lost a cent on stock) are weighted at 20 percent under Basel and by the other banking regulators. NCUA should weight FHLB consolidated obligations and stock at 20 percent to be comparable to other banking regulators.

Member Business Lending

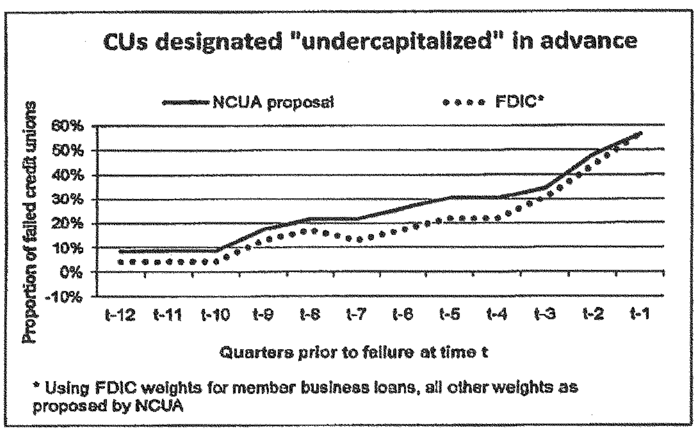
The proposed rule factors concentration risk into the proposed risk-weighting for MBLs by setting the risk-weights to correspond with the percent of assets in MBLs held by the credit union. As mentioned above, NAFCU believes that concentration risk should be controlled through the supervision and examination process and not a one-size-fits-all capital regime that requires credit unions to hold more capital without allowing those credit unions with less risk to hold less capital. The FDIC does not take concentration risk into consideration and risk-weights all business loans at 100 percent. NAFCU believes that NCUA should follow the FDIC and risk-weight MBLs at 100 percent regardless of the concentration of credit union's assets in MBLs as seen in the chart below.

MBL's as % of CU Assets	NCUA Proposed Risk-Weights	FDIC Risk-Weights
0-15% percent of assets	100 percent	100 percent
>15 to 25% of assets	150 percent	100 percent
>25% of assets	200 percent	100 percent

The next chart shows that the capital cushion for credit unions would still shrink from current levels using the FDIC weights for MBLs, but the impact would not be as severe as it would be under the NCUA proposal. The FDIC weights would result in a benefit to the capital cushion for credit unions at every asset level size above $250 million as compared to the proposed rule as seen in the next graph.



The next chart uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for MBLs. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is very little difference between when the NCUA or FDIC weights would have designated a credit union as "undercapitalized" prior to its failure. This is significant because it means that changing the risk-weighting to the FDIC risk-weights for MBLs will only slightly change the early warning system indications for troubled credit unions as compared with NCUA's proposed rule.



Furthermore, there are a number of credit unions chartered historically for business-loan purposes that will be significantly hurt by this proposed rule. The risks to the portfolios of these special credit unions, including concentration risk, should be managed through the examination and supervision process, not through these capital risk-weights. NAFCU

believes that credit unions with proven minimal losses in business lending should be given credit for diversified portfolios and proven underwriting standards. Additionally, the proposed risk-weights would negatively impact credit unions with the low income credit union designation (LICUs), which are not subject to the statutory MBL cap. These LICUs would have a disincentive to utilize their ability to exceed the MBL cap in order to provide business loans to their members due to the restrictive requirements to hold more capital.

The proposed rule states that "MBLs that are government guaranteed at least 75 percent, normally by the Small Business Administration (SBA) or U.S. Department of Agriculture, would receive a lower risk-weight of 20 percent under the proposed rule."[35] This 75 percent threshold does not include beneficial programs that are guaranteed at between 50 percent and 75 percent such as the SBA Express program which helps many member small businesses. NCUA should factor in all guarantees made by the SBA or U.S. Department of Agriculture when determining risk-weighting for MBLs.

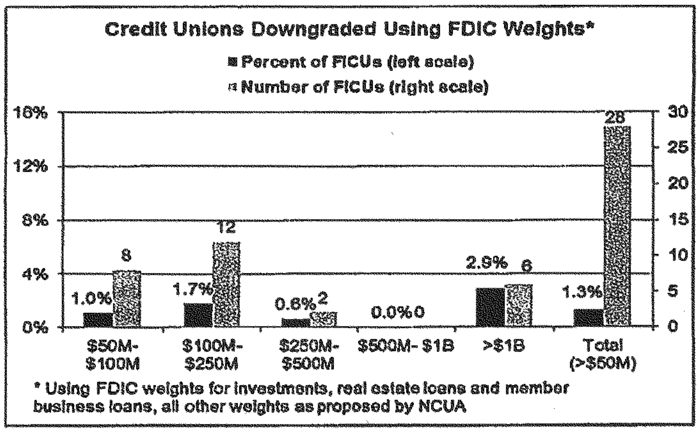
Another issue that NCUA has failed to address with this proposed rule is the difference risks based on the types of MBL loans by category. For example, risk-weights could also be broken down into types of loans using call report data and given appropriate risk-weights based on actual risk for the following categories: (1) agricultural MBLs; (2) construction and development; (3) non-farm, non-residential; (4) commercial and industrial loans; and (5) unsecured business loans. At this time the call report does not collect information on write-offs for different types of MBLs, but NCUA could modify the call report to collect this information.

The Effects of Combined FDIC Weights

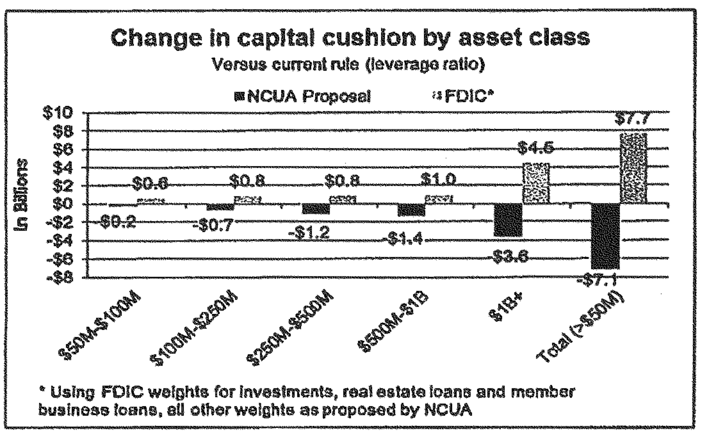
As shown in the sections above, NAFCU believes that NCUA should use the FDIC risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs rather than the NCUA's proposed risk-weights that incorporate interest rate and concentration risk. While previous graphs show the industry wide benefits to credit unions of changing the individual risk-weights from what was proposed by the NCUA to the FDIC risk-weights, the following graphs show the *combined* benefit of changing the proposed risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs to FDIC risk-weights.

This first graph shows the number and percent of credit unions that will be downgraded by asset class as a result of changing non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs to FDIC risk-weights. 28 federally insured credit unions will be downgraded as opposed to more than 200 which would be downgraded under the proposed rule. NAFCU believes that this is a more appropriate result and represents a more balanced system.

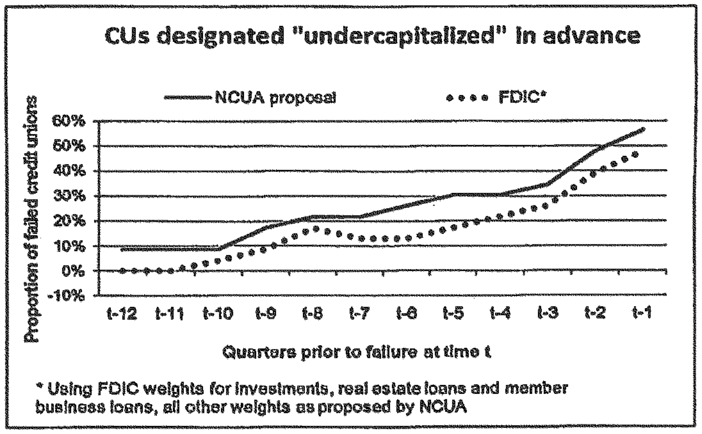
[35] Prompt Corrective Action - Risk-Based Capital, 79 Fed. Reg. 11184, 11196.



The next graph shows the change in capital cushion by asset class as a result of changing the individual risk-weights from what was proposed to the FDIC risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs. It shows a benefit to credit unions capital cushion for credit unions in every asset category as compared to the proposed rule.



The chart below uses NCUA call report data to determine the proportion of credit unions that would have been designated as "undercapitalized" prior to failure based upon NCUA's proposed rule and the FDIC risk-weights for non-delinquent first mortgage real estate loans, other real estate loans, investments, and MBLs. This proportion is tracked over the twelve quarters prior to a credit union's failure. The chart indicates that there is very little difference between when the NCUA or FDIC weights would have designated a credit union as "undercapitalized" prior to its failure.



Importantly, changing the risk-weighting for these assets to the FDIC risk-weights does not compromise the NCUA's stated intent for the proposed rule to serve as an early warning system for troubled credit unions. Using the FDIC risk-weights will still accomplish this essential function of a balanced risk-based capital system. NAFCU strongly believes that NCUA should align the risk-weights for these assets with the FDIC risk-weights.

Credit Union Service Organizations (CUSOs)

The proposed rule sets a 250 percent risk-weight for investments in CUSOs and 100 percent for loans to a CUSO. In the proposed rule, NCUA does not include rationale as to why investments in CUSOs should get a proposed risk-weight of 250 percent except to say that a CUSO is an unsecured equity investment with no secondary market. Any final rule should include more detailed rationale, as well as any data used to support the final risk-weight.

The proposed rule also fails to explain the difference in proposed risk-weights between the 250 percent for investments in CUSOs and 100 percent for loans to CUSOs. This would suggest that loans to CUSOs are 2.5 times safer than investments in CUSOs, or in the reverse, that investments in CUSOs are 2.5 times riskier than a loan to a CUSO. Consumer debt that is over sixty days delinquent is currently rated at 150 percent while investments in a CUSO are rated at 250 percent.

Although there have been a couple of high-profile credit union losses partially driven by bad CUSO investments, the overwhelming majority of CUSOs are performing very well, generating considerable savings through economies of scale, and providing much needed non-interest income to the credit union owners. During a time of increased regulatory costs, shrinking fee income, and artificially depressed interest rates, it is imperative that credit unions are able to use CUSOs to decrease overhead costs while increasing business.

NCUA's argument that CUSOs represent a safety and soundness threat to the NCUSIF is also without merit. Less than 22 basis points of credit union assets are invested in CUSOs

and do not represent a systematic risk that could take down the share insurance fund. Those same 22 basis points are less than what credit unions have paid in annual corporate assessments in 2012. Each credit union may only invest less than 1 percent of its assets into CUSOs.[36] For example, suppose that in an unlikely scenario a credit union lost its entire investment in a CUSO. This loss alone would not be material and the consequences of requiring a disproportionate amount of capital, as compared with actual risk, are more far reaching as credit unions will not enjoy those cost savings made available only through the collaborative model of CUSOs.

NCUA is making policy decisions that affect business decisions for credit unions through these proposed risk-weights. This proposed rule could force credit unions to reconsider current and future investments in CUSOs. Credit unions might divest currently held investments and not invest in future CUSOs. This will hurt members and credit unions alike.

If NCUA declines to lower the risk-weighting to a reasonable level for investments in CUSOs, NCUA should at least consider differentiating between different types of CUSOs and assessing a risk-weight that accurately measures the risk of loss. Some of the possible factors to consider would be the types of services provided by a given CUSO (mortgage servicing, IT, compliance, etc.), whether the amount of investment is material, whether the CUSO has a history of profitability or loss, or whether the investment has already been recovered by the credit union through income or savings. Then NCUA could provide lower risk weights for CUSOs that present less of a risk to credit union assets.

Mortgage Servicing Assets (MSA)

The proposed rule would set the risk-weight at 250 percent for mortgage servicing assets (MSAs). This is an artificially high and excessive risk-weight relative to the actual risk presented by the underlying assets. The 250 percent weight is punitive and indicates a change in NCUA's view regarding loan participations.

Last year NCUA finalized a rule on loan participations that was intended to help credit unions and NCUA better manage the potential concentration risk in loan participations. The loan participation rule is working and should be allowed to continue to do so instead of assigning artificially higher risk-weights for mortgage servicing assets.

The proposed rule does not include a mechanism for NCUA to differentiate between an asset that is sold with recourse versus one that is sold without recourse. This would change the actual risk to a credit union depending on the underlying loans in a mortgage servicing asset. This one-size fits all approach does not appropriately measure actual risk.

MSAs are fairly liquid and gain value as rates rise. These present excellent opportunities to gain income and help prevent against some forms of interest rate risk. Also, credit unions do a great job servicing loans and want to continue to serve members. Many credit unions originate loans and then sell those loans to reduce interest rate and liquidity risk, yet retain

[36] 12 CFR 712.2(a).

the servicing due to the relationship with the member and because these are valuable assets. This arbitrary risk-weight provides a disincentive to retain those servicing rights.

NAFCU believes that NCUA should set the risk-weights for mortgage servicing assets at 150 percent. NCUA should also find a way to consider whether the loan is a recourse loan and assign those a 150 percent risk-weight. NCUA could then allow a lower weighting of 100 percent if the loans are sold without recourse but are serviced by the credit union.

Corporates Paid-In Capital

The proposed rule would set a risk-weight for paid-in corporate capital at 200 percent. This is one of the higher risk-weights proposed by this rule and does not appear to accurately represent the unique nature of corporate credit unions.

The corporate credit unions have had more regulatory changes over the past five years than any other sector of the credit union system including additional capital requirements. These changes include: stricter investment limits, concentration risk prohibitions, and governance changes. These prior regulatory changes to the corporate credit union system and the eliminated risks should be represented through a lower risk-weight.

The proposed risk-weight does not reflect the actual risk of this asset. The proposed rule suggests that corporate paid-in capital is two times as risky as a dollar invested in a mortgage loan in excess of 35 percent of assets. This could also serve as a disincentive to credit unions to invest in corporate credit unions and thereby endanger the current corporate credit union structure.

A weight that reflects the actual risk for paid-in capital to corporate credit unions would benefit natural person credit unions, corporate credit unions, and the share insurance fund. Paid-in capital would be more appropriately weighted at 125 percent to recognize that the corporate credit union structure is different than it once was, and now presents less risk to the credit union system. The 125 percent also recognizes that the corporates paid-in capital is riskier than safer investments such as treasuries or consumer loans.

Individual Minimum Capital Requirements

The proposed rule provides NCUA with the ability to require a higher minimum risk-based capital ratio for an individual credit union in any case where the Agency determines the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate. This means NCUA may establish increased individual minimum capital requirements upon its determination that the credit union's capital is, or may become, inadequate in light of the credit union's circumstances, regardless of the actual risk-based capital ratio of the credit union.

In other words, NCUA can increase a credit union's individual risk-based capital requirement by subjective action through the examination process or "supervisory assessment" based on the determination that the credit union needs additional capital based

on the credit union's balance sheet risk. A survey of NAFCU's membership taken in April 2014 found that over 65 percent of respondents have serious concerns about this portion of the rule.

NAFCU believes there are serious concerns regarding the legal authority of NCUA to enact this portion of the rule, as discussed above.

In addition to potential legal issues, this portion of the proposal seems to undermine the stated purpose of the rule. On the one hand, credit unions are led to believe that the proposal is designed to factor in a number of different risks including interest rate and concentration risk. On the other hand, if the risk-based capital ratios laid out in the proposal do not result in the numbers NCUA examiners would like to see, NCUA can change the rules for an individual credit union. This makes it nearly impossible for a credit union to make a sound business decision concerning its portfolio makeup, leading to even more uncertainty for credit unions and credit union members.

Individual Minimum Capital Requirement Appeals Process

The proposed appeals process does not alleviate any of the underlying concerns with the individual minimum capital requirements portion of the rule. The process itself lays a great deal of burden on individual credit unions to prove that the NCUA action was not an appropriate exercise of discretion by the Agency. The process also requires credit unions to appeal to the same NCUA Board that, according to statute, is required to make the judgment in the first place.

While the proposed rule allows credit unions to seek the opinion of the NCUA's Ombudsman, the NCUA Board is not bound by, or required to give deference to, the Ombudsman's recommendations. NAFCU believes that NCUA should enact an independent appeals process free of examiner retaliation. It is important that the independent appeals process include appeals to non-interested parties that do not have an opportunity to retaliate against individual credit unions that make appeals.

Goodwill and Other Issues

The proposed rule fails to include a number of components to the numerator portion of the risk-based capital ratio including goodwill, other intangible assets, and identified losses not reflected as adjustments to components of the risk-based numerator.

The loss of goodwill within the risk-based capital ratio numerator presents two significant issues to consider. First, it penalizes credit unions for past actions. Goodwill is present on the balance sheets of credit unions recently involved in mergers. Without goodwill, credit unions will be unable to fully realize the benefit of merging in troubled credit unions.

Secondly, this can present significant problems in the future. The credit union industry has seen increased consolidation in the past few years and this is a trend that is likely to continue. Without goodwill as a component of the numerator, a healthy credit union is less likely to agree to take on a troubled credit union as a partner (even at the request of

NCUA). This is going to make it harder and more expensive for NCUA (and the industry as a whole) to find merger partners for troubled or failing credit unions that will ultimately lead to more expensive liquidations for the NCUSIF.

NAFCU believes that NCUA should reconsider removing goodwill from the numerator portion of the risk-based capital ratio.

Allowance for Loan and Lease Losses

In the capital elements of the risk-based capital ratio numerator, the proposed rule limits ALLL to 1.25 percent of risk assets. The discussion in the rule states this limitation is proposed to provide an incentive for granting quality loans and recording loan losses timely. The disregard for excess ALLL does not provide an equitable solution.

Credit unions are generally more conservative than banks when it comes to ALLL. This cap of 1.25 percent will penalize a credit union for being conservative with its allowance and provide a disincentive for holding ALLL above the 1.25 percent cap.

NAFCU encourages NCUA to consider changing the 1.25 percent cap to 1.50 percent of risk assets to provide a better incentive for fully funding ALLL above 1.25 percent. In addition, in the most recent Financial Accounting Standards Board (FASB) proposal on ALLL (the Current Expected Credit Loss model), issued in December 2012, if put into place, has the potential to significantly increase ALLL reserves by as much as 20-50 percent. If those changes are put into place, NCUA should increase the limit of ALLL to be included in the risk-based capital numerator comparable to the additional levels of ALLL required.

Supplemental Capital

Supplemental capital authority is needed now more than ever considering the restrictions brought on by this rule. NCUA should continue to call on Congress to pass a legislative solution that modernizes capital standards to allow supplemental capital.

Currently, a credit union's net worth ratio is determined solely on the basis of retained earnings as a percentage of total assets. Because retained earnings often cannot keep pace with asset growth, otherwise healthy growth — such as growth resulting from taking deposits — can dilute a credit union's regulatory capital ratio and trigger non-discretionary supervisory actions under PCA rules. Allowing eligible credit unions access to supplemental capital, in addition to retained earning sources, will help ensure that healthy credit unions can achieve manageable asset growth and continue to serve member-owners efficiently.

While supplemental capital authority is important for those credit unions that are able to raise it, it is important to understand that supplemental capital authority is not the answer to all of the problems with this proposed rule. There is a difference between the authority to raise supplemental capital and the ability of individual credit unions to actually obtain it.

Not every credit union would be able to use that important tool to actually raise significant capital even if the credit union were given the authority to do so.

Implementation Date

NCUA has proposed an implementation time period and effective date of 18 months after the passage of a final rule and its publication in the *Federal Register*. During that 18 months implementation period, credit unions would need to prepare balance sheets for the new risk-based capital ratio requirements, and would also be required to continue to comply with the current PCA requirements of part 702 on NCUA's rules and regulations.

NAFCU believes that the proposed 18-month implementation timetable is not long enough for a rule as complex and impactful as this proposed rule. The proposed revisions to net-worth and capital requirements will vastly affect a credit union's decision making and it will take time for a credit union to adjust its balance sheets related to this new regulation. Credit unions will also need to adjust internal systems and operations well in advance of the effective date.

Credit unions will be faced with difficult decisions when attempting to raise risk-based capital ratios under the proposed rule. Credit unions will have to either divest assets that are more heavily risk weighted or generate retained earnings. It is difficult to generate retained earnings in a short period of time when credit unions are being forced to divest the assets that have the largest returns and produce the most retained earnings.

When comparing NCUA's proposed timeframe and the time frame afforded to banks during the implementation of BASEL standards, it is evident that the proposed implementation timeframe is insufficient. Given the difficulties that credit unions will face to accumulate additional capital through retained earnings, a longer time frame for the implementation of this rule is necessary.

NAFCU believes any implementation period should be no less than three years after passage of any final rule. Credit unions will need at least that long to make safe and sound decisions about potentially fundamental changes to core business decisions including investments and product offerings. This would also be more consistent with the time frame given to the banking industry during the BASEL standards implementation. On September 10, 2013, the FDIC issued a consolidated interim final rule (Basel III interim final rule) and its final rule was issued on April 14, 2014. While some portions of the rule take effect as soon as two years after the final rule, all portions of the rule do not become fully effective until January 1, 2019, almost five years after the rule was finalized.

Conclusion

In conclusion, NAFCU is supportive of the idea of a risk-based capital regime for credit unions; however, the current NCUA proposal does not achieve the desired system and would ultimately harm credit unions. If it were to be implemented as proposed, credit unions would be at a significant competitive disadvantage to banks. As proposed, the rule is one-size-fits-all and would serve to stifle growth, innovation, and diversification at

credit unions. NAFCU hopes that the NCUA Board will ultimately withdraw the proposal and work with Congress to modernize capital standards in accordance with the recommendations in NAFCU's "Five Point Plan for Regulatory Relief"

Alternatively, should the NCUA Board fail to withdraw the proposal, it should remove the interest rate and concentration risk components that are currently incorporated into the risk weightings and lower the risk-weights to accurately reflect the risk associated with specific assets and to become comparable to the standards of other banking regulators. The NCUA Board should also remove the provision regarding individual capital requirements as this authority rests on questionable legal grounds and its inclusion increases uncertainty for credit unions.

Thank you for your continued commitment to listen to feedback from credit unions on this important issue. Should you have any questions or would like to discuss these issues further, please feel free to contact me or PJ Hoffman, Regulatory Affairs Counsel, at PJHoffman@nafcu.org or (703) 842-2212.

Sincerely,

B. Dan Berger
President and CEO
National Association of Federal Credit Unions

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Dan Berry
Chief Operating Officer
Duke University FCU
Assets: $109,877,949

John Buckley
President/CEO
Gerber FCU
Assets: $121,916,895

Joe Clark
Chief Legal Officer
Truliant FCU
Assets: $1,667,349,920

Connie Dumond
Manager
Greater Woodlawn FCU
Assets: $110,670,295

John Farmakides
President/CEO
Lafayette FCU
Assets: $396,760,547

John Harwell
AVP Risk Management
Apple FCU
Assets: $1,845,999,114

Mitchell Klein
Chief Risk Officer
Citadel FCU
Assets: $1,880,414,011

Jim Laffoon
President/CEO
Security Service FCU
Assets: $7,679,605,307

Janet Larson
Director
SunState FCU
Assets: $297,621,812

Leanne McGuinness
SVP/CFO
The Summit FCU
Assets: $719,691,062

Michael Pardon
President/CEO
Sea Air FCU
Assets: $146,830,582

Jane Verret
Chief Administration
Campus FCU
Assets: $509,914,856

Susan Lezotte
AVP Compliance
Eli Lilly FCU
Assets: $1,033,855,869

Jim Mooney
President/CEO
Chevron FCU
Assets: $2,352,852,646

Wayne Schulman
SVP, Corporate Counsel
Logix FCU
Assets: $3,703,062,025

Attachment B: XCEL FCU's comment letters on the NCUA's
Prompt Corrective Action/ Risk-Based Capital proposal

From: Linda McFadden
To: Regulatory Comments
Cc: Nicola Foggie
Subject: Prompt Corrective Action, Risk-Based Capital
Date: Monday, May 26, 2014 4:59:24 PM

May 26, 2014

Dear Gerard Poliquin, Secretary of the Board,

This letter will address XCEL Federal Credit Union's viewpoint and concerns regarding the Risk Based Capital Proposed Rule.

XCEL FCU and the credit union industry remains a strong and viable in the aftermath of the recession. Even with the loss of some corporate credit unions, natural person credit unions took up the charge and relieved the stress that such economic times caused. With this information in mind, XCEL feels that this new proposal is not necessary and the NCUA has not adequately justified the need for this rule/change. Credit unions continue to be stronger, more self-reliant than other banking entities. So, why are we trying to fix/adjust what isn't broken.

Capital requirements should not be a substitute for proper credit union management or appropriate examinations. The proposal, as it is written, would negatively impact XCEL Federal Credit Union, taking us from a well-capitalized credit union to adequately-capitalized. Now is not the time to restrict credit union growth, which is the result, if this proposal goes forward. This proposal will restrict XCEL from implementing products and programs which are needed to compete in the financial industry. Reducing assets and cutting expenses to gain capital is not the solution for safety and soundness of the insurance fund. Running a fundamentally sound financial institution, while giving our members the best products and services and, the latest technology, is!

The proposed rule will force XCEL's board and management only to think of gathering more capital to protect the insurance fund instead of why we are in business to begin with. XCEL has had steady balanced growth with good solid returns over the past few years but to achieve the new capital requirements we would to change our business model from being a credit union for our members to a focus on profitability. We might as well become a bank. XCEL did our part for the corporate bailout so why does NCUA think it is necessary to make these restrictions. Why should we cut service to our members because the insurance fund, which weathered the economic stress of the recession, wants even more protection?

XCEL is all for safety and soundness but since the recession; NCUA has put additional restrictions on all credit unions with concentration limits and restrictions. XCEL gladly complied and developed a sound concentration risk policy and set limits on our already diversified loan and investment portfolio. This exercise only proved that our credit union was already well managing this portion of the business.

With the proposed regulation XCEL would need to curtail participation lending. Participation loans help to mitigate risk and ensures steady loan growth during non-peak member lending season. If the underwriting criteria are as or, in some cases even more conservative, why should we have to reserve more than is necessary just because it is participated out with other credit unions also regulated by NCUA.

If NCUA continues with this proposal, we would hope that for the industry's sake, the impact of the risk weights is well thought out before requiring any implementation. As an example, the proposed rule assigns rigid risk-weights to many federally backed investments that when properly examined represent much less risk with less return. This is taking caution to the extreme. Credit unions need to have someplace to put excess cash other than a liquid overnight account with little or no return for the investment. We could address many more of the individual risk weights but I feel the main point to make is as presented they are not in the best interest of the credit union industry and our members.

Last but not least is removing the 1% NCUSIF capital deposits out of the calculation. This is just wrong! Taking those funds out of the calculation will put undue pressure on many credit unions unjustifiably.

Sincerely,

Linda McFadden, President / CEO

XCEL Federal Credit Union

1460 Broad St.

Bloomfield, NJ 07003

Linda McFadden
XCEL Federal Credit Union
President / CEO
T: 800-284-8663 x3024
D: 201-499-1653
F: 201-714-5736
LindaMcFadden@XCELfcu.org
www.XCELfcu.org

XCEL
FEDERAL CREDIT UNION
Uniting Service and Technology

1460 Broad Street, Bloomfield, NJ 07003

May 28, 2014

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: Comments on NCUA Prompt Corrective Action –
Risk-Based Capital Proposed Rule

Dear Mr. Poliquin:

On behalf of the Board of Directors and Management Staff of XCEL Federal Credit Union (XCEL), I am writing to you regarding the proposed rule on Prompt Corrective Action and Risk-Based Capital (RBC). In reviewing the proposal, and the multiple comment letters from the Credit Union industry, we at XCEL are shaken at the potentially devastating effect this proposal will have on us, the credit union industry, the American consumer, and our nation's small businesses.

We ask you to strongly consider the comments posted by former Senator D'Amato and former Speaker Gingrich, when they point out that your proposal is contrary to the language and intent of the 1998 Revisions to the Federal Credit Union Act. Many other current and former legislators have expressed similar concerns to you, challenging the legality of your proposal.

XCEL concludes, as have others, that if your RBC proposal is implemented, it would put us at a significant competitive disadvantage to banks here in the Northeast. The rule is based on a poorly designed "one-size-fits-all" concept and would stifle our growth, potential innovation, and diversification. We ask the NCUA Board to withdraw the proposal or alternatively make major modifications to the proposal before any rule is finalized.

The proposal's RBC ratio for well capitalized credit unions is set at 10.5 percent. This increase to current PCA limits of 7.0 percent cannot be supported by the arbitrarily weight limits assigned to concentration risk components. We urge that you lower the risk weights to more accurately reflect risks associated with our credit union's specific assets. We further urge NCUA to defer to the industry suggestion of a joint committee made up of NCUA and Credit Union leaders to review and create a more realistic threshold and rational for PCA.

XCEL
FEDERAL CREDIT UNION
Uniting Service and Technology

1460 Broad Street, Bloomfield, NJ 07003

Under the proposed rule, XCEL will be faced with many difficult decisions when attempting to reach the RBC ratios stated. We face the possibility of having to divest ourselves of profitable assets that, under your rule, are more heavily risk weighted in order to generate higher retained earnings your proposal seeks from us. We feel that in the current economic climate, this would be virtually impossible to accomplish and fulfill our mission of serving our members under the credit union model.

We hope you will consider our thoughts as you review and hopefully revise your RBC proposal.

Sincerely:

Daniel H. Moffit
CHAIRMAN, Board of Directors

XCEL Federal Credit Union Board of Directors:

VICE-CHAIRMAN
Joseph Tolciss

TREASURER
Salvador Schiano

SECRETARY
Richard Masella

DIRECTORS
Gennaro Aprile
Phyllis Ford
Jerome Lafragola
Stacey Walker
Jerome Lafragola
Donald Monah

DIRECTOR EMERITUS
Tom Doogan

Copy to:

B. Dan Berger
President and CEO
National Association of Credit Unions

Bill Chaney
President and CEO
Credit Union National Association

Attachment C: NAFCU's "Five Point Plan for Regulatory Relief" released in February 2013

Learn How NAFCU's Five-Point Plan Will Bring Regulatory Relief to Credit Unions

In February 2013, NAFCU was the first trade association to call on this Congress to provide comprehensive broad-based regulatory relief for credit unions. As part of this effort, NAFCU sent Congress a five-point plan for regulatory relief that will significantly enhance credit unions' ability to create jobs, help the middle class, and boost our nation's struggling economy. The five-point plan is built on a solid framework of recommendations that provide regulatory relief through the following:

1. Administrative Improvements for the Powers of the NCUA

- Allow a federal credit union to petition NCUA for a waiver of a federal rule in favor of a state rule.
- Provide NCUA the authority to delay implementation of CFPB rules that affect credit unions and to tailor those rules for credit unions' unique structure.
- Require a cost/benefit analysis of all rules that includes a three-year look back and reevaluation of rules that cost 20 percent or more than their original cost estimate.
- Enact new examination fairness provisions to help ensure timeliness, clear guidance and an independent appeal process free of examiner retaliation.
- Improve the Central Liquidity Facility by removing the subscription requirement for membership and permanently removing the borrowing cap.

2. Capital Reforms for Credit Unions

- Direct NCUA and industry representatives to conduct a study on prompt corrective action and recommend changes.
- Modernize capital standards by directing the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks and allows the NCUA Board to authorize supplemental capital.
- Establish special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

3. Structural Improvements for Credit Unions

- Direct NCUA, with industry input, to conduct a study of outdated corporate governance provisions in the Federal Credit Union Act and make recommended changes to Congress.
- Improve the process for expanding a federal credit union's field of membership by allowing voluntary mergers among multiple common bond credit unions, easing the community charter conversion process and making it easier to include those designated as "underserved" within a credit union's field of membership.

NAFCU

National Association of Federal Credit Unions | www.nafcu.org

4. Operational Improvements for Credit Unions

- Raise the arbitrary cap on member business loans to 27.5% or raise the exemption on MBL loans from $50,000 to $250,000, adjusted for inflation, and exempt loans made to non-profit religious organizations, businesses with fewer than 20 employees and businesses in "underserved areas."
- Remove requirements to mail redundant and unnecessary privacy notices on an annual basis, if the policy has not changed and new sharing has not begun since the last distribution of the notice.
- Allow credit unions greater authority and flexibility in how they invest.
- Provide NCUA the authority to establish longer maturities for certain credit union loans and greater flexibility in responding to market conditions.
- Provide federal share insurance coverage for Interest on Lawyers Trust Accounts (IOLTAs).

5. 21st Century Data Security Standards

- Establish national standards for safekeeping of all financial information.
- Establish enforcement standards for data security that prohibit merchants from retaining financial data, and require merchants to disclose their data security policies to customers.
- Hold merchants accountable for the costs of a data breach, especially when it was due to their own negligence; shift the burden of proof in data breach cases to the party that incurred a breach and require timely disclosures in the event of a breach.

For more information, visit **www.nafcu.org/regrelief.**

NAFCU

National Association of Federal Credit Unions | www.nafcu.org

Attachment D: NAFCU's "Dirty Dozen" – Twelve Regulations to Eliminate or Amend

NAFCU's "Dirty Dozen" - Twelve Regulations to Eliminate or Amend

1. **Expand credit union investment authority** to include permissible investments in derivatives, securitization and mortgage servicing rights. NAFCU strongly pushed for the expansion of credit unions' investment authority to include the ability to engage in limited derivatives activities. NAFCU will continue to seek this authority for qualified credit unions. In addition, NAFCU will push for the authority to securitize loans and expanded ability to invest in mortgage servicing rights.

2. **Seek updates and modernization of the NCUA's fixed assets rule.** In particular, the NCUA should: (1) increase the current 5 percent aggregate limit; (2) re-define what constitutes "fixed assets"; and, (3) improve the process of obtaining a waiver.

3. **Improve the process for credit unions seeking changes to their field of membership.** Improvements should include: (1) enabling credit unions to strengthen their associational membership charter; (2) streamlining the process for converting from one charter type to another; (3) remove or greatly increase the current population limits for serving members in a metropolitan area (1 million) and contiguous political jurisdictions (500,000); and, (4) making it easier for all credit unions to add "underserved" areas within their field of membership.

4. **Increase the number of transfers allowed to be made per month from savings accounts.** The restriction on "convenience transfers" under Regulation D presents an ongoing concern for NAFCU and its members. Members are often unable to understand and remember the arbitrary limits on the number and types of transfers the regulations permit them to make from their savings account. Members expect to have the ability to transfer their funds with ease to and from particular accounts, and the regulation's six-transfer limitation from savings accounts creates an undue burden for both members and credit unions. This six-transfer limitation should be updated and increased to at least nine transfers per month, while still making a distinction between savings and transaction accounts.

5. **Seek added flexibility for credit unions that offer member business loans.** These improvements could include: (1) securing credit union-friendly changes to the waiver process; (2) increasing the general minimum loan-to-value ratio from 80% to 85%; and, (3) securing removal of the 5 year relationship requirement.

6. **Update the requirement to disclose account numbers to protect the privacy of members.** Credit unions are currently required to list a member's full account number on every periodic statement sent to the member for their share accounts pursuant to Regulation E. These requirements need to be updated to allow the credit union to truncate account numbers on periodic statements in order to protect the privacy of the member and to reduce the risks of fraud and identity theft.

7. **Update advertising requirements for loan products and share accounts.** The regulatory requirements for advertisement of credit unions' loan products and share accounts have not kept pace with technological changes in the current market place. The requirements of Regulation Z and Truth in Savings should be updated to reflect these changes and advances in practical advertisements and the disbursement of information, while maintaining the integrity and accuracy of the information that the member truly needs to know from the advertisement.

8. **Modernize NCUA advertising requirements** to keep up with technological changes and an increasingly mobile membership. Update NCUA regulations to clarify that the official sign is not required to be displayed on (1) mobile applications, (2) social media, and (3) virtual tellers.

9. **Seek improvements to the Central Liquidity Facility** by reducing the amount of time that it takes for a credit union to secure access to liquidity. In addition, work with the NCUA to secure changes the Central Liquidity Facility by removing the subscription requirement for membership and permanently removing the borrowing cap.

10. **Obtain flexibility for federal credit unions to determine their choice of law.** Federal credit unions should be allowed the opportunity to choose the jurisdiction under which they operate without surrendering their federal charter. To this end, NAFCU will work with the NCUA to establish a waiver process under which a federal credit union, taking into account safety and soundness considerations, would choose the state law under which it wants one or more of its operations.

11. **Update, simplify and make improvements to regulations governing check processing and funds availability.** These enhancements should include: changing outdated references (i.e., references to non-local checks); changes that are required by statute and are already effective and incorrectly stated in the regulation; and changes that enable credit unions to address fraud.

12. **Eliminate redundant NCUA requirements to provide copies of appraisals upon request.** Credit unions are required to provide copies of appraisals under the CFPB's final mortgage rules upon receipt of an application for certain mortgages. The NCUA's requirements to provide a copy upon request should be amended to remove this duplicative requirement.

PREPARED STATEMENT OF MARCUS M. STANLEY, PH.D.

POLICY DIRECTOR, AMERICANS FOR FINANCIAL REFORM

SEPTEMBER 16, 2014

Mr. Chairman and Members of the Committee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform. AFR is a coalition of more than 200 national, State and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.

Community banks can bring unique benefits to the communities they serve. The qualities that generally characterize community banks—deep roots in a particular locality, an emphasis on relationship as opposed to transactional banking, and a business focus on traditional lending and deposit gathering activities—can create special advantages for both prudential risk management and customer service. They also create a special affinity for small businesses. Community banks hold almost half (45 percent) of small loans to business, despite accounting for less than 15 percent of total banking assets. The health of community banking is thus a valuable focus for this Committee.

At the same time, community banking is still banking, and the basic principles of banking regulation apply. While community banks today are not large enough to create the kinds of risk to the financial system seen in the 2008 crisis, the failure of a community bank holding publicly insured deposits will still directly impact the deposit insurance fund. Furthermore, a consumer who is victimized by an unfair business practice is equally harmed whether this practice occurs at a community bank, a mid-size bank, or a large Wall Street bank.

Thus, in making regulatory decisions, policymakers should seek to preserve the special benefits of community banking without undermining the core regulatory goals of prudential soundness and consumer protection, either for community banks or for other larger institutions who may also seek regulatory accommodations.

There is no contradiction in these goals. Permitting unsound practices that bring temporary profits at the expense of later losses or bank failures does not serve the long-term health of community banking. This is particularly true since bank failures lead to additional costs to the deposit insurance fund that must be paid by assessments on healthy and successful community banks. And permitting a minority of institutions to compete by foregoing consumer protections does no favors to those institutions that make the effort to treat consumers fairly.

In my testimony today, I would like to make several broad points. The first point concerns size. Community banks are small. 99.7 percent of community banks have fewer than $5 billion in assets, and these banks hold 94 percent of community banking assets.[1]

Furthermore, the economic problems in the community banking sector appear most concentrated among the smaller entities in community banking. In terms of long-term structural change, the entire decline in the number of banks over the last three decades has occurred among banks with fewer than $1 billion in assets, particularly those with less than $100 million. The number of FDIC-insured banks with fewer than $1 billion in assets has declined by two-thirds since the mid-1980s, while the number of banking institutions with more than $1 billion in assets has increased by a third.

More recent profit trends show that there is a continuing divergence in the fortunes of the smallest banks and the rest of the sector. In 2013, over 97 percent of banks with more than $1 billion in assets had returned to profitability. In contrast, approximately 9 percent of banks with fewer than $1 billion in assets were unprofitable last year, a rate more than three times higher than for larger banks. The problem was most acute among the very smallest banks, those with fewer than $100 million in assets, where over 13 percent were unprofitable. The general pattern of a divergence by size has remained in place during the first half of this year. During the first 6 months of 2014, not a single bank with more than $10 billion in assets registered a loss, but more than 12 percent of banks with less than $100 million in assets did.

It may seem obvious that community banks are small. But it is a point worth making, since we often see larger banks seek regulatory accommodation when there

[1] All the data on community banks and bank profitability by size in this testimony is based on information from the FDIC Quarterly Banking Profile, available at *https://www2.fdic.gov/qbp/index.asp,* and the 2012 FDIC Community Banking Study, available at *https://www.fdic.gov/regulations/resources/cbi/study.html.* The classification of community banks was performed by the FDIC using a functional (*i.e.,* not size-based) definition of community banking.

is little evidence that these larger banks either share the unique characteristics of community banks or face the kind of economic issues seen among smaller banks. The data above suggest that measures aimed at assisting community banks should generally be limited to those banks with fewer than $5 billion in assets, and should focus most on those banks with fewer than $1 billion in assets.

The second point I would like to make concerns community banks and the regulatory response to the 2008 global financial crisis. Community banks were obviously not the central contributor to the 2008 crisis. This is not because community banks cannot create systemic risk. Two of the largest systemic banking crises in the last century, the Great Depression and the 1980s Savings and Loan crisis, were driven by the failures of relatively small community banks. But community banks alone are too small a share of today's financial system to create a systemic crisis of the scale seen in 2008. Key players in that crisis were large Wall Street dealer banks, large commercial banks and thrifts that played a key role in securitization markets, and nonbank mortgage originators.

This suggests that the regulatory response to the crisis, particularly those responses aimed at systemic risk, should focus on these kinds of entities. And for the most part, it has. Most new areas of Dodd-Frank regulation have been 'tiered', either in statute or through regulatory action, so that they have their greatest impact on banks that are significantly larger than community banks. Examples include new derivatives rules which generally exempt banks with under $10 billion in assets from mandatory clearing and margining, new prudential requirements instituted by the Federal Reserve under Section 165 of the Dodd-Frank Act, which are limited to bank holding companies with over $50 billion in consolidated assets and apply most stringently to 'advanced approaches' banks with in excess of $250 billion in assets, and new supplementary leverage ratio rules that generally apply to 'advanced approaches' banks and are most stringent for banks with over $700 billion in assets.

But as I'm sure others on this panel will point out, this does not mean that the financial crisis has had no effect on the oversight of community banks. It has. The financial crisis taught many hard lessons about credit risk, securitization risk, and the significance of consumer protection. These are lessons that apply in all areas of banking. The failures to properly underwrite and manage risk that we saw during the crisis affected community banks as well. Over 450 banks failed between 2008 and 2012, more than three times the total number that failed over the 15 years prior to the financial crisis. The great majority of these were community banks. At one point during this period the deposit insurance fund showed an aggregate deficit of over $20 billion. The U.S. Treasury and the U.S. taxpayer are the final backstop for any lasting deficit in this fund. Regulators are applying, and should apply, what they have learned about oversight of lending, securitization, and consumer protection to ensuring the soundness of community banks.

Regulators have applied the lessons of the crisis to community banks in several ways. In prudential regulation, this has occurred through the mechanism of FDIC supervision and through the new Basel capital rules. These changes have resulted in stronger prudential oversight of commercial and residential real estate lending, as well as securitization holdings, and a more stringent definition of capital. While motivated by the financial crisis, these changes are not mandated by the Dodd-Frank Act. They would likely have occurred in any case as a response to the crisis experience.

The creation of the Consumer Financial Protection Bureau was, of course, a result of the Dodd-Frank Act. The CFPB is intended to address consumer fraud and abuse by the financial industry. The CFPB does not directly supervise banks with under $10 billion in assets, although its rules do apply to them. An exemption of community banks from new consumer rules would clearly be inappropriate, as it would create a two-tier system of consumer protection that would allow practices that have proven exploitative and dangerous to continue in one segment of banking.

My final point addresses some ways in which policymakers can accommodate the needs of community banks in regulatory implementation. First, regulators should explore additional technical assistance aimed at lowering the fixed costs of regulatory reporting for community banks. Regulation, particularly regulation that involves extensive reporting or analysis requirements, generally creates a fixed cost for initial compliance, with the marginal costs of additional regulated transactions much lower thereafter. A smaller bank generally has fewer transactions to spread these fixed costs over. Technical assistance aimed at assisting community banks in creating shared infrastructure for standardized reporting and analysis would be helpful in reducing these initial fixed costs, particularly for the smallest community banks which might otherwise need to hire consultants or additional employees. The FDIC has already placed significant technical assistance on their Web site and

should explore additional ways to provide such assistance or help small banks create mutual resources for regulatory compliance.

Second, policymakers should be attentive to the ways in which stronger regulation of larger banks, especially the very largest banks, is necessary to help level the playing field in financial services. As Members of this Committee know, regulators themselves admit that the problem of 'too big to fail' has not been solved. The fact that markets permit the largest banks to operate with lower capital levels and funding costs than community banks is likely related to the understanding that the unsolved TBTF issue may lead to greater government support in the event of bank failure. Legislative efforts to mandate higher capital levels for the largest banks, such as the bill introduced by Senators Brown and Vitter, are valuable in this area, as are regulatory rules that scale capital requirements by bank size.

There is another, related, difference between community banks and large Wall Street banks. Large banks are more heavily engaged in complex financial market activities whose risks have in many cases not been well understood and for which both regulators and private counterparties have permitted inappropriately low levels of prudential safeguards. Examples of such activities are large-scale broker-dealer and derivatives activities with associated large trading books and collateral accounts, central roles in originate-to-distribute securitization, and reliance on wholesale money markets. Efforts by regulators to make the capital and liquidity costs of these financial market activities reflect their true risks are a key component of new financial regulations. Reforms in this area should also help local relationship-oriented banking become more competitive with large-scale transactional banking.

Thank you for your time and attention. I look forward to taking questions.

PREPARED STATEMENT OF MICHAEL D. CALHOUN

PRESIDENT, CENTER FOR RESPONSIBLE LENDING

SEPTEMBER 16, 2014

Good morning Chairman Johnson, Ranking Member Crapo, and Members of the Committee.

Thank you for the opportunity to testify on the need to maintain strong and reasonable consumer financial protections in the wake of the financial crisis.

I am the President of the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution. For 30 years, Self-Help has focused on creating asset building opportunities for low-income, rural, women-headed, and minority families, primarily through financing safe, affordable home loans. In total, Self-Help has provided $6 billion in financing to 70,000 home buyers, small businesses, and nonprofits and serves more than 80,000 mostly low-income families through 30 retail credit union branches in North Carolina, California, and Chicago.

CRL recognizes the importance of small lenders and credit unions, and the financial services they provide. We also appreciate the different business model they use to provide these services and support regulatory oversight that appropriately recognizes and accommodates these differences. Community banks, credit unions, and other smaller financial institutions often have smaller transactions and closer ties to borrowers and the communities they serve. This allows for more tailored lending and underwriting that result in more successful lending. Smaller financial institutions also participate much less in capital market transactions than their larger bank counterparts. CRL agrees that in the context of regulatory reform, it is important to continue to recognize the work of small lending institutions and how important it is for these institutions to be able to continue to successfully conduct their business in the community. Fortunately, the Consumer Financial Protection Bureau (CFPB) and other financial regulators also acknowledge these differences and have worked to tailor their rules accordingly. However, when adopting separate rules or exceptions to rules, it is essential to carefully craft them to ensure that consumer protections are not compromised.

1. The CFPB and Other Regulators Have Recognized That it is Essential To Have a Flexible Approach That Supports Small Depository Institutions.

The regulators of small depository institutions have adopted a flexible approach to regulation and oversight. The CFPB has taken a lead in adopting regulations that are balanced for financial institutions and has made accommodations for smaller lenders. The CFPB's most visible and important rules have addressed past flaws in mortgage lending, which proved to be the underlying cause of the financial crisis

that led to the great recession. The new mortgage rules strike the right balance of protecting consumers without constraining lenders from extending credit broadly. The rules-required by The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1]—address a key cause of the mortgage meltdown and ensuing recession: the practice of many lenders to make high-risk, often deceptively packaged home loans, without assessing if borrowers could repay them. Because of these reforms, lenders now must assess a mortgage borrower's ability to repay a loan.

Families who, in the past, were too often steered into unfair, harmful financial products will benefit from the safer mortgage standards defined in the CFPB's Qualified Mortgage ("QM") rule. While protecting borrowers, the CFPB's rule also provides lenders with significant legal protection when they originate qualified mortgages. The rule rightfully provides certain exemptions for small and community lenders.

We note that the housing crisis was not merely caused by a drop in housing values. Reckless and poorly regulated mortgage lending undermined the housing market and sparked the crisis. As noted above, the CFPB then promulgated the QM rule and the Ability-to-Repay standard, which established reasonable and clear conditions under which the market can move toward safer lending. The new rules, which went into effect on January 10, 2014, established four pathways to QM status. With some exceptions for certain agencies and small lenders, loans will meet QM criteria if: 1) they are fully amortizing (*i.e.,* no interest-only or negatively amortizing loans; 2) the points and fees do not exceed 3 percent of total loan amount, 3) the terms do not exceed 30 years, and 4) the rate is fixed or, for adjustable-rate loans, has been underwritten to the maximum rate permitted during the first 5 years.

The CFPB also established an Ability-to-Repay provision that requires lenders to determine whether a borrower can afford a mortgage. Lenders are deemed to have complied with the Ability-to-Repay provision if they originate loans that meet the QM definition. This provision will prevent features such as no documentation loans that allowed for reckless lending and resulted in a myriad of defaults and foreclosures. Reforms such as these will allow the housing market to recover, more borrowers to achieve successful homeownership, and it will significantly reduce the likelihood of the Nation experiencing a similar housing crisis in the future.

When a loan gains QM status, it carries with it a legal presumption of complying with the Ability-to-Repay requirements. The rule creates two different kinds of legal presumptions: a 'safe harbor' and a 'rebuttable presumption.' Under a 'safe harbor,' a borrower is unable to challenge whether the lender met its Ability-to-Repay obligations. If the loan is a prime QM loan, under a 'rebuttable presumption,' the borrower has the ability to raise a legal challenge but must overcome the legal presumption that the lender complied with this Ability-to-Repay obligation.

The CFPB adopted numerous special provisions for small depository institutions to ensure that they can participate and compete in the financial services market. For example, the CFPB created the small creditors definition when it promulgated the QM rule, a special designation that was not required by the Dodd-Frank Act. The CFPB created this designation using its regulatory authority with the goal of preserving access to credit for those who rely on the services of small creditors. Under this definition, lenders need to meet two criteria to count as a small creditor: first, the institutions must have assets of less than $2 billion and second, originate no more than 500 first-lien mortgages per year. Mortgages originated by an eligible small creditor can obtain QM status if the loan meets the points and fees threshold, is fully amortizing, does not include interest-only payments, and has a term of no more than 30 years. In addition, the lender is also "required to consider the consumer's debt-to-income ratio or residual income and to verify the underlying information."[2] However, these lenders do not need to meet the 43 percent debt-to-income ratio threshold or use the debt-to-income ratio standards in Appendix Q. These bright line rules provide appropriate guidance for small lenders, while still offering appropriate flexibility.

In addition, the CFPB created a QM definition for small lenders specific to balloon loans. This designation is required by Dodd-Frank for small lenders operating predominantly in rural or under-served areas. The Bureau used its regulatory authority to establish a 2-year transition period that allows all small creditors—regardless of whether they operate in rural or underserved areas—to obtain QM status for bal-

[1] Pub. L. 111–203.

[2] Consumer Financial Protection Bureau, Ability to Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 34430, 35487 (June 12, 2013) (rule was issued by the CFPB on May 29, 2013 and printed in the Federal Register on June 12, 2013).

loon loans that are held in portfolio. After the transition period, the balloon loan exception only applies to those lenders who operate in rural or underserved areas under a definition that CFPB will continue to study. The mortgage rules also establish a minimum period of time for which escrows must be held for higher-priced mortgages. The CFPB also created an exemption to the escrow requirement for small creditors operating predominately in rural and underserved areas.

Small creditors receive accommodations regarding the legal safeguards of QM loans. The rule establishes a two-tiered system regarding legal protections for lenders. For the vast majority of loans, lenders will have a 'safe harbor' against potential legal challenges from borrowers. Somewhat higher costing loans will have a 'rebuttable presumption.' The threshold between the two depends on the loan's annual percentage rate (APR) relative to the average prime offer rate (APOR). A loan's APR is a figure that represents the overall cost of the loan, including both the interest rate as well as some specified fees. The APOR is a calculation that reflects the APR for a prime mortgage, and these figures are released on a weekly basis.

For the general QM definition using a 43 percent debt-to-income ratio threshold or the definition based on eligibility for purchase or insurance by Fannie Mae, Freddie Mac, and government agencies, the dividing line between a 'safe harbor' and a 'rebuttable presumption' is 1.5 percent above APOR for a first-lien mortgage and 3.5 percent above APOR for a subordinate lien mortgage. For loans below the thresholds, a lender receives a 'safe harbor.' For loans above the thresholds, they receive a 'rebuttable presumption.' Regarding small lenders, the CFPB adjusted the first-lien threshold for a safe harbor upward to match the second-lien threshold, resulting in a 3.5 percent threshold for both first and second-lien mortgages to receive the safe harbor.[3] For instance, for a 30 year first-lien mortgage (with today's APOR rate of 4.16 percent),[4] larger lenders originating QM loans receive safe harbor protection at an interest rate of 5.66 percent, whereas small lenders receive safe harbor protection for a higher interest rate of 7.66 percent. The effect of this CFPB created exception is a significant additional flexibility for smaller lenders.

The CFPB continues to review appropriate considerations for small lending institutions. The CFPB has requested comment on whether to increase the 500 first-lien mortgage cap under QM's small-creditor definition.[5] CRL expressed support to a reasonable increase of the 500 loan cap, limiting any potential increase to rural banks or for loans held in portfolio. We also encouraged the CFPB to examine data and feedback to determine if the 500 loan cap is creating problems for small-servicers to conduct business and reach underserved markets.

2. Reasonable Flexibility With Oversight is Essential but Exceptions and Exemptions Must Be Carefully Drawn To Protect Consumers and To Mandate Responsible Lending.

As outlined above, the CFPB has rightfully taken careful consideration to formulate rules that protect consumers and allow for broad access to credit. However, we have serious concerns about some proposed legislation that would loosen consumer protections.

The Portfolio Lending and Mortgage Access Act (H.R. 2673), introduced in the House of Representatives, would inappropriately exempt all mortgage loans held in portfolio.[6] These mortgages still carry significant risk to consumers, financial institutions, and the overall economy. In the financial crisis, many of the toxic loans, such as negative amortization loans underwritten to initial teaser rates were held in bank portfolios. These loans had initial payments that covered only a small amount of the accruing interest. As a result, the balance of the loans dramatically increased each year. Lenders made these loans based upon only this initial, artificially low payment, even though the loans required borrowers to make dramatically higher payments after a few years. Further increasing the risk of these loans, many lenders did not even document the income of the borrowers, instead making no documentation ("no-doc") loans. Hundreds of billions of dollars of these loans were made, and many were kept on bank portfolios. These loans soon crashed, helping to trigger the financial crisis, and devastating banks such as Washington Mutual and Wachovia.

Portfolio loans also pose risks for consumers and tax-payers. For refinance loans, borrowers put their hard earned equity at stake. This equity covers the risk of the

[3] Consumer Financial Protection Bureau, Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide 28 (2014), available at *http://files.consumerfinance.gov/f/201401_cfpb_atr-qm_small-entity-compliance-guide.pdf.*

[4] *Available at https://www.ffiec.gov/ratespread.*

[5] 79 Fed. Reg. 25,730, 25746 (May 6, 2014).

[6] Note that this legislation does not set a loan size limitation, nor does it establish a loan-holding period.

lender in the event of foreclosure, but borrowers lose all of their home wealth. Many portfolio lenders in the housing expansion period engaged in these asset-based loans, with disastrous results for consumers. It is important to remember that in the subprime mortgage market, which was a trigger for the crisis, only 10 percent of loans were first-time homeowner loans; the bulk of these were refinance loans, largely based on the homeowners' equity.[7] Therefore, it is imperative to preserve Ability-to-Repay standards for these loans.

The Ability-to-Repay standard and the QM rule are also important safeguards for the mortgage market. When the housing market expanded, sustainable mortgages, such as 30-year fixed-rate mortgages with full documentation were squeezed out by toxic products that appeared to be more affordable for consumers, but in fact had hidden costs and a high risk of foreclosure. Lenders who did not offer these toxic products saw their market shares plummet. They often felt they had to offer similar products in order to maintain market share and stay in business. The result was a race to the bottom. If exceptions to these critical lending standards are not very carefully drawn, we risk a repeat of this disastrous period of lending. I urge both bodies of Congress to reject the Portfolio Lending and Mortgage Access Act and any similar legislation that weakens responsible and safe lending standards set forth by regulators such as the CFPB.

Conclusion

A healthy national economy depends on both healthy community financial institutions and consumer protections. We applaud the work of credit unions and small lenders who provide services to communities greatly in need of opportunity. We also applaud the role small creditors have played in creating successful homeownership for many who would not otherwise have the opportunity.

The reckless and predatory lending that occurred without appropriate safeguards resulted in one of the worst financial disasters of American history. In order to avoid the repetition of past mistakes that proved to be devastating for American families, regulators like the CFPB must protect the American people and ensure access to a broad, sustainable mortgage market. We understand the need for appropriate flexibility for small depositories, but it must be balanced against the need for consumer safeguards, and not extend exemptions tailored for small banks and credit unions to larger financial institutions. I look forward to continuing to work with these community institutions, their associations, the regulators, and this Committee to ensure that these institutions can thrive while consumers are protected. Thank you for the opportunity to testify today, and I look forward to answering your questions.

[7] Center For Responsible Lending, Subprime Lending: A Drain on Net Homeownership, CRL Issue Paper No. 14 , TBL 1 (2007) , *available at http://www.responsiblelending.org/mortgage-lending/research-analysis/Net-Drain-in-Home-Ownership.pdf.*

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM TONEY BLAND

Q.1. As I highlighted in the hearing, increased regulatory burden on small depository institutions is concerning especially in light of the fact that we have lost approximately one-half of our banks and credit unions in the last 25 years. Is your agency prepared to do an empirical analysis of the regulatory burden on small entities in addition to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) review? If so, what specific steps can your agency take to ensure that such empirical analysis is comprehensive and meaningful? If not, please explain why not.

A.1. The OCC currently conducts analyses of the effects of our rules specifically on small entities. For each OCC rulemaking, the Regulatory Flexibility Act (RFA) requires Federal agencies including the OCC to determine whether a new rule will have a significant economic impact on a substantial number of small entities. If the OCC concludes that the rule does have such an impact, then the OCC must prepare initial (at the proposed rule stage) and final (at the final rule stage) regulatory flexibility analysis. OCC economists conduct the analyses required by the RFA. In addition, the Paperwork Reduction Act (PRA) requires the OCC to estimate the burden (as defined in that statute and its implementing regulations) imposed by the rules it adopts on all entities, including small entities.

The OCC complies with these requirements and, in addition, conducts other analyses required by law to assess the economic effect of a proposed or final rule. For example, the OCC evaluates the economic impact of final rules pursuant to the requirements of the Congressional Review Act (CRA).

Q.2. Comptroller Curry recently stated that he is chairing the EGRPRA effort at the Federal Financial Institutions Examination Council (FFIEC). When can Congress expect a first report of the agencies' EGRPRA findings and recommendations?

A.2. The EGRPRA statute requires the FFIEC to submit a report to Congress at the end of the EGRPRA review process that summarizes the significant issues raised in the public comments and the relative merits of such issues. This report will include an analysis of whether the Agencies are able to address the regulatory burdens associated with these issues or whether the burdens must be addressed by legislative action. The review process will be completed by the end of 2016.

The agencies recently announced the schedule for EGRPRA outreach meetings. The first outreach meeting will be held in Los Angeles on December 2, 2014. Comptroller Curry and I will attend. The outreach meetings will feature panel presentations by industry participants and consumer and community groups, as well as give

interested persons an opportunity to present their views on any of the 12 categories of regulations listed in a June Federal Register notice.

The reduction of regulatory burden is an ongoing process at the OCC. We will make changes to our regulations to address burden identified during the EGRPRA process, where appropriate, and will not wait until the end of the EGRPRA process. For example, the OCC is currently in the process of integrating certain OCC and former Office of Thrift Supervision rules, and we will take relevant comments that we receive through the EGRPRA process into account as we finalize these rules.

Q.3. Your agency recently revised their guidance on third-party payment processors to remove the previously designated high-risk merchant categories that have caused financial institutions to cease banking relationships with a number of legitimate businesses. Nonetheless, just last week I have heard from two Idaho constituents who had difficulty obtaining new banking services. What steps are you taking on the ground to make sure banks can actually provide services to these legitimate businesses, and that examiners are promptly and adequately trained to implement the revised guidance?

A.3. The OCC issued Bulletin 2008–12 regarding payment processors on April 24, 2008, and incorporated Federal savings associations into the guidance as of October 13, 2013. The OCC has not otherwise revised the guidance. As an agency, we have made a concerted effort to communicate a balanced message regarding risk management expectations to OCC supervised institutions. Comptroller Curry addressed the Association of Certified Anti-Money Laundering Specialists and his comments outline this balanced approach. Specifically, Comptroller Curry stated "[Banks] shouldn't feel that [they] can't bank a customer just because they fall into a category that on its face appears to carry an elevated level of risk. Higher-risk categories of customers can call for stronger risk management and controls, not a strategy of avoidance."[1] Comptroller Curry echoed these comments in remarks before the American Bankers Association and the Risk Management Association. Deputy Chief Counsel Daniel P. Stipano, in his written and oral statements before the Subcommittee on Oversight and Investigations also stated that, "[a]s a general matter, the OCC does not recommend or encourage banks to engage in the wholesale termination of categories of customer accounts. Rather, we expect banks to assess the risks posed by individual customers on a case-by-case basis and to implement appropriate controls to manage each relationship."[2]

The OCC also publishes a quarterly summary for all national banks and Federal savings associations of all significant speeches, testimony, and bulletins to ensure the timely exchange of information. We continue to use this vehicle to underscore our position on

[1] Remarks by Comptroller of the Currency Thomas J. Curry before the Association of Anti-Money Laundering Specialists, March 17, 2014.

[2] Testimony of Daniel P. Stipano before the Subcommittee on Oversight and Investigations, July 15, 2014.

acceptable risk management practices and supervisory expectations.

In addition to our public statements, we continue to reinforce previous policy publications that provide appropriate and relevant guidance to the industry and our examiners. The OCC's Payment Processor Risk Management Guidance (OCC Bulletin 2008–12) was issued in April 2008, and this guidance is still appropriate and relevant. The guidance outlines the OCC's expectations for how national banks and Federal thrifts should manage the risks associated with payment processors. Together with our Risk Management Guidance on automated clearing house (ACH) activities (OCC Bulletin 2006–39), issued in September 2006, we have provided the industry with foundational guidance for appropriate payment risk management.

The OCC recently issued a Statement on Banking Money Services Businesses (MSBs). The Statement reaffirms our expectations regarding the providing of banking services to MSBs. The Statement reiterates our longstanding position that banks should assess the risks posed by individual customers on a case-by-case basis, and implement appropriate controls to manage these relationships commensurate with the risks associated with their customers. It further states that, as a general matter, the OCC does not direct banks to open, close, or maintain individual accounts, nor do we encourage banks to engage in the wholesale termination of categories of customer accounts without regard to the risk, presented by the individual customer, or the bank's ability to manage the risk.

Finally, as a part of our ongoing examiner training efforts, we continue to re-emphasize that higher risk in the banking sector does not mean unacceptable or unmanageable risk. We stress to our examiners during their training that if a bank has higher risk products, services, and customers, the quality of the bank's risk management should be commensurate with the risk level of the institution. This message is critical to the supervision of our industry and cannot be overstated. To that end, in September 2014, we held a nationwide Knowledge Sharing Call, to discuss emerging risks related to BSA/AML and to reinforce our risk management supervisory expectations with our examination staff.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM TONEY BLAND

Q.1. The Independent Community Banks of America recently delivered to you a petition from their members. The petition requests relief from filing the long form call report every 65 days. In order to reduce the staff time and research necessary to file these reports every quarter, ICBA recommends that highly rated community banks be allowed to submit short form call reports in the 1st and 3rd quarters and long form call reports in the 2nd and 4th quarters. Is this a viable option that you could implement? If so, why not do it? If not, why not?

A.1. The OCC is mindful that both existing and new regulatory reporting requirements have the potential to create regulatory burden, especially on smaller financial institutions. Therefore, where

possible, the OCC seeks to reduce this regulatory burden, as well as provide guidance and resources for community banks to reduce the complexity in regulatory reporting.

OCC staff has met with representatives from the ICBA to discuss their concerns about regulatory reporting burden and their proposal for a short-form call report. In response to the concerns raised by the ICBA and others, the OCC and other members of the FFIEC are exploring steps that could be taken to lessen regulatory reporting requirements for community banks, including a possible short-form report as recommended by the ICBA. Our objective will be to provide meaningful regulatory relief, while still meeting the OCC's minimum data needs to maintain safety and soundness. As this work moves forward, the OCC and other members of the FFIEC plan to continue the dialogue with the ICBA and other interested parties and to publish any proposed changes for notice and comment.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM LARRY FAZIO

Q.1. As I highlighted in the hearing, increased regulatory burden on small depository institutions is concerning, especially in light of the fact that we have lost approximately one-half of our banks and credit unions in the last 25 years. Is your agency prepared to do an empirical analysis of the regulatory burden on small entities in addition to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) review? If so, what specific steps can your agency take to ensure that such empirical analysis is comprehensive and meaningful? If not, please explain why not.

A.1. NCUA is ever mindful of the impact of regulation on small credit unions, and we are proactive in our efforts to identify outdated, ineffective, unnecessary, or excessively burdensome regulation. We then take steps to eliminate or ease those burdens, consistent with safety and soundness.

As part of NCUA's voluntary participation in the EGRPRA review, NCUA will evaluate the burden on small entities for those regulations within NCUA's control. However, NCUA has no authority to provide regulatory relief from requirements under the Bank Secrecy Act and anti-money laundering laws imposed by other Federal agencies.

The agency's existing efforts to address regulatory burden go beyond our voluntary participation in the EGRPRA review. For example, it is NCUA's long-standing regulatory policy to conduct a rolling review of one-third of the agency's regulations each year so that the agency reviews all of its regulations at least once every 3 years. Similar to EGRPRA, this policy opens NCUA regulations to public review and comment and is designed to help the agency identify opportunities to streamline, modernize, or even repeal regulations when appropriate.

More recently, under NCUA Board Chairman Matz, the agency also has undertaken a Regulatory Modernization Initiative that aims to reduce regulatory burdens and synchronize the agency's rules with the modern marketplace. As part of this initiative, NCUA took perhaps its biggest step toward easing the regulatory

burden on small institutions by amending the definition of "small entity" from a threshold of less than $10 million in assets to less than $50 million in assets. The process of raising this small credit union threshold involved an empirical review of the activities, balance sheet composition, and cost structures of credit unions by size, as well as thoughtful consideration of comments received throughout the rulemaking process. As a result, today, more than 4,000 credit unions (approximately 65 percent of the industry) qualify for regulatory relief under this new threshold.

In addition to reducing the regulatory burden on small credit unions, NCUA is committed to helping them succeed. In 2004, the agency established the Office of Small Credit Union Initiatives to foster credit union development and deliver financial services for small, new, and low-income credit unions. Today, the office offers training, consulting, grants, loans, and valuable partnership and outreach to thousands of small credit unions.

Q.2. In June, Chairman Johnson and I expressed concerns about the amount of new capital that could be needed under the NCUA's proposal on risk-based capital, and the rule's impact on credit unions in rural communities like those in Idaho and South Dakota. How will the proposed rule affect credit unions in small communities and rural communities? What areas of the proposed rule is the NCUA looking to adjust in light of the comments received?

A.2. Following the comment period on the risk-based capital proposal during which NCUA received more than 2,000 comment letters, NCUA Board members publicly expressed a willingness to reconsider the risk weights in several asset categories, including agricultural and member business loans. Chairman Matz also made statements in official correspondence to Members of the Senate Banking Committee and others in Congress expressing her commitment to carefully examine how the rule might affect availability of credit for consumers, home buyers, family farmers and small businesses in rural areas and underserved communities.

However, the rule as originally proposed and any potential changes to it will not go forward. After the hearing, Chairman Matz announced her intention to issue a revised proposed rule for a new comment period rather than go forward with the issuance of a final rule.

The decision was reached as the final proposal began to take shape. As staff reviewed changes being contemplated, they noted potential concerns with Administrative Procedure Act compliance as a result of significant structural changes being considered. Subsequently, Chairman Matz determined that it would be prudent to issue a revised proposed rule for public comment.

Based on stakeholder comments on the initial proposed rule, the amended proposal will include a longer implementation period and revised risk weights for mortgages, investments, member business loans, credit union service organizations and corporate credit unions, among other changes. Stakeholders will also be invited to comment on an alternative approach for addressing interest rate risk.

Q.3. What specific compliance challenges do your members face in preparation for the new capital structure as proposed by the

NCUA? How can your members mitigate some of those challenges? If the risk-based capital proposal gets finalized as-is, will credit unions and their members face higher cost and lesser availability of credit as a result?

A.3. One of NCUA's primary goals in drafting the proposed rule was to minimize compliance challenges by relying primarily on data already collected on the Call Report to calculate a credit union's risk-based capital ratio. As initially proposed, the rule would have required the collection of some additional data, but the agency determined this change did not represent a material increase to the burden of completing the Call Report.

By excluding small, noncomplex credit unions (those with assets less than $50 million) from the proposed rule's requirements and looking at the current make-up of the industry, NCUA was able to determine that only 3 percent of all credit unions (or 199 credit unions) would be reclassified according to their net worth and subject to prompt corrective action.

The Board recognizes the importance of giving these credit unions ample time to make the changes necessary to achieve their desired classification—accumulate additional capital or reduce portfolio risk—and to update their internal systems, policies, and procedures to account for these changes. The agency received many comments from the public on this issue and the Board has signaled that it will reconsider the length of the implementation period to ensure credit unions have adequate time to improve their prompt correction action classifications. When the Board issues a revised proposed rule for a new comment period, the implementation period will be longer than the 18 months initially proposed.

The NCUA Board both understands and shares the policy objective of ensuring continued prudent lending to support the Nation's economy. Prior to announcing the intent to issue a revised proposed rule for a new comment period, all of our analysis indicated that a small minority of credit unions would need to adjust their business plans in response to the revised regulation. The agency has aimed and will continue to endeavor to mitigate any potential impact on the cost or availability of credit to consumers and businesses served by those credit unions by providing them with sufficient time to improve their prompt corrective action classification.

Ensuring that credit unions hold sufficient capital to withstand reasonable economic shocks is fundamental to ensuring the safety and soundness of the credit union system. Sufficient capital at each federally insured credit union, combined with the strength of the National Credit Union Share Insurance Fund, will protect 98 million credit union members from losses and contribute to the overall stability of the economy.

Q.4. Since 1990 more than half of all credit unions—roughly 6,000 institutions—have disappeared. In your experience, what role has regulatory burden played in credit unions' decisions to merge or cease operations?

A.4. Much of the decline since 1990 is the result of voluntary mergers between credit unions, so while a credit union may "disappear" in name, the result is often a larger, stronger credit union that can offer more or better services to a larger field of membership.

In my experience, a credit union is often motivated to merge or forced to cease operations because it lacks the resources to manage a range of internal and external challenges. The evolution of regulation burdens may be one of these challenges, but the most common reasons for a merger or closure are:

- The retirement of a long-term CEO and the lack of a succession plan.
- An aging or declining field of membership resulting in stagnant or declining growth.
- Poor management decisions, insufficient internal controls, or employee fraud.

Because nearly two-thirds of the credit union system is comprised of "small entities" with less than $50 million in assets, mergers are common. To decrease the likelihood of mergers, NCUA's Office of Small Credit Union Initiatives offers a wide variety of programs to assist small credit unions. To help viable small credit unions thrive, 28 NCUA staff offer individualized consulting, loan and grant opportunities, targeted training, and valuable partnership and outreach on strategic management and operational issues. These efforts are in addition to the agency's concerted efforts to reduce the regulatory and supervisory burdens for small credit unions, whenever possible and consistent with safety and soundness.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM LARRY FAZIO

Q.1. NCUA's proposed risk-based capital rule contains a provision allowing NCUA to impose individual minimum capital requirements on a credit union. This section of the proposal also states that: "The appropriate minimum capital levels for an individual credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based, in part, on subjective judgment grounded in agency expertise." What role do you foresee individual examiners and their recommendations playing in the assessment of these individual minimum capital requirements in any final rule?

A.1. As mentioned in the response to Senator Crapo, NCUA is not moving forward with the existing proposed risk-based capital rule. Instead, NCUA will issue a revised proposed rule for a new comment period.

As initially proposed, the risk-based capital rule did not grant new authority to NCUA to impose minimum capital requirements on individual credit unions. Part 702 of NCUA's prompt corrective action regulations prescribes certain mandatory and discretionary supervisory action that the NCUA Board is permitted to take against a credit union that is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized.

The proposed rule did not expand or otherwise change this authority; it simply set forth the process NCUA would use to require an individual credit union to hold higher levels of risk-based capital to address unique supervisory concerns.

The NCUA Board recognizes the impact an individual minimum capital requirement could have on a credit union and applies a very high duty of care and review to any such action. NCUA must provide notice and give the credit union an opportunity to respond before imposing a higher capital requirement. This requirement would also be subject to appeal and could not be imposed by an individual examiner. Instead, the authority would be reserved for the NCUA Board.

The role of the examiner does not change under the proposed risk-based capital rule. NCUA examiners are responsible for classifying the credit unions they examine according to their levels of capital and for communicating that classification to the credit unions and the appropriate offices within the agency. Any action taken in response to the deterioration of a credit union's capital level is prescribed by the rule, not the individual examiner.

Q.2. NCUA is charged by Congress to oversee and manage the National Credit Union Share Insurance Fund (NCUSIF), the Temporary Corporate Credit Union Stabilization Fund, the Central Liquidity Fund, and its annual operating budget. These funds are comprised of monies paid by credit unions. Currently, NCUA publicly releases general financial statements and aggregated balance sheets for each fund. However, the agency does not provide non-aggregated breakdowns of the components that go into the expenditures from the funds. Why doesn't the agency provide greater disclosure of the nonaggregated amounts disbursed and allocated for each fund?

A.2. NCUA financial statements and footnote disclosures are presented as required by Generally Accepted Accounting Principles (GAAP) as evidenced by all funds receiving a clean audit opinion from the independent auditor. Detailed expenditure information is presented on the face of the financial statements for the Operating Fund, Central Liquidity Facility, and Community Development Revolving Loan Fund.

For the Share Insurance Fund, expenditure data is aggregated within the principal financial statements as required by GAAP, but more detailed information can be found within the financial statement disclosures. For example, on the face of the 2013 Share Insurance Fund's Statement of Net Cost, an aggregate balance is presented for operating expenses. However, within the financial statement footnotes, operating expenses are detailed by the following specific line item categories: employee salaries; employee benefits; employee travel; contracted services; administrative costs; and rent, communication, and utilities. The 2013 audited financial statements can be found on the agency's Web site.[1]

In addition to preparing audited annual financial statements for each fund, the agency presents its annual budget proposal to the NCUA Board at the November open Board meeting. NCUA formulates the agency's operating budget using zero-based budgeting techniques in which every expense is justified each year. Once approved, the operating budget is subsequently adjusted at the open Board meeting each July based on a mid-year financial analysis.

[1] See *http://go.usa.gov/wWfA.*

A portion of the Operating Budget is reimbursed from the Share Insurance Fund through the Overhead Transfer Rate. The share of the Operating Budget paid for by the Share Insurance Fund is also presented to the Board for approval at the open November Board meeting.

Budgetary materials presented at the Board meetings and other explanatory budgetary materials are available to the public on the agency's Web site.[2]

The Temporary Corporate Credit Union Stabilization Fund follows a similar budget formulation and presentation process with its annual budget presented to the Board at the December open Board meeting. Materials presented to the Board related to the 2014 budget are found on the NCUA's Web site.[3]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MORAN FROM LARRY FAZIO

Q.1. NCUA's risk-based capital proposal requires a credit union, upon receiving notice from the NCUA that they intend to impose individual minimum capital requirements, to provide a response to NCUA explaining why the credit union does not feel the individual minimum capital is appropriate. The proposal allows the credit union to request the NCUA Ombudsman to provide a recommendation to the NCUA. However, there appears to be no independent appeals process for the credit union to pursue. Essentially, the credit union is required to protest the requirement to the same body who intends to impose them in the first place. Why is there no independent appeals process for these individual minimum capital requirements?

A.1. Any decisions to impose minimum capital requirements on individual credit unions will be made solely in the interest of protecting the safety and soundness of the National Credit Union Share Insurance Fund. NCUA alone is responsible for the Share Insurance Fund and, therefore, has not instituted a process for appealing capital requirements to an independent third party.

The power to impose an individual minimum capital requirement, which NCUA has never used, is included in the agency's current risk-based net worth rule and is consistent with the Basel Capital accords. The Federal Deposit Insurance Corporation has also long maintained this authority, and NCUA used the FDIC's rule as a basis for the proposed rule.

As initially proposed, the proposed risk-based capital rule would improve the transparency around the process by which a minimum capital requirement would be imposed. The initial proposed rule demonstrates that there is ample opportunity for a credit union to appeal or protest such a requirement. Under the proposed rule, a credit union would have the opportunity to:

- Explain its objection to the individual minimum capital requirement.
- Request a modification to the requirement.

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[2] See *http://go.usa.gov/wWGB.*
[3] See *http://go.usa.gov/wWGQ.*

- Provide documentation, evidence, or mitigating circumstances it wants NCUA to consider in deciding whether to establish or amend the requirement.
- Request a review and recommendation from the NCUA's Ombudsman.

The NCUA Ombudsman, which was established by the NCUA Board in 1995 to investigate complaints and recommend actions, is independent from other agency operations and reports directly to the NCUA Board. In the context of Board-imposed individual minimum capital requirements, the Ombudsman will help the complainant define options and will recommend actions to the parties involved, but cannot at any time decide on matters in dispute or advocate the position of the complainant, NCUA, or other parties.

Q.2. Do you intend to include an independent appeals process in any final rule?

A.2. For the reasons stated above, the NCUA Board seems unlikely at this time to institute an independent appeals process in the final rule.

RESPONSE TO WRITTEN QUESTION OF SENATOR CRAPO FROM CHARLES A. VICE

Q.1. The Federal regulators are undertaking an EGRPRA review of outdated, unnecessary and overly burdensome regulations. The State regulators are a part of that review through their representative's seat at the FFIEC. What specific steps will State regulators undertake to ensure that this EGRPRA review produces meaningful results with positive consequences for small entities?

A.1. The Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA") requires the Federal prudential banking agencies and FFIEC to identify outdated, unnecessary, or unduly burdensome regulations every 10 years. This process presents an opportunity for Federal regulators to identify regulatory challenges facing financial institutions, an important step that must be taken to right-size regulations for community banks.

State regulators are represented at the FFIEC by the State Liaison Committee ("SLC"), the Chairman of which has a voting seat on the Council. The SLC, with the help of CSBS, has encouraged community bankers across the country to engage in the EGRPRA comment process to best position the FFIEC to identify laws and regulations that are not suitable for the community bank business model. As a part of the process, the SLC and other State regulators are committed to participating in industry outreach meetings to garner broad input on what works and what needs to be changed.

While CSBS supports the current EGRPRA process, gathering information is meaningless if the information is not analyzed and used to develop implementable action plans. Accordingly, the SLC will evaluate public comments submitted during the process to help identify specific areas of laws and regulations which are outdated, necessary and overly burdensome with respect to the community banking business model.

RESPONSE TO WRITTEN QUESTION OF SENATOR MORAN FROM DENNIS PIERCE

Q.1. The Privacy Notices Modernization Act, S. 635, was introduced by Sen. Sherrod Brown and myself to relieve financial institutions of the annual requirement that their privacy policy disclosures be physically mailed to their customers. This legislation is supported by 74 Senators in addition to Senator Brown and myself. Consumer Financial Protection Bureau Director Richard Cordray has testified that this annual mailing requirement may be an area where the cost of compliance outweighs the benefit to the consumer. Building upon that, the CFPB has begun a rulemaking in an attempt to address this issue. However, I remain unconvinced that the CFPB will be able to fully address the issue without a modification of the statute. Would you please elaborate on the CFPB's attempt to address this issue? Would you please also share whether S. 635 would provide the actual relief intended by the supporters of this bill?

A.1. CUNA supports S. 635, the Privacy Notices Modernization Act. We appreciate the strong support for this legislation. This legislation will provide regulatory relief to financial institutions, including credit unions, by exempting them from annual privacy notice requirements when certain conditions are met.

As you note, 74 Senators have cosponsored the legislation; we believe the bill has the support of nearly every Senator. Companion legislation (H.R. 749) passed the House of Representatives in 2013 by voice vote. This legislation is an example of the vast majority of Senators and Representatives coming together on a bipartisan basis to support legislation that both reduces regulatory burden and enhances consumer protection. S. 635 would make the privacy notices consumers receive more meaningful to consumers because they would be sent only when a financial institution changes its privacy policy. This is commonsense legislation, which is why nearly every Senator and Representative supports the bill.

You have asked me to elaborate on our views of the proposal by the Consumer Financial Protection Bureau (CFPB) on this matter. While we generally support the CFPB's proposal as a step in the right direction, the legislation remains important for several reasons and we strongly encourage its enactment.

Under the CFPB's proposal, credit unions and other financial institutions would be permitted to post privacy notices online instead of delivering them to member/customers if an institution meets certain conditions: (1) the institution does not share information with nonaffiliated third parties except for purposes covered by the exclusions allowed under Regulation P; (2) the institution does not include on its annual privacy notice an opt out under the Fair Credit Reporting Act (FCRA); (3) the annual privacy notice is not the only method used to satisfy the requirements of the FCRA; (4) key information on the annual privacy notice has not changed since the institution provided the immediately previous privacy notice; and (5) the institution uses the Regulation P model form for its annual privacy notice.

Although the proposal is a step in the right direction, we feel it is more prescriptive than it needs to be. Without the enactment of S. 635, we are not certain that the Bureau will modify its proposal.

Even still, enactment of S. 635 is preferable because it would provide immediate relief, with no requirement on the CFPB issue a rule in order for institutions to take advantage of the provisions of the legislation.

Finally, we do not think changes to S. 635 are needed, although legislative history making it clear to the CFPB that it should not use any discretionary authority to impose additional conditions on financial institutions would be helpful.

We appreciate your support for S. 635 and look forward to working with you to secure its enactment.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM LINDA McFADDEN

Q.1. What specific compliance challenges do your members face in preparation for the new capital structure as proposed by the NCUA? How can your members mitigate some of those challenges? If the risk-based capital proposal gets finalized as-is, will your members and their members face higher cost and lesser availability of credit as a result?

A.1. The biggest challenge facing XCEL FCU today is NCUA's risk-based capital proposal. Capital requirements should not be a substitute for proper credit union management or appropriate examinations. The proposal, as it is written, would negatively impact XCEL FCU, taking us from a well-capitalized credit union to adequately capitalized. This proposal will be putting restraints on the growth of credit union and will restrict XCEL from implementing products and programs which are needed to compete in the financial industry. Reducing assets and cutting expenses to gain capital is not the solution for safety and soundness of the insurance fund. Running a fundamentally sound financial institution, while providing our members with the best products and services, and the latest technology is a necessity to keep us viable in this industry for generations to come.

This ongoing issue is of the utmost importance to credit unions of all sizes and the one-size-fits-all approach currently being taken by NCUA will stifle growth, innovation and diversification, not only at XCEL, but at credit unions in general.

The proposed rule will force XCEL's board and management to change our business model even though we have had steady balanced growth with good solid returns over the past few years. We have developed a sound concentration risk policy and set limits on our diversified loan and investment portfolio. This proves that our credit union has been managing this portion of the business well for years. If the NCUA continues forward without heeding current concerns on the proposal, XCEL would need to email certain aspects of our lending, ultimately hiring our members and the local economy.

NAFCU's Economics and Research department's analysis of the proposed rule determined that credit unions with more than $50 million in assets will have to hold $7.1 billion more in additional reserves to achieve the same capital cushion levels that they currently maintain. While NCUA contends that a lower amount of capital is actually needed to maintain current capital levels, the

agency ignores the fact that most credit unions maintain a capital cushion above the minimum needed for their level—often because NCUA's own examiners have encouraged them to do so. Because credit unions cannot raise capital from the open market like other financial institutions, this cost will undoubtedly be passed on to the 98 million credit union members across the country. A survey of NAFCU's membership taken found that nearly 60 percent of respondents believe the proposed rule would force their credit union to hold more capital, while nearly 65 percent believe this proposal would force them to realign their balance sheet. *Simply put, if the NCUA implements this rule as proposed, credit unions will have less capital to loan to creditworthy borrowers, whether for a mortgage, auto, or business loan.*

Attached for your reference is XCEL's comment letters to the NCUA on the agency's prompt corrective action/risk-based capital proposal.

From: Linda McFadden
To: Regulatory Comments
Cc: Nicola Foggie
Subject: Prompt Corrective Action, Risk-Based Capital
Date: Monday, May 26, 2014 4:59:24 PM

May 26, 2014

Dear Gerard Poliquin, Secretary of the Board,

This letter will address XCEL Federal Credit Union's viewpoint and concerns regarding the Risk Based Capital Proposed Rule.

XCEL FCU and the credit union industry remains a strong and viable in the aftermath of the recession. Even with the loss of some corporate credit unions, natural person credit unions took up the charge and relieved the stress that such economic times caused. With this information in mind, XCEL feels that this new proposal is not necessary and the NCUA has not adequately justified the need for this rule/change. Credit unions continue to be stronger, more self-reliant than other banking entities. So, why are we trying to fix/adjust what isn't broken.

Capital requirements should not be a substitute for proper credit union management or appropriate examinations. The proposal, as it is written, would negatively impact XCEL Federal Credit Union, taking us from a well-capitalized credit union to adequately-capitalized. Now is not the time to restrict credit union growth, which is the result, if this proposal goes forward. This proposal will restrict XCEL from implementing products and programs which are needed to compete in the financial industry. Reducing assets and cutting expenses to gain capital is not the solution for safety and soundness of the insurance fund. Running a fundamentally sound financial institution, while giving our members the best products and services and, the latest technology, is!

The proposed rule will force XCEL's board and management only to think of gathering more capital to protect the insurance fund instead of why we are in business to begin with. XCEL has had steady balanced growth with good solid returns over the past few years but to achieve the new capital requirements we would to change our business model from being a credit union for our members to a focus on profitability. We might as well become a bank. XCEL did our part for the corporate bailout so why does NCUA think it is necessary to make these restrictions. Why should we cut service to our members because the insurance fund, which weathered the economic stress of the recession, wants even more protection?

XCEL is all for safety and soundness but since the recession; NCUA has put additional restrictions on all credit unions with concentration limits and restrictions. XCEL gladly complied and developed a sound concentration risk policy and set limits on our already diversified loan and investment portfolio. This exercise only proved that our credit union was already well managing this portion of the business.

With the proposed regulation XCEL would need to curtail participation lending. Participation loans help to mitigate risk and ensures steady loan growth during non-peak member lending season. If the underwriting criteria are as or, in some cases even more conservative, why should we have to reserve more than is necessary just because it is participated out with other credit unions also regulated by NCUA.

If NCUA continues with this proposal, we would hope that for the industry's sake, the impact of the risk weights is well thought out before requiring any implementation. As an example, the proposed rule assigns rigid risk-weights to many federally backed investments that when properly examined represent much less risk with less return. This is taking caution to the extreme. Credit unions need to have someplace to put excess cash other than a liquid overnight account with little or no return for the investment. We could address many more of the individual risk weights but I feel the main point to make is as presented they are not in the best interest of the credit union industry and our members.

Last but not least is removing the 1% NCUSIF capital deposits out of the calculation. This is just wrong! Taking those funds out of the calculation will put undue pressure on many credit unions unjustifiably.

Sincerely,

Linda McFadden, President / CEO

XCEL Federal Credit Union

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XCEL
FEDERAL CREDIT UNION
Uniting Service and Technology

1460 Broad Street, Bloomfield, NJ 07003

May 28, 2014

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: Comments on NCUA Prompt Corrective Action –
Risk-Based Capital Proposed Rule

Dear Mr. Poliquin:

On behalf of the Board of Directors and Management Staff of XCEL Federal Credit Union (XCEL), I am writing to you regarding the proposed rule on Prompt Corrective Action and Risk-Based Capital (RBC). In reviewing the proposal, and the multiple comment letters from the Credit Union industry, we at XCEL are shaken at the potentially devastating effect this proposal will have on us, the credit union industry, the American consumer, and our nation's small businesses.

We ask you to strongly consider the comments posted by former Senator D'Amato and former Speaker Gingrich, when they point out that your proposal is contrary to the language and intent of the 1998 Revisions to the Federal Credit Union Act. Many other current and former legislators have expressed similar concerns to you, challenging the legality of your proposal.

XCEL concludes, as have others, that if your RBC proposal is implemented, it would put us at a significant competitive disadvantage to banks here in the Northeast. The rule is based on a poorly designed "one-size-fits-all" concept and would stifle our growth, potential innovation, and diversification. We ask the NCUA Board to withdraw the proposal or alternatively make major modifications to the proposal before any rule is finalized.

The proposal's RBC ratio for well capitalized credit unions is set at 10.5 percent. This increase to current PCA limits of 7.0 percent cannot be supported by the arbitrarily weight limits assigned to concentration risk components. We urge that you lower the risk weights to more accurately reflect risks associated with our credit union's specific assets. We further urge NCUA to defer to the industry suggestion of a joint committee made up of NCUA and Credit Union leaders to review and create a more realistic threshold and rational for PCA.

XCEL
FEDERAL CREDIT UNION
Uniting Service and Technology

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Under the proposed rule, XCEL will be faced with many difficult decisions when attempting to reach the RBC ratios stated. We face the possibility of having to divest ourselves of profitable assets that, under your rule, are more heavily risk weighted in order to generate higher retained earnings your proposal seeks from us. We feel that in the current economic climate, this would be virtually impossible to accomplish and fulfill our mission of serving our members under the credit union model.

We hope you will consider our thoughts as you review and hopefully revise your RBC proposal.

Sincerely:

Daniel H. Moffit
CHAIRMAN, Board of Directors

XCEL Federal Credit Union Board of Directors:

VICE-CHAIRMAN	**TREASURER**	**SECRETARY**
Joseph Tolciss	Salvador Schiano	Richard Masella

DIRECTORS

Gennaro Aprile	Stacey Walker	Donald Monah
Phyllis Ford	Jerome Lafragola	
Jerome Lafragola		

DIRECTOR EMERITUS
Tom Doogan

Copy to:

B. Dan Berger	Bill Chaney
President and CEO	President and CEO
National Association of Credit Unions	Credit Union National Association

Q.2. Since 1990 more than half of all credit unions—roughly 6,000 institutions—have disappeared. In your experience, what role has regulatory burden played in credit unions' decisions to merge or cease operations?

A.2. Credit unions have a long track record of helping the economy and making loans when other lenders often have left various markets. This was evidenced during the recent financial crisis when credit unions kept making auto loans, home loans, and small business loans when other lenders cut back. Still, credit unions have always been some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital. Credit unions continue to play a crucial role in the recovery of our Nation's economy.

Credit unions remain a relatively small part of the marketplace when compared to the banking industry. They are oftentimes a lender of last resort for consumers that have been denied credit via other financial institutions.

Today, credit union lending continues to grow at a solid pace, up about 14 percent in March compared to 2009. In short, credit unions didn't cause the financial crisis, helped blunt the crisis by continuing to lend during difficult times, and perhaps most importantly, continue to play a key role in the still fragile economic recovery. Although credit unions continue to focus on their members, the increasing complexity of the regulatory environment is taking a toll on the credit union industry. While NAFCU and its member credit unions take safety and soundness extremely seriously, the regulatory pendulum post-crisis has swung too far toward an environment of overregulation that threatens to stifle economic growth.

During the consideration of financial reform, NAFCU was concerned about the possibility of overregulation of good actors such as credit unions, and this was why NAFCU was the only credit union trade association to oppose the CFPB having rulemaking authority over credit unions. Unfortunately, many of our concerns about the increased regulatory burdens that credit unions would face under the CFPB have proven true. While there are credible arguments to be made for the existence of a CFPB, its primary focus should be on regulating the unregulated bad actors, not adding new regulatory burdens to good actors like credit unions that already fall under a functional regulator. As expected, the breadth and pace of CFPB rulemaking is troublesome, and the unprecedented new compliance burden placed on credit unions has been immense. While it is true that credit unions under $10 billion are exempt from the examination and enforcement from the CFPB, all credit unions are subject to the rulemakings of the agency and they are feeling this burden. While the CFPB has the authority to exempt certain institutions, such as credit unions, from agency rules, they have been lax to use this authority to provide relief.

As noted in your question, the impact of this growing compliance burden is evident as the number of financial institutions continues to decline. Nearly 21 percent of all credit unions (more than 1,600) have gone away since 2007. A main reason for the decline is the increasing cost and complexity of complying with the ever-increasing onslaught of regulations. Since the 2nd quarter of 2010, we have lost 957 federally insured credit unions, 96 percent of which

were smaller institutions below $100 million in assets. Many smaller institutions simply cannot keep up with the new regulatory tide and have had to merge out of business or be taken over.

This growing demand on credit unions is demonstrated by a 2011 NAFCU survey of our membership that found that nearly 97 percent of respondents were spending more time on regulatory compliance issues than they did in 2009. A 2012 NAFCU survey of our membership found that 94 percent of respondents had seen their compliance burdens increase since the passage of the Dodd-Frank Act in 2010. Furthermore, a March 2013 survey of NAFCU members found that nearly 27 percent had increased their full-time equivalents (FTEs) for compliance personnel in 2013, as compared to 2012. That same survey found that over 70 percent of respondents have had noncompliance staff members take on compliance-related duties due to the increasing regulatory burden. This highlights the fact that many noncompliance staff are being forced to take time away from serving members to spend time on compliance issues. Furthermore, a number of credit unions have also turned to outside vendors to help them with compliance issues—a survey of NAFCU members, conducted in June of 2014, found that nearly 80 percent of respondents are using third-party vendors to help comply with the new CFPB TILA–RESPA requirements.

At XCEL FCU we have felt the pain of these burdens as well. There are costs incurred each time a rule is changed and most costs of compliance do not vary by size, therefore it is a greater burden on smaller credit unions like mine when compared to larger financial institutions. We are required to update our forms and disclosures, to reprogram our data processing systems and to retrain our staff each time there is a change, just as large institutions are. Unfortunately, lending regulation revisions never seem to occur all at once. In recent years, XCEL FCU has spent over $13,000 just to update our loan documents and train our staff on these new documents. If all of the changes were coordinated and were implemented at one time, these costs would have been significantly reduced and a considerable amount of XCEL FCU's resources that were utilized to comply could have been used to benefit our members instead.

In some cases, our ability to provide service to our members has been hindered. For example, XCEL FCU eliminated processing outgoing international wires and ACHs due to the complexity of the revised remittance regulations that were implemented. We felt the risk and compliance requirements involved with providing these services were excessive.

In 2013, the CFPB implemented eight new mortgage rules, seven of which were finalized in October 2013 and were effective by January 2014. A majority of credit unions are small financial institutions like mine which operate with a limited staff. It is a struggle to keep abreast with the constantly changing regulations. Tracking the proposals and the changes made to them as they work through the regulatory process began to monopolize my senior management's time. Timeframes between when the rules are being finalized and are effective are often becoming shorter and shorter. These shorter periods do not provide ample time to read through these rules to ensure that we stay in compliance. This is one of the

reasons that I found it necessary to hire an additional staff person to work as a Compliance Officer, so that my senior management staff can concentrate on other responsibilities that they have. This cost is an additional $50,000 in salary and benefits.

RESPONSE TO WRITTEN QUESTION OF SENATOR MORAN FROM LINDA McFADDEN

Q.1. The Privacy Notices Modernization Act, S. 635, was introduced by Sen. Sherrod Brown and myself to relieve financial institutions of the annual requirement that their privacy policy disclosures be physically mailed to their customers. This legislation is supported by 74 Senators in addition to Senator Brown and myself. Consumer Financial Protection Bureau Director Richard Cordray has testified that this annual mailing requirement may be an area where the cost of compliance outweighs the benefit to the consumer. Building upon that, the CFPB has begun a rulemaking in an attempt to address this issue. However, I remain unconvinced that the CFPB will be able to fully address the issue without a modification of the statute. Would you please elaborate on the CFPB's attempt to address this issue? Would you please also share whether S. 635 would provide the actual relief intended by the supporters of this bill?

A.1. Thank you for this important question. NAFCU and its member credit unions support the bipartisan legislation introduced by Sen. Brown and yourself that would remove the requirement that financial institutions send redundant paper annual privacy notices if they do not share information and their policies have not changed, provided that they remain accessible elsewhere. These duplicative notices are costly for the financial institution and often confusing for the consumer as well.

As you know, similar legislation has passed the House by voice vote and this legislation has over 74 cosponsors in the Senate. We strongly encourage the Senate to pass this small measure of relief this year.

As noted in your question above, earlier this year the Consumer Financial Protection Bureau proposed changes to Regulation P in regards to annual privacy notices. The proposed rule revises Regulation P, implementing section 503 of the Gramm-Leach-Bliley Act (GLBA) to provide an alternative delivery method for annual privacy notices under certain conditions. NAFCU appreciates the CFPB taking an important step to achieving the goal of improved annual privacy notice requirements especially as a legislative solution remains elusive. Still, as discussed below, NAFCU believes that legislative action and certain adjustments are necessary to the CFPB proposal to provide the necessary clarity and relief that the CFPB is attempting to achieve through the proposal.

GLBA requires financial institutions and a wide variety of other businesses to issue privacy disclosure notices to consumers. The notices must be "clear and conspicuous" and disclose in detail the institution's privacy policies if it shares customers' nonpublic personal information with affiliates or third parties. The law also requires telling existing and potential customers of their right to opt out of sharing nonpublic personal information with third parties.

Such disclosures must take place when a customer relationship is first established and annually in paper form as long as the relationship continues even if no changes have occurred. This proposal would change these annual privacy notice requirements for financial institutions that do not engage in information sharing activities for which their customers have the right to opt out. Specifically, it would allow such financial institutions to post their annual privacy notices online rather than delivering them individually.

Under the proposal, a credit union would be allowed to post its privacy notice online rather than mailing the notice, if it meets the following conditions: (i) it does not share the customer's nonpublic personal information with nonaffiliated third parties in a manner that triggers GLBA opt-out rights; (ii) it does not include on its annual privacy notice information about certain consumer opt-out rights under section 603 of the Fair Credit Reporting Act (FCRA); (iii) it's annual privacy notice is not the only notice provided to satisfy the requirements of section 624 of the FCRA; (iv) the information included in the privacy notice has not changed since the customer received the previous notice; and (v) it uses the model form provided in GLBA implementing Regulation P.

Credit unions that choose to rely on this new method of delivering privacy notices would also be required to: (i) convey at least annually on another notice or disclosure that their privacy notice is available on its Web site and will be mailed upon request to a toll-free number. This notice or disclosure would have to include a specific Web address that takes the customer directly to the privacy notice; (ii) post their current privacy notice continuously on a page of its Web site that contains only the privacy notice, without requiring a login or any conditions to access the page; and (iii) promptly mail their current privacy notice to customers who request it by telephone.

NAFCU strongly supports the CFPB's proposal to allow the posting of privacy notices online under certain conditions because we believe it will significantly reduce regulatory burden without impacting consumers' ability to access their privacy policies. NAFCU continues to hear from our members that annual privacy notices provide little benefit, especially when there has been no change in policy or if customers have no right to opt out of information sharing because the credit union does not share nonpublic personal information in a way that triggers such rights. Instead, the mailed privacy notices are often a source of confusion to consumers. Furthermore, they represent an unproductive expense for credit unions that could be better directed toward serving consumers. Accordingly, NAFCU and our members believe that the proposed alternative delivery method will allow consumers to be informed regarding their financial institution's privacy policy without being inundating with redundant information. For those consumers who wish to read their annual privacy notices, NAFCU believes the notices' availability on the Web site and by mail, upon request, will appropriately meet consumers' needs in an efficient and cost effective manner for credit unions.

NAFCU appreciates the Bureau's efforts to ease the annual privacy notice requirements. However, it urges the CFPB to allow credit unions to tailor Regulation P's Model Privacy Notice to fit

their individual policies and circumstances. Although many credit unions, like other financial institutions, use Regulation P's model form, they often slightly modify it to fit their memberships' specific circumstances. Under the proposal, however, using the Model Privacy Notice would become a requirement for credit unions seeking to post their privacy notices online. Because the proposal is unclear as to whether and to what extent a credit union could modify the Model Privacy Notice and still qualify for the alternative delivery method, NAFCU and its members would like additional assurances that this condition, if adopted, would allow credit unions to vary the model form in manners that comply with Regulation P.

While NAFCU strongly supports the proposed alternative delivery method, we question whether some of the proposal's stipulated conditions for posting privacy notices online are appropriate. NAFCU believes it is inappropriate to require credit unions to maintain a toll-free number for customers to call and request that a hard copy of the annual notice be mailed to them. A number of NAFCU's members do not currently have a toll-free number and requiring one for the purpose of this proposal would impose a significant burden. Because credit unions invest significant time and energy toward member service, NAFCU and our members do not object to a requirement of providing paper copies of the annual privacy notice upon request. We do, however, object to a requirement that would mandate credit unions to bear additional, unnecessary costs. Credit unions should be given the flexibility to develop reasonable means appropriate for their specific memberships by which a consumer can request a copy of the annual privacy notice. Accordingly, NAFCU urges that the Bureau not require credit unions to maintain a toll-free number in order to post their privacy notices online. In the alternative, NAFCU proposes that the CFPB provide an exception from this proposed requirement for credit unions that do not otherwise have a toll-free telephone number.

Further, NAFCU believes that the CFPB should not require credit unions to continuously post their privacy notices on their Web sites. While NAFCU understands the Bureau's intention of ensuring that consumers have consistent access to their annual privacy notices, we believe that this requirement could unintentionally expose credit unions to frivolous lawsuits. Under the proposal, credit unions that choose to post their annual privacy notices online would be required to post their current privacy notices continuously on their Web sites. This "continuously" verbiage would effectively require that credit unions' Web site remain functional at all times. In light of the unique nature of cyberspace, however, this requirement is practically impossible. While credit unions, like all financial institutions and business, strive to operate and maintain their Web sites' constant functionality, there are sometimes internet disruptions that are beyond the control of Web sites' servers, servicers, or sponsors. By including the "continuously" verbiage, the CFPB opens up the door for malicious individuals to sue credit unions for minor Web site disruptions that are beyond their control. These frivolous lawsuits will only drive up operational costs, and, in turn, lead to higher costs for consumers. NAFCU and our members strongly recommend that the Bureau remove "continuously" from the proposal.

Given these factors, we believe that the best solution to address the privacy notice issue is for the Senate to enact the legislation pending before it.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

NASCUS

Submission for the Record
From Mary Martha Fortney, NASCUS President and CEO
To Senate Committee on Banking, Housing, and Urban Affairs
Hearing on Examining the State of Small Depository Institutions
September 16, 2014

Chairman Johnson, Ranking Member Crapo, and distinguished Members of the Committee:

The National Association of State Credit Union Supervisors (NASCUS) appreciates the opportunity to provide this written statement for the record of the September 16, 2014 Senate Committee on Banking, Housing, and Urban Affairs hearing regarding the state of small depository institutions. As the professional association of the nation's state credit union regulatory agencies, NASCUS has been committed to enhancing state credit union supervision and advocating for a safe and sound state credit union system since its inception in 1965.

NASCUS would like to take this opportunity to thank the committee for its continued attention to this matter and to provide a few recommendations for legislative action moving forward.

As you heard from several of the witnesses during the September 16 hearing, there is a pronounced trend toward consolidation within the credit union movement, with the greatest impact being felt by small credit unions. Although some of this consolidation is a natural consequence of the demand for increasingly complex and technologically streamlined financial services, regulatory burden is also having a real impact.

To the extent that compliance costs are forcing otherwise safe and well-run credit unions to close or merge, it is the responsibility of the regulators and Congress to find solutions that keep vital financial services in the communities that these small institutions serve. There are currently several proposals before Congress that would further this important goal. We urge the committee to take action on these bills.

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Supplemental Capital –Capital Reform

Supplemental capital is a necessary tool for safety and soundness and critical to the credit union system's long term health and sustainability. Without access to supplemental capital, a small community credit union can easily find itself without sufficient regulatory capital if loan demand decreases at the same time that deposits increase. Unfortunately, this can force otherwise healthy credit unions to discourage deposits and limit lending. Restricting regulatory capital for credit unions to retained earnings limits the ability of the nation's credit union members to reinvest in their credit unions and in some cases to access their credit unions during times of increased savings. NASCUS supports legislation in the House that would accomplish this important capital reform, H.R. 719, the Capital Access for Small Businesses and Jobs Act, which would authorize federal and state regulators to allow well-managed credit unions to access supplemental capital and count that capital toward the credit union's net worth. From a regulatory standpoint for well-managed, healthy credit unions, a supplemental capital program can provide increased systemic stability, additional balance sheet management tools and an extra buffer to mutualized losses. We recommend the committee consider adopting similar legislation.

Privacy Notifications

The Privacy Notice Modernization Act (S.635) would help reduce regulatory burden without diluting consumer protection standards. Although sending an annual privacy policy notification to all customers may be merely an inconvenience to large institutions, it imposes a significant cost on smaller institutions. Furthermore, sending a notification only when some aspect of the privacy policy has changed helps to draw the consumers attention to that change, thereby better serving the consumer protection goals of the legislation. NASCUS supports this common sense regulatory relief measure and urges the Senate to take action as soon as possible.

IOLTA Trust Accounts

The Credit Union Share Insurance Fund Parity Act (S. 2698/S.2699) would benefit small credit unions by providing federal deposit insurance coverage for trust accounts held at federally insured credit unions. Currently, in order for a trust or escrow account to be federally insured in a credit union, all owners of the trust must be credit union members. This prevents credit unions from providing Interest on Lawyer Trust Accounts (IOLTAs) and similar accounts to members who need those services. These accounts do not represent an inherent safety and soundness concern and create a competitive disadvantage for credit unions compared to banks. We urge passage of this important legislation.

In closing, we encourage the committee to remain actively engaged in regulatory oversight. Just as state legislatures work to ensure that state regulators strike the correct balance in supervising local financial institutions, Congress has a role to play in ensuring that federal regulators remain committed to right-sizing regulations. For example, the EGRPRA review process can be a valuable tool to minimize outdated, unnecessary, or unduly burdensome requirements, and NASCUS appreciates the committee's dedication to improving the

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productivity of that exercise. In addition, several members of the committee have been active in providing meaningful oversight to the risk-based capital deliberations, and we encourage you to remain engaged in that debate as the rule is finalized.

NASCUS appreciates the opportunity to submit written comments on this important issue. NASCUS and its state regulator members are available to answer any questions that the committee may have regarding the safety and soundness or regulatory burden of any of these proposed reforms. We look forward to continued dialogue and progress in the continued effort to eliminate unnecessary regulatory burdens.

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STATEMENT

OF

DAVID BARIS

PRESIDENT, AMERICAN ASSOCIATION OF BANK DIRECTORS

BEFORE THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

ON

"EXAMINING THE STATE OF SMALL DEPOSITORY INSTITUTIONS"

WASHINGTON, D.C.

SEPTEMBER 16, 2014

Mr. Chairman, Ranking Member Crapo and members of the Committee - thank you for the opportunity to submit this statement for the hearing record. The subject of the hearing is an important one. Community banks provide essential and unique banking services throughout the United States.

Founded in 1989, the non-profit American Association of Bank Directors is the only trade group in the United States solely devoted to bank directors and their information, education, and advocacy needs. The Institute for Bank Director Education was established in 1993 as the educational arm of AABD. Its purpose is to act as a clearinghouse for education programs designed for bank and savings institution directors that support the nationally recognized Director Certification Program.

The community banking model is under attack. Community banks face unprecedented challenges from an overreaching compliance regimen, competitive pressures, the overhang from the Great Recession, and lower margins and earnings.

The state of community banks cannot be fully evaluated without considering the state of community bank boards of directors.

They are overburdened, at undue risk of personal liability, and often underpaid for the risk and obligations that they assume. The banking industry is losing good bank directors and director candidates from fear of personal liability and the burdens they undertake as

directors. We know of bank boards that are changing their behavior to become more risk averse, to a point where qualified borrowers may not be able to qualify for loans or where the board is unwilling to offer new products or services needed by their communities.

Regulatory burdens

At a time when the viability of the community banking model is being widely questioned, it is the board of directors that must focus on strategic and capital planning, along with enterprise risk management.

That is difficult to do in light of the extraordinary burdens placed on bank boards of directors by the federal banking agencies.

AABD has identified more than 800 provisions in federal banking statutes, regulations and regulatory "guidance" that impose obligations on bank boards and board committees. AABD has collated these provisions in the *Bank Director Regulatory Burden Report, 2014 Edition.*

Some of these requirements are management in character for which the board of directors is unsuited to fulfill, not having the training and experience required for that role.

These obligations establish no priorities. All are treated equally. The essential roles of the board of directors to help set strategy and risk management systems and controls will often be lost in the morass.

At least for directors of large institutions, there are normally resources available to support the board to meet its obligations. Not so for many community banks.

The issuance of the 2014 Edition of *Bank Director Regulatory Burden Report* comes as the federal banking agencies begin to conduct their decennial review of regulatory burdens, in the form of rules, due in 2016 as required by section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA).

Many of the obligations imposed on bank boards of directors are created through regulatory "guidance" or "guidelines", which generally are not adopted through rule making procedures required under APA. Yet, in the world of banking supervision, written guidance is often considered as important to bank examiners as rules or regulations, and they apply them during examinations as if they were rules. Conscientious bank directors will want their banks to meet the guidelines and will spend time and resources in order to accomplish that. As such, these guidelines are indistinguishable from other burdens on bank directors created by a formally adopted rule. That is the reason why the federal banking agencies should evaluate guidelines as part of their decennial review under EGRPRA as if the guidelines were rules.

Once a bank board and its committees wade through legal requirements, compliance and bank regulatory obligations, there is little time for strategic planning, an essential need for community banks to survive.

Among our recommendations to the federal banking agencies are the following:

- An agency evaluation of existing regulations and written guidance specifying bank director responsibilities to determine the overall burden on bank directors; eliminate unnecessary and duplicative requirements and requirements that are management in character or where the burden outweighs the benefits from such regulation or guidance; and organize the requirements so that they are easily retrievable and usable;
- Incorporation into the agencies' procedures a requirement that they will thoroughly consider the impact of proposed regulations and guidance on the burdens on bank directors, including their cumulative effects, and not add to the burdens unless the benefits of the proposed rule or guidance clearly outweigh the burdens;
- Proposal and adoption of a rule by the agencies that clarifies that bank boards of directors may delegate management duties to management and rely reasonably on management to perform such duties without incurring personal liability; and
- As part of the decennial review, a proposal by the agencies in the Federal Register that opens public comment to all current regulations and guidance that impose obligations on bank boards of directors or their committees to determine which ones are necessary or unduly burdensome.

As to the Senate Banking Committee, we urge it to evaluate, through oversight hearings and investigation, the aggregate effect federal banking agency actions are having on the duties and responsibilities of bank directors.

The agencies have been through the decennial review process once before, in 2006 and the two years that preceded that year. AABD's review of the 2006 effort concluded that it was an unsatisfactory and flawed process and result from the perspective of bank boards of directors. Numerous regulations and regulatory "guidance" that were unnecessary or unduly burdensome were ignored and have remained on the books ever since. Many regulatory burdens have been added since 2006. In its comment letter, AABD urges the Agencies this time to take steps to avoid the mistakes made in the 2006 process.

AABD's *Bank Director Regulatory Burden Report* pointed out that the limited scope of the 2006 review was a factor in the failure to address or remedy the regulatory burdens imposed on bank directors. The agencies gave notice and invited public comment on a very limited, prescribed set of regulations that included only four regulations directly burdening bank directors. A more inclusive public notice process might have engendered a dialogue that could have opened up discussions of the numerous unnecessary or excessively burdensome regulations and regulatory guidance that impose obligations on bank boards of directors.

On July 31, 2007, the FFIEC and its constituent federal banking agencies published the 69-page Joint Report to Congress on EGRPRA, detailing the Agencies' fulfillment of EGRPRA. The Joint Report highlights some of the comments that the Agencies received during the notice and comment period. Some commentators recommended that the Agencies conduct a study of examination reports to evaluate whether examiners were appropriately distinguishing management from board obligations in their examination findings, conclusions, and

recommendations. Commentators also suggested that the agencies review existing regulations that examiners rely on to support their prescriptions that directors undertake more managerial-type responsibilities. However, the Joint Report simply informs Congress that the agencies received comments relating to the burdens on bank directors, without reference to the actions taken in response to the comments.

Given this history, it is important for the agencies to state clearly in a future Notice that regulatory burdens on bank boards of directors and their committees are considered burdens on the banks themselves. This arguably is a truism but necessary nonetheless to be reflected in a future Notice so that commenters will know that the agencies are interested in receiving comments on the regulatory burdens facing bank boards of directors and their committees. It goes without saying that bank boards are integral to the safe and sound operation of those institutions.

The duties and responsibilities of bank directors flowing from all these sources are numerous, burdensome, overwhelming, frustrating, sometimes conflicting, and often unnecessary. They divert the time and attention of bank board of directors and board committees away from the essential role they should play- meeting their fiduciary duties of care and loyalty by overseeing (NOT managing) the institution. Bank directors should be focused on establishing a prudent risk management system, monitoring adherence to that system, establishing and overseeing the strategic plan of the bank and overseeing the performance and compensation of management. Instead bank boards have become overwhelmed with compliance and regulatory matters, so much so that compliance and bank regulatory requirements have become a major line of business replete with administrative minutia and duties falling on the board that rightly should be left to bank management or in some instances dispensed with entirely.

Further, imposing management-like responsibilities on bank directors also confuses and misaligns the appropriate roles of the board of directors and management. Board members typically are not professional bankers. They are not loan officers, financial analysts, or bank regulatory experts - - they are doctors, teachers, attorneys, businesspersons and investors. They typically are not bank professionals and should not be expected to perform management functions. Instead of performing professional management-like responsibilities, the board of directors should be tasked with hiring and supervising individuals that can competently manage the banking institution. The ability of bank boards to delegate management functions to management to rely reasonably on them should be, but has not been, a clearly articulated and accepted facet of bank regulation and supervision.

Finally, the accumulation of so many duties and responsibilities from so many various regulatory sources in a manner that often is overlapping, duplicative and sometimes resulting in the inappropriate imposition of management-like minutia, especially when coupled with the increasing focus of enforcement and liability, negatively impacts the willingness of qualified individuals to serve as bank directors. This is not a consequence that is good for the health of the nation's banking system or the nation's economy. For community banks, the effects are magnified.

Personal liability risks

All bank directors face the possibility of heightened risk of personal liability from a number of sources. We believe that these risks impact on the willingness of community banks to be competitive in their market and qualified persons to serve on their boards.

The most significant source of liability since 2007 is that of directors of failed banks being sued by the FDIC as receiver.

Virtually of the banks that have failed since 2007 have been community banks. In a substantial number of bank failures, bank directors have been sued by the FDIC or the FDIC has authorized suit against them.

The heart of most of the suits is the fact that the board or loan committee of the board approved a small number of large loans, the losses from which contributed to the failure of the institution. This is a peculiarly community bank issue because generally speaking, it is only community bank directors, not large bank directors, who approve individual loans. Larger institutions typically view the underwriting and approval of loans as being a management function.

For community bank directors, their involvement is based on pressure from examiners to be involved in the underwriting process and the fact that many community bank directors will know or know of the customer or applicant, which allows them to play potentially a useful role in the review process. But no federal law or regulation requires board or board committee approval of loans other than certain insider loans.

By doing more than is legally required, community bank directors may be assuming greater risk of personal liability if their institution fails.

While AABD has advised many bank boards to stop approving loans, most continue to do so. The question remains whether they are willing to approve loans to credit worthy borrowers where some risk of repayment exists or continue to limit, as many banks continue to do, to make loans only to the strongest borrowers. We also know from a recent survey reported to the Committee that many community banks are staying clear from offering new products and services that might be needed by their communities out of fear that either the bank or its board may be subject to liability or regulatory criticism.

The following are some of the factors that AABD believes contribute to the fear of personal liability that motivates community bank director resignations and others to reject offers to serve as community bank directors. For those who remain, they will increasingly guide their community banks to avoid even reasonable risk involved in providing credit and other banking services to those in their community. It is within the power of the federal banking agencies and/or Congress to eliminate many of these factors.

FDIC suits grounded in simple, not gross negligence

Despite the FDIC's policy of not approving suits against directors of failed banks unless it has determined that they committed gross negligence, the FDIC's complaints often assert simple negligence, even in states which, in the view of AABD, have adopted a gross negligence standard.

Always being blamed for bank failures

Invariably, the Inspectors General of the FDIC, Fed and Treasury, in their Material Loss Reviews, point the finger at bank boards for having contributed to the failure of their banks. See AABD Report on Material Loss Reviews dated January 29, 2013. Bank directors now know that if their bank fails, they will be blamed, regardless of the facts and circumstances.

Outdated FDIC policy on bank director responsibilities

The FDIC bases its decision whether to sue directors of failed banks on an old and outdated policy statement that ignores the right of bank directors to rely reasonably on the work and opinions of bank management and advisors and that applies a simple negligence standard even though most states apply a gross negligence standard.

Enforcement authority that allows imposition of liability without culpability

For several decades, the federal banking agencies have had the authority to impose civil money penalties on directors without having to prove that the directors did anything wrong. All it takes is that the Bank violate a law or regulation or engage in an unsafe or unsound banking practice and the director "participate" in the violation or practice, whether knowingly or unknowingly. The director can meet his or her fiduciary duties but that would not matter.

Over the past six years, directors have seen a huge uptick in enforcement actions against banks and insiders, including directors. They are feeling more vulnerable, for good reason. The Reports of Examination routinely warn boards of directors that they are susceptible to civil money penalties for the slightest infraction.

Demands by examiners for the net worth of bank directors

AABD has received reports that during examinations, bank examiners will require directors to provide them their net worth or recent tax returns, even if they are not borrowers from their bank. This is a highly offensive request that violates basic principles of privacy and can only intimidate directors for no reason. The in terrorism effect on bank directors is not measurable.

Restrictions on bank directors' right to preserve records for legal defense purposes and defend themselves for official actions

In 2012, the FDIC issued a financial institution letter that suggests that bank directors are not entitled to access to bank records for the purpose of defending their official actions as directors. The agencies also sometimes bar bank directors in receipt of a 15-day letter or notice of other enforcement action from having their attorneys have access to reports of examination that are necessary to defend the action. No other corporate directors are so restricted.

Limitations on directors insuring against risk of civil money penalties

After the FDIC adopted a rule in 1993 barring banks from paying premiums for insurance to cover civil money penalties imposed on bank directors, a number of carriers offered an endorsement to banks' D&O insurance that would allow directors to pay the premium directly to the carrier for such insurance. The FDIC did not object to that practice until only two years ago, concluding that so long as the coverage was part of the bank D&O policy, it was prohibited by the rule even though the directors paid for the insurance.

Difficulty obtaining D&O insurance to cover regulatory risks

As a result of the FDIC's aggressive suits against bank directors and officers over the past few years, the insurance carriers have refused to cover regulatory risks for an increasing number of banks.

Barring insurance that would cover costs defending directors against agency administrative actions

The FDIC's 1993 rule referred to above also bars insurance from covering defense costs incurred by bank directors in an agency enforcement proceeding if the director ultimately loses the case or if the case is settled. The directors may be covered, depending on the policy, for defense costs prior to formal notices being issued by the agencies, but once the notice is served, the directors run the substantial risk that they will either lose or settle the case, which happens in most enforcement proceedings. This FDIC rule makes it exceedingly difficult for bank directors to defend themselves against an enforcement action through the administrative process, thus depriving them of due process protections afforded to them in law.

Forcing restitution through administrative means

In 2005, AABD issued a report questioning the appropriateness of the federal banking agencies to force a director or officer to make restitution through administrative means rather than through a court of law. This is another potential threat to bank directors and remains a concern of AABD and its members.

Authority to use deep pocket subpoenas to obtain personal financial statements and tax returns

The FDIC has the authority and has used that authority to subpoena personal financial statements from former directors of failed banks without first going to a court of law to prove

that the need to review the financial statements was justified. Private parties that are considering law suits don't have that authority.

Community bank director resignations

The continuing regulatory burdens facing community bank directors and the heightened risk of personal liability have taken their toll on community bank boards. The loss of qualified bank directors should be of concern to the Committee and the federal banking agencies and could have negative effects on the success of certain community banks.

24.5% of bank respondents to a survey conducted by AABD earlier this year advised AABD that at least one of the following had occurred during the past five years:

- Director resigned citing fear of personal liability
- Director candidate refused offer to become director because of fear of personal liability and/or
- Director refused to serve on Board Loan Committee or resigned from that committee because of fear of personal liability.

The AABD survey results are disheartening to those who advocate, as AABD does, for a strong bank board that is able to attract and retain the best people possible to serve as bank directors,

It may very well be that many bank boards of directors continue to consist of highly capable directors. However, attrition caused by personal liability fears is of concern and can be relatively easily rectified by appropriate actions taken by the federal banking agencies and the U.S. Congress.

Summary

Community banks face formidable challenges. So do their boards of directors, which also contribute to their banks' challenges. The federal banking agencies should take steps to minimize regulatory burdens on bank directors and undue risk of personal liability. The Committee should play an important role in overseeing the federal banking agencies' rules, guidance and policies that make it more difficult for qualified persons to serve as community bank directors and to accept reasonable risks in order for their community banks to survive and succeed in continuing to serve their communities.