FINANCING MAIN STREET: HOW DODD-FRANK IS CRIPPLING SMALL LENDERS AND ACCESS TO CAPITAL

HEARING

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OF THE

COMMITTEE ON SMALL BUSINESS

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THURSDAY, SEPTEMBER 17, 2015

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX AND CAPITAL ACCESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 1:00 p.m., in Room 2360, Rayburn House Office Building. Hon. Tom Rice [Chairman of the Subcommittee] presiding.

Present: Representatives Rice, Chabot, Luetkemeyer, Hanna, Brat, Radewagen, Kelly, Chu, Hahn, and Payne.

Chairman RICE. We are going to go ahead and proceed. I will call to order this meeting of the Subcommittee on Economic Growth, Tax and Capital Access of the Small Business Committee. Thank you to everybody, especially to our witnesses for being here.

Five years ago, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. With its passage came an onslaught of regulations. As we are aware, prior to Dodd-Frank's passage, there was a commonly repeated phrase of "too big to fail," and a sense that our economy had been hurt due to large financial institutions inappropriate actions. This law was meant to curtail the inappropriate and risky actions of these "too big to fail" banks and increase financial stability and transparency while providing greater consumer protection.

Today, we are not seeing the benefits promised by the proponents of the law. The economy is not rebounding exponentially. We are not seeing financially stronger and smarter banking. Instead, as we will hear from our witnesses today, the small guys, who did not create the problems, are the ones who are suffering. The losers in this equation are small businesses, both the everyday Main Street business that has trouble getting a loan, and the local bank that has to hire compliance officers instead of getting capital into the hands of local small businesses.

These small financial institutions, our community banks and credit unions, are traditionally the individuals who lend to small firms. Recent research has found that community banks provide over 50 percent of the loans to small businesses. Especially in rural communities, like my district, the burdens created by Dodd-Frank are causing many small financial institutions to merge with larger entities or shut their doors completely, resulting in far less options where already there were not many options to choose from.

We have all heard that Dodd-Frank contained exemptions meant to ensure that financial institutions under a certain size would be unaffected. The creators and proponents of this legislation have repeatedly assured folks that they truly understand the importance of small financial institutions and that these entities were not why the law was created, nor were the proponents intending to harm them. Unfortunately, as we will hear today, even the smallest financial institutions are feeling the effects the burden of this law, and not just this law, but exponential growth in all federal banking regulations as it trickles down and creates substantial regulatory burdens.

At this time, I would just like to put up a couple of graphs that exhibit the point that I am trying to make here.

You know, all of us—Republican, Democrat, House, Senate, the President—say repeatedly—I have heard the President say over and over again that we need to simplify and streamline regulations affecting small business. I think there is a graph before this one. This is the first one? Okay.

Well, if you will look, that is all the regulations that have been issued. This is a study done by the Mercatus Center that looks at mandates and prohibitions and regulations. And if you look at this, you will see that all of the regulations issued under the Obama Administration, including Obamacare, EPA, the war on coal, all these other things, and then the regulations under Dodd-Frank there in the lighter colored line, the regulations issued just under Dodd-Frank outnumber the regulations issued in every other area of the federal government.

Next slide, please.

All right. There was another slide that I have got a copy of here, but it shows that in the six years since the president has been in office, that the number of regulations issued by the Administration is higher than any Administration since Richard Nixon. In six years. And we still have two years to go.

Next? Or excuse me. On this slide, yeah, that is the first slide I wanted there. Yeah. Can you make that bigger?

If you look at the top, you will see the top line is the regulations issued under the current Administration, and then underneath that—in six years—and you will see every President since Richard Nixon under there. And this Administration has already outpaced the number of regulations, despite the fact that they say we need to streamline and simplify regulations applying to small business. You know, let us look at not just—not just hear the words, but let us look at what is actually happening.

Okay. Next slide. And then you will see the regulations, which are more than any other Administration in the last 40 years. Most of those regulations are under Dodd-Frank. And in fact, we are just over halfway through with the rules that are supposed to be implemented under Dodd-Frank. So many more tens of thousands of regulations ultimately will be issued under this law. And those regulations obviously have a stifling effect on banking.

Next slide, please.

Dodd-Frank was passed under the guise of “too big to fail,” that we needed to do what we could to prevent large institutions from becoming so large that they were a threat to our financial system. This graph is a graph of the assets held by the large banks. And if you will see in that red line, it is the percentage of total banking assets held by large financial institutions. And since 2010—it is hard to read—but the total banking assets in the country since Dodd-Frank was passed, held by large financial institutions, has increased from 39 percent to about 42 or 43 percent. And I think this is the top five largest U.S. banks only. So Dodd-Frank has been a failure in terms of preventing these banks from becoming “too big to fail,” its primary mission.

Next slide, please.

Let us look at the effect on small banks. This is the number of banks being formed in the country. From 2000 to 2010, the number of banks being formed in the country averaged about 100 per year. And if you will look, since 2010, when Dodd-Frank was implemented, I think the average is about one or two banks per year, which is a scary, scary thing for our economy, because small banks are typically the new banks, and they are the primary lenders for small business. And small business employs 75 percent of the people in this country. So should we be surprised with no banks being formed that small businesses struggle to find capital—access to capital being one of America’s biggest assets in the past? Should we be surprised that our economy continues to limp along at 2 percent instead of 4 percent?

Next slide, please.

This is the number of business startups and business closings. And you will see since 2009, that for the first time since the Great Depression, that business closings out number business startups in this country. Could that perhaps be tied to a lack of access to capital? I think that is very likely. I do not think this is coincidental. And again, this is small businesses going out of business at a faster pace than small businesses are being created, and these businesses are the primary employers of the American people.

Next slide, please.

This slide, okay, the primary source of wealth building in the country for the last 50-plus years, 100 years, has been homeownership. And you can see that homeownership has taken a nosedive and continues to dive, due largely to these new lending restrictions under Dodd-Frank. Homeownership now stands at the lowest level in 48 years.

Next slide, please.

And this is participation of people in the workforce. And you can see that it took a nosedive after the recession and continues to—it is now at record levels percentage of people who are outside of the workforce in this country.

So we have got the highest number of people that are outside the workforce in 30 years.

Back up a slide.

The lowest homeownership in 50 years.

Back up a slide.

The slowest rate of net business formation in 80 years.

Next slide. Back up a slide.

The lowest rate of bank formation in 80 years.

Next. Back up a slide.

So this is not a record, an economic record that anybody should be proud of. And Dodd-Frank plays a big part in this equation.

So with that, I want to thank all of our witnesses for being here this afternoon. I look forward to your testimony.

I now yield to Ranking Member Chu for her opening remarks.

Ms. CHU. I want to thank all of you for being here today. Today's hearing will focus on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the impact of these regulations on small financial institutions and on access to capital for small businesses.

In 2008, our country faced one of the worst economic downturns in history. In the midst of this financial crisis, the U.S. lost four million jobs, seven million people faced foreclosure, and many entrepreneurs abandoned their dreams and small businesses closed their doors believing that they would never open again.

After taking extraordinary steps to stabilize the economy, Congress enacted the Dodd-Frank Act in July 2010 to address the loopholes that caused the collapse. The bill established strong new standards for the regulation of large leveraged financial institutions and made the protection of consumers seeking mortgages and credit products a top priority.

While this legislation was primarily directed at the largest financial firms, we often hear that small banks are impacted primarily due to the high cost for compliance, and it is clear that the small lenders on Main Street are not the ones responsible for the financial crisis. Community banks and credit unions are on the frontlines of community lending providing personal, familiar services to small businesses and entrepreneurs. These entities should not be forced to carry the burden of new regulations.

For these reasons, critical measures have been put in place to ensure that any new regulatory burden on the small banking community is properly mitigated. First, many of the Dodd-Frank Act provisions only apply to institutions with over $10 billion in assets, leaving 98.2 percent of all banks in the U.S. largely exempt. Second, new regulations created by the Consumer Financial Protection Bureau that do apply to small financial institutions are subject to the Regulatory Flexibility Act and the Small Business Regulatory Enforcement Fairness Act.

Now, in the midst of this, small business lending has increased. In fact, according to the Thomson Reuters/PayNet Small Business Lending Index, access to credit has continued to improve for small businesses, reaching its highest level ever in June 2015. Moreover, small business lending is up 19 percent over the same period in 2014, pointing to steady economic growth.

The Federal Reserve has found lending standards for small firms have eased considerably since the recession, while loan balances at community banks have increased nearly 9 percent in the last year alone.

And finally, even Small Business Administration lending has reached record levels. SBA is currently on track to make 65,000 loans totaling over $26 billion in its 7(a) and 504 programs combined. In fact, the National Federation of Independent Businesses reports a historically low 3 percent of small business owners are unable to fulfill their capital needs.

Critics of Dodd-Frank point to the decreasing number of small financial institutions as proof of regulations that are too burdensome, but it is crucial to remember that the decline in the number of community banks did not begin with Dodd-Frank. For the past 30 years, the number of community banks in the U.S. has been declining at a rate of 300 per year for the past 30 years, and 80 percent of these losses were actually due to mergers and consolidations.

There is no doubt that the regulations implemented by Dodd-Frank will impact many facets of the financial industry, and there is also no doubt that the economy has been improving at a greater pace since its passage. Private employers have created 12 million jobs, and unemployment has been cut in half. The housing market is recovering, and small business credit has returned to pre-recession levels in many sectors.

Both democrats and republicans have introduced legislation to make technical corrections to the bill that will support community banks. However, moving forward, it is essential that we legislate prudently and avoid allowing big banks to exploit the genuine concerns of small institutions to promote legislation that benefits Wall Street at the expense of the American people.

Today, eight years after the housing bubble burst, small business is creating two out of three new private jobs and resuming its position as the economic engine of our country. The success of these businesses depend on their access to capital and credit and small financial institutions, like the credit unions and community banks represented here today, play an extensive role in lending to them. As both lenders and borrowers, small businesses have much at stake when it comes to financial regulatory reform. It is my hope that the testimony today will add important perspectives on the interaction between Dodd-Frank and Main Street and we can all learn.

I want to thank the witnesses for being here today and I yield back.

Chairman RICE. Okay. If Committee members have an opening statement prepared, I ask they be submitted for the record.

I would like to take a moment to explain the timing lights to you. You will each have five minutes to deliver your testimony. The light will start out as green. When you have one minute remaining, the light will turn yellow. Finally, at the end of your five minutes, it will turn red, and there will be a certain amount of flexibility allowed there. I ask that you try to adhere generally to the time limit.

Our first witness is B. Doyle Mitchell, Jr., President and CEO of Industrial Bank located here in Washington, D.C. Industrial Bank was founded by Mr. Mitchell's grandfather in 1934, and is currently the sixth largest African-American owned bank in the country with $370 million in assets. Mr. Mitchell has worked at the Industrial Bank since 1984. Mr. Mitchell is testifying on behalf of the Independent Community Bankers of America.

Welcome, sir. You have five minutes, and you may begin.

STATEMENTS OF DOYLE MITCHELL, JR., PRESIDENT/CHIEF EXECUTIVE OFFICER, INDUSTRIAL BANK; SCOTT EAGERTON, PRESIDENT/CEO, DIXIES FEDERAL CREDIT UNION; MARSHALL LUX, SENIOR FELLOW, MOSSAVAR-RAHMANI CENTER FOR BUSINESS AND GOVERNMENT JOHN F. KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY; JULIA GORDON, SENIOR DIRECTOR HOUSING AND CONSUMER FINANCE, CENTER FOR AMERICAN PROGRESS

STATEMENT OF B. DOYLE MITCHELL, JR.

Mr. MITCHELL. Thank you, Mr. Chairman, and Ranking Member Chu, for the opportunity to testify before this Subcommittee.

As you stated, my name is B. Doyle Mitchell, Jr. I am president and CEO of Industrial Bank headquartered in Washington, D.C. The bank was founded by my grandfather at the height of the Great Depression in 1934. We just celebrated our 81st birthday, and we are the oldest and largest African-American commercially-owned bank in the Washington metropolitan area. We have over 100 employees, and I testify today on behalf of 6,000 community banks represented by the Independent Community Bankers of America. Thank you again for convening this hearing.

In addition to being a member of ICBA, I am also former immediate past-chair of the National Bankers Association, which is a trade association for the nation's minority-owned and women-owned financial institutions. There is an extremely important segment of community banks like mine that were founded to serve minority communities and historically underserved areas often ignored by larger financial institutions. Community banks play a critical role in providing small business credit, and yet, the vital partnership between community banks and small businesses is at risk today because of the exponential growth of regulation. Dodd-Frank is really just the pile-on of regulation. And in a few short years, the nature of community banking has fundamentally changed from lending to compliance.

I was speaking to my CFO two days ago and he was talking about the growth in the call reports going from 60 pages to 80. I believe regulatory burden has contributed significantly to the loss of 1,300 community banks since 2010. While, yes, there have been acquisitions and consolidations, many community banks that I come in contact with have just thrown their hands up and given up. And so the good news is there is a solution, and ICBA's plan for prosperity is a regulatory relief agenda that will allow Main Street's small businesses to prosper. A copy of the plan is attached to my written statement.

Now, I come in contact with hundreds of banks on an annual basis from four different associations. So while ICBA has put this forth, I can tell you I do not get any argument from other bankers. The plan includes 40 recommendations—nearly 40 recommendations covering major threats to community banking, and I want to focus my comments on the plan's mortgage reform provisions.

Home equity is often an entrepreneur's greatest source of capital, and they should be able to tap into that to start or expand a business. However, it is often hard for self-employed individuals to document their income as required by the CFPB's qualified mortgage, or QM rule. QM is a safe harbor that shields a lender from draconian litigation risk. For most community banks, QM essentially puts a tight box around underwriting and loan terms. Because it is inflexible and does not give bankers discretion, such as ours, to use his or her judgment, QM is cutting off small business credit.

We believe any mortgage community bank holes in the portfolio should be QM. And we sell loans, but we sell about 50, 60, sometimes 70 percent of our loans, and the loans we hold in portfolio are those creative loans that QM would effectively stop from occurring.

We are encouraged by the bills' introduction in the Senate and the House so far. Two bills in particular best represent the scope of the plan for prosperity. The Clear Act, H.R. 1233, sponsored by Representative Blaine Luetkemeyer, includes the portfolio QM provision that I described, in addition to other provisions designed to preserve community bank mortgage lending and servicing, reform bank oversight and examination, and provide relief from redundant annual privacy notices.

The second bill is H.R. 1523, introduced by Representative Scott Garrett, which would provide community banks with new capital options to strengthen their viability. Minority banks are always looking for additional capital and most other community banks are as well. We encourage you to co-sponsor these important bills as well as other bills embodying the plan for prosperity provisions.

One last item I would like to note is that ICBA believes community banks should be excluded from CFPB's forthcoming small business data collection rules. Small banks did not create those problems and they should apply to the institutions or larger institutions that actually do. This rule will require information reporting on every small business loan application, much like HMDA, which is very tedious. HMDA, at this point, probably has nearly 100 different data points, and if you miss one, the examiners will call you in violation of law.

Thank you again for the opportunity to testify. I look forward to your questions.

Chairman RICE. I am pleased to introduce our next witness, one of my constituents, Scott Eagerton, the President and CEO of Dixies Federal Credit Union, which is headquartered in South Carolina's Seventh District and serves all of Florence and Darlington Counties. This small credit union has 7,000 members and nearly $42 million in assets. Mr. Eagerton is testifying on behalf of the National Association of Federal Credit Unions. Thank you for making the journey here today, sir. You may begin.

STATEMENT OF SCOTT EAGERTON

Mr. EAGERTON. Good afternoon, Chairman Rice and Ranking Member Chu and members of this Subcommittee. My name is Scott Eagerton. I am testifying on behalf of NAFCU. I serve as the president and CEO of Dixies Federal Credit Union headquartered in Darlington, South Carolina. NAFCU and our members thank you for holding this hearing today.

During the consideration of financial reform, NAFCU was concerned about the possibility of overregulation of good actors, such as credit unions. This is why NAFCU was the only credit union trade association to oppose CFPB having rulemaking authority over credit unions. Unfortunately, many of our concerns about increased regulatory burden of credit unions have been proven true. The CFPB's primary focus should be on regulating the unregulated bad actors, not creating new burdens for good actors like credit unions. While it is true credit unions under 10 billion are exempt from CFPB examination and enforcement, all credit unions are subject to the CFPB rules.

The impact of the growing compliance burden is evident in the number of credit unions that continue to decline, dropping more than 17 percent in the second quarter of 2010. Ninety-six percent of those smaller institutions were like mine, below $100 million in assets. At Dixies, our compliance cost has risen fivefold since 2009, from about $20,000 a year to $100,000 annually. We spend more today on compliance than we do on loan loss.

During financial reform, the National Credit Union Administration moved to a 12-month exam cycle for credit unions, increasing costs for both the agency and for credit unions. We now have four full-time staff members who spend two weeks preparing for an exam, two weeks during the exam, and two weeks following the exam. The average cost in wages is about $30,000 per exam.

The financial crisis is now over. We believe the NCUA should use their authority to return back to the 18-month exam cycle for healthy and well-run credit unions.

New regulation on top of new regulation has hindered Dixies' business and our ability to retain top talent. We have had several staff departures due directly to these frustrations. Most of our staff has indicated that they do not want to participate in real estate lending because of the cost of change and regulatory uncertainty. Through August of this year, Dixies has already spent over $20,000 for system upgrades and software licenses. This does not include the time to set up the software and train on it. That costs roughly an additional 7,500 bucks.

Discussions with NAFCU member credit unions led to the creation of the NAFCU Five-point Plan for Regulatory Relief, which is outlined in my written testimony. One area where the CFPB could be most helpful to credit unions would be to use its legal authority under Section 1022 of Dodd-Frank to exempt credit unions from various rulemakings. Congress can also bring greater accountability and transparency to the CFPB by making structural improvements to the agency. For example, enacting H.R. 1266 of the Financial Products Safety Commission Act of 2015 would replace the sole director of the agency with a bipartisan five-person commission. The qualified mortgage rule is a prime example of a regulation that was unintended with unintended consequences. Because the rule was written with a "one size fits all," it has significantly limited member access to a variety of mortgage products. We decided the liability risk was not worth it. This has resulted to our mortgage portfolio shrinking from 60 percent prior to the crisis to 30 percent today. Despite a strong track record, we are now making fewer mortgage loans in South Carolina.

Finally, credit unions are not immune to the regulatory creep from Dodd-Frank. Despite strong credit union performance during the financial downturn, the NCUA board proposed a new risk-based capital system for credit unions. NAFCU maintains that this costly proposal is unnecessary and will further burden credit unions. We believe that Congress should enact legislation H.R. 2769 to stop and study proposals before moving forward.

In conclusion, the Dodd-Frank Act has a significant impact on credit unions, despite not being the cause of the financial downturn. We would urge members to support credit union regulatory relief efforts as outlined in my written testimony. Additionally, the Subcommittee should also encourage regulators to provide relief where they can without congressional action.

Thank you for the opportunity to share my thoughts with you today. I welcome your questions.

Chairman RICE. Thank you, sir.

Our third witness is Marshall Lux, a senior fellow at the Mossavar-Rahmani Center for Business and Government at Harvard University's John F. Kennedy School of Government. Mr. Lux worked in the financial services industry for over 30 years. We look forward to your testimony, sir. Please begin.

STATEMENT OF MARSHALL LUX

Mr. LUX. Thank you. Chairman Rice, Ranking Member Chu, and members of the Subcommittee, thank you for the opportunity to speak with you today. In doing so, I will draw heavily from the State and Fate of Community Banking, which is a working paper I co-published in February 2015 as a senior fellow at the Mossavar-Rahmani Center for Business and Government at Harvard, with Robert Green, a research assistant at the center who is seated directly behind me.

Before I begin, let me be clear that the views expressed here do not necessarily reflect those of any organization and that either Robert Green or I are affiliated with, and instead stem from independent scholarly research we have undertaken to understand the critical issues facing America's financial system.

Capital access for small business remains a critical pillar of economic vitality. Members of this Committee are likely aware that small businesses account for roughly one-third of enterprise employment. But the current size of a business matters less than its potential to expand. Capital access is critical to achieving such growth.

As of 2012, banks were the primary financial institution for 85 percent of small businesses. In our February working paper, Mr. Green and I found that an astonishing 51 percent of small business loans were from community banks. And why is this? Community banks leverage interpersonal relationships in lieu of financial statements and data-driven models in making decisions. As Federal Governor Tarulla has noted, credit extensions to small firms is an advantage in which the relationship-lending model of community banks retains a competitive advantage. It means that community banks are of special significance to local economies.

Yet, the state of small business banking today is different than that of several years ago. For starters, the number of community banks—banks with less than $10 billion in assets—has declined rapidly in recent years. It did start with Dodd-Frank. In mid-1994, there were 10,329, and in mid-2014, there were only 6,094. Similarly, since 1994, community banks share a view as U.S. banking assets has decreased by more than half to 18 percent.

More concerning to this Committee is the post-crisis decline in the volume of bank loans to small business. In the four years before the crisis, from mid-2003 to 2007, outstanding loans to small business grew 25 percent in 15 percent of community banks. Yet, outstanding bank loans to small business is attributable to small community banks which realized a 17 percent fall. During this time, small business lending by larger community banks remained relatively flat.

What factors are at play here? Nonbank lenders, while growing rapidly and increasingly playing a viable role in both credit and the overall U.S. economy have, and will, only fill some of the gap left in the wake of less community banks mobile lending. The vast share of small business lending is still performed by banks, so while these nonbank firms and technology-based platforms are a factor, community banks will remain a critical part of small business lending.

Instead, a major cause of decreased community banking small business lending is our nation's tepid economic recovery. Labor force participation is at a 10-year low. Quarterly GDP has averaged just 2-1/2 percent in the last two years.

In August 2015, a survey of small businesses by the National Federation of Independent Banks reinforced this concern. It found that 49 percent of respondents were on the credit sidelines with no good reason to borrow. But the most troubling fact is that the firms seeking credit may not be able to access it. As former small business head Karen Mills and a colleague recently noted, "While measuring the credit gap is difficult, the evidence strongly suggests that there are acute impediments to accessing capital for many credit-worthy small businesses." Dodd-Frank shrinks credit access because of its shared scope. It stands to increase financial regulatory restrictions by 32 percent.

As a recent paper published by the Federal Reserve of Richmond said, "Banking scholars have found that new entities are more likely when there are fewer regulatory restrictions. The current bank or lack of new bank formation inherently hampers credit access."

Furthermore, a recent IBA study found that 21 percent of banks report new regulatory burdens as a factor. For 83 percent of small banks, compliance costs have increased at least 5 percent. This capital is not being deployed in our economy.

Some will argue that because consolidation has occurred, Dodd-Frank is not a factor in declining community banking. But in fact, large-scale regulatory accumulation with the banking sector has simultaneously occurred with rapid consolidation. Regulatory restrictions within Title XII——

Chairman RICE. If you could wrap up your testimony.

Mr. LUX. Sure. Absolutely.—grew every year.

Reforming financial regulatory process is critical. Mr. Green and I propose several strategies to do so. Credit benefit analysis brings about transparent deliberation and regulators to avoid unintended consequences.

While Dodd-Frank was intended to focus on large banks, there is trickle down. Community banks have recently reported held to the same stress tests and capital standards as large financial institutions.

In conclusion, small businesses clearly play a critical role in bringing about heightened U.S. growth, and community banks today are, and for many years have been essential sources of credit—their reliance upon community banks from a variety of factors, an emphasis on relationship-based lending, on standard lending, geographic necessity. One out of five people lives in a county with only one community bank.

Certainly, market factors may diminish the role of community banks in small business lending. Unfortunately, regulatory pressures, such as those brought by Dodd-Frank are undermining the competitiveness of community banks.

Chairman RICE. Thank you, sir. We are going to have to wrap it up. Thank you.

Mr. LUX. Okay. Thank you.

Chairman RICE. I now yield to Ranking Member Chu for the introduction of her witness.

Ms. CHU. It is my pleasure to introduce Ms. Julia Gordon, senior director of Housing and Consumer Finance at the Center for American Progress. Gordon has written extensively about the Dodd-Frank Act and has been cited in the New York Times, Wall Street Journal, and the Washington Post among others.

Prior to joining the Center for American Progress, Gordon managed the Single Family Policy Team at the Federal Housing Finance Agency and served as senior policy counsel at the Center for Responsible Lending. Ms. Gordon received her bachelor's degree in Government from Harvard College and her J.D. from Harvard Law School.

Welcome, Ms. Gordon. We are so happy to have you here today.

STATEMENT OF JULIA GORDON

Ms. GORDON. Thank you so much, and good afternoon, Chairman Rice, and Ranking Member Chu and distinguished members of the Subcommittee. I really appreciate being invited to discuss the very important topic of small lenders and access to capital.

Small lenders, as everyone has discussed today, play a critical and unique role in meeting America's credit needs. They often serve nonmetropolitan areas poorly served by larger institutions, and they focus their lending on everyday customers, such as small businesses and families.

Over the past five years, a number of indicators of health of small banks have shown consistent improvement—financial performance, overall health, the overall lending. It is absolutely certain though that the overall number of small institutions continues to decline. As Ranking Member Chu noted, this trend began decades ago, and the pace of that decline, kind of the slope of the line on the chart in my testimony, has not been affected by any individual regulation or piece of legislation, including the Dodd-Frank Act, which, of course, is a very large set of regulations.

Now, this makes sense because the pressures driving the decline in small bank are not just regulatory pressures, although, of course, that is a factor. It is also unlikely that a decline would have been triggered at the moment of signing of the Dodd-Frank Act because it took quite a while for the provisions to be implemented. In fact, they are not all implemented yet. Even the CFPB was not open for business until a full year after the act was passed.

Other factors driving this decline all surround the simple fact that in today's complex financial market, size matters. The vast majority of small banks that have exited the industry have actually merged or consolidated. Less than 20 percent of those exits have been due to failure or simply exiting the business entirely. So those banks are still out there doing business in a larger form.

Now, these pressures are because larger financial institutions engage in a wide variety of activities and serve a broad array of markets and that better insulates them. When particular business lines or markets are experiencing difficulties, they can rely on economies of scale. A very big factor, and one of the pressing challenges facing all lenders today, is the rapid pace of technological change and innovation. Today's customers demand everything from online lending on mobile devices to cloud-based systems where documents and other items can be stored. And these demands can be tougher to meet for small lenders, many of which have aging and inflexible technology infrastructures and limited staff and financial resources for projects of that nature. There is also the weak demand that Mr. Lux talked about, that the economy is still recovering from the worst downturn since the Great Recession. And because of the terrible mortgage lending in the run-up to the crisis, the loss in home equity, which is generally the largest source of capital for starting small businesses has, you know, was hit very, very hard, and there is still a lot of negative equity out there and people are reluctant to tap their equity.

So, you know, while, of course, regulatory compliance is part of the challenge, policymakers have recognized that, which is why many of Dodd-Frank's provisions do not actually apply to the smaller institutions. Enhanced supervision only applies to the very largest institutions, and only four out of approximately 5,900 community banks must undergo stress tests.

Small lenders also are exempt from many of the new rules governing mortgage lending, which gives them much more flexibility than larger lenders. And if they were willing to take advantage of this flexibility, they could see a significant competitive advantage in the marketplace.

Now, no regulation is perfect, and we have supported a number of small regulatory changes that could reduce compliance costs without weakening consumer protections or endangering safety and soundness. And there is a targeted regulatory reform package supported by the ranking members of both the House Financial Services Committee and the Senate Banking Committee that would ease some of the burden. You know, relates to things like the exam schedule that I believe Mr. Eagerton mentioned.

Unfortunately, some of the more sweeping legislative proposals, particularly the very large package that passed the Senate Banking Committee, uses the rhetoric of helping small banks to advance the regulatory reform agenda of larger banks, and that could actually increase and accelerate that chart that Chairman Rice showed earlier of the big banks having more business and cement the advantages that those institutions have relative to the smaller institutions. So we need to be very careful about that.

If we really want to help small lenders, what we need is a strong, proactive agenda to help upgrade technology, improve marketing, and gain access to cloud-based resources that can help smaller institutions work more like larger ones. We also need an agenda to support entrepreneurship and formation of small business, whether it is providing people with higher quality education, portable benefits that prevent job lock, upgrading investments and technology.

Chairman RICE. If you could be wrapping up.

Ms. GORDON. And welcoming new entrepreneurs through our immigration system. An agenda like that would address the obstacles facing small business without putting America's taxpayers on the hook again for risking unsustainable lending practices.

Thank you for inviting me today, and I look forward to your questions.

Chairman RICE. Thank you, ma'am.

I have quite a number of questions. I learn so much every time I hear you speak. I have a couple of general questions for the guys in here on the ground that are doing the banking work. And I am going to start with you, Mr. Mitchell.

Do you think you were adequately regulated before the financial crisis? In other words, has additional regulation made your business safer? More efficient? More profitable? Are you serving your customers better as a result of this additional regulation?

Mr. MITCHELL. Absolutely not, Mr. Chairman. In fact, even before Dodd-Frank, I think we were overregulated. I have been in the business for 30 years and I have seen periods of additional regulation. And it always increases. It always increases.

My colleague spoke a little bit about the amount of money that he spends on regulation. What we spend—and we are only $370 million—dwarfs that. And I do not see any benefit to the customer. Community banks take care of their customers anyway. That is what we do. So the answer is no.

Chairman RICE. All right. And you lend to a broad spectrum of people. The new tightened lending requirements, have they affected your ability to lend to the top 1 percent, to the wealthy people? Or would you say it disproportionately affects the middle class?

Mr. MITCHELL. You know what? It affects lending to all people because many times we think about the regulations while we are actually trying to look at and underwrite a loan. You know, in the back of your mind you are always thinking about what if the regulators do this.

Chairman RICE. When you say "many times," give me a percentage, somewhere between zero and 100.

Mr. MITCHELL. Half.

Chairman RICE. Half? You think about regulations half the time when you are making a loan?

Mr. MITCHELL. Yes.

Chairman RICE. And is it more common that you would be prevented from making a loan to a wealthy person or to a middle-class person?

Mr. MITCHELL. It is always tougher on those that are low, moderate, and middle class.

Chairman RICE. Have not the new lending restrictions taken away your ability to loan to somebody that might have been on the border?

Mr. MITCHELL. No question about it.

Chairman RICE. And would you say that disproportionately affects a minority community?

Mr. MITCHELL. Absolutely.

Chairman RICE. Mr. Eagerton, I am going to go to you next, sir. Do you think you were adequately regulated prior to the financial crisis?

Mr. EAGERTON. Absolutely.

Chairman RICE. And do you think that all these new regulations have made your bank safer? Have made it more efficient? Have allowed you to better take care of your customers?

Mr. EAGERTON. It is probably one of the biggest threats that we face today. I spend about $9,000 a year on loan loss reserves for real estate loans. We spend 120 to make sure we are in compliance.

Chairman RICE. All right. And would you say that these regulations affect more your ability to loan to wealthy people or to people who you might otherwise have been on the borderline and you might have taken a chance on?

Mr. EAGERTON. The latter, for sure.

Chairman RICE. So you think it disproportionately affects the middle class?

Mr. EAGERTON. Absolutely.

Chairman RICE. And minority borrowers?

Mr. EAGERTON. Absolutely.

Chairman RICE. Mr. Lux, can you generally describe for me, you know, we were talking earlier about the SBA kind of filling the gap for these community banks. Ms. Chu referred to the SBA making 65,000 loans. Do you think the SBA can fill the gap that these community banks are leaving open?

Mr. LUX. Not at all. Nor can these new lenders that are emerging. Karen Mills has a wonderful paper that you all should read, if you have not, on small business lending. But there is no question. The SBA has never been able to fill the gap, and they are not going to be able to fill a very large, gaping tap.

Chairman RICE. Do you think the additional regulatory burden, not just by Dodd-Frank but the accumulative banking regulations since the financial crisis—you know, the pendulum has swung. Right? It had swung too far to be too loose, and clearly it swung the other way. Do you think that shaves points off of our GDP? Do you think that negatively affects our economy?

Mr. LUX. Yeah, I do. I mean, the amount of, you know, we are talking about small banks and small lending, but even for the larger banks it is a huge amount of money that has transitioned out of the economy for, I would argue, no good reason. And when you try to interpret a law that is six times larger than Basel III. You know, they created in a heartbeat a bunch of laws that are yet to be even interpreted. But that is really important to recognize, that a lot of Dodd-Frank has not been implemented, and it just gets worse and worse. I frankly think it is a drag on the economy and sort of the work that we are doing, which is——

Chairman RICE. If you can wrap up, my time is up.

Mr. LUX. Okay.

Chairman RICE. Thank you, sir. Thank you very much.

Mr. LUX. Sure.

Chairman RICE. I now recognize Ms. Chu, the Ranking Member.

Ms. CHU. Ms. Gordon, small businesses are the backbone of our economy, and small lenders are largely responsible for getting small businesses and entrepreneurs the capital they need. Many critics of the Dodd-Frank Act point to the declining number of community banks and credit unions as proof that the regulations are too burdensome. However, you state that Dodd-Frank is not the cause of the decline. Can you tell us why you believe this is true, and what are the factors that have led to the decline?

Ms. GORDON. I spoke about some of this in my earlier testimony. And just to hone in on a few things, we went through a very, very bad financial crisis, and that impacted a variety of things. For one thing, the decline in home equity was monumental. Home equity is a key resource that people use when they are starting or expanding home businesses. Even now as we are coming out of that period of negative equity, consumer confidence remains shaky and we see particularly in the mortgage market people unwilling to borrow against their homes or concern that they are actually not back in positive equity.

I will say there is an area, something we can all agree on is that in terms of mortgage lending, the pendulum has swung too far in the opposite direction. And what is interesting is much of that is not so much because of the Dodd-Frank rules, per se. What you hear from Fannie and Freddie and FHA, which are the major secondary market channels for mortgage lending right now, is that banks themselves are placing what we call overlays on the credit box established by those secondary market entities because those banks themselves are feeling very, very risk averse, no doubt due to the pressures that we have all been through over the last decade. And it is particularly interesting in this Committee where, as you know, starting a small business is a risky thing and really, people have to take chances. And we are in an environment now where our lenders do not appear to take any chances at all. And that is not so much about regulation because there actually have not been enforcement actions against the type of institutions represented at the table here. In fact, these institutions are exempt from most of the mortgage rules. They are exempt from parts of QM. They can still continue to make balloon loans. They do not have to deal with escrow accounts for higher price loans. If they are holding loans in portfolio, they do not have to adhere to the QM debt-to-income ratio restrictions. So they have got a lot of flexibility that they could use to compete. But what I have heard when I talk to lenders is that their lawyers and their risk offers are telling them, "Do not do it. Do not do it. Do not try it." And that is not a question of the rule needing to be changed; that is something about the environment that we need to change.

I think we should all be very open to ensuring that the regulations are applying to the right group. If there are some exemptions that need to be widened to bring in a few more institutions with higher asset sizes because of all this consolidation, we should look at that. You know, again, things like exam schedules, make sure they are not too burdensome. But some of the core changes of Dodd-Frank, like requiring that lenders check whether a borrower can pay back a loan before they make that loan, it is a shame we ever had to regulate about that. That should have been common business sense, but it was widely disregarded and that led to the crisis. So we need that rule.

Ms. CHU. In fact, I wanted to ask about that. Low income and minority communities were devastated by predatory mortgage lending in the years leading up to the housing crisis. How are these communities better off today with the ability to repay and qualify mortgage rules that we enacted under Dodd-Frank?

Ms. GORDON. Well, what we know today is that when someone gets a mortgage, we are probably supporting what I call "home ownership," rather than just home buyership. The importance of the home is that you can afford it and you can sustain it over the life of the loan. So people getting loans now, especially under the new stringent requirements, that are much more likely to be successful and to build wealth. We do need to take some actions to reduce these overlays so that more people can get into the market, and a lot of that has to do with working with Fannie, Freddie, and FHA to give more certainty to lenders about when they are going to get a buyback request.

Ms. CHU. Thank you. I yield back.

Chairman RICE. Representative Kelly?

Mr. KELLY. Thank you, Mr. Chairman. And thank you, witnesses, for being here.

While I was home in the district in August, I visited all 22 counties which I have, and I visited lenders, bankers, credit unions, in all those counties where they exist. And over and over again I was shown the effects of Dodd-Frank on these small banks. In Mississippi, we have nothing but small banks. And the new regulations that are coming out that are about to come in are five or six three-inch binders worth of new regulations that my small Mississippi banks must comply with in order to run their business, many of them who do not have as many employees as you, Mr. Mitchell, who has a small bank, but not as small as some of the ones that I represent. In Mississippi, small businesses, and specifically our banks, our small banks, are the cornerstone of every single town. It is the basis of why we have a town. And if there is not a bank, there is not a town. Mr. Eagerton, the same way. Every military institution I have ever been on or installation, the credit union there is the cornerstone of one of those military installations.

That being said, Mr. Mitchell specifically, can you tell me in any way that Dodd-Frank, since its enactment and the regulations that currently exist and those that are coming, can you tell me how they make banks more accessible? How they make lending more fair? How they make you more responsible as a bank to the people that you lend money to? How it has made it more time sensitive in the way that you respond to your end customer, and how it protects our customers better?

Mr. MITCHELL. Thank you, Mr. Kelly. In my travels I have come across, as I said, a number of banks, and certainly, I have come across a number of CDFIs in the state of Mississippi. And I feel their pain as well. Dodd-Frank had a lot of great intentions. It really did. The problem with Dodd-Frank is you cannot outlaw and you cannot regulate a corporation's motivation to drive profits at all costs. So while it had a lot of great intentions, in over 1,000 pages, it has not helped us serve our customers any better. Just like the institutions in your state, community banks, you know, we are there for our customers. We actually really do care about our customers. Dodd-Frank was intended for maybe 50 to 100 institutions. It was not intended for mainstream institutions, minority banks around the country, like the one in Newark, New Jersey, City National. Mr. Payne, your father was a great individual.

So it has not helped. It has not helped. It has only increased our cost. And if my costs of complying were as low as Mr. Eagerton's, I would be happy. But our cost of compliance is probably approaching a half million dollars.

Mr. KELLY. I actually was a loan closing attorney in a former life. It has been many, many years because it was too complex for me in 1999 when I closed my last loan, and that was way before all this.

Mr. MITCHELL. Do you have any idea what it is going to be like on October 1?

Mr. KELLY. I do not want to know. That is why I came to Congress, I think.

But that being said, do you think that more regulation and more paperwork and thicker loan packages that take a longer time to implement are better or worse? Do they cost more or less for the end consumer, the person who is getting the loan? Mr. Mitchell?

Mr. MITCHELL. It costs way more. The loan package is probably this thick, and if anyone in this room bought a house 20 years ago, you already remember how many documents you had to sign, how many documents you had to read. I bought my first house in 1989, and it was a chore, as a banker, for me to get through it all. I only hope I can stay in my house forever now.

Mr. KELLY. And one final question from a consumer standpoint. That thick regulation, the thick amount of the loan closing package that you have right now, do the majority of your customers when they are signing those loan document papers, do they understand what they are signing or are they relying on an attorney who in most cases is not representing them but representing someone else? Do they understand what is in all those regulations that they are signing that is supposed to protect them?

Mr. MITCHELL. Absolutely not. Absolutely not. It is not any clearer about what they are signing. In fact, it is even more cumbersome for them now. We do mortgage loans. And I was sharing with someone before the hearing, the unfortunate thing is we are seriously—we have done mortgage loans for 81 years. We are seriously thinking about getting out of the mortgage business. And that would be a tragedy, because we do a lot of lending for minority customers.

Mr. KELLY. Thank you, Mr. Mitchell, and I yield back the balance of my time, Mr. Chairman.

Chairman RICE. Representative Hahn?

Ms. HAHN. Thank you, Mr. Chairman, Ranking Member Chu. Thank you for holding this hearing today.

And although I was not in Congress when Dodd-Frank passed, I do believe that our second great recession in 2008 really required Congress to step in and protect the consumer. And there may be unintended consequences from Dodd-Frank that hurt access to capital for our small businesses. But I think at this point, I do not think we should be throwing out the baby with the bathwater. I think we should work together to fix some of those provisions that would help our small lenders. But, you know, while some of you think the recession is over and the crisis has passed, I will tell you I represent people in my district who did lose their homes and who lost their jobs and have not recovered yet. So I am not convinced that we need to ease regulations as yet. We know what happened before when there were no regulations, and certainly the banks and the mortgage lenders took advantage of people.

I was going to ask Ms. Gordon, you touched on it a little bit, but I do worry that the lobbying effort underway to reform Dodd-Frank is coming from big banks under the guise of helping small banks. In fact, the legislation that passed through the Senate Banking Committee earlier this year is very broad and would lift major regulations off of big banks. Honestly, and again, you touched on it, but who do you think will benefit more from the Senate Banking Committee's Dodd-Frank reform legislation—small community banks or big banks?

Ms. GORDON. Absolutely the big banks. We will just take as an example the question of exemptions from the qualified mortgage requirement for loans held in portfolio. And as we know, loans held in portfolio, the incentives tend to be aligned better than for loans that are sold into the secondary market and securitized. The community banks represented at this table already have that exemption and there is a proposal out there to raise the threshold of asset size for that exemption.

I will note something interesting there which I think when we are changing these definitions, if we do broaden some of these definitions, it might make sense to look less at asset size per se than actually at what kind of business the institution engages in. The FDIC has some criteria they look at about what kinds of business you are doing so that folks doing that kind of bread and butter business, lending to small businesses, lending to families, can be defined that way as opposed to businesses doing something more complex and up there in the derivatives market or something.

Ms. HAHN. Thank you.

Ms. GORDON. Can I add one thing about loan closings? Which is, the CFPB just undertook a big study of loan closings because they were very concerned about that thick package of closing documents. And to their surprise, as well as frankly mine, they found that only a handful of those documents had to do with federal regulatory requirements. The vast majority, more than half of those documents, are required by the banks themselves. So if they want to get rid of them, that is actually in their control. It turned out not to be in the CFPB's control.

Ms. HAHN. Thank you for that.

Mr. Eagerton, I am a big supporter of credit unions. I am a member of the ILWU Credit Union back in my hometown, and I have worked very closely with my credit unions who I give great credit to for being really the community banks in most of our communities.

One of the things I think we can do to help credit unions is to lift this arbitrary cap that was not a result of Dodd-Frank but it was a result of Congress in the 1990s putting this arbitrary cap on how much our credit unions could lend. And I think I have been a big advocate of raising that cap, and I know Ranking Member Chu and I are both co-sponsors on the Credit Union Small Business Jobs Creation Act, which would lift that cap. I know the big banks are very opposed to that, but I would like to see that happen because I think that would do more than lifting regulations to allowing our credit unions to really get in there and make those loans.

Could you just tell us what that would mean if Congress passed the bill on raising that arbitrary cap?

Mr. EAGERTON. Well, first, let me start with this. I think that is an excellent idea. Most credit unions today are capped at 12.25 percent of their assets.

Ms. HAHN. Right. Right.

Mr. EAGERTON. So by raising that cap, you would allow credit unions to continue to do member business loans. What most credit unions find today is that just as soon as they get the program up and running, get the staff hired, they have to stop because they meet that cap. So I think that is an excellent idea.

Ms. HAHN. Thank you very much. Mr. Chairman, I yield back.

Chairman RICE. Thank you, Ms. Hahn.

Mr. Hanna?

Mr. HANNA. Thank you.

Ms. Gordon, I take these gentlemen at their word. I mean, and I also think that part of the issue that was never really addressed was the fact that borrowers are also complicit in their own problems. And the bigger the loan application, the more complex, the less likely it is that people actually understand what they are doing, especially when they are anticipating that the value of the property as you indicated was going to go up 10 percent a year and it actually did not. And why would it, right? Things do not grow to the sky.

What I want to say, too, is what I have noticed is that because of consolidations on economies of scale as you had mentioned are so obvious in the banking business and seem to work so well, and I take your points about banks at the lower end needing to be more efficient, maybe look to bigger banks to see what they should be doing, what I see is that the role of smaller banks is even more critical now than it has ever been because with this consolidation, larger banks are less willing, and frankly it is not profitable for them to do the kind of banking that Mr. Kelly spoke of. And what I see is a reduction in the willingness and the capacity of people to borrow, not just because they are increasing their loan requirements but because it is just simply not worth it for banks to do a 100,000, 200,000 loan. The internal costs are so great.

So I would suggest that what Mr. Mitchell and Mr. Eagerton do and what Mr. Lux spoke about, that we should find ways to reduce burdens on smaller banks because the entrepreneurs, as Mr. Mitchell and Eagerton pointed out, at the lower end, that is where the growth is. I mean, it is a small guy that gets big. And frankly, that is what we want.

And I do not mean to make a statement here too much, but I wonder what anybody thinks about that, especially you, Mr. Mitchell. I mean, you are a small bank. Mr. Eagerton is a small bank. What do you think of that?

Mr. MITCHELL. Well, I think you are absolutely right. As Ms. Hahn spoke of, you know, I think larger banks do want to try to benefit from an effort that really should be tightly geared towards community banks. We do not want to throw the baby out with the bathwater, but the bathwater needs to be drained significantly because it is pretty dirty. So you are absolutely right. You cannot expect a trillion dollar institution to focus on $100,000 loans. And as you reduce the number of community banks, what you end up with is fewer larger banks that cannot focus on $100,000 loan. So you are absolutely right.

Mr. HANNA. And to your point about minorities, that speaks exactly to that.

Go ahead, Ms. Gordon. I am sorry.

Ms. GORDON. I mean, you are posing a very, very important question, which is if there is a problem with regulatory burden, do you address it by exempting the smaller institutions, thereby giving them potentially a competitive advantage in the marketplace? Or do you address it by getting rid of those regulations all together, which leaves the small institutions still subject to the same disadvantages relative to large ones that they have been for a long time? And I have been very interested to hear from a lot of small institutions that do not seem to realize which exemptions they have. Not only are small institutions exempted from a number of these rules, but a number of these rules do not apply to the smallest loans. And there I think you have real questions about how this is working.

Mr. HANNA. These gentlemen know their numbers. They are not sitting here dumb. They are telling you what it is costing them. They are telling you it is a burden. So they may not be aware of everything, but they are certainly aware of the fact that they spend $75,000 or $100,000 when they used to spend nine. Twenty? That is what they look at. I am sure you are correct.

Ms. GORDON. No, that is absolutely true. But I have heard from banks come and tell me, “I cannot do this kind of loan, that kind of loan, or that kind of loan.” And that is what their risk officers or their lawyers are telling them, and it is just not right.

Mr. HANNA. But your point was a good one, that perhaps some loans should be looked at differently by the federal government.

Ms. GORDON. Absolutely. And I——

Mr. HANNA. I mean, in a way you are on their side.

Ms. GORDON. Exactly. I completely agree that they should be exempted from a number of these roles.

Mr. HANNA. My time is expired. Thank you.

Mr. MITCHELL. If I may, while we are not examined by CFPB, we are still subject to the rules that they write. So the exemptions are not as clear as you may anticipate that they are. We would not be here if that was the case.

Chairman RICE. Thank you, sir.

Mr. Payne?

Mr. PAYNE. Thank you, Mr. Chairman. I would like to thank you for having this hearing and also our ranking member, Ms. Chu.

Mr. Mitchell, it is good to meet you, and thank you for those kind words in reference to my father. In your testimony, you recommend reforming Regulation D of an accredited investor. And your recommendation will change the definition to now include the value of the primary residence in determining if a person's net worth has met the million dollar requirement to be an accredited investor. Can you tell us why this would be beneficial to small businesses and how it could increase access to capital?

Mr. MITCHELL. Yes, sir. Number one, community banks, and particularly minority banks, we are always seeking capital as in the case of City National.

Mr. PAYNE. Right.

Mr. MITCHELL. And what the rules say, as they stand now, it limits the pool of those investors that we can go to for capital. And so by including the residence in the net worth calculation, it opens up the pool to just more individuals without us having to go through a number of steps, a number of hoops to offer capital to those investors.

Mr. PAYNE. So it would be critically beneficial to them?

Mr. MITCHELL. Absolutely. Absolutely.

Mr. PAYNE. And it would make a world of change in reference to them being able to be accredited?

Mr. MITCHELL. Absolutely. In a private offering, which is a small offering of capital, it just opens up the pool to a number of other people.

Mr. PAYNE. Thank you. I know you mentioned the bank in my town, City National, on several occasions, and my father, and now I, have struggled to help maintain viability in that community because of the work that they do on the ground, every single day, for people who necessarily cannot walk into other institutions and even get someone to speak to them at all.

Mr. MITCHELL. Fortunately, they have just completed their recapitalization and they are on solid ground for the future under the direction of the NBA chairman, Preston Pinkett.

Mr. PAYNE. And Mr. Pinkett will sit on my forum at the Congressional Black Caucus tomorrow, and if you are in town, we are going to make sure we invite you as well.

Mr. MITCHELL. Thank you very much.

Mr. PAYNE. My second question is to Mr. Mitchell as well since, you know, I am referencing your testimony, but all panelists can answer. Mr. Mitchell, in your testimony you recommend community banks be excluded from the small business data collection requirement under Section 1071 of the Dodd-Frank. However, we know that there is discrimination in small business lending and the collecting of this data in one place would specifically help women- and minority-owned small businesses. Representative Chris Van Hollen and I have recently led a letter to the CFPB director outlining the importance of this requirement. Eight-two members have joined us on this letter and I hope we can get several more on this Committee on it because it is undoubtedly important. You mentioned privacy concerns; however, we know that Section 1071 regulations will be formatted similarly to the HMDA, which explicitly prohibits institutions from including information that will identify the applicant or borrower, such as their name, date of birth, or social security number. Can you tell the Committee why the ICBA believes that community banks should be excluded from this extremely important regulation?

Mr. MITCHELL. Well, it goes back to the fact that community banks, we actually care about our customers, and I think when you look at most of the discrimination in lending and predatory practices in lending, it has been systemically present in larger institutions. Community banks, we are here to make loans. We want to make loans. And since we are part of the community, our reputations are at stake if we engage in those practices. So while there is a clear need to try to outlaw discrimination at any level, I do not think it is necessary for community institutions. HMDA is a very tedious—while necessary, it is a very tedious requirement. And the data points of HMDA have grown so much it is almost impossible for institutions to comply on an ongoing basis. I mean, we spend a lot of time on money on HMDA data collection and ensuring its accuracy, and I see this as another form of that.

Mr. PAYNE. Thank you. I was going to try to get other members on the panel, but I will yield back.

Chairman RICE. Thank you, Mr. Payne.

Mr. Luetkemeyer?

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I am not a member of the Subcommittee. I am just here today as an interested, concerned member of Congress with regards to this particular issue. As a former bank regulator, as a former banker, I have got some insights into this that certainly give me pause when I look at the title of the hearing today: How Dodd-Frank is Crippling Small Lenders Access to Capital.

I see every day in talking to all the folks in my world that the banks and the credit unions are impacted in a way by these regulations that absolutely is cutting off credit to every day folks to be able to live their lives the way they would like to with regards to buying homes, financing cars, providing educational opportunities for the kids, as well as business opportunities for themselves.

Mr. Lux, you made the comment a while ago that Dodd-Frank shrinks access by scope. Can you elaborate on that just a second?

Mr. LUX. Sure. If it is okay I would like to just make a general statement, and I will——

Mr. LUETKEMEYER. Very quickly. I have got five minutes and you talk very slowly. I need my time.

Mr. LUX. Okay. You will get your time back.

Simply put, Dodd-Frank needs to be streamlined. Someone needs to take a hard look at this 856-page document and look at the implications of it. The only thing I would like to say is it is a gift to academics because my second paper was on the growth of mortgage finance in light of Dodd-Frank and the paper that we will be authoring in the fall will be how the underbanked have grown.

Mr. LUETKEMEYER. Very good. Thank you.

Mr. Mitchell, I know that we have a deadline coming up here, and you made mention of it a minute ago with TRID. I am one of the guys who has been harping on CFPB to try and have some forbearance there, and they pay lip service to it but they will not put anything in writing. I am very concerned about this. For them, it is an opportunity to go after people doing a legitimate job of doing the best they can and getting caught in this timeframe here. Can you explain your concerns about it? Or do you have concerns about it at all? I know you mentioned it a minute ago.

Mr. MITCHELL. Yeah. We have a lot of concerns about it. In fact, we had an expert title attorney come and speak to our lenders about the upcoming requirements. And while we are actually trying to shorten the amount of time from application to closing, she, in no uncertain terms, said that it would add 15 days easy to the process as the paperwork is very difficult. Settlement companies are still trying to get their hands around the requirements. And that is pretty scary.

Mr. LUETKEMEYER. Mr. Eagerton, would you like to comment on that as well?

Mr. EAGERTON. Well, the CFPB qualified mortgage rule, that basically hampers our business. We are not real comfortable with that. I can remember 20 years ago making my first mortgage loan. Thinking back, that guy probably had a 45 percent DTI. I still see him every month. He makes his payment on time. No issues. I understand that there is some opposition at the table that says we may or may not be exempt, but that is a very wide line between us and the regulators. So I think that is part of it. And I also would like to see the CFPB have a five-person bipartisan panel as opposed to just one person.

Mr. LUETKEMEYER. You know, CFPB is a figment of our creation of Dodd-Frank here, and to me it is the most dangerous agency in Washington because it is unaccountable. There is no oversight, in my mind, anyway. And once the director is appointed, he is there for his term. They are making rules and regulations without very little oversight or impact. They refuse to accept comments from the outside, and so in discussing this TRID issue, for example, with the director, I mean, we are supposed to take him at his word that he is going to behave in a responsible manner, and I look at this as an opportunity to go after institutions. And it is very concerning to me, especially from the standpoint that I recently had—yesterday had somebody in my office who owns a business. The CFPB went after them from the standpoint that within their document, one of their operational documents that they had to a customer, is a phrase. And CFPB fined them $10 million because they are anticipating doing a rule down the road that this phrase would no longer be compliant with. All of you now are going to have to have a crystal ball sitting on your desk, or be clairvoyant, to know what CFPB may do in the future. This is how far we have gone. This is how far over the top this agency has become. This is the environment that has been fostered by Dodd-Frank, and it is doing more than crippling access to capital for our people; it is crippling the economy.

I appreciate you being here today. Thank you very much for your testimony.

Chairman RICE. Thank you, Mr. Luetkemeyer.

Mr. Brat?

Mr. BRAT. Thank you very much, Mr. Chairman. Thank you for holding this hearing today. I think it is very interesting. I did my Ph.D. in economic growth, and part of the subtitle of this hearing, we have not talked much about economic growth. And so I think that is interesting to bring up now in some respects.

The people of my District Virginia 7 say Dodd-Frank is a huge burden on their businesses. I have a small business short-term lender in Culpepper, Virginia, that expects to be driven out of business by the expected CFPB rule. Chairman Rice and Ranking Member Chu, I have a letter from that constituent, Brandon Payne, as well as testimony he provided to members of the CFPB Small Business Advisory Review Panel, and I would like to request that this be inserted into the hearing record.

Chairman RICE. Without objection.

Mr. BRAT. Thank you very much.

Mr. Payne's check cashing provides valued service to people without other options. CFPB is trying to eliminate this market, and I think we have heard similar testimony from the folk with us here today. The gentlemen in business here, I mean, I hear Ms. Gordon at the end of the table from the government and the regulators saying that they are trying to make your life easier. And you guys in economics are called the data points; right? So it does not get any more real. You are the data. What do you have to say to the government in terms of them making your life easier? It seems to me you are giving Ms. Gordon some very clear testimony on how the regulations are hurting people, and yet, we are kind of talking by each other. And so there has to be some give and take. And so I will pose that question to you in a minute.

I want to get to the economic growth piece also. In Econ 101, you get a nice graph at the beginning of your textbook that has got robots on it and pizza down on the other. Right? One is an investment good and one is a consumer good. And that is your first chart you learn because it has to do with economic growth. And so as a society, you can either invest in robots and grow in the future, or have a pizza party. And this country has been having a pizza party for a few decades now and our growth rate is suffering because of it.

I think on that graph you can also juxtapose, instead of having robots and pizza, you can have robots and three-ring binders. And so when I studied economic growth, growth in its simplest form and at the cross-country level is usually a function of capital stock, human capital, education. You can measure that in some ways. R&D you can throw in there, something like that. And technology. And you can throw labor in there. Right?

So growth is caused by those things. Now, I am trying to get the government to understand, and maybe you guys can help me make this argument, but when you are hiring employees to read through three-ring binders and do all the regulatory burden, you are not hiring someone else with human capital that can help you get capital and technology, et cetera, to grow the economy and grow your firm. I think that is about as straightforward a way as I can put it.

And then the expert on regulation says what you guys should be doing. I wrote you should be, you know, if you small business people were more clever, you would be doing more marketing and technology and taking risks, et cetera. And so that is our guidance from the regulators, is that you guys, you know, you should be doing more marketing and technology and taking risks. But I am trying to show this tradeoff, that if you are constantly buying three-ring binders and people to go through three-ring binders day after day after day, you cannot hire the person in marketing, and you cannot hire the person in technology, and you are going to be reluctant to take risks.

So Mr. Mitchell and Mr. Eagerton, can you tell us how profound is the impact on your businesses when you have to pay for this regulatory thing? And speak to Ms. Gordon and the regulators so they get a sense of, hey, this is real. There is a real tradeoff that is hurting us, and we are going to go out of business.

Mr. MITCHELL. I will speak very briefly. As an econ major——

Mr. BRAT. Oh, good.

Mr. MITCHELL. I certainly appreciate your analogy. And the extension of credit and the multiplier effect is what makes the economy go. It is not really actually rocket science that small businesses create most of the jobs. And small businesses get most of their credit from small and community financial institutions. It is pretty much as simple as that.

Mr. BRAT. Yep. Pretty simple.

Mr. MITCHELL. And the amount of time that we spend on compliance is tremendous. One hundred twenty people, a third of their job is compliance, and that does not produce loans and move the multiplier effect——

Mr. BRAT. So they are not moving. Right.

Mr. MITCHELL.—to grow the economy.

Mr. BRAT. Do you buy that, Mr. Eagerton?

Mr. EAGERTON. I agree with him 100 percent. And, you know, compliance is just, really, the pendulum has swung way too far for our institution. We do not have a three-ring binder, but what we have is we have a boardroom. And so I will assign three staff members to go in and look at the Dodd-Frank Act. They come out a week later and they go, “Here is a stack.” It is 800 pages. I am sure you have seen it. But, “Here is a stack that is going to affect our institution and this is what we need to do about it.”

So during that time, understand that I have a staff of basically 20 people. Okay? So for that week, they are basically out of commission. And then they are going to come back with a plan of action of what we are going to do. I really feel like we are getting away from helping people and making sure that we make the loans that Washington agrees with. And I think that needs to change.

Mr. BRAT. Thank you guys very much. Thank you.

Chairman RICE. Thank you, Mr. Brat.

They have called for votes. Do you have anything you want to add?

We have been talking about babies and bathwater. And I want to finish this up just looking at what is swimming around in our bathwater right now, the graphs I started out with, the big banks are still getting bigger, small bank formations are at 80-year lows. Net business startups are at 80-year lows. Homeownership is at 50-year lows. Workforce participation is at 30 year lows. We are in a bad spot, and I think Dodd-Frank, and just general banking regulation, has a lot to do with that. I think we vastly diminished access to capital in this country and we need to deal with it or it bears poorly for our economy.

Thank you for being here. Thank you to the witnesses. Thank you for those who came and participated in the audience. The meeting is adjourned.

[Whereupon, at 2:33 p.m., the Subcommittee was adjourned.]

APPENDIX

INDEPENDENT COMMUNITY
BANKERS of AMERICA

Testimony of

B. Doyle Mitchell, Jr.
President and CEO of Industrial Bank
Washington, D.C.

On behalf of the
Independent Community Bankers of America

Before the

United States House
Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access

Hearing on

"Financing Main Street: How Dodd-Frank is Crippling Small Lenders and Access to Capital"

September 17, 2015
Washington, D.C.

Chairman Rice, Ranking Member Chu, and members of the subcommittee, my name is Doyle Mitchell, and I am President and CEO of Industrial Bank, a $370 million asset bank headquartered in the District of Columbia. Industrial Bank was founded in 1934, in the depth of the Great Depression, and is the oldest and largest African American-owned commercial bank in the metropolitan Washington, D.C. area. We have over 100 employees. I testify today on behalf of the more than 6,000 community banks represented by the Independent Community Bankers of America. Thank you for convening this hearing on the destructive impact of new regulation on small business lending.

In addition to being a member of ICBA, I am also the Immediate Past Chairman of the National Bankers Association, a trade association for the nation's minority and women-owned banks. While many community banks serve rural areas and small towns, there is also an important segment of community banks like mine that serve urban areas and that were founded to serve minority communities that were historically ignored by other financial institutions.

At the outset of this statement, I would like to thank the members of this committee for your leadership in increasing in the legal lending limit for the Small Business Administration's (SBA's) 7(a) guaranteed lending program before it reached its cap this summer. Community banks make up the majority of SBA lenders. This committee acted with all due haste to prevent a disruption in vital credit to thousands of small businesses.

Community Banks and Small Business Lending

Community banks are prodigious small business lenders. Though we hold less than 20 percent of U.S. banking industry assets, we hold a disproportionate market share of small business loans – 55 percent – supporting a sector responsible for more job creation than any other. We provide small business credit in good times as well as challenging times. Federal Reserve data shows that while overall small business lending contracted during the recent recession, lending by a majority of small community banks (those of less than $250 million in assets) actually increased, and small business lending by banks with asset sizes between $250 million and $1 billion declined only slightly. By contrast, small business lending by the largest banks dropped off sharply. The viability of community banks is linked to the success of our small business customers in the communities we serve, and we don't walk away from them when the economy tightens.

The type of small business lending community banks do simply cannot be duplicated by a bank based outside the community. As a recent study by my fellow panelist Marshall Lux noted: "In certain lending markets, the technologies larger institutions can deploy have not yet proven effective substitutes for the skills, knowledge, and interpersonal competencies of many traditional banks." [1]

[1] "The State and Fate of Community Banking." Marshall Lux and Robert Greene. Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School. February 2015.

Regulatory Overkill Poses a Grave Threat to the Community Bank-Small Business Partnership

The exponential growth of regulation in recent years is suffocating community banks' ability to serve their small business customers. Compliance has become a major distraction for community bank managers. Any community banker will tell you that their job has fundamentally shifted from lending and serving customers to struggling to stay on top of ever-changing rules and guidance. Every aspect of community banking is subject to new regulation, but the impact is especially severe in the area of mortgage lending.

Banks need more scale to accommodate the increasing expense of compliance which includes hiring, training, software, and other costs. I believe this increase in regulatory burden has contributed significantly to the decrease of 1,342 community banks in the U.S. since 2010. The number of banks with assets below $100 million shrunk by 32 percent, while the number of banks with assets between $100 million and $1 billion fell by 11 percent.[2] A financial landscape with fewer, larger banks will reduce access to credit for small businesses.

Legislative Solutions Are Needed

The good news is that there are readily available legislative solutions to this pending crisis. Working with community bankers from across the nation, ICBA developed its Plan for Prosperity, a platform of legislative recommendations that will provide meaningful relief for community banks and allow them to thrive by doing what they do best – serving and growing their communities. Each provision of the Plan was crafted to preserve and strengthen consumer protections and safety and soundness. I encourage the members of this Committee to review the Plan, which is attached to this statement.

While the Plan contains nearly 40 separate legislative recommendations, they are organized around three pillars: Relief from mortgage regulation to promote lending; improved access to capital to sustain community bank independence; and reforming oversight and examination practices to better target the true sources of risk. Each of these pillars helps small businesses by preserving and strengthening the community banks that partner with them. I will note a few of the recommendations under each pillar.

Mortgage Reform for Community Banks

Every aspect of mortgage lending is subject to new, complex, and expensive regulations that are upending the economics of this line of business. In ICBA's 2014 Community Bank Lending Survey, which surveyed over 500 community banks nationwide, 44 percent of respondents said that they made fewer first lien residential mortgage loans in 2014 when the CFPB's qualified mortgage rules were in effect than they made in 2013. The improved housing market should have created more loans, not fewer. More troubling, 73 percent of respondents said that regulatory burdens were preventing them from making more residential mortgage loans.

[2] Parsons, Richard J. Bank Think. American Banker, Feb. 16, 2015.

Small business owners often use home equity loans to finance their businesses. However, small business owners may have difficulty complying with the income documentation requirements under the ability-to-repay rule, despite their excellent credit. The underwriting requirements of the "qualified mortgage" (or QM) rule – which shields lenders from litigation under the ability-to-repay rule by defining mortgages that are deemed to comply with the rule – are inflexible and do not afford the lender discretion to use judgment or to weigh compensating factors such as high net worth in making credit decisions. You hear the same story again and again from community bankers all over the country.

Key provisions of the Plan for Prosperity are designed to keep community banks in the business of mortgage lending and to give them more flexibility in extending credit. Plan provisions include:

- "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.
- An exemption from any escrow requirements any first lien mortgage held in portfolio by a lender with less than $10 billion in assets.

The principal rationale for these provisions, and the reason they can be safely enacted, is they apply only to loans originated and held in portfolio by community banks. 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.

Access to Capital

The second pillar of the Plan for Prosperity is capital access and preservation for community banks. A number of the provisions are dedicated to strengthening community bank viability by creating new options for capital raising and capital preservation.

One such provision 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.

Three capital provisions of the Plan for Prosperity would amend Basel III for banks with assets of $50 billion or less to restore the original intent of the accord which was intended to apply only to large, internationally active banks.

ICBA also recommends reforming Regulation D, which governs private offerings of shares, so that anyone with a net worth of more than $1 million, including the value of their primary residence, would qualify as an "accredited investor." The number of non-accredited investors that could purchase stock under a private offering should be increased from 35 to 70.

Reforming Bank Oversight and Examination to Better Target Risk

The third pillar of the Plan for Prosperity is improving the exam environment for community banks. This includes three provisions as described below.

Call Reports

The quarterly call report filed by community banks 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. In September of last year, nearly 15,000 community bankers representing 40 percent of all community banks nationwide signed an ICBA petition to the regulatory agencies calling for more streamlined quarterly call report filings. 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.[3] Thirty percent said it had increased significantly. A typical $500 million asset community bank spends close to 300 hours a year of senior level, highly-compensated staff time on the quarterly call report.

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 multi-billion dollar 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

[3] 2104 ICBA Community Bank Call Report Burden Survey.
http://www.icba.org/files/ICBASites/PDFs/2014CallReportSurveyResults.pdf

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.

Extended Exam Cycle

Under current agency rules, a bank with assets of less than $500 million that has a CAMELS rating of 1 or 2 is eligible for an exam cycle of 18 months. Banks that do not meet these criteria are examined on a 12 month cycle. The extended exam cycle allows examiners to focus their limited resources on the banks that pose the greatest systemic risk. In order to more fully of reap the benefit of risk-focused exams, the exam cycle can and should be further extended to 24 months and available to banks with assets up to $2 billion, provided they have a CAMELS rating of 1 or 2. Preparations for bank exams, and the exams themselves, distract bank management from serving their communities to their full potential.

Strengthen Accountability in Examinations

The trend toward oppressive, micromanaged regulatory exams is an ongoing concern to community bankers nationwide. ICBA believes that the best means of creating a more balanced exam environment is to create a workable appeals process. ICBA's Plan for Prosperity calls for the creation of an independent body 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.

The current appeals process is arbitrary and frustrating. Appeals panels, or other processes, routinely lack the independence and market expertise necessary to reach a fair, unbiased decision.

Cutting the Red Tape in Small Business Lending: Eliminate Data Collection

Before closing I would like to note an additional Plan for Prosperity provision that should be of particular interest to this committee because it is directly related to small business lending. Under a forthcoming regulation, whenever a business seeks credit at a financial institution, the institution must inquire whether the business is women-owned, minority-owned, or a small business. The financial institution must maintain a record of the response to the inquiry together with additional information such as the census tract of the business and its gross annual revenues, whether or not a loan is subsequently approved. These records must be compiled and submitted annually to the CFPB, which will make the data available to any member of the public upon request. In addition, the records must be kept separate from the credit application and accompanying information and shielded from access by the underwriters or anyone involved in making credit determinations. In other words, the requirement creates a separate bureaucracy within the financial institution that cannot be integrated with lending operations.

I appreciate and sympathize with the motivation behind the new requirement. Lending discrimination, which is illegal under fair lending laws, must not be tolerated. But this new data collection requirement is especially inefficient, and may not be feasible in certain cases such as in organizations that are too small to accommodate fire wall structures. Community banks will be disproportionately burdened by this requirement because they concentrate more on small business lending than other financial institutions. Further, data collected by community banks and subsequently made public by the CFPB could compromise the privacy of applicants in small communities where an applicant's identity may be easily deduced, despite the suppression of personally identifying information. For these reasons, ICBA believes community banks should be excluded from new small business data collection requirements.

Introduced Legislation

The 114th Congress provides a unique opportunity to provide meaningful regulatory relief for community banks. ICBA urges this Committee and all House members not to let this opportunity slip.

We're encouraged by the bills that have been introduced in the Senate and House so far, several of which are noted below.

The Community Lending Enhancement and Regulatory Relief Act of 2015 (the "CLEAR Act", H.R. 1233), introduced by House Small Business Committee Vice Chair, Rep. Blaine Luetkemeyer, contains seven provisions spanning all three pillars of ICBA's Plan for Prosperity and has been endorsed by 34 state community bank associations. These provisions include qualified mortgage status for any mortgage held in portfolio; an exemption for loans held in portfolio from new escrow requirements for higher priced mortgages for any lender with less than $10 billion in assets; an increase in the CFPB's small servicer exemption threshold from 5,000 loans to 20,000 loans; allowing well rated banks to file a short form call report in the first and third quarter of each year and to be examined on a 24 month examination cycle; and eliminating the annual privacy notice requirement when a bank has not changed it privacy policies.

The Community Bank Access to Capital Act (H.R. 1523), introduced by Rep. Scott Garrett, includes provisions to exempt banks with assets of $50 billion or less from the Basel III regulatory capital rule, which was originally intended to apply only to large, internationally active banks, and provide an exemption from internal control attestation requirements for community banks with assets of less than $1 billion. Community bank internal control systems are monitored continually by bank examiners.

The Portfolio Lending and Mortgage Access Act of 2015 (H.R. 1210), introduced by Rep. Andy Barr, would provide QM status to any residential mortgage held in portfolio by the originator. H.R. 1210 passed the House Financial Services Committee in July.

The Community Institution Mortgage Relief Act (H.R. 1529), introduced by Rep. Brad Sherman, would providethat any mortgage held in portfolio by a financial institution with assets of $10 billion or less is exempt from escrow requirements. H.R. 1520 would also raise the CFPB small servicer exemption threshold to 20,000 mortgages serviced annually. H.R. 1529 passed the House Financial Services Committee in March.

The Right to Lend Act (H.R. 1766), introduced by Rep. Robert Pittenger, would repeal Section 1071 of the Dodd-Frank Act, which contains the onerous small business data collection requirement discussed above.

The Small Bank Exam Cycle Reform Act (H.R. 1553), introduced by Rep. Scott Tipton, would allow a highly rated bank with assets of less than $1 billion to use an 18 month exam cycle. H.R. 1553 passed the House Financial Services Committee in July.

The Financial Products Safety Commission Act of 2015 (H.R. 1266), introduced by Rep. Randy Neugebauer, would change the structure of the CFPB so that it is governed by a five member commission rather than a single director. Commission governance would allow for a variety of views and expertise on issues before the CFPB and thus build in a system of checks and balances that is absent in a single director form of governance.

The **Financial Institutions Examination Fairness and Reform Act (H.R. 1941)**, introduced by Reps. Lynn Westmoreland and Carolyn Maloney, would go a long way toward improving the oppressive examination environment by creating a workable appeals process. This legislation would improve the appeals process by taking it out of the examining agencies and empowering a newly created Independent Examination Review Director, situated in the Federal Financial Institutions Examination Council, to make final appeals decisions.

ICBA urges the members of this Committee to cosponsor the bills noted above.

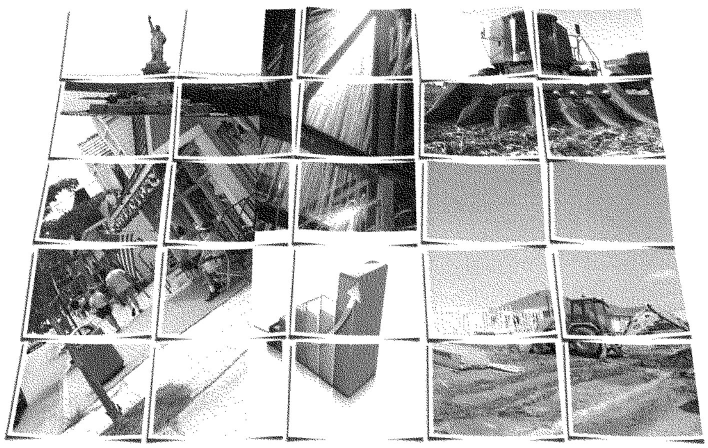
Closing

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 the destructive impact they have on small business lending. ICBA hopes to work with this committee to craft urgently needed legislative solutions.

ATTACHMENTS

- ICBA Plan for Prosperity

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.

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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.

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.

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.

NAFCU

Testimony of

Scott Eagerton

President and CEO of Dixies Federal Credit Union

On behalf of the

National Association of Federal Credit Unions

"Financing Main Street: How Dodd-Frank is Crippling Small Lenders and Access to Capital"

United States House Small Business Committee

Subcommittee on Economic Growth, Tax, and Capital Access

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Introduction

Good afternoon, Chairman Rice, Ranking Member Chu and Members of the Subcommittee. My name is Scott Eagerton and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the President and CEO of Dixies Federal Credit Union, headquartered in Darlington, South Carolina. I have over 20 years of financial industry experience, including the last 10 years in my current role.

Dixies Federal Credit Union was founded on August 25, 1947. Originally serving employees of the Dixie Cup and Plate Company, Dixies is now a community credit union serving 7,000 members in Florence and Darlington counties with nearly $42 million in assets.

As you are aware, NAFCU is the only national organization exclusively representing the federal interests of the nation's federally insured credit unions. NAFCU-member credit unions collectively account for approximately 70 percent of the assets of all federal credit unions. The overwhelming tidal wave of new regulations in the wake of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank) is having a profound impact on all credit unions and their ability to serve their 101 million member-owners nationwide.

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.

Credit unions are not banks. The nation's approximately 6,100 federal insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. Furthermore, unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the *Credit Union Membership Access Act* (CUMAA—P.L. 105–219). In the "findings" section of that law, Congress declared that, "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means...[and it] continue[s] to fulfill this public purpose."

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. Furthermore, there are many consumer protections already built into the *Federal Credit Union Act,* such as the only federal usury ceiling on financial institutions and the prohibition on prepayment penalties that other institutions have often used to bait and trap consumers into high cost products.

Despite the fact that credit unions are already heavily regulated, were not the cause of the financial crisis, and actually helped blunt the crisis by continuing to lend to credit worthy consumers during difficult times, they are still firmly within the regulatory reach of Dodd-Frank, including all rules promulgated by the Consumer Financial Protection Bureau (CFPB).

Lawmakers and regulators readily agree that credit unions did not participate in the reckless activities that led to the financial crisis, so they shouldn't be caught in the crosshairs of regulations aimed at those entities that did. Unfortunately, that has not been the case thus far. Accordingly, finding ways to cut-down on burdensome and unnecessary regulatory compliance costs is a chief priority of NAFCU members.

Today's hearing is important and the entire credit union community appreciates your interest in the effects of Dodd-Frank on small businesses such as credit unions.

Dodd-Frank and Its Impact on Credit Unions

During the consideration of financial reform, NAFCU was concerned about the possibility of overregulation of good actors such as credit unions, and this is why NAFCU was the only credit union trade association to oppose the new 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. The CFPB's primary focus should be on regulating the unregulated bad actors, not creating new regulatory burdens for good actors like credit unions that already fall under a prudential 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 are feeling this burden. While the CFPB has the authority to exempt certain institutions, such as credit unions, from agency rules, they have unfortunately been reluctant to use this authority on a broad scale.

The impact of the growing compliance burden is evident as the number of credit unions continues to decline, dropping by more than 17% (1,280 institutions) since the 2nd quarter of 2010; 96% of those were smaller institutions like mine, below $100 million in assets. A main reason for the decline is the increasing cost and complexity of complying with the ever-increasing onslaught of regulations. 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% of respondents were spending more time on regulatory compliance issues than they did in 2009. A 2013 NAFCU survey of our membership found that 93% of respondents had seen their compliance burden increase since the passage of Dodd-Frank in 2010. At Dixies FCU our compliance costs have risen five-fold since 2009, from about $20,000 a year to $100,000 annually. In addition to adding a full-time employee, non-compliance staff including myself, are regularly needed to help with the compliance workload, taking us away from our normal day-to-day duties serving our members. Many credit unions find themselves in the same situation.

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 forced to take time away from serving members to spend time on compliance issues. Every dollar spent on compliance, is a dollar taken away from member service, additional loans, or better rates.

Unfortunately, consumers are the ones who suffer the most. As credit unions increasingly reassign staff resources to compliance work, there is a proportional decline in member service.

July 21, 2015, marked the five year anniversary of the *Dodd-Frank Act* becoming law. The legislation was supposed to restore the U.S. economy, end "too-big-to-fail" and promote financial stability. Since enactment, we have witnessed large banks grow and small banks and credit unions disappear. A law that was meant to eliminate the risky activities of the biggest banks on Wall Street nearly halted the time-tested undertakings on Main Street. In my testimony today, I will describe the current challenges my credit union and the industry faces in the wake of Dodd-Frank and describe ways that Congress and the regulators can help.

NAFCU

Dodd-Frank Impact

- **Rules Passed:** 224
- **Rulemaking Pages:** 7,365
- **Initial Industry Labor Hours:** 20 million
- **Annual Industry Labor Hours:** 24.2 million
- **Rules Still to be Passed:** Nearly 200

Source: House Financial Services Committee

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Growing Regulator Budgets in the Wake of Dodd-Frank

The budget of the National Credit Union Administration (NCUA) is funded exclusively by the credit unions it regulates and insures. Every single dollar spent by NCUA starts as a dollar from a credit union somewhere in the United States, and any NCUA expenditure has a direct impact on the daily operations of all regulated and insured credit unions—it's a dollar that could otherwise be used to make a loan to a member or provide a new service. In the current regulatory environment, every dollar becomes that much more important as credit unions of various sizes and complexities expend significant financial and human resources to bring their systems and procedures into compliance with new requirements.

Accordingly, NCUA's budget process is of the utmost and ever-increasing importance to NAFCU's membership, the credit union industry, and Congress. Bipartisan legislation, the *National Credit Union Administration Budget Transparency Act,* H.R. 2287, has been introduced by Representatives Mick Mulvaney and Kyrsten Sinema to require greater transparency and credit union input during NCUA's budget process. NAFCU views this legislation as crucial because credit unions currently have no ability to formally comment or have input on any part of NCUA's budget—every dollar of which they ultimately fund.

Part of this increased cost, both for the agency and for credit unions, has been the move in the financial reform era to 12-month exam cycles for credit unions which NCUA made in 2008 and continues today. NCUA had refined its supervision and examination process in 2001, and, in doing so, developed a Risk-Focused Examination (RFE) approach. Under this approach, eligible federal credit unions that were healthy and posed minimal risks had an examination completed every 12 to 24 months, with a target completion frequency of 18 months. During this time, Dixies' averaged an exam abut every 18 months, with the exam averaging about a week. Under the new 12-month examination regime established in 2008, we now have four full time staff members who spend two weeks preparing for the exam, two weeks working with examiners and at least, two weeks following the exam. The cost in wages for that exam was approximately $30,000.

The financial crisis is now over. We believe NCUA should use the authority they already have and return to an 18-month exam cycle for healthy and well-run credit unions. This simple step will help with costs both at the agency and at credit unions and be a step forward to reducing regulatory burden.

Overwhelming Regulatory Burdens on Credit Unions in the Wake of Dodd-Frank

Credit unions are proud of their long track record of helping the economy grow and making loans when other lenders have left various markets. This was evidenced during the recent financial crisis when credit unions kept making auto, home, and small business loans when other lenders cut back.

Although credit unions continue to focus on members' needs, the increasing complexity of the regulatory environment is limiting their ability and taking a toll on the 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 NCUA and the CFPB work to prevent the next financial crisis, even the most well intended regulations have the potential to regulate our industry out of business.

Unfortunately, credit unions like Dixies often become the victim of poor planning and execution by the regulators; new regulation on top of new regulation has hindered Dixies' business and our ability to retain top talent. For example, every time the CFPB changes or updates a mortgage-related rule, several costs are incurred. Most compliance costs do not vary by size, resulting in a greater burden on smaller credit unions like mine. Like large institutions with compliance and legal departments, with each change our small staff is required to update our forms and disclosures, reprogram our data processing systems, and retrain our staff. Unfortunately, these regulation revisions never seem to occur all at once. If all of the changes were coordinated and were implemented at one time, these costs would be significantly reduced and a considerable amount of our resources that were utilized to comply could have been used to benefit our members instead.

In 2015 alone, we have seen this occur four times already. We have had staff departures due directly to these frustrations. Most of our staff has indicated that they do not want to participate in real estate lending because of the constant changes and regulatory uncertainty. Through August of this year, Dixies FCU spent more than $20,000 for systems upgrades and software licenses; this does not even include the man hours spent setting up and learning how to operate the new software. For that we joined a credit union service organization (CUSO) to help with compliance and training of our compliance officers. The cost for membership and training was roughly an additional $7,500. During these times of regulatory adjustment, it is nearly impossible to make mortgage loans; this hurts our members as well as the overall business.

Credit Unions Need Regulatory Relief Post Dodd-Frank

Regulatory burden is the top challenge facing credit unions today. 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 initial "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. The need for regulatory relief is even stronger in 2015, which is why we released an updated version of the plan (Appendix A) for the 114th Congress.

The 2015 plan calls for relief in five key areas: (1) Capital Reforms for Credit Unions, (2) Field of Membership Improvements for Credit Unions, (3) Reducing CFPB Burdens on Credit Unions, (4) Operational Improvements for Credit Unions, and (5) 21st Century Data Security Standards.

Recognizing that there are also 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" list of regulations to remove or amend in December of 2013 that outlined twelve key regulatory issues credit unions face that should be eliminated or amended. While some slight progress was made on several of these recommendations, we have updated that list for 2015 to outline the "Top Ten" (Appendix B) regulations that regulators can and should act on now to provide relief. This list includes:

1. Improving the process for credit unions seeking changes to their field of membership;
2. Providing more meaningful exemptions for small institutions;
3. Expanding credit union investment authority;
4. Increasing the number of Reg D transfers allowed;
5. Additional regulatory flexibility for credit unions that offer member business loans;
6. Updating the requirement to disclose account numbers to protect the privacy of members;

7. Updating advertising requirements for loan products and share accounts;

8. Improvements to the Central Liquidity Facility (CLF);

9. Granting of waivers by NCUA to a federal credit union to follow a state law; and

10. Updating, simplifying and making improvements to regulations governing check processing and fund availability.

NAFCU continues the flight and looks forward to working with Congress to address the many legislative and regulatory challenges faced by the credit union industry today.

Regulators Must Be Held Accountable for Cost and Compliance Burden Estimates

One of the biggest contributors to regulatory burden for credit unions is the fact that cost and time burden estimates issued by regulators such as NCUA and CFPB are often grossly understated. Unfortunately, there often is never any effort to go back and review these estimates for accuracy once a proposal is final. We believe Congress should require periodic reviews of "actual" regulatory burdens of finalized rules and ensure agencies remove or amend those rules that vastly underestimate the compliance burden. A March 2013, survey of NAFCU's membership found that over 55% of credit unions believe compliance cost estimates from NCUA and CFPB are lower than the actual costs incurred when the credit union actually has to implement the proposal.

We believe Congress should use their oversight authority to require regulators to provide specific details on how they determined their assumptions in their cost estimates when submitting those estimates to OMB and publishing them in proposed rules. It is important that regulators be held to a standard that recognizes burden at a financial institution goes well beyond additional record keeping.

For example, several of NAFCU's members have told us that they have had to spend over 1,000 staff hours to train and comply with all of the requirements of the CFPB's Qualified Mortgage (QM) rules. The CFPB is not the only regulator with inaccurate estimates. NCUA's 2014 submission to OMB estimates the time to complete the Call Report to be 6.6 hours per reporting cycle. A recent NAFCU survey of our members found that many spend between 40 to 80 hours or more to complete a call report. Something is amiss. That's a number of hours of regulatory burden that are not being recognized on just one form. More needs to be done to require regulators to justify that the benefits of a proposal outweigh its costs.

Regulatory Coordination is Needed

With numerous new rulemakings coming from regulators, coordination between the agencies is more important than ever and can help ease burdens. 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.

For example, NAFCU has been on the forefront encouraging the Financial Stability Oversight Council (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.

The CFPB Can Provide Relief to Credit Unions

NAFCU has consistently maintained that the tidal wave of the Bureau's new regulations, taken individually, and more so in their cumulative effect, have significantly altered the lending market in unintended ways. In particular, the ability-to-repay, qualified mortgage, and mortgage servicing rules have required credit unions of various sizes and complexities to make major investments, and incur significant expenses. Taken all together, these regulations have made credit unions rework nearly every aspect of their mortgage origination and servicing operations.

One area where the CFPB could be the most helpful to credit unions would be to use its legal authority under Section 1022 of Dodd-Frank 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. While the CFPB has taken steps, such as their small creditor exemption, more needs to be done to exempt all credit unions.

Credit unions are also further hampered by the fact that the CFPB does not have one consistent definition of "small entities" from rule to rule. We are pleased that the CFPB makes an effort to meet its obligations under the Small Business Regulatory Enforcement Fairness Act (SBREFA). However, we believe that the Bureau must do more to address the concerns of smaller financial institutions in its final rulemaking, so that new rules do not unduly burden credit unions.

Under SBREFA, the CFPB is required to consider three specific factors during the rulemaking process. First, the agency is to consider "any projected increase in the cost of credit for small entities." Second, the CFPB is required to examine "significant alternatives to the proposed rule which accomplish the stated objective of applicable statutes and which minimize any increase in the cost of credit for small entities." Third, the CFPB is to consider the "advice and recommendations" from small entities (5 U.S.C. § 603(d)). This directive serves an important function. When Congress passed the *Dodd-Frank Act,* it expected the newly established CFPB to be a proactive regulatory body. NAFCU believes the decision to subject the CFPB to SBREFA was a conscious decision to help ensure that regulations, promulgated with large entities in mind, do not disproportionately impact small financial institutions that were not responsible for the financial crisis.

Legislative Changes to Dodd-Frank and the CFPB

NAFCU also supports measures to bring greater accountability and transparency to the CFPB by making structural improvements to the agency. A key element of this reform would be to enact H.R. 1266, the *Financial Product Safety Commission Act of 2015,* which would replace the sole director of the agency with a bipartisan five-person commission (as was initially proposed for the agency). Such a move should help improve CFPB rulemaking by ensuring debate and discussion about proposals that can incorporate multiple viewpoints. It can also help address the issue of streamlining the issuance of new rules, by establishing a public meeting agenda.

There are also a number of other areas where reforms can be made to provide relief to credit unions:

Qualified Mortgages

The Qualified Mortgage Rule (QM) is a prime example of a well-intentioned regulation with unintended consequences. QM and the associated ability-to-repay rule were meant to protect borrowers from mortgages they could not afford. However, because the rule was written in a one-size-fits-all manner it has significantly limited access to a variety of mortgage products that could be tailored to individual borrowers. For example, we no longer offer non-QM loans at Dixies FCU. In addition to pressure from our examiners urging us to strictly limit any home loan, we decided the liability risk simply wasn't worth it. This has resulted in our mortgage portfolio shrinking from 60% prior to the crisis to 30% today. Despite a strong track record, we are making fewer mortgage loans in north eastern South Carolina today, than we did before Dodd-Frank due to this regulatory pressure.

Given the unique member-relationship credit unions have, many make good loans that work for their members that don't fit into all of the parameters of the QM. NAFCU would support the changes below, whether made legislatively or by the Bureau, to the QM standard to make it more consistent with the quality loans credit unions are already making. Further, credit unions should have the freedom to decide whether to make loans within our outside of the standard without pressure from regulators.

Loans Held in Portfolio

NAFCU supports legislation exempting mortgage loans held in portfolio from the QM definition as the lender already assumes risk associated with the borrower's ability-to-repay. Credit unions have historically been portfolio lenders, providing strong incentives to originate quality loans that are properly underwritten. Additionally, credit union charge off rates are incredibly low compared to market averages, suggesting that loans held in portfolio are less likely to become delinquent or to into default.

Points and Fees

NAFCU strongly supports bipartisan legislation (H.R. 685) to alter the definition of "points and fees" under the "ability-to-repay" rule. H.R. 685 has passed the House and awaits Senate action. Under the bill, affiliated title charges and escrow charges for taxes and insurance would be exempted from the calculation of "points and fees," Under current law, points and fees may not exceed three percent of a loan amount for a loan to be considered a qualified mortgage. Services provided to the consumer, our members, from an affiliated company count against the three percent cap. Unaffiliated services do not count against that cap. Oftentimes, when affiliated services are used, the consumer can save closing costs on their mortgage. However, the current definition does not recognize this consumer advantage.

In addition to the exemptions provide for in H.R. 685, NAFCU supports exempting from the QM cap on points and fees that double counting of loan officer compensation, lender-paid compensation to a correspondent bank, credit union or mortgage brokerage firm, and loan level price adjustments which is an upfront fee that the Enterprises charge to offset loan-specific risk factors such as a borrower's credit score and the loan-to-value ratio.

Making important exclusions from the cap on points and fees will go a long way toward ensuring many affiliated loans, particularly those made to low- and moderate-income borrowers, attain QM status and therefore are still available in the future.

40-year Loan Product

Credit unions offer the 40-year product their members often demand. To ensure that consumers can access a variety of mortgage products, NAFCU supports mortgages of duration of 40 years or less being considered a QM.

Debt-to-Income Ratio

NAFCU supports Congress directing the CFPB to revise aspects of the 'ability-to-repay' rule that dictates a consumer have a total debt-to-income (DTI) ratio that is less than or equal to 43 percent in order for that loan to be considered a QM. This arbitrary threshold will prevent otherwise healthy borrowers from obtaining mortgage loans and will have a particularly serious impact in rural and underserved areas where consumers have a limited number of options. The CFPB should either remove or increase the DTI requirements on QMs.

Regulation E

As NAFCU outlined in our "Top Ten" 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 § 205.9(b)(2), 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.

NAFCU has encouraged the CFPB to amend Regulation E 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. At Dixies, we have had to purchase a new cyber security insurance policy and spend thousands on addressing card fraud issues.

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, such as H.R. 2205, the *Data Security Act of 2015,* 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.

Remittances

The *Dodd-Frank Act* added new requirements involving remittance transfers under the *Electronic Fund Transfer Act* (EFTA) and directed the CFPB to issue final rules amending Regulation E to reflect these additions. Under this mandate, the Bureau, released a series of final rules concerning remittances, all of which became effective on October 28, 2013.

In February 2012, the CFPB issued its first set of final rules on remittances. These rules required, among other things, remittance service providers, including credit unions, to provide a pre-payment disclosure to a sender containing detailed information about the transfer requested by the sender, and a written receipt on completion of the payment. Following the release of the February 2012, final rule, the CFPB issued on August 20, 2012, a supplemental final that provided a safe harbor for determining whether a credit union is subject to the remittance transfer regulations. Specifically, a credit union that conducts 100 or fewer remittances in the previous and current calendar years would not be subject to the rules.

In May 2013, the Bureau modified the final rules previously issued in 2012, to address substantive issues on international remittance transfers. This final rule eliminated the requirement to disclose certain third-party fees and taxes not imposed by the remittance transfer provider and established new disclaimers related to the fees and taxes for which the servicer was no longer required to disclose. Under the rule, providers may choose, however, to provide an estimate of the fees and taxes they no longer must disclose. In addition, the rule created two new exceptions to the definition of error: situations in which the amount disclosed differs from the amount received due to imposition of certain taxes and fees, and situations in which the sender provided the provider with incorrect or incomplete information.

NAFCU opposed the transaction size-based threshold for the final rule's safe harbor. The CFPB relied on an institution size-based threshold, rather than a transaction size-based threshold, in its recently released mortgage rules, and NAFCU urged the Bureau to adopt a similar approach for differentiating between remittance transfer providers. Additionally, NAFCU raised concerns with the final rule's requirement of immediate compliance if an entity exceeds the safe harbor's 100 transaction threshold. It encouraged the CFPB to allow entities who exceed the safe harbor threshold a realistic period in which to meet the standards of the final rule.

NAFCU continues to raise concerns that the regulatory burden imposed by the final rule leads to a significant reduction in consumers' access to remittance transfer services. At Dixies FCU we decided to avoid the headache of the new burdens associated with the changes and simply run our members' remittance transfers through a third party vendor. NAFCU has heard from a number of its members that, because of the final rule's enormous compliance burden, they have been forced to discontinue their remittance programs.

HMDA Changes Going Beyond the Dodd-Frank Act

The *Dodd-Frank Act* transferred *Home Mortgage Disclosure Act* (HMDA) rulemaking authority to the CFPB and directed the Bureau to expand the HMDA dataset to include additional loan information that would help in spotting troublesome trends. Specifically, Dodd-Frank requires the Bureau to update HMDA regulations by having lenders report the length of the loan, total points and fees, the length of any teaser or introductory interest rates, and the applicant or borrower's age and credit score. However, in its proposal, the Bureau is also contemplating adding additional items of information to the HMDA dataset. NAFCU has urged the CFPB to limit the changes to the HMDA dataset to those mandated by Dodd-Frank.

HMDA was originally intended to ensure mortgage originators did not "redline" to avoid lending in certain geographical areas. The HMDA dataset should be used to collect and provide reasonable data for a specific reason. The Bureau contends that it is going beyond Dodd-Frank's mandated changes to get "new information that could alert regulators to potential problems in the marketplace" and "give regulators a better view of developments in all segments of the housing market." These open-ended statements could be applied to virtually any type of data collection, and do not further the original intent of HMDA. NAFCU urged the CFPB to amend the dataset to advance the original purpose of HMDA, rather than using it as a vehicle to "police" its recent Qualified Mortgage rules.

The various mortgage-related regulations promulgated by the CFPB have exponentially increased credit unions' regulatory burden and compliance costs. Any additions to the HMDA dataset will create even more operational expenses for credit unions. Credit unions that collect and report HMDA data through an automated system will have to work with their staffs and vendors to update their processes and software. Those without automated systems will experience particularly significant implementation costs. The CFPB should eliminate unnecessary regulatory burden and compliance costs by limiting the changes to the HMDA dataset to those mandated by Dodd-Frank.

TILA/RESPA

Dodd-Frank directed the CFPB to combine the mortgage disclosures under the *Truth in Lending Act* (TILA) and *Real Estate Settlement Procedures Act* (RESPA). Under this mandate, the Bureau, in November 2013, released the integrated disclosures rule (TRID). This 1900-page rule requires a complete overhaul of the systems, disclosures, and processes currently in place for a consumer to obtain a mortgage. For example, the rule mandates the use of two disclosures: the three-page Loan Estimate (which replaces the Good Faith Estimate an initial Truth in Lending Disclosure); and the five-page Closing Disclosure (which replaces the HUD-1 and final Truth in Lending disclosure). There are also a number of stringent timing requirements and other substantive changes lenders must follow. The rule is set to be effective October 3, 2015, but lenders are still feeling pressure to be compliant on time as the CFPB has not indicated that they will provide a safe harbor grace period, and has prohibited early compliance so that institutions can test their systems. The sheer magnitude of this rule, read in conjunction with the totality of the other mortgage rules, has created a very burdensome regulatory environment and many credit unions are finding it difficult to continue lending. In addition to this new disclosure, credit unions must comply with the current disclosure requirements, which are extensive. After failed attempts to obtain a legislative safe-harbor from TRID compliance we asked for clear guidance from the regulators.

NCUA stated that they recognize that the TRID Rule poses "significant implementation challenges" for industry, and has indicated that regulator will be sensitive to the good-faith efforts of lenders to comply with the TRID rules in a timely manner. While this is not the perfect solution, it will hopefully lead to the industry and examiners working together to ensure expectations are clear. We would also encourage Congress to address this issue further by passing H.R. 3192, the *Homebuyers Assistance Act.*

Legal Opinion Letters

In attempting to understand ambiguous sections of CFPB rules, NAFCU and many of its members have reached out to the CFPB to obtain legal opinion letters as to the agencies interpretation if it's regulations. While legal opinion letters don't carry the weight of law, they do provide guidance on ambiguous section of regulations. Many other financial agencies such as NCUA, FTC, FDIC and others issue legal opinion letters so as to help institutions and other agencies understand otherwise ambiguously written rules. The CFPB has declined to do so. What they have done is set up a help line where financial institutions can call for guidance from the agency. While this is helpful, there are reports of conflicting guidance begin given depending on who answers the phone. This is not just unhelpful, but confusing when NCUA examines credit unions for compliance with CFPB regulations.

NCUA's Risk-Based Capital Proposal: A Solution in Search of a Problem

Credit unions are not immune to regulatory creep from the *Dodd-Frank Act*. One of the central themes of Dodd-Frank was the concept of higher capital requirements for riskier activities for banks. Bank regulators would establish certain capital levels institutions must retain, otherwise they would face prompt corrective action from the regulator to restore the institution to that level. The *Federal Credit Union Act* (FCUA) requires the NCUA Board to adopt by regulation a system of prompt corrective action for federally insured credit unions that is "comparable to" the *Federal De-*

posit Insurance Act. The Federal Deposit Insurance Corporation mdernize4d its risk-based capital system post Dodd-Frank in 2013.

Despite the fact that credit unions had a stellar track record of performance during the financial downturn, in January of 2014, the National Credit Union Administration (NCUA) Board proposed a new risk-based capital system for credit unions. On January 15, 2015, the National Credit Union Administration (NCUA) Board, in a 2-1 vote, issued a revised risk-based capital proposed rule for credit unions after a lot of industry and Congressional concern was expressed regarding the first proposal. We were encouraged to see that the revised version of this proposal addresses some changes sought by our membership. However, NAFCU maintains that this costly proposal is unnecessary and will ultimately unduly burden credit unions and the communities they serve.

A Costly Experiment for Credit Unions

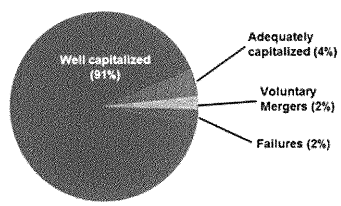
While this proposal is only designed to apply to credit unions over $100 million in assets, NAFCU and its member credit unions remain deeply concerned about the real cost of this proposal. NAFCU's analysis estimates that credit unions' capital cushions (a practice encouraged by NCUA's own examiners) will suffer over a $470 million hit if NCUA promulgates separate risk-based capital threshold for well capitalized and adequately capitalized credit unions (a "two-tier" approach). Specifically, in order to satisfy the proposal's "well-capitalized" thresholds, today's credit unions would need to hold at least an additional $729 million. On the other hand, to satisfy the proposal's "adequately capitalized" thresholds, today's credit unions would need to hold at least an additional $260 million. Despite NCUA's assertion that only a limited number of credit unions will be impacted, this proposal would force credit unions to hold hundreds of millions of dollars in additional reserves to achieve the same capital cushion levels that they currently maintain. A majority of credit unions responding to a survey of NAFCU members expect that this new proposal will force them to hold more capital in the long run and almost as many also believe it will slow their growth. The funds used to meet these new onerous requirements are monies that could otherwise be used to make loans to consumers or small businesses and aid in our nation's economic recovery. The requirements in this proposal will serve to restrict lending to consumers from credit unions by forcing then to park capital on their books, rather than lending to their members.

Impact Analysis

NCUA estimates that 19 credit unions would be downgraded if the new risk-based proposal were in place today. NAFCU believes the real impact is best illustrated with a look at its implications during a financial downturn. Under the new proposal, the number of credit unions downgraded more than doubles during a downturn in the business cycle. Because the nature of the proposal is such that, in many cases, assets that would receive varying risk weights under the proposal are grouped into the same category on NCUA call reports, numerous assumptions must be made to estimate impact.

Under our most recent analysis, NAFCU believes 45 credit unions would have been downgraded during the financial crisis under this proposal. Of those 45, 41 of credit unions would be well-capitalized today. To have avoided downgrade, the institutions would have had to increase capital by $145 million, or an average $3.2 million per institution. As the chart on the next page demonstrates, almost all of the credit unions that would have been downgraded—95%—are well capitalized or adequately capitalized today. This provides strong evidence that NCUA's risk-based capital proposal is unnecessary and unduly burdensome.

Current status of the credit unions that would have been downgraded in 2009 under RBC2



Source: NCUA call report data

Legislative Change

NAFCU wants to be clear—we support an risk-based capital system for credit unions that would reflect lower capital requirements for lower-risk credit unions and higher capital requirements for higher-risk credit unions. However, we continue to believe that Congress needs to make statutory changes to the *Federal Credit Union Act* in order to achieve a fair system. Such a system should move away from the static net-worth ratio to a system where NCUA joins the other banking regulators in having greater flexibility in establishing capital standards for institutions. We also believe that capital reform must include access to supplemental capital for all credit unions.

NAFCU has outlined a legislative solution that will institute fundamental changes to the credit union regulatory capital requirements in our Five-Point Plan for Regulatory Relief. The plan, as it relates to capital reform:

- Directs the NCUA to, along with industry representatives, conduct a study on prompt corrective action and recommend changes;
- Modernizes capital standards to allow supplemental capital, and direct the NCUA Board to design a risk-based capital regime for credit unions that takes into account material risks; and,
- Establishes special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

Recognizing that a number of questions remain regarding NCUA's risk-based capital proposal, on June 15, 2015, Representatives Stephen Fincher, Denny Heck and Bill Posey introduced the *Risk-Based Capital Study Act of 2015* (H.R. 2769). This NAFCU-backed legislation will stop NCUA from moving forward with their second risk-based capital proposal until completing and delivering to Congress a thorough study addressing NCUA's legal authority, the proposal's impact on credit union lending, capital requirements for credit unions compared to other financial institutions and more. The agency would not be able to finalize or implement the proposal before 120 days after the report goes to Congress. We urge members to support this legislation.

Credit Unions Want to Help Small Businesses Recover

When Congress passed the *Credit Union Membership Access Act* in 1998, it put in place restrictions on the ability of credit unions to offer member business loans (MBLs). Congress codified the definition of an MBL and limited a credit union's member business lending to the lesser of either 1.75 times the net worth of a well-capitalized credit union or 12.25 percent of total assets.

As the country continues to recover from the financial crisis, many credit unions have capital to help small businesses create jobs. However, due to the outdated and arbitrary MBL cap, their ability to help stimulate the economy is hampered. Removing or modifying the cap would help provide economic stimulus and create jobs without using taxpayer funds to do so.

A 2011 study commissioned by the Small Business Administration's (SBA) Office of Advocacy that looked at the financial downturn found that bank business lending was largely unaffected by changes in credit unions' business lending, and credit unions' business lending can actually help offset declines in bank business lending during a recession (James A. Wilcox, *The Increasing Importance of Credit Unions in Small Business Lending,* Small Business

Research Summary, SBA Office of Advocacy, No. 387 (Sept. 2011)). The study shows that during the 2007–2010 financial crisis, while banks' small business lending decreased, credit union business lending increased in terms of the percentage of their assets both before and during the crisis.

In June of 2015, the NCUA Board proposed changes to their member business lending rules that would eliminate the unnecessarily bureaucratic process currently in place for credit union member business loans that requires credit unions to seek NCUA approval (or a "waiver") for basic and routine lending decisions. It is important to recognize that NCUA's proposed MBL rule would provide regulatory relief, but does not alter the statutory cap on credit union member business lending established in the *Federal Credit Union Act* and is not an attempt to circumvent Congressional intent. This statutory cap imposes an aggregate limit on an insured credit union's outstanding MBLs and the proposed rule does nothing to change that. Second, NCUA's proposal does not alter the requirement that credit unions have strong commercial lending underwriting standards.

Credit unions ultimately need Congress to provide relief from the arbitrary cap. A few bills have been introduced in this Congress to do that:

Representatives Ed Royce and Greg Meeks introduced H.R. 1188, the *Credit Union Small Business Jobs Creation Act.* This legislation would raise the arbitrary cap on credit union member business loans from 12.25% to 27.5% of total assets for credit unions meeting strict eligibility requirements.

Additionally, NAFCU supports legislation (H.R. 1133) introduced by House Veterans Affairs Committee Chairman Jeff Miller to exempt loans made to our nation's veterans from the definition of a member business loan. We also support H.R. 1422, the *Credit Union Residential Loan Parity Act,* introduced by Representatives Royce and Jared Huffman, which would exclude loans made to non-owner occupied 1- to- 4 family dwelling from the definition of a member business loan and legislation.

Furthermore, NAFCU also supports exempting from the member business lending cap loans made to non-profit religious organizations, businesses with fewer than 20 employees, and businesses in "underserved areas."

Providing credit unions regulatory relief, and enacting these MBL proposals, would help credit unions maximize their ability to provide capital to our nation's small businesses.

Conclusion

The *Dodd-Frank Act* has had a significant impact on credit unions, despite credit unions not being the cause of the financial downturn. Unfortunately, small credit unions like mine are disappearing post Dodd-Frank at an alarming rate as they cannot keep up with the new regulatory burdens. While the CFPB has tried to address the issue with limited exemptions, they have not gone far enough. Many credit unions are saying "enough is enough" when it comes to the overregulation of the industry. 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. We need regulatory relief—both legislatively and from the regulators.

We would urge members support for credit union relief measures pending before the House and the additional issues outlined in NAFCU's Five Point Plan for Credit Union Regulatory Relief and NAFCU's "Top Ten" list of regulations to review and amend. Additionally, Congress needs to provide vigorous oversight of the CFPB and NCUA, particularly concerning their 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 subcommittee 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.

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Testimony before the U.S. House Committee on Small Business Subcommittee on Economic Growth, Tax and Capital Access

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Hearing Titled: "How Dodd-Frank is Crippling Small Lenders and Access to Capital"

Delivered to the Subcommittee on September 17, 2015

Chairman Rice, Ranking Member Chu, and members of the Subcommittee, thank you for the opportunity to speak before you today. In doing so, I will draw heavily from "The State and Fate of Community Banking," a working paper I co-published in February 2015 as a Senior Fellow at the Mossavar-Rahmani Center for Business & Government at Harvard University's John F. Kennedy School of Government with Robert Greene, a Research Assistant at the Center who is seated behind me today. Before I begin, let me make clear that the views expressed here today do not necessarily reflect those of any organization that either Robert Greene or I are affiliated with, and instead stem from independent scholarly research we have undertaken to understand the critical issues facing America's financial system.

The Critical Role of Community Banks in Small Business Lending

Capital access for small businesses remains a critical pillar of economic vitality. Members of this committee are likely aware that small businesses account for approximately one-third of enterprise employment.[1] But the current size of a business matters much less than its potential to expand, and capital access is critical to achieving such growth.

As of 2012, banks were the primary financial institution for over 85 percent of small businesses.[2] In our February working paper, Mr. Greene and I found that an astonishing 51 percent of small business bank loans were from community banks.[3]

Why is this? Community banks leverage interpersonal relationships in lieu of financial statements and data-driven models in making lending decisions.[4] As Fed Governor Daniel

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[1] Anthony Caruso, U.S. Census Bureau, Economics & Statistics Administration, U.S. Department of Commerce, *Statistics of U.S. Businesses Employment and Payroll Summary: 2012* (Feb. 2015).
[2] Karen Mills & Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game" (General Management Unit Working Paper No. 15-004, Harvard Business School, July 2014), 17.
[3] Marshall Lux & Robert Greene, "The State and Fate of Community Banking" (Mossavar-Rahmani Center for Business & Government, John F. Kennedy School of Government, Harvard University, M-RCBG Associate Working Paper Series, Working Paper No. 37, Feb. 2015), 11.

Tarullo has noted: "[C]redit extension to smaller firms is an area in which the relationship-lending model of community banks retains a comparative advantage. It means that community banks are of special significance to local economies."[5]

Recent Trends in Community Bank Small Business Lending

Yet the state of community bank small business lending today is different than that of several years ago. For starters, the number of community banks (banks with less than $10 billion in assets) has declined rapidly in recent years. In mid-1994 there were 10,329 and in mid-2014 there were only 6,094.[6] Similarly, since 1994, community banks' share of U.S. banking assets has decreased by more than half to 18 percent (SEE FIGURE 1).[7]

Most concerning to this subcommittee is the post-crisis decline in the volume of bank loans to small businesses (SEE FIGURE 2).[8] In the four years before the crisis (from mid-2003 to mid-2007), outstanding bank loans to small businesses grew 25 percent overall, and 15 percent at community banks.[9] Yet outstanding bank loans to small businesses have declined 10 percent between mid-2010 and mid-2014, and much of this decline is attributable to small community banks (defined as banks having $1 billion or less in assets), which realized a 17 percent fall.[10] During this time, small business lending by larger community banks remained relatively flat.[11]

What factors are at play here? Non-bank lenders, while growing rapidly and increasingly playing a valuable role in both credit markets and the overall U.S. economy, have and will only fill only some of the gaps left in the wake of less community bank small business lending. The vast share of small business lending is still performed by banks,[12] so while these non-bank firms and technology-based platforms are a factor, community banks will remain a critical part of small business lending markets even if, or as, the market share of alternative credit sources grows rapidly.

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[4] *See* U.S. Government Accountability Office, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rulemakings*, GAO-12-881, September 2012, 17-18.
[5] Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System (speech at the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, Ill., May 8, 2014).
[6] Lux & Greene, *supra* note 3, at 15. There were 6,937 community banks in mid-2010, meaning that the number of community banks declined 12 percent between mid-2010 and mid-2014. FDIC, *Statistics on Depository Institutions, All SDI Data* (calculation by Marshall Lux & Robert Greene).
[7] Lux & Greene, *supra* note 3, at 15. In mid-1994 community banks held 41 percent of U.S. banking assets. *Ibid.*
[8] Small business loans are defined as the sum of loans "secured by nonfarm nonresidential properties with original amounts less than $1,000,000" and "currently outstanding commercial and industrial loans less than $1,000,000 held in domestic offices." *See* FDIC, Statistics on Depository Institutions, SDI Map & Definitions (accessed Sep. 14, 2015); Small Business Administration, *Small Business Lending in the United States 2013* (Dec. 2014).
[9] FDIC, *Statistics on Depository Institutions, All SDI Data* (calculation by Marshall Lux & Robert Greene).
[10] *Ibid* (calculation by Marshall Lux & Robert Greene).
[11] Community banks with $1 billion or more realized a 0.8 percent decrease in small business loans outstanding between mid-2010 and mid-2014. *Ibid* (calculation by Marshall Lux & Robert Greene).
[12] *See* Mills & McCarthy, *supra* note 2, at 42.

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Instead, a major cause of decreased community bank small business lending is our nation's tepid economic recovery: labor force participation is at a 10-year low[13] and quarterly GDP growth has averaged at just 2.5 percent for the last 2 years.[14] An August 2015 survey of small businesses by the National Federation of Independent Businesses (NFIB) reinforces this concern: it finds that 49 percent of respondents were on the "credit sidelines" with "no good reason to borrow."[15]

But the most troubling factor is that firms seeking credit may be unable to access it. As former Small Business Administration head Karen Mills recently noted, while measuring the credit gap is difficult, the evidence "strongly suggests" that there are "acute impediments" to accessing capital for many creditworthy small businesses.[16]

How Is Dodd-Frank Impacting Community Banks and Small Business Credit Access?

Dodd-Frank shrinks credit access because of its sheer scope; it stands to increase financial regulatory restrictions by 32 percent.[17] As a recent paper published by the Federal Reserve Bank of Richmond notes, "banking scholars [] have found that new entries are more likely when there are fewer regulatory restrictions."[18] The current lack of new bank formation[19] inherently hampers credit access. Furthermore, a recent ICBA survey found that 21 percent of banks report new regulatory burdens as a factor in preventing commercial lending.[20] Also, according to another recent survey, for 83 percent of small banks compliance costs have increased at least 5 percent since the passage the Dodd-Frank Act.[21] That is capital not being deployed in our economy.

Some will argue that because consolidation has occurred for quite some time, Dodd-Frank is not a factor in declining community bank lending. But in fact large-scale regulatory accumulation within the banking sector has simultaneously occurred with rapid consolidation; regulatory restrictions within Title 12 of the Code of Federal Regulations – which regulates

[13] Bureau of Labor Statistics, U.S. Department of Labor, Labor Force Statistics from the Current Population Survey, Seasonally Adjusted Labor Force Participation Rate (accessed Sep. 14, 2015).
[14] Bureau of Economic Analysis, U.S. Department of Commerce, National Economic Accounts (accessed Sep. 14, 2015).
[15] William C. Dunkelberg & Holly Wade, *NFIB Small Business Economic Trends* (Aug. 2015), 4
[16] Karen Mills, "Is A Gap In Small-Business Credit Holding Back The American Economy?," *Forbes* (Jul. 2014)
[17] Patrick McLaughlin & Robert Greene, "Dodd-Frank's Regulatory Surge: Quantifying Its Regulatory Restrictions and Improving Its Economic Analyses" (Mercatus on Policy, The Mercatus Center at George Mason University, Feb. 2014) (using RegData to measure regulatory restrictions, which are defined as "words that indicate an obligation to comply, such as 'shall' or 'must'").
[18] Roisin McCord, Edward Simpson Prescott & Tim Sablik "Explaining the Decline in the Number of Banks since the Great Recession" (Economic Brief 15-03, The Federal Reserve Bank of Richmond, Mar. 2015), 4.
[19] *See ibid*, at 1 (there was only one newly formed U.S. bank in 2013, and no new banks formed in 2012).
[20] Independent Community Bankers of America, *2014 ICBA Community Bank Lending Survey* (Jan. 2015), 3
[21] Hester Peirce, Ian Robinson & Thomas Stratmann, "How Are Small Banks Faring under Dodd-Frank?" (Working Paper 14-05, The Mercatus Center at George Mason University, Feb. 2014), 34.

banks and banking – grew every year between 1999 and 2008.[22] This regulatory accumulation is intuitively more costly for smaller institutions. As Fed Governor Tarullo notes: "Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets."[23] How costly is it? A 2014 study published by the Minneapolis Fed finds that hiring just two additional personnel at small community banks results in one-third of these banks becoming unprofitable.[24]

What Does This Mean for Policy-Makers?

Reforming federal financial regulatory processes is critical to expanding small business credit access. Mr. Greene and I propose several strategies to do so in our working paper, one of which is requiring that financial regulators undertake robust economic analyses of financial regulatory rulemakings.[25] Cost-benefit analysis brings about transparent deliberation that enables regulators to avoid unintended regulatory costs to small businesses and other stakeholders.[26]

Another solution to expand small business credit access is to exempt community banks from certain rulemakings. Yet I urge the subcommittee to recognize that exemptions often fail to exempt – regulatory standards "trickle down."[27] For example, community banks have recently reported being held to the same stress test and capital standards as large financial institutions.[28] Similarly, almost half of responding community banks in a recent Mercatus Center survey report being impacted by the Durbin Amendment from which they are formally exempted.[29] So while it is appropriate to exempt community banks from the Volcker Rule and Section 956 compensation requirements,[30] a broader examination of our financial regulatory system and its ever-increasing regulatory restrictions is necessary. Future American economic vitality is at stake.

Conclusion

In conclusion, small businesses clearly play a critical role in bringing about heightened U.S. economic growth, and community banks today are, and for many years have been, essential sources of credit for these firms. The reliance upon community banks by small businesses stems

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[22] Patrick McLaughlin & Robert Greene, "Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank" (The Mercatus Center at George Mason University, Jul. 2013). The authors use RegData to measure regulatory restrictions. For an explanation of RegData's methodology, *see supra* note 17.
[23] Tarullo, *supra* note 5.
[24] Ron Feldman, Ken Heinecke & Jason Schmidt, "Quantifying the Costs of Additional Regulation on Community Banks" (Economic Policy Paper 13-3, Federal Reserve Bank of Minneapolis, May 2013), 4-5.
[25] Lux & Greene, *supra* note 3, at 27-30.
[26] *See* Cass Sunstein, *Cost-Benefit Analysis and the Knowledge Problem*, Regulatory Policy Program Working Paper RPP-2015-03, Mossavar-Rahmani Center for Business & Government, John F. Kennedy School of Government, Harvard University, 2015); Eric A. Posner & E. Glen Weyl, *Benefit-Cost Paradigms in Financial Regulation* (University of Chicago, Coase-Sandor Institute for Law & Economics, Working Paper No. 660, Oct. 2013).
[27] *See* Frank Keating, "Trickle-down regulation is a real-life problem," *The Hill* (Feb. 2, 2015).
[28] *See ibid.*
[29] Peirce et al., *supra* note 21, at 41.
[30] *See* Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System (speech at the Community Bankers Symposium, Chicago, Ill., November 7, 2014).

from a variety of factors: an emphasis on relationship-based business, non-standardized lending practices, and geographic necessity, to name a few. Certainly, market factors may diminish the role of the community bank in small business lending, and to the extent that occurs and credit demands continue to be met there is not reason for concern. Unfortunately, regulatory pressures – such as those brought about by Dodd-Frank – are undermining the competitiveness of community banks, preventing new community banks from forming, and curbing their ability to lend. This trend merits action. While cost-benefit analysis and exempting community banks from particularly burdensome rulemakings would be steps in the right direction, a broader effort to simplify and streamline U.S. bank regulation is best suited to curb this troubling trend that threatens the ability of American small businesses to access capital.

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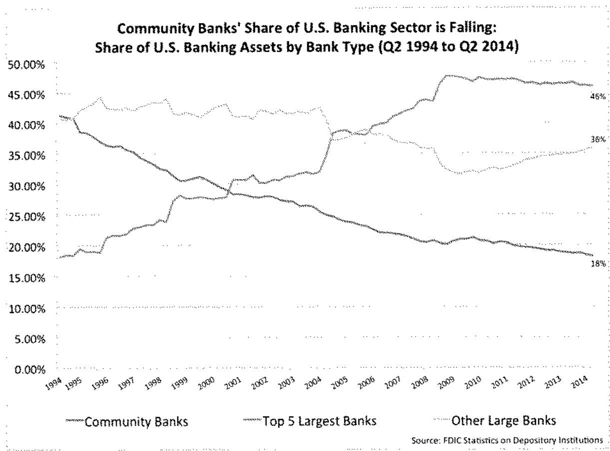
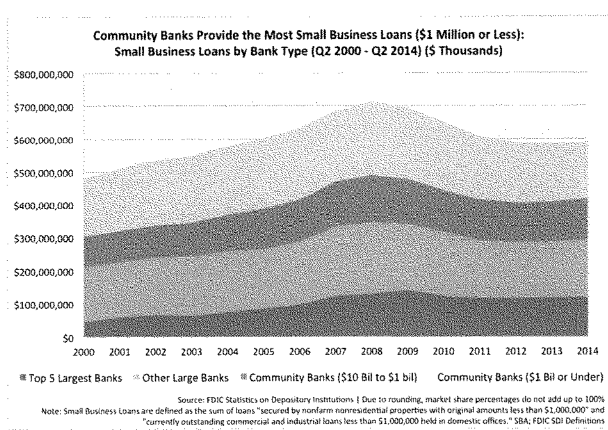
Figure 1



Source: Lux & Greene, *The State and Fate of Community Banking* (Feb. 2015)

Figure 2



Source: Lux & Greene, *The State and Fate of Community Banking* (Feb. 2015)

Center for American Progress

"Financing Main Street:
How Dodd Frank is Crippling Small Lenders and Access to Capital"

Testimony before the U.S. House of Representations Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access

Julia Gordon
Senior Director of Housing and Consumer Finance
Center for American Progress
September 17, 2015

Good afternoon, Chairman Rice, Ranking Member Chu, and members of the subcommittee. My name is Julia Gordon, and I direct the Housing and Consumer Finance team at the Center for American Progress, a nonpartisan think tank dedicated to improving the lives of Americans through progressive ideas and action. Thank you so much for convening this hearing on the important topic of small lenders and access to capital. This testimony is based primarily on a recent CAP issue brief on financial reform and small banks, which is attached.[1]

Small lenders play a critical and unique role in meeting the credit needs of their communities. For example, small community banks often serve the nonmetropolitan and rural areas that are poorly served by larger institutions. Additionally, smaller institutions such as community banks and credit unions generate their profits from core activities of taking deposits and lending, including small business lending, mortgage lending, and other personal lending.[2]

While the term "small lender" is difficult to define, the FDIC definition of community banks encompasses 93 percent of the nation's approximately 6,400 depository institutions.[3] Added to that are credit unions and non-bank lending institutions.

Although they still constitute a large percentage of all banks, there is no question that the number of small, community banks is declining overall. This trend began decades ago. Underlying this trend is a core problem for all small lenders: the complexity of today's financial market means size matters.[4] Larger banks engage in a wide variety of activities and serve a broader variety of markets, which can better insulate them from losses when particular business lines or markets are experiencing economic hardship. They can also rely on economies of scale to deliver services in a more cost effective way.

Additionally, one of the pressing challenges facing all lenders today is the rapid pace of technological change and the demands of today's customers for everything from online loan applications and mobile applications to cloud-based systems where documents and other items can be stored and accessed by both lender and customer. While some small lenders have proven nimble in this area, many smaller institutions work on aging, inflexible systems housed on local servers, and the necessary upgrades would consume significant resources.

For these reasons among others, the Government Accountability Office, or GAO, has concluded that, "larger banks generally are more profitable and efficient than smaller banks, which may reflect increasing returns to scale."[5]

Not surprisingly then, a 2012 FDIC study of community banks showed that more than 80 percent of the banks that exited the industry between 1984 and 2011 left to become larger banks, either through a merger with an unaffiliated bank or consolidation with another chartered bank within the same organization. Only 17 percent of the banks that left the industry did so because they failed.[6]

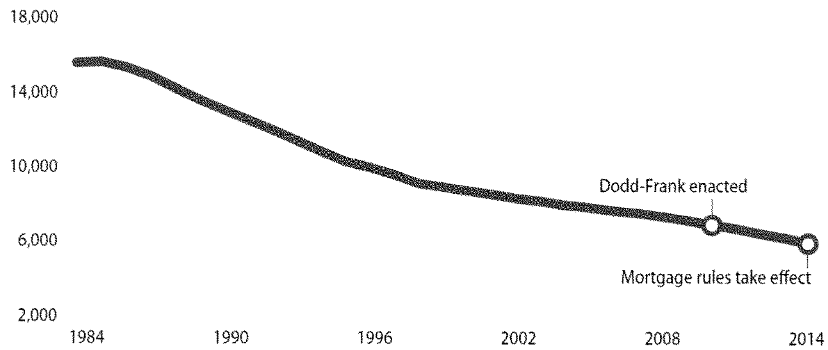
Another challenge facing community banks is their location. Community banks are more likely to be located in nonmetropolitan and rural areas, which experience slower population and economic growth than metropolitan areas and many of which suffer from severe disinvestment and underemployment.[7]

Finally, general regulatory compliance is part of the challenge for smaller institutions. By definition, a small lender must use a greater share of resources than a large one to update its legal disclosures, follow regulatory changes, or meet with bank examiners. This burden falls particularly hard on lenders whose technology is the least flexible and most difficult and costly to update.

That said, the data simply does not support the inference that the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 either caused or even accelerated the decline in small banks. The chart below demonstrates that looking at the situation over time, the slope of the small bank decline barely changes with the enactment of Dodd-Frank.

Financial reform is not causing the declining number of community banks

Number of U.S. community banks



Source: Federal Deposit Insurance Corporation, "Historical Community Banking Reference Data," available at https://www.fdic.gov/regulations/resources/cbi/data.html (last accessed May 2015).

In a paper written earlier this year, Marshall Lux and Robert Greene point to a decline of community banks' share of banking sector assets and lending between 2010 and 2014 as evidence that financial reform is the culprit in this decline.[8] However, their own data show that for the two to three years prior to 2010, the assets and lending shares of community banks rise somewhat anomalously. After 2010, community banks resumed a decline in line with historical trends. This is not surprising, since even if financial reform has had an impact, it's unlikely that a decline would have been triggered by the mere passage of Dodd-Frank, rather than the full implementation of its provisions, which occurred much later. For example, the Consumer Financial Protection Bureau, or CFPB, did not open for business until a full year after its enactment, and the first CFPB rulemakings of note did not become effective until January 2014.

It is also worth noting that one of Dodd-Frank's most impactful changes to the financial landscape -- instituting enhanced supervision of large, complex, and interconnected financial institutions – does not affect any institution defined as a community bank by the FDIC. In fact, only four out of the approximately 5,900 community banks are even subject to the regulator-devised stress tests that monitor banks' ability to withstand a dramatic change in economic conditions.[9]

Additionally, financial regulators already have given small banks a significant number of exemptions from the financial reform rules with which larger institutions must comply. By and large, these targeted exemptions enable small banks to meet the credit needs of their communities without weakening consumer protections or endangering the safety and soundness of the U.S. community banking sector.

For example, a core part of the Dodd-Frank rules relate to ensuring safe mortgage lending. These rules are implemented by the CFPB, which has extensively considered the unique needs of community banks and their borrowers. Under both statutory direction and its own exemption authority, the CFPB has given these institutions the flexibility that they need to offer high-quality lending that meets the needs of their communities:

- Small banks have greater underwriting flexibility when making Qualified Mortgages, or QM, loans—those that are eligible for the highest level of protection from legal challenges—because if small banks hold the loans on portfolio, they are not bound to the fixed debt-to-income ratio limit that applies to larger lenders.[10]
- Small institutions serving rural or underserved areas can get QM protection for loans that require a balloon payment, although the general QM definition bans balloon loans.[11]
- The CFPB recently proposed expanding the definition of small institutions, as well as the rural definition, so that more banks would qualify for a variety of mortgage rule exemptions, including more flexibility to make QM loans.[12]
- Small institutions serving rural or underserved areas are exempt from requirements that they maintain escrow accounts for higher-cost loans.[13]
- Small creditors are exempt from most mortgage-servicing rules.[14]
- An array of mission-oriented lenders, such as Community Development Financial Institutions and state Housing Finance Agencies, are fully exempt from the entire CFPB Ability-to-Repay rule.[15]

Smaller banks and small businesses also receive special treatment in other ways. CFPB is the only financial regulator subject to the requirements of the Small Business Regulatory Enforcement Fairness Act (SBREFA), which requires the agency to allow a Small Business Advocacy Review panel to comment on potential rulemakings before they are issued for public comment. [16] Because the SBREFA process takes place before the Administrative Procedure Act requirements kick in, it has allowed for less formal and more candid conversations between small business interests and the CFPB. These conversations enable CFPB staff to understand small business interests better and in many cases to make directional changes before the formal rulemaking takes place.

What's more, in addition to creating a mandated consumer advisory council, the CFPB has voluntarily created community bank and credit union advisory councils as well. These groups' unique perspectives inform the CFPB during rulemaking, supervision, and enforcement. (The FDIC and the Federal Reserve Board of Governors have also formed community bank advisory councils since the financial crisis.) [17]

Despite the challenges of size, location, and compliance, most community banks have seen significant and consistent improvement in their financial performance and even have increased their lending in the years since Congress passed Dodd-Frank. Data from the FDIC indicate that on important measures of performance and financial health—such as return on equity, leverage ratio, percentage of noncurrent assets, and percentage of banks that are unprofitable—community banks have seen significant and consistent improvement over the past five years.[18]

The truth is that while new regulation may have some impact, a far wider range of factors affects the level and availability of credit for small businesses. These factors include the lack of standardization and profitability of small business lending, the long-standing pressures towards bank consolidation discussed above, and the weak demand for credit.[19] For example, one out of every four small-business owners uses home equity to finance their business, so the huge drop in home equity caused by risky and unsustainable mortgage lending may have done far more to damage small business access to capital than any particular regulation.[20]

It is critical to remember that financial reform was passed after a major crisis that left America's economy in shambles and resulted in the worst recession since the Great Depression. Complex, misleading, and insufficiently regulated financial products compounded by inadequate oversight lay at the center of this crisis. Because new rules aimed at protecting the mortgage market and the financial system will protect against future crises and help prevent massive, national declines in home equity, these rules should ultimately strengthen the prospects for small businesses.

In cases where data support specific changes that could reduce compliance costs without weakening consumer protections or endangering lender safety and soundness, policymakers should pursue these reforms in a careful and tailored way. However, wholesale rolling back of financial reform and consumer protections in the name of helping small lenders could revive the risky practices and predatory and unsustainable lending that led to the financial crisis, once again putting taxpayers and the economy as a whole at risk.

Thank you for inviting me to testify today, and I look forward to your questions.

[1] David Sanchez, Sarah Edelman, and Julia Gordon, "Do Not Gut Financial Reform in the Name of Helping Small Banks," (Washington: Center for American Progress, 2015), available at https://www.americanprogress.org/issues/housing/report/2015/07/07/113119/do-not-gut-financial-reform-in-the-name-of-helping-small-banks/

[2] Federal Deposit Insurance Corporation, "FDIC Community Banking Study" (2012), available at https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf

[3] The FDIC defines community banks by aggregating all charter-level data under a holding company into a single banking organization and excluding banks for which more than half of assets are in certain specialized areas. For the remaining banks, those under a certain size threshold—$1 billion in 2010—are considered community banks, while those above that threshold are considered community banks if they make a meaningful amount of loans, take a meaningful amount of deposits, and operate within a limited geographic scope. Federal Deposit Insurance Corporation, "Statistics on Depository Institutions, Second Quarter 2015," available at https://www2.fdic.gov/sdi/ (last accessed September 2015).

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[6] FDIC, "FDIC Community Banking Study."

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[11] Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide," Section 4.6.2.

[12] Consumer Financial Protection Bureau, "CFPB Issues Proposal To Facilitate Access To Credit In Rural And Underserved Areas," Press release, January 29, 2015, available at http://www.consumerfinance.gov/newsroom/cfpb-issues-proposal-to-facilitate-access-to-credit-in-rural-and-underserved-areas/.

[13] Consumer Financial Protection Bureau, "TILA Higher-Priced Mortgage Loans (HPML) Escrow Rule: Small Entity Compliance Guide" (2014), Section 4, available at http://files.consumerfinance.gov/f/201401_cfpb_tila-hpml-escrow_compliance-guide.pdf.

[14] Consumer Financial Protection Bureau, "2013 Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z) Mortgage Servicing Final Rules: Small Entity Compliance Guide" (2013), Section 3, available at http://files.consumerfinance.gov/f/201306_cfpb_compliance-guide_2013-mortgage-servicing-rules.pdf.

15 Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide," Section 3.13.

16 5 U.S.C. §§ 603(d), 609(d)(2).

17 Consumer Financial Protection Bureau, "Advisory groups," available at http://www.consumerfinance.gov/advisory-groups/ (ast accessed September 2015); Government Accountability Office, "Community Banks and Credit Unions."

[18] Federal Deposit Insurance Corporation, "Quarterly Banking Profile: Community Banking Performance, Second Quarter 2015," Table I-B, available at https://www5.fdic.gov/qbp/2015jun/commb1.html (last accessed September 2015).

[19] Cite: Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology may Change the Game," Harvard Business School Working Paper 15-004 (2014),

available at http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf

[20] Mark Schweitzer and Scott Shane, "The Effect of Falling Home Prices on Small Business Borrowing" (Cleveland: Federal Reserve Bank of Cleveland, 2010), available at https://www.clevelandfed.org/Newsroom%20and%20Events/Publications/Economic%20Commentary/2010/ec%20201018%20the%20effect%20of%20falling%20home%20prices%20on%20small%20business%20borrowing.aspx

Center for American Progress

Do Not Gut Financial Reform in the Name of Helping Small Banks

By David Sanchez, Sarah Edelman, and Julia Gordon July 7, 2015

Recognizing the unique role of small, community banks, lawmakers across the political spectrum have recently been debating the right way to help these institutions meet the credit needs of their communities.

Recently, financial reform opponents have seized upon the challenges facing small banks as an opportunity to launch a campaign for regulatory rollback. They claim that these rules have harmed small banks and made it unprofitable for them to lend to consumers. In the name of helping community banks, lobbyists representing a wide range of financial institutions—including both larger banks and nondepository financial institutions—have proposed a broad suite of policies that would undo many of the financial reforms and consumer protections put in place in the wake of the financial crisis to prevent similar crises in the future.

There is no question that the number of small, community banks is declining. This trend predates financial reform by decades, and the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 does not appear to have altered the pace of the decline.[1] Reasons for this trend include basic economies of scale that drive consolidation in any number of industries, including compliance costs, as well as the increased role of technology in banking and population and economic decline in some areas where community banks operate.[2]

Despite these challenges, most community banks have seen significant and consistent improvement in their financial performance and even have increased their mortgage and other lending in the years since Congress passed Dodd-Frank. In short, while compliance costs are undeniably high and the number of very small banks continues to decline, the specific requirements of Dodd-Frank do not appear to be the cause of the decline or to be hampering the overall performance of the sector.

However, recognizing that compliance is always a challenge for smaller institutions even when they are doing well, financial regulators already have given small banks a significant number of exemptions from the financial reform rules with which larger institutions must comply. By and large, these targeted exemptions enable small banks to meet the credit needs of their communities without weakening consumer protections or endangering the safety and soundness of the U.S. community banking sector.

In contrast, the approach to regulatory reform promoted by banking and mortgage industry lobbyists and recently passed by the U.S. Senate Committee on Banking, Housing and Urban Affairs is not focused on community banks.[3] Indeed, the proposed reforms would actually remove some of the competitive advantages that the current law's tailored exemptions give smaller banks. These changes would blow a hole in financial reform and make it far more likely that there will be a resurgence of the risky lending that led to the crisis in the first place.

This brief describes the activities of community banks, identifies the challenges these banks face, describes existing regulatory exemptions, and recommends how to ensure that any regulatory reform serves the purpose of strengthening these institutions without undermining critical consumer and systemic protections.

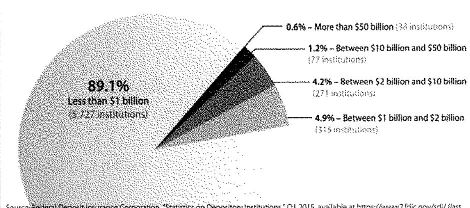
What are community banks and whom do they serve?

There is no single definition of a small or community bank. Generally, community banks are understood to serve narrower geographies than larger financial institutions and rely on relationship-based lending rather than automated processes. Many analysts define small or community banks based on their asset size, such as those with assets totaling less than $1 billion, as shown in Figure 1.

FIGURE 1

The vast majority of banks are small

U.S. depository institutions by asset size, first quarter of 2015



Source: Federal Deposit Insurance Corporation, "Statistics on Depository Institutions," Q1 2015, available at https://www2.fdic.gov/sdi/ (last accessed June 2015).

The Federal Deposit Insurance Corporation, or FDIC, has created a more nuanced definition of a community bank that takes into account its lending and deposit-taking activities and the geographic location of branches. This definition eliminates certain specialty institutions—for example, banks that primarily issue credit cards—and institutions that operate on a more national scale.[4]

Under this definition, the FDIC deemed 93 percent of the nation's approximately 6,400 depository institutions as community banks at the first quarter of 2015.[5] The average community bank has approximately $340 million in assets and operates out of six offices all based in one state and one large metropolitan area.[6]

The unique role community banks play in meeting the credit needs of communities across the country explains why they receive considerable attention from policymakers. Community banks are more likely to be located in nonmetropolitan and rural areas, which are often poorly served by larger institutions; without them, many of these areas would have limited physical access to mainstream financial services.[7] Community banks also tend to generate their profits from core activities of taking deposits and lending, while other banks often generate large portions of their profits from activities such as trading, investment banking, and securitization.[8]

Additionally, community banks tend to focus more heavily on agriculture and small-business lending, likely due to both their locations and their reliance on relationship-based lending, which means they often can use more flexible lending guidelines because they know and better understand their customers.[9]

What are the problems facing small banks?

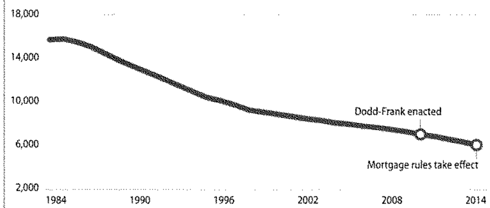
As noted above, the challenges facing community banks are long-standing issues that predate financial reform by decades. As Figure 2 shows, the number of community banks in the United States has declined at a rate of about 300 per year for the past 30 years.[10] This rate has remained essentially unchanged in the years since Congress passed Dodd-Frank.

A primary problem for small banks is that the complexity of today's financial market means size matters. Large banks can benefit from the economies of scale that make certain operations more efficient, while small banks cannot.[11] The Government Accountability Office, or GAO, has concluded that, "larger banks generally are more profitable and efficient than smaller banks, which may reflect increasing returns to scale."[12]

FIGURE 2

Financial reform is not causing the declining number of community banks

Number of U.S. community banks



Source: Federal Deposit Insurance Corporation, "Historical Community Banking Reference Data," available at https://www.fdic.gov/regulations/resources/cbi/data.html (last accessed May 2015).

A 2012 FDIC study of community banks showed that more than 80 percent of the banks that exited the industry between 1984 and 2011 left to become larger banks, either through a merger with an unaffiliated bank or consolidation with another chartered bank within the same organization.[13] Only 17 percent of the banks that left the industry did so because they failed.[14]

One particularly important area in which scale matters is consumer finance. For example, many smaller institutions do not offer credit cards, where the competitive advantage is gained through large-scale investments in mass marketing, data mining, and cybersecurity.[15] Scale also matters for residential mortgage lending, which is increasingly technology driven and difficult for institutions that cannot hold large portfolios of undiversified assets. Despite these challenges, both smaller and larger community banks originate a larger share and number of home purchase mortgages today than they did in 2010.[16]

A related concern for smaller institutions is the fixed cost of general regulatory compliance, which stems from a vast number of regulations, of which the Dodd-Frank Act is just one component. A small bank must use a greater share of resources than a large bank to update its legal disclosures or meet with bank examiners. Small banks, however, benefit from a number of exemptions from the new regulatory changes, as discussed below, and no single change in legal responsibility appears to explain the longstanding decline of these institutions.

Another challenge facing community banks is their location. Community banks are more likely to be located in nonmetropolitan and rural areas, which experience slower population and economic growth than metropolitan areas, and many of these areas suffer from severe disinvestment and underemployment.[17] These factors may limit the prospects of the community banks that serve just these particular areas, driving interest in merging with banks that serve more dynamic locations.

Despite the challenges of scale and location, community banks as a whole have performed remarkably well, even in the years since financial reform. Data from the FDIC indicate that on important measures of performance and financial health—such as return on equity, leverage ratio, percentage of noncurrent assets, and percentage of banks that are unprofitable—community banks have seen significant and consistent improvement over the past five years.[18]

Additionally, the vast majority of community banks are increasing the volume of loans they make—including mortgages—outperforming the industry at large.[19] Data show that community bank earnings have grown considerably in recent quarters, despite the fact that they have had to comply with the new mortgage rules.[20] Research from the Federal Reserve Bank of Kansas City indicates that as the economy recovers and interest rates increase, community banks can expect to become increasingly profitable.[21]

Community banks already enjoy preferential treatment under financial reform rules

Financial reform legislation and the regulations that implement it already consider the unique needs of small, community banks and provide them with a broad number of exemptions and accommodations.

For example, a central component of financial reform was the enhanced supervision of large, complex, and interconnected financial institutions. Yet no institutions identified as community banks by the FDIC are subject to such supervision, and only two community banks out of the approximately 6,000 community banks are subject to the regulator-devised stress tests that monitor a bank's ability to withstand a dramatic change in economic conditions.[22]

Another central component of financial reform was the creation of new rules designed to prevent the risky, unsustainable mortgage lending that was at the center of the financial crisis. Under these rules, banks must underwrite all mortgages using the commonsense principle that consumers must demonstrate an ability to repay the loans.

The mortgage rules—which are implemented by the newly created Consumer Financial Protection Bureau, or CFPB—take into account the unique needs of community banks and their borrowers. Under both statutory direction and its own exemption authority, the CFPB has given these institutions the flexibility that they need to offer high-quality lending that meets the needs of their communities:

- Small banks have greater underwriting flexibility when making Qualified Mortgage, or QM, loans—those that are eligible for the highest level of protection from legal challenges—because if small banks hold the loans on portfolio, they are not bound to the fixed debt-to-income ratio limit that applies to larger lenders.[23]

- Small institutions serving rural or underserved areas can get QM protection for loans that require a balloon payment, although the general QM definition bans balloon loans.[24]

- The CFPB recently proposed expanding the definition of small institutions, as well as the rural definition, so that more banks would qualify for a variety of mortgage rule exemptions, including more flexibility to make QM loans.[25] Under the new definitions, roughly 93 percent of all institutions engaged in mortgage lending would be eligible for these exemptions.[26]

- Small institutions serving rural or underserved areas are exempt from requirements that they maintain escrow accounts for higher-cost loans.[27]

- Small creditors are exempt from most mortgage-servicing rules.[28]

- An array of mission-oriented lenders, such as Community Development Financial Institutions and state housing finance agencies, are fully exempt from the entire CFPB Ability-to-Repay requirement.[29]

Smaller banks and small businesses also receive special treatment in other ways. Small businesses, for example, have the opportunity to submit early rulemaking comments to the CFPB, which is the only financial regulator subject to this requirement.[30] The CFPB has also voluntarily created community bank and credit union advisory councils. These groups' unique perspectives inform the CFPB during rulemaking, supervision, and enforcement. The FDIC and the Federal Reserve Board of Governors have also formed community bank advisory councils since the financial crisis.[31]

In short, while lobbyists for the banking and the mortgage industries look to roll back financial reform by claiming that the rules make it impossible for smaller institutions to compete, it is clear that these community banks already benefit from special treatment across a wide range of rules. Furthermore, given the breadth of the exemptions and leeway they receive, smaller institutions arguably have an advantage in lending compared to larger institutions.

Whom does the Senate Banking Committee reform legislation help?

Although much of the pushback against financial reform is presented in defense of community banks, the legislation recently passed by the U.S. Senate Committee on Banking, Housing and Urban Affairs simply serves to roll back financial reforms, which would enable larger institutions to return to risky practices.

The crowning example of this Trojan horse approach is the provision that would deem almost all loans held in a bank's portfolio as Qualified Mortgages, even if they have risky or predatory features or are only held for a short period of time.[32] Under this new definition, lenders would be shielded from all liability for these mortgages, and they would have no legal responsibility to consider whether these loans are affordable to their borrowers. As noted above, community banks already have access to exemptions that give them more flexibility in making Qualified Mortgages when holding loans in portfolio, so this new exemption would primarily help larger institutions.

The bill would also strip critical protections for buyers of manufactured homes—many of whom are rural, lower income, and/or seniors—by raising the cost threshold for a loan to receive the enhanced protections that Congress put in place for high-cost loans, such as prohibiting balloon payments.[33] As a result, manufactured housing residents would pay much higher interest rates before receiving the same protections that residents of site-built homes enjoy. This provision would also apply to the whole market, not just small, community banks.

Additionally, the Senate bill would impede efforts to monitor and manage systemic risk at large institutions by raising the minimum asset value at which a bank-holding company becomes automatically eligible for enhanced supervision by the Federal Reserve. The minimum asset value would increase from $50 billion to $500 billion, exempting all but the six largest bank-holding companies from requirements that make the U.S. financial system safer.[34]

The bill would also make it harder for regulators to safeguard the financial system by imposing burdensome requirements for regulators to revisit financial protection rules wholesale on a regular basis under the Economic Growth and Regulatory Paperwork Reduction Act, even though the Dodd-Frank rules are brand new. In fact, only 60 percent of the rules under Dodd-Frank have even been finalized.[35] The Senate bill provides financial institutions of all sizes with a path to make routine and repeated challenges to their examinations by regulators.

In short, rather than providing targeted relief for the real problems facing community institutions, these deregulatory proposals would significantly hollow out the reforms put in place after the crisis that protect against risky bank activity and predatory and dangerous loans.

An amendment from the ranking member of the Senate Banking Committee offered a more responsible approach to reform, but it lost on a party-line vote.[36] This amendment focuses exclusively on assisting small institutions in various ways. Although it would raise the small-creditor QM portfolio exemption to institutions with up to $10 billion in assets, banks between $2 billion and $10 billion in assets would have to demonstrate that they have the characteristics and engage in the basic activities of community banks by devoting significant resources to deposit taking and lending and by operating in a limited geography.

Building on that Senate amendment, the Center for American Progress recommends considering other steps to ensure that exemptions are narrowly targeted to benefit institutions that demonstrate a commitment to meeting the credit needs of their communities. For example, there could be requirements related to a bank's Community Reinvestment Act performance or more prescriptive numerical requirements for serving community residents.[37]

Conclusion

In implementing financial reform, legislators and regulators already have recognized the important role that small banks play in communities across the country and the unique needs of these institutions, providing them with exemptions from requirements that apply to their larger counterparts. Legislators should therefore be skeptical of calls for further regulatory relief and should carefully consider the costs and benefits.

To the extent that data suggest specific policy changes that can help community banks address compliance costs without weakening consumer protections or endangering their safety and soundness, policymakers should pursue these reforms in a careful and tailored way. Otherwise, rolling back financial reform and consumer protections in the name of helping small banks could bring back the risky practices and predatory and unsustainable lending that led to the financial crisis and could result in additional taxpayer bailouts in the future.

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Endnotes

1 *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111–203, 111th Cong., 2d sess. (July 21, 2010), available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm.

2 The reduction in numbers—about 300 per year for the past 30 years, see Figure 2—is largely due to consolidation of small institutions rather than institutions literally shutting their doors.

3 *Financial Regulatory Improvement Act of 2015*, S. 1484, 114 Cong. 1 sess. (Government Printing Office, 2015).

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11 Adam Levitin, "Preserving Consumer Choice and Financial Independence," Testimony before the U.S. House of Representatives Committee on Financial Services, March 18, 2015, available at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=398783.

12 Government Accountability Office, "Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings," GAO-12-881, Report to Congressional Requesters, September 2012, available at http://www.gao.gov/assets/650/648210.pdf.

13 Federal Deposit Insurance Corporation, "FDIC Community Banking Study."

14 Ibid.

15 Levitin, "Preserving Consumer Choice and Financial Independence."

16 Center for American Progress analysis of Home Mortgage Disclosure Act, or HMDA, data for owner-occupied, 1–4 unit home purchase mortgages for 2010 and 2013. Community banks are identified using the FDIC's definition; smaller community banks are those with less than $1 billion in assets. See Consumer Financial Protection Bureau, "The Home Mortgage Disclosure Act," available at http://www.consumerfinance.gov/hmda/explore (last accessed May 2015); Federal Deposit Insurance Corporation, "Community Banking Reference Data," available at https://www.fdic.gov/regulations/resources/cbi/data.html (last accessed June 2015).

17 Federal Deposit Insurance Corporation, "FDIC Community Banking Study."

18 Federal Deposit Insurance Corporation, "Quarterly Banking Profile: Community Banking Performance, First Quarter 2015," Table I-B, available at https://www2.fdic.gov/qbp/2014dec/qbpcb.html (last accessed June 2015).

19 Federal Deposit Insurance Corporation, "Quarterly Banking Profile: Community Banking Performance, First Quarter 2015"; Federal Deposit Insurance Corporation, "Quarterly Banking Profile: Community Banking Performance, Fourth Quarter 2014."

20 Ibid.

21 Charles S. Morris and Kristen Regehr, "What Explains Low Net Interest Income at Community Banks?", *Federal Reserve Bank of Kansas City Economic Review* (Q2 2014): 59–87, available at http://www.kc.frb.org/publicat/econrev/pdf/14q2Morris-Regehr.pdf.

22 Center for American Progress analysis of Federal Deposit Insurance Corporation, "Community Banking Reference Data." Enhanced supervision applies to banks with assets totaling more than $50 billion. Banks with assets between $10 billion and $50 billion are also subject to stress tests, though they are less stringent than the stress tests for larger institutions.

23 Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide" (2013), Section 4.3, available at http://files.consumerfinance.gov/f/201308_cfpb_atr-qm-implementation-guide_final.pdf.

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27 Consumer Financial Protection Bureau, "TILA Higher-Priced Mortgage Loans (HPML) Escrow Rule: Small Entity Compliance Guide" (2014), Section 4, available at http://files.consumerfinance.gov/f/201401_cfpb_tila-hpml-escrow_compliance-guide.pdf.

28 Consumer Financial Protection Bureau, "2013 Real Estate Settlement Procedures Act (Regulation X) and Truth In Lending Act (Regulation Z) Mortgage Servicing Final Rules: Small Entity Compliance Guide" (2013), Section 3, available at http://files.consumerfinance.gov/f/201306_cfpb_compliance-guide_2013-mortgage-servicing-rules.pdf.

29 Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide," Section 3.13.

30 5 U.S.C. §§ 603(d), 609(d)(2).

31 Consumer Financial Protection Bureau, "Advisory groups," available at http://www.consumerfinance.gov/advisory-groups/ (last accessed May 2015); Government Accountability Office, "Community Banks and Credit Unions."

32 *Financial Regulatory Improvement Act of 2015*. See also Letter from Julia Gordon to Chairman Richard Shelby and Ranking Member Sherrod Brown, May 20, 2015, available at https://cdn.americanprogress.org/wp-content/uploads/2015/05/FRIA.pdf.

33 Ibid.

34 Ibid.

35 DavisPolk, "Dodd-Frank Progress Report: First Quarter 2015" (2015), available at http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

36 U.S. Senate Committee on Banking, Housing and Urban Affairs, "Democrats Urge Targeted Relief for Community Lenders, Stronger Consumer Protections," Press release, May 21, 2015, available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.MinorityNews&ContentRecord_id=a9ead66b-f70a-adc4-e87a-b168140890b8&Region_id=&Issue_id.

37 *Community Reinvestment Act*, Public Law 95-128, 95th Cong., 1st sess. (October 12, 1977).

AUMUA AMATA COLEMAN RADEWAGEN
American Samoa

COMMITTEE ON SMALL BUSINESS
Chairman
Subcommittee on
Health and Technology
Subcommittee on
Economic Growth, Tax and Capital Access

Congress of the United States
House of Representatives
Washington, DC 20515–5200

COMMITTEE ON NATURAL RESOURCES
Vice-Chairman
Subcommittee on
Indian, Insular, and Alaska Native Affairs
Subcommittee on
Oversight and Investigation

COMMITTEE ON VETERANS' AFFAIRS
Subcommittee on Economic Opportunity

September 24, 2015

Mr. Doyle Mitchell, Jr.
President/CEO
Industrial Bank
Washington D.C.

Dear Mr. Mitchell,

Can you discuss how credit risk works for community banks? Can you name any other factors that may prevent the existence and start-up of community banks? I ask because there is not one community bank in my district, American Samoa, and instead my people rely on banks such as the Bank of Hawaii, who has had operational challenges in the past due to my district's geographical isolation. The Bank of Hawaii actually closed their branches in American Samoa two years ago only to be forced to reopen by law. The only other bank in American Samoa is far from a community bank and that is the ANZ Bank from Australia. So the restrictions contained in Dodd-Frank are quite alarming to me because they are just more hurdles my district must jump in order to create a sovereign community bank.

Sincerely,

Aumua Amata

Aumua Amata Coleman Radewagen
Member of Congress

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INDUSTRIAL BANK
Getting Things Done.
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B. Doyle Mitchell, Jr.
President and CEO

October 8, 2015

Del. Auma Amata Coleman Radewagen
Member of Congress
1339 Longworth House Office Building
Washington, D.C. 20515

Dear Del. Radewagen:

Thank you for your inquiry regarding the challenges community banks face in today's regulatory environment. The nation's 6,000 community banks are committed to investing in their local communities through loans to families and small businesses. Unfortunately, the regulatory environment can present challenges that inhibit the ability of community banks to meet the credit needs of their customers. The Independent Community Bankers of America is committed to reducing the regulatory burden faced by community banks in order to allow them to better serve their customers and communities.

Community banks rely on a number of factors to determine a borrower's credit risk. In addition to analyzing a customer's financial condition including repayment ability, source and value of collateral (if applicable) community banks will often consider factors like family history and discretionary spending in making lending decision. A community banks willingness to consider these other factors and willingness to create customized products is one of its unique characteristics and a reason why they are so vital to their communities.

Unfortunately, there are 1,342 less community banks in the country today since 2010. The number of banks with assets below $100 million shrunk by 32 percent, while the number of banks with assets between $100 million and $1 billion fell by 11 percent.[1] A financial landscape with fewer but larger banks will reduce access to credit for small businesses and consumers. Much of this decline can be attributed to the burden posed by added rules and regulations over the last several years. Many community banks do not have the scale to absorb rising compliance costs.

In addition to leading the fight on Capitol Hill to reduce the regulatory burden for community banks, the Independent Community Bankers of America has been working with bank regulators to find ways to lower the barriers to new bank entry. According to the FDIC, only three new banks have been chartered in the U.S. since 2010. Comparatively, in the years before the financial crisis, approximately 100 new community banks were started each year in the U.S. Even in the depths of the savings and loan crisis in the 1980s when 1,800 savings and bank institutions failed an average of 196 de novo banks and savings institutions were formed from 1984 through 1992[2].

According to the FDIC's Community Banking Study (December 2012), community banks hold a majority of banking deposits outside of large cities. For the residents of six hundred rural or micropolitan counties,

[1] Parsons, Richard J. Bank Think. American Banker, Feb. 16, 2015.
[2] Federal Deposit Insurance Corporation data

community banks are the only banks that serve them. Although, as of 2011, they held only 14% of banking industry assets, community banks held 46% of the industry's small loans to farms and businesses.

Certainly, the Great Recession is a factor in community leaders' decisions whether to form a de novo bank. In addition, the business of community banking has become progressively more difficult, with narrowing net interest margins, asset quality issues and substantial compliance costs. The burdens on bank directors and management have increased substantially over a number of years, and there is no end in sight.

In 2009 the FDIC revised the rules governing de novo banks, effectively making it harder for a new bank to be formed. Amongst the new rules, the FDIC required the applicant raise capital prior to opening that would be sufficient to maintain its leverage ratio at a minimum of 8% for seven years based on the applicant's pro forma financial statements.

For example, if an applicant projected its assets to be at $100 million in three years, that would require upfront capital of $8 million plus some extra to cover initial losses that are common among de novo banks. But if the applicant is required to project over seven years, the assets at the end of year seven could be $300 million or more. That would require $24 million in upfront capital, an amount that is beyond the reach of many in communities where it is virtually impossible to attract capital from outside sources. In addition, such an investment would be highly unattractive to investors given the low return on equity that would be available to the bank for many years.

Fortunately, the FDIC produced new guidance in November 2014 that aimed to make it more attractive for investors to form new banks. In its new guidance, the FDIC clarified that the 8% minimum leverage ratio is in effect for only the first three years, rather than a full seven years.

While the FDIC's guidance will help improve the environment for de novo bank applications, more must be done. Congress and the federal bank regulators must do more to reduce the burdensome regulatory environment in order to promote an environment where community banks can flourish. The Federal Reserve's low interest rate policy has compressed net interest margins and must be reversed to improve community bank profitability. These changes, along with a stronger economy will help improve the climate for new bank formation in the U.S.

Please do not hesitate to contact me if you have questions. I can be reached at 202.722.2014.

Sincerely,

B. Doyle Mitchell Jr.
President and CEO
Industrial Bank

Luxton Corp
DBA Payne's Check Cashing
727 North Main Street
Culpeper, VA 22701

May 12, 2015

Via email: cfpb_payday_sbrefa@cfpb.gov

Small Business Advisory Review Panel Members
On Potential Rulemakings for Payday, Vehicle, Title,
And Similar Loans
c/o Consumer Financial Protection Bureau
1700 G Street, N.W.
Washington, DC 20552-0003

Re: Written Comments of Small Entity Representative Brandon Payne

Dear Members of the Small Business Advisory Review Panel:

I am Manager of Payne's Check Cashing in Culpeper, Virginia. After attending Virginia Tech and serving six years in the Navy, I returned to Culpeper to work for my Dad. He is an entrepreneur who has created multiple companies in his adult life and started Payne's Check Cashing 15 years ago. I run day-to-day operations for our three storefront locations in Virginia, one in Culpeper and two in Charlottesville. We offer payday loans, title loans, check cashing, money orders and bill payment services. We have 13 employees covered by a group health care plan in which our company pays 50% of the premium cost. Two of our senior managers started out as clerks. We value our employees and endeavor to provide them with quality training and opportunities for growth. All of us know our customers well and we are part of the communities we serve. We are regulated by the Virginia Bureau of Financial Institutions. We have separate licenses for payday lending and title lending and each license type is examined every 12 to 18 months.

My Overall Comments on the CFPB Proposals and SBREFA Panel Proceedings

I was both surprised and pleased to receive the call from CFPB, interviewing me as a candidate to serve as a Small Entity Representative for our industry's SBREFA Panel. I very much appreciated the opportunity that was extended to me—to help represent the voice of small businesses in this extremely important rulemaking process.

I did not know what to expect in the Panel proceeding. As an operator of only three stores in one state, I did not have the resources of outside counsel to interpret for me the complexities of the

CFPB's Outline of Proposals. Although I studied them often and intently during the short period of time between their release and the Panel meeting, I was not—and still am not—equipped to understand them completely or to calculate their cumulative financial impact on my business.

During the Panel discussions, I learned that I was not alone. In fact, most of the SERs felt as I do, that the CFPB did not provide us with data that specifically measures the proposal's impact on small businesses. Operating in the state of Virginia, which has one of the most complicated state regulatory frameworks for payday lending in the country, I also think the Bureau had a duty to analyze the negative impact of state laws that have imposed severe restrictions to address borrower use and frequency. Even though these state laws are generally less restrictive than the Bureau's proposals appear to be, I would think that a careful analysis comparing the state models to the CFPB proposals would provide a valuable tool for determining the impact of the proposals. Additionally, I neither saw in the CFPB proposals, nor heard in the Panel meeting, any evidence to show that the Bureau had examined whether or not the state laws and CFPB proposals could work together. Finally, I was struck by the absence of information in two areas that I thought the Dodd-Frank Act specifically required the CFPB to consider: (1) consideration of the adverse impacts of the proposals on consumers in rural and underserved communities; and (2) negative impacts to the cost and availability of credit to small businesses.

I came away from the Panel meeting with more questions than answers. As a result, I strongly recommend that the CFPB provide me and the other small businesses with the information we need to adequately understand the complexities and costs of the proposals so that we can provide informed feedback. I urge the Bureau to seriously consider the concerns raised by the SERs in the Panel meeting and provide a more data-driven analysis and proposal for us to review and provide comments.

Specific Concerns with the CFPB Proposal

Complexity and Costs

The complexities of this proposal are far beyond what I've experienced in my state—and Virginia has one of the most, if not the most, complex regulations in the country. Implementation of the current Virginia law took effect in 2009 and hit our family-owned business hard. At the time, we had 5 storefront locations in rural areas and had plans to expand into more rural locations. That did not happen after the law was passed.

While there may have been good intentions behind the law, many of the changes had adverse effects on both lenders and borrowers. Most small lenders went out of business. Our company was forced to close two stores, which were located in rural areas where customers have few options for the loans they need. In fact, since we closed our stores, not one loan company has moved into either community to fill the credit void.

The financial impact was harsh, the human toll was painful. We had to lay off employees who had good benefits and a number of them were women who were sole providers for their families. The happy customers we were in business to serve were no longer happy. The credit product they knew in the past became almost impossible to use. Customers were upset and our managers were in tears because the changes were as hard to explain as they were to understand. In my reading of the CFPB proposals, I find that they are so difficult for ME to understand that I cannot imagine how we would explain them to our customers. Based on what I can understand of the restrictions the CFPB is proposing, the impact on our company and our customers will be that there will be no options left in our communities for short-term credit.

In the absence of adequate small business impact data provided by the Bureau, I cannot begin to quantify the total cost of what the CFPB measures would be. I can provide cost examples from our Virginia experience. However, based on my reading of the CFPB proposal and my knowledge of the Virginia law, the costs of complying with the CFPB proposal would be at least as severe as the changes to our state law.

One such example is software costs. Based on my experience in Virginia, the CFPB's estimates of software conversion costs to implement its proposals grossly understate the true costs. When the new Virginia law was implemented in 2009, our company went through 5 different software companies over the span of 4 years before finding one that could comply with the new regulations. The attached chart (Attachment I) details our software conversion cost. However, this cost does not include our having to run multiple software platforms simultaneously at times, just to handle the number of regulatory changes. Nor does it include computer hardware costs, the costs of increased payroll and training, customer wait time and various related cost factors. And based on our experience, we will not know what the real costs will be until we get into the process of making the changes and sourcing the vendors.

Another example is training costs, which are directly proportional to the complexity of the transaction. Attachment II shows actual training costs for a new hire in our company for the period before implementation of the complex Virginia law in 2009 and the period following implementation to present. Additionally, we have made a good faith estimate of what those same costs might be under the CFPB proposals—as we understand them. As you can see, the cost for our company to train a newly hired employee increased 163.4% when the 2009 state law became effective. Our estimated cost for the same level of training under the CFPB proposals represents a 108% increase over current costs. With these estimated figures for the CFPB proposals, our training cost for one new employee would be more than five times higher than it was in 2008. And these costs do not even include the re-training of existing employees.

These are but two examples of how costly the CFPB regulatory requirements would be on small businesses, based on our experience in Virginia. It is important to note that these are fixed expenses that do not vary with loan volume. Since the cost of a loan in Virginia is a fixed fee, there is no way for a small business to recover any of the increase in fixed expenses. The only lenders that seem to be surviving in Virginia are the largest lenders who can make up these fixed costs with loan volume. Small lenders like my business were clearly hit the hardest.

In addition to these hard costs, the complexity of the transaction under the CFPB's proposal would lengthen customer wait times and increase their frustration with the product. Our employees and customers would relive the Virginia experience all over again—but at an exponentially higher level.

Financially, we would not be able to remain in business, once all remaining costs of the CFPB proposals are considered.

Finally, I cannot see how the complexities of our Virginia state law and those in the CFPB proposal could possibly work together. Here's just one example. Virginia's law mandates that the borrower's minimum loan term is determined by pay frequency: minimum 14 day loans for consumers who are paid weekly; 28 days for bi-weekly; 31 days for semi-monthly; and 62 days for monthly. Under the CFPB proposal, weekly, bi-weekly and semi-monthly paid customers in Virginia would fall under the short-term covered loan rules. Monthly paid customers fall under long-term covered rules—but because they have a balloon payment (single pay loan), they would fall back under short-term covered loan rules if you use the ability to repay (ATR) method. If I'd like to use the alternative method, I'd have to go back to the long-term covered loan alternatives. But the NCUA method will clearly not be profitable, due to the 28% APR cap. The 5% PTI would not be profitable either, as the 5% is far too low. This means the only option a monthly paid customer in Virginia would have is the ATR method. If you, the Panel members, are confused by reading this, imagine how confused I am—and how utterly confusing it would be to explain all this to my customers. I am concerned and bewildered by the fact that CFPB has not taken the time or the trouble to look at these kinds of conflicts with state laws.

Impact on Rural and Underserved Communities
We live in a small town and are often stopped by our customers in public places and thanked for being here to help them out. The large majority of our customers are extremely pleased with our products and service. We know our customers by face and name and have a great working relationship with them.

Our family business always has been, and will continue to be, a proud sponsor of local businesses and charities in our communities. We've been a five-year sponsor of the Scott M. Fisher Foundation Fund for suicide prevention, as well as an on-going supporter of the local Volunteer Fire Department, and The Free Clinic of Culpeper, to name a few.

We have the support of our communities and I am greatly concerned that the CFPB proposals will have a severe ripple effect throughout our small towns—negatively impacting our company, our customers and our communities. Not only will our customers be left without suitable credit options, our employees will lose good-paying jobs with benefits in communities where there are few employment opportunities. And the towns' businesses, which depend on the purchase of goods and services by our company, employees and customers, will greatly suffer.

Impact of the Cost and Availability of Credit to Small Businesses
With no data on which to support its hypothesis, the Bureau believes there are very few small businesses that depend on short-term loans to fund their business. That is simply not true—and the negative consequences to these local businesses will be dire.

We have a number of small business customers who use our vehicle title loans as a source of funds for their businesses.

I've got a homebuilder, for example, who says he does not have time to jump through the hoops and fill out all the documentation to get a bank loan—even if he could qualify. He uses our loans as a cash flow tool. He understands the cost of our loans, only borrows the amount he needs (versus a larger bank loan) and knows exactly when he can pay us back.

Another customer owns a janitorial service and has taken out title loans to cover employee payroll while he waits to be paid for completed jobs.

These are just two illustrations of the importance of our service to these vital service-providers in our communities.

Closing Thoughts
Again, I am most appreciative of being able to participate in this process. My overall concern, however, is that we SERs did not have the benefit of appropriate information from the CFPB upon which we could have given more substantive feedback. My earnest request is that the CFPB conduct the research required in order to answer our questions, address our issues and produce an alternative set of proposals that take that information into account.

Sincerely,

Brandon Payne

Brandon Payne

Attachments

Attachment I

Software Costs

Software	Initial Purchase Cost	Maintenance fee/Year (#of Stores)	Years Used	Total Costs
BEST Inc	Purchased prior to 2009	$1000/Store (5 for 1yr) $1000/Store (3 for 3yrs)	4	$14,000.00
BetaCom	$7,000.00	None	1	$7,000.00
MasterTechSoft (assisted with Development)	$5,000.00	None	2	$5,000.00
Ksoft	$15,000.00	$300/Store (3)	3	$17,700.00
Cashwise	$17,000.00	$3140.00/Store (3)	2	$26,420.00

Attachment II

New Hire Training Hours and Costs

Short Term and Long Term Loans with Balloon Payments

Original Virginia Payday Loan Laws (2002-2008)		Post Virginia Law Change (2009-Present)		Estimates With CFPB Proposal	
Training Topic	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**
Underwriting Documents	4 hours 2 hours/Trainer 2 hours/ Trainee	Underwriting Documents	8 hours 4 hours/Trainer 4 hours/ Trainee	Underwriting Documents	16 hours 8 hours/Trainer 8 hours/ Trainee
• Documents required for loan application		• Documents required for loan application		• Documents required for loan application	
Training Topic	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**
Underwriting Loan	20 hours 10 hours/Trainer 10 hours/ Trainee	Underwriting Loan	42 hours 21 hours/Trainer 21 hours/ Trainee	Underwriting Loan	84 hours 42 hours/Trainer 42 hours/ Trainee
• Qualifying for loan • Understanding documents provided		• Qualifying for loan • Understanding documents provided		• Qualifying for loan • Understanding documents provided	
Training Topic	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**
Software and Reporting Systems	60 hours 30 hours/Trainer 30 hours/ Trainee	Software and Reporting Systems	120 hours 60 hours/Trainer 60 hours/ Trainee	Software and Reporting Systems	180 hours 90 hours/Trainer 90 hours/ Trainee
• Company Software • 3rd Party Reporting Systems		• Company Software • State Mandated Reporting System		• Company Software • State Mandated Reporting System • Bureau Mandated Reporting System	
Training Topic	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**	**Training Topic**	**Hours/Trainer & Trainee**
Compliance & Regulatory Training	32 hours 16 hours/Trainer 16 hours/ Trainee	Compliance & Regulatory Training	80 hours 40 hours/Trainer 40 hours/ Trainee	Compliance & Regulatory Training	160 hours 80 hours/Trainer 80 hours/ Trainee
• Loan Terms and conditions		• Loan Terms and conditions		• Loan Terms and conditions	
Total Hours: 58 hours (8 Days)		**Total Hours: 125 hours (16 Days)**		**Total Hours: 220 hours (28 days)**	
Total Training Costs: $1044.00 Trainer: $10.00/hour X 58 hours = $580.00 Trainee: $8.00/hour X 58 hours= $464.00		**Total Training Costs: $2750.00** Trainer: $12.00/hour X 125 hours = $1500.00 Trainee: $10.00/hour X 125 hours= $1250.00		**Total Training Costs: $5720.00**** Trainer: $15.00/hour X 220 hours = $3300.00 Trainee: $11.00/hour X 220 hours= $2420.00	

**** Also with the new CFPB proposal all current employees would need training on the new regulations. We estimate that it would take 91 hours (12 days). With an average salary of $15.00/employee and 12 employees, this would cost $16,380.00 ($1365.00/employee), not including the cost of the person conducting training. ****

Luxton Corp
DBA Payne's Check Cashing
727 North Main Street
Culpeper, VA 22701

September 16, 2015

The Honorable Tom Rice, Chairman
Committee on Small Business
Subcommittee on Economic Growth, Tax, and Capital Access
U.S. House of Representatives
Washington, DC 20515

The Honorable Dave Brat
Representative for the 7th District of Virginia
U.S. House of Representatives
Washington, DC 20515

Chairman Rice and Congressman Brat,

I manage a small, family owned business based in Culpeper, Virginia, where our business Payne's Check Cashing offers payday loans, title loans, check cashing, money orders, and bill payments services. In addition to running a small business, many of our customers are small businesses that use our vehicle title loans as a source of capital. I compliment the Subcommittee for holding a hearing this week on how Dodd-Frank is impacting small financial institutions.

I am writing to you so that I can tell you the story of my interaction with the Consumer Financial Protection Bureau (CFPB). Through my story, I am hopeful that the Small Business Committee will help ensure that the CFPB is responsive to small business concerns.

The Dodd-Frank Act requires the CFPB to consider the views of small businesses like ours prior to moving forward with regulation. Last spring the CFPB began considering regulations to regulate our business, and I became involved with the small business stakeholder process that is run by CFPB and is governed by the Small Business Regulatory Enforcement Fairness Act (SBREFA). While the "Report of the Small Business Review Panel" was completed in July 2015, the CFPB keeps the report secret until the bureau issues a proposed rule. Since the report is already finalized, I believe it is entirely appropriate for me to share my experience and to forward you the comments I provided the CFPB (see attached).

From the start of the SBREFA process, my fellow small business owners who served on the Small Business Review Panel and I tried to impress upon the CFPB that each of our businesses are regulated by the states in which we operate. We were frustrated that the Bureau apparently lacked an understanding of how state regulatory authorities, like the Virginia Bureau of Financial Institutions, work with us to protect consumers. It was even more frustrating that CFPB officials could not identify failings in the state regulatory framework that would prompt a federal overlay of new regulatory obligations.

I was also frustrated by the lack of appreciation the CFPB seemed to have for our customers and the relationship we have with them, which is the foundation for our business. When customers come to us in Culpeper, Madison, and Charlottesville, it is often because there is no other place for them to go. Many of our customers come to us after banks and credit unions have turned them down. The CFPB, in its proposal released in March, incorrectly assumes that if our stores close, our customers would simply go somewhere else for credit. That is not the case. I worry that the CFPB does not understand, and if they move forward with their rulemaking, our customers will fall victim to unregulated and unlicensed lenders and inferior forms of credit.

I spent a great deal of time trying to help people at the CFPB understand how we run our business and the novelty of relationship-based lending. In my education effort, I tried to make sure the CFPB had a greater appreciation of our customers and their financial needs. While I was honored to be part of the SBREFA process, the effort will only be worth it if the CFPB truly listened to small businesses, and if the CFPB incorporates our suggestions into its proposed regulations.

I appreciate your attention to these issues, and I ask that you make sure the CFPB proceeds in a way that bolsters my ability to provide needed short-term loans for my customers.

Sincerely,

Brandon Payne

Attachment (1)
Written Comments of Small Entity Representative Brandon Payne