Testimony of

Jeff Plagge

On behalf of the

American Bankers Association

before the

Committee on Banking, Housing, and Urban Affairs

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September 16, 2014

Chairman Johnson, Ranking Member Crapo, and members of the Committee, my name is Jeff Plagge. I am president and CEO of Northwest Financial Corp of Arnolds Park, Iowa, and Chairman of the American Bankers Association. Northwest Financial Corp is a privately owned, two bank holding company with approximately $1.6 billion in assets. One of our banks is a $230 million rural community bank and the other one is a $1.4 billion bank with rural and metro branches. Overall, we are true community bank organization with 27 branches, serving communities throughout Western Iowa and Omaha, Nebraska.

I appreciate the opportunity to be here to represent the ABA and discuss the state of community banking. The ABA is the voice of the nation's $15 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $11 trillion in deposits and extend over $8 trillion in loans. Our median member has just $190 million in assets and over 85 percent of our members hold under $1 billion in assets.

The state of our community banks is strong, but the challenges we face are enormous. As I travel the country in my role as Chairman of the ABA, I am constantly impressed by how resilient community bankers are and how dedicated they are to serving their communities. Like all small businesses, they have suffered through the great recession. Every day these banks work to meet the needs of their customers, but their ability to do so has been made much more difficult by the avalanche of new rules and regulations. For example, banks have had to deal with 8,040 pages of final rules from the Dodd-Frank Act alone, with an additional 6,112 pages of proposed rules. This is

an enormous challenge for any bank, but is nearly impossible for community banks, which typically employ fewer than 40 employees.

The impact goes beyond just dealing with new compliance obligations—it means fewer products are offered to customers. For example 58 percent of banks have held off or canceled the launch of new products—designed to meet consumer demand—due to expected increases in regulatory costs or risks. Additionally, 44 percent of banks have been forced to reduce existing consumer products or services due to compliance or regulatory burden. This means less credit in our communities. Less credit means fewer jobs, lower income for workers, and less economic growth.

If left unchecked, the weight of this cumulative burden could threaten the model of community banking that is so important to strong communities, strong job growth and a better standard of living. It is already having an impact. The sad fact is that over the course of the last decade, over 1,500 community banks have disappeared. Today, it is not unusual to hear bankers—from strong, healthy banks—say they are ready to sell because the regulatory burden has become too much to manage. These are good banks that for decades have been contributing to the economic growth and vitality of their towns but whose ability to continue to do so is being undermined by excessive regulation and government micro-management. Each bank that disappears from the community makes for fewer opportunities in that community.

The key to changing this trend is stop treating all banks as if they were the largest and most complex institutions. Financial regulation and examination should not be one-size-fits-all. All too often, regulation intended for the largest institutions become the standard that is applied to every bank. Such an approach only layers on unnecessary requirements that add little to improve safety and soundness, but add much to the cost of providing services—a cost which customers ultimately bear. Instead, the ABA has urged for years that a better approach to regulation is to take into account the charter, business model, and scope of each bank's operations. Regulators challenge community banks to consider Enterprise Risk Management assessments and programs to better identify and manage our risk. This same model should be used by Regulators to assign risk categories to banks and then to regulate accordingly. This would ensure that regulations and the exam process add value for banks of all sizes and types.

The time to address these issues is now before it becomes impossible to reverse the negative impacts. ABA believes that the regulators can take action under their own authority, without any new laws, to help community banks. There are also actions that Congress can take. We are appreciative of the efforts of many on this committee for introducing bills that can make a difference, including Senators Brown, Toomey, Manchin, Warner, Moran, and Tester (S. 635, S. 727, S.1349, S. 1916, and S. 2698). While no single piece of legislation can relieve the burden that community banks face, many of these bills could begin to provide much needed relief. We urge Congress to work together—House and Senate—to get legislation passed and sent to the President that will help community bankers better serve our customers.

In my testimony today I would like to make the following four points:

- Community banks face an avalanche of regulation that limits their ability to serve their communities;
- Regulation cannot be "one size fits all," and must be tailored to fit a bank's individual model;
- Congress should act to enact key bills that will provide relief for community banking; and
- More can and must be done to address tax-favored competitors and liquidity access for community banks.

I. Community Banks Face an Avalanche of Regulation that Limits Their Ability to Serve Their Communities

Community banks, as do all banks, work hard every day to meet the credit and financial needs of their customers and communities. Community banks have a presence much greater than their total assets suggests. According to the FDIC, community banks accounted for just 14 percent of the U.S. banking assets in our nation, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions.[1] In 629 U.S. counties—almost one-fifth of all U.S. counties—the only banking offices are operated by

[1] FDIC Community Banking Study - https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf

community banks. Without community banks, many rural areas, small towns, and urban neighborhoods would have little or no physical access to mainstream banking services

The ability to meet local needs has not been easy with the increased regulatory costs and the staff workload from new the regulatory requirements. During the last decade, the regulatory burden for community banks has multiplied tenfold and it is no surprise that ***nearly one of every 5 community banks disappeared*** in that period.

Unfortunately, the cumulative impact of years of new regulations and the proliferation of non-bank, non-taxed, and subsidized competitors (such as credit unions and the Farm Credit System) are combining into a potent mixture that will surely, if left unchecked, lead to more and more consolidation of small banks and represents a systemic risk to the community bank model.

Make no mistake about it, this burden is keenly felt by all banks, but particularly small banks that do not have as many resources to manage all the new regulations and the changes in existing ones. Besides the real hard dollar costs, there are important opportunity costs related to the products and services that cannot be offered or offered only at higher costs to our customers. In dramatic illustration of this point, a 2011 ABA survey of bank compliance officers found that compliance burdens have caused almost 45 percent of the banks to stop offering loan or deposit accounts. In addition, almost 43 percent of the banks decided to ***not*** launch a new product, delivery channel or enter a geographic market because of the expected compliance cost or risk.

Furthermore, research by the Federal Reserve over the years has confirmed that the burden of regulations falls disproportionately on smaller banks. The Federal Reserve Bank of Minneapolis has estimated that hiring one additional employee to respond to the increased regulatory requirements would reduce the return on assets by 23 basis points for the median bank with total assets of $50 million or less. To put this estimate in perspective, such a decline could cause about 13 percent of the banks of that size to go from being profitable to unprofitable.

At my institution, we have always had a good relationship with our regulators, making sure they know and understand what we do and how we do it. We proactively reach out to our regulators to discuss the implementation of new regulations so we increase our chances of getting it right the first time. But to illustrate the cumulative impact that excessive oversight can have on a community bank, consider what our two bank, privately owned holding company has had to deal with. ***In the last 12 months alone, we have had a dozen separate exams***:

1. Full safety & soundness and compliance OCC exam at First National Bank of Creston (FNBC)
2. Full OCC IT Exam at FNBC
3. Full FDIC Compliance exam at Northwest Bank (NWB)
4. Full State & FDIC Safety & Soundness exam at Northwest Bank
5. Third-party loan review at both banks
6. Third-party intrusion exam at our IT center
7. Third-party compliance reviews
8. FDICIA testing
9. FDICIA Audit
10. Full Financial Audit
11. FDIC HMDA exam at NWB
12. Offsite Federal Reserve exam (holding company) of all of our ongoing internal compliance, FDICIA and Audit reviews and processes

All of the above (external only and does not include our internal audit and compliance reviews) turned into approximately 125 pages of requests with 967 direct questions and/or copies of documents. The 967 direct questions and requests for copies of documents do not include the sub-items under those 967 items and direct questions. To be clear, these are not "yes/no" questions. These are requests for piles and piles of paper or electronic filings. The list of requests with all of the sub-requests under the core questions probably doubles the number of direct items I have already listed.

Our employees and our third party consultants have over 1,000 hours of work on Financial Deposit Insurance Corporation Improvement Act (FDICIA) requirements alone during this 12 month period of time. These FDICIA requirements are in place because we are over $1 billion in assets. All of this adds up to an enormous expense but my bigger concern is the burden it puts on my staff and ultimately our customers. As a $1.6 billion bank, we are better able to spread out some of the compliance costs than our smaller brethren. For the median-sized bank in this country with $174 million in assets and 41 employees, the burden is magnified tremendously. As I have traveled

the country and spoken with bankers, I have been shocked to learn the challenges they face. Here are a few stories I have heard and some results from our surveys:

- A $70 million bank in Kansas has dedicated 3.5 of 25 full-time employees to compliance-related tasks. This means 15 percent of the bank's employees focus solely on regulatory compliance.
- A Texas community bank originated over 1,200 mortgages with a total mortgage staff of 18. In 2012, that same bank originated just over 1,000 loans with a mortgage staff of 25—due entirely to increased compliance burden.
- 18 percent of banks subject to the remittance rule plan to stop offering remittance services altogether, while 42 percent plan on increasing fees to cover additional compliance costs.
- Of community banks, 6 percent report having discontinued residential lending following DFA, with an additional 9 percent anticipating exiting the mortgage business. This does not include an even higher percentage of banks that now limit their mortgage activities to QM mortgages only, due to the ongoing liability and legal risks of making non-QM loans.

Ultimately, this excessive burden leaves banks less able to meet the needs of their communities and support growth on main streets across America. Every dollar spent on compliance is a dollar that cannot be lent. This means less credit in our communities to support economic growth, job creation and income growth.

II. Regulation Cannot be "One Size Fits All," and Must be Tailored to Fit a Bank's Individual Model

Time and again, I hear from bankers wondering why the complex set of rules, reporting requirements, and testing that are imposed upon the largest most diverse and global institutions become the standard applied to the smaller community banks in the country. The approach seems to be: "If it's the "best practice" for the biggest banks it must be the best practice for all banks." Such an approach makes no sense in our diverse banking system with different business models and strategies.

Of course, the supervisory process should assure risk is identified and managed prudently, that bank officials and directors are aware of and understand risk, and that sufficient capital and reserves are available to absorb losses. This risk assessment must be appropriate to the type of institution. In

the aftermath of the financial crisis, the pendulum of bank examination has swung to the extreme—affecting every sized bank. Overbroad, complicated restrictions supplant prudent oversight. Inconsistent examinations hinder lending, increase costs, and create procedural roadblocks that undermine the development of new products and services to bank customers.

The banking agencies should move towards customized examinations that consider the nature of a bank's business model, charter type, and perhaps most important, bank management's success at managing credits, including a borrower's character, prior repayment history and strength of personal guarantees. Regulators' traditional focus on a bank's asset size is misplaced. In today's complex banking environment, an array of risk factors have a far greater impact on a banks' ability to serve its customers—as well as its likelihood to get in trouble—than asset size.

In this regard, examiners should give credit to well-run banks that know their customers and local communities, and have far more experience in identifying which borrowers are creditworthy and which are not, than examiners themselves, especially if examiners are new to a region. This one-on-one relationship banking model is at the core and culture of community banking. If everything is going to be forced into a standard regulatory box or run through automated credit approval models, then we might as well accept the fact that community bank consolidation will accelerate. One-size-fits-all judgments about such standards as to whether and how much to reserve against loans, especially when driven solely by numerical analysis, effectively take away bankers' autonomy and the value of their judgment in contributing to the best allocation of capital to enhance growth.

Banks, like other private enterprises, should be allowed and encouraged to run their businesses to meet the needs of their community, their customers and their business model, provided they have sufficient capital and reserves to absorb losses and have demonstrated a record of good management. Auditors consider the myriad of differences among their clients when making a determination of performance; bank examinations should not be any different.

To be fair, the regulators have made improvements and they have their own challenges in meeting all of the new requirements associated with Dodd-Frank and other new regulations. The introduction of the Financial Institutions Examination Accountability Act (H.R. 1553) was instrumental in facilitating the current regulatory changes. But more can be done. The starting place for that is for Congress to enact legislation that creates a balanced and transparent approach to bank examinations and establishes a way for banks to appeal those examination decisions without fear of

retaliation. Everyone involved in this process has a vested interest in making the process more efficient and more effective.

The Financial Institutions Examination Fairness and Reform Act (S.727) introduced by Senators Moran (R-KS) and Manchin (D-WV) is an excellent starting point. Although no single piece of legislation could remedy all concerns about the current supervisory environment, the following provisions are critical to improving the examination process:

- **Require timely exam reports** by the regulators (including the CFPB) and more information about the facts upon which the agency relied in making examination decisions.
- **Ensure consistent treatment and clarity** regarding how the regulatory agencies and their examiners treat loans with respect to nonaccrual, appraisal, classification, and capital issues.
- **Create an interagency examination ombudsman** within the Federal Financial Institutions Examination Council (FFIEC) to ensure the consistency and quality of all examinations, which create an avenue of accountability to assure that the examination process is applied in a manner appropriate to the charter, business model, and size and scale of each bank's operations, rather than in a one-size-fits-all way. The Ombudsman should have clear authority to take corrective action to remedy examination errors. Moreover, the Ombudsman can conduct confidential outreach to measure whether actions to address community bank concerns are actually achieving their intent.
- **Provide for expedited appeals of examinations without fear of reprisals.**
- **Prohibit any Regulatory Retaliation** against the bank, their service providers, and any institution-affiliated party as defined in the Federal Deposit Insurance Act. An agency cannot delay or deny action that would benefit a bank or institution-affiliated party that is appealing an agency decision.

III. Congress Should Act to Enact Key Bills that Will Provide Relief for Community Banking

ABA applauds members of this committee for taking the issue of regulatory burden seriously and holding hearings such as todays. Members on and off of this committee have also introduced a number of bills to address specific issues and address the problem. I have already touched on the

Financial Institutions Examination Fairness and Reform Act (S.727) introduced in this committee, which would help reform the financial services examination process. We would like to thank Senators Brown, King, Manchin, McConnell, Moran, Toomey, Tester and Warner for introducing some of the legislation we will discuss below.

➢S. 1349 – Community Lending Enhancement and Regulatory Relief Act

The Community Lending Enhancement and Regulatory Relief Act would reduce the number of notice requirements banks have to send, prompt the SEC to conduct a cost-benefit analysis of any new accounting principle, limit attestation requirements for small banks, and expand the QM safe harbor.

➢S. 2698 – RELIEVE Act

The RELIEVE Act contains helpful provisions that ABA supports to ease regulatory burdens. It would help small bank and thrift holding companies raise more capital by raising the threshold for the Federal Reserve's Small Bank Holding Company Policy Statement from $500 million to small bank and savings and loan holding companies with less than $1 billion in consolidated assets. Additionally, it would increase the availability of credit in rural communities by defining "rural" more broadly for purposes of the qualified mortgage rules and increase the annual mortgage origination limit from 500 to 1,000 per year.

➢S. 635 – Privacy Notice Modernization Act

The Privacy Notice Modernization Act would eliminate redundant mailings of annual privacy notices when a financial institution's privacy policy has not changed.

➢S. 1916 – HELP Rural Communities Act

The Helping Expand Lending Practices (HELP) in Rural Communities Act, would direct the Consumer Financial Protection Bureau (CFPB) to establish an application process under which a person who lives or does business in a state may apply to have an area designated as a rural area if it has not already been designated as such by the Bureau.

IV. More Can and Must be Done to Address Tax-Favored Competitors and Liquidity Access for Community Banks.

The bills that have been introduced by this committee are important first steps to addressing the problem of regulatory burden, but more can and must be done. Community banks face tremendous additional pressure as they struggle to address this growing regulatory burden. Concerns with losing access to the Federal Home Loan Bank System as well as competition from tax favored entities place additional burdens on community banks.

➢ The FHFA's recent proposal could hurt access to this important system

The Federal Housing Finance Agency's (FHFA) recent proposal – issued September 2nd – would dramatically change the qualifications for membership in the Federal Home Loan Bank System. Because so many banks of all sizes rely on the Federal Home Loan Banks for liquidity to make loans, this rule could have profound implications for the banking.

The FHFA proposal would impose an ongoing asset test on FHLB members, requiring that they track and report on the mortgage related assets they hold on their books. This would replace the current system which requires applicants to show that they have ten percent of their assets in long term mortgages to be approved for entry in to the System. Members who fail the ongoing test can be forced out of the System, destabilizing the System's capital base. The new proposal will reduce liquidity, make borrowing from the System less certain and more expensive.

The proposal would also redefine captive insurance companies as no longer eligible for System membership. The types of entities eligible for membership in the System are delineated in statute, including insurance companies. The proposed rule, therefore, runs counter to the plain meaning of the statute, and declare captive insurance companies ineligible.

Access to liquidity, particularly for community banks, is critical. This rule is unnecessary, runs counter to the authorizing statue, and would potentially put at risk an important source of liquidity for banks at a time when such liquidity is vitally necessary.

➢ Tax-favored credit unions and the farm credit system GSE are hurting community-based lenders

Not only do banks face incredible pressure from new regulations placed on them, but they must also compete with a number of tax-favored entities such as the credit union industry and the Farm Credit System (FCS). Both the credit union industry and the FCS have outgrown their charters and no longer deserve the tax advantage that they are given. Both were established with the goal of helping extend credit to those who had little access to it, but both have grown far beyond this and use their tax advantage to compete in virtually all aspects of community banking.

Credit unions were founded to serve those of modest means, and were given special tax treatment to support this goal. Many credit unions, however, have outgrown their special tax treatment and compete directly with banks. In fact, there are over 200 credit unions with more than $1 billion in assets, larger than 90 percent of the banks in our country. These institutions have morphed into full banks in disguise and no longer serve their mission, if they want to be full service banks, they should pay the same taxes as the banks they compete with.

The Farm Credit System has veered significantly from its charter to serve young, beginning, and small farmers and ranchers, and now primarily serves large established farms, who could easily obtain credit from the private sector. It has grown into a $261 billion behemoth offering complex financial services. To put this in perspective, if the Farm Credit System were a bank it would be the ninth largest in the United States, and larger than 99 percent of the banks in the country. The Farm Credit System no longer serves its intended charter, and thus does not deserve its special tax treatment.

Conclusion

Community banks have been the backbone of all the Main Streets across America. Our presence in small towns and large cities everywhere means we have a personal stake in the economic growth, health, and vitality of nearly every community. A bank’s presence is a symbol of hope, a vote of confidence in a town’s future. When a bank sets down roots, communities thrive.

Congress has the opportunity to act on legislation—championed by members of this committee—to help turn the tide of community bank consolidation and protect communities from

losing a key partner supporting economic growth. We urge action on S. 635,S. 727, S.1349, S. 1916, and S. 2698.

An Avalanche of Regulation

"As battle-scarred survivors of a financial crisis and deep recession, community bankers today confront a frustratingly slow recovery, stiff competition…and the responsibility of complying with new and existing regulations. Some observers have worried that these obstacles—particularly complying with regulations—may prove insurmountable."

– Ben Bernanke, October 2, 2013

A majority of small banks tend to have just **one compliance officer** who must understand and implement all the new regulations.

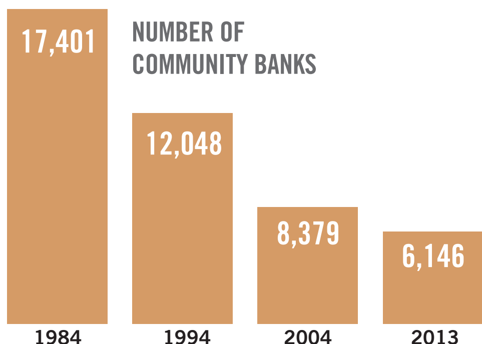
Source: ABA 2013 Bank Compliance Officer Survey

Each new regulation is hundreds of single-spaced, 3 column, 9-point font pages.

Pages	Rule
456 pages	Servicing Rules
408 pages	ATR/QM
313 pages	2013 HOEPA Rule
275 pages	Basel III
272 pages	Volcker Rule
248 pages	Remittance Rule
225 pages	Loan Originator Rules

Source: Number of Federal Register Pages

Heavy regulatory burden has helped fuel consolidation of community banks.



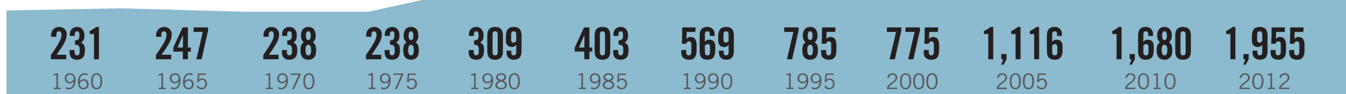
NUMBER OF COMMUNITY BANKS

Source: Federal Deposit Insurance Corporation. Number of banks with assets under $1 billion.

"Almost one out of every five U.S. counties…have no other physical banking offices except those operated by community banks."

– FDIC Community Banking Study

Number of Items per Call Report Jump



Source: Call Report, Federal Financial Institutions Examination Council

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For the median bank with just 40 employees, excessive regulation and costs are overwhelming.

Durbin Amendment

- Capped the price of debit interchange fees
- A recent study estimated a **loss to consumers** of between $22 billion and $25 billion due to higher fees and lost services

Registration of Municipal Advisors

- **Duplicative** registration for bank advisors to municipalities
- **332 pages** of final rules
- Additional 63 pages issued by MSRB of proposed rules

BSA/AML

- **439 pages** in the FFIEC BSA/AML exam manual alone—not including the additional advisories and guidance issued
- **972,000 SARs filed** last year by depository institutions—these are in addition to the CTRs banks must file
- Program requirements are enormous and oversight is of a micromanagement structure

Capital

- Basel III capital rule: **275 pages** requiring new risk weights—Not limited to international banks
- Comprehensive Capital Analysis and Review (CCAR)
- Economically constraining leverage capital requirements

Remittances

- **248 pages** issued by the CFPB
- Requires new costly disclosures—leading many to consider **dropping** this service for customers

Housing Reform

- **QM/Ability to Repay**, 408 pages
- **Loan Originator Rules**, 225 pages
- **HOEPA Rules**, 313 pages
- **Servicing Rules**, 456 pages

… and **more** to come

Reg C

Home Mortgage Disclosure

Managing the avalanche of new regulation has imposed tremendous costs for banks of all sizes, both in terms of dollars paid and services and products they are able to offer their customers. Ultimately, the cost of over-regulation will be felt by bank customers in the form of restricted credit and fewer services and products available.

Dodd-Frank

- Charged federal financial regulators with writing and enforcing **398 new rules**
- 5,905 pages of proposed regulations with additional **7,708 pages of final rule**
- Requiring more than **60 million hours of paperwork** for compliance
- Only **half** of the way through mandated rules

CFPB's Reg F

Fair Debt Collection Practices Act

Reg V
Fair Credit Reporting

Liquidity
- Proposals do not fit U.S. markets and banks
- Small banks held to internationally active bank standards

Reg B
Equal Credit Opportunity

Derivatives Rules
- Too few banks are treated as "end users"
- **Cost to small banks: about $600 million**

What's Being Said:

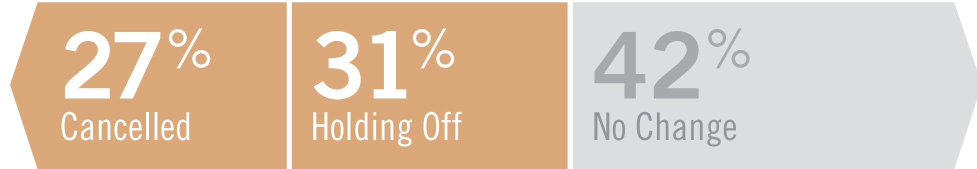
- A $70 million bank in Kansas has dedicated 3.5 of 25 employees to compliance-related tasks. This means **15% of the bank's employees focus just on red tape.**
- Of community banks, **6%** report having **discontinued residential lending** following DFA, with an additional **9% anticipating exiting** the mortgage business.
- Federal Reserve Governor Elizabeth Duke noted that "hiring one additional employee would **reduce the return on assets by 23 basis points** for the median bank in the group of smallest banks, those with total assets of $50 million or less. To put this estimate in perspective, such a decline could cause about **13 percent of the banks of that size to go from profitable to unprofitable.**"
- A Texas community bank originated 1,296 mortgages in 2009 with a total mortgage staff of 18. In 2012, the bank originated 1,080 mortgage loans with a total mortgage staff of 25—due to **increased compliance burden.**
- **18%** of banks subject to the remittance rule **plan to stop offering remittance services altogether** while 42% plan on increasing fees to cover additional compliance costs.
- A regional bank operating in the Midwest spent **$20 million** on FinCEN's BSA/AML regulation alone.

Every extra hour a bank employee spends on compliance is an hour that cannot be used to serve the bank's local community.

Source: Average results of 10 ABA member banks for the year 2013

More Regulation = Fewer Products

Many banks have **decided not to launch** a new product, delivery channel, or enter a new market due to expected increased regulatory costs/risks, while nearly an additional third are **holding off** on these decisions to determine the regulatory impact.



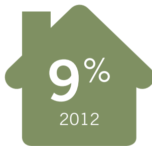
44%
Reduced current consumer financial products or services due to compliance regulatory burden.

In addition, 78% of banks have said they will or may need to change their nature, mix and volume of mortgage products in response to regulatory changes.

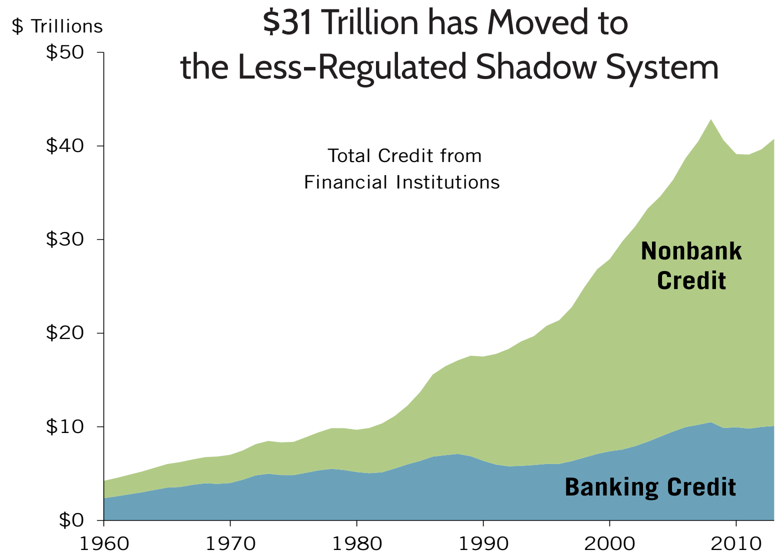
Source: ABA 2013 Bank Compliance Officer Survey

Excessive Rules on Banks Push Business to Less Regulated Shadow System

Market share of non-bank mortgage servicers has nearly tripled in 3 years



Source: "Mortgage Market Gets Reshuffled," *The Wall Street Journal*, March 9, 2014. Includes the 30 largest servicers in data.



Source: Federal Reserve and Bureau of Labor Statistics. Inflation Adjusted, Base = 2013.

The Avalanche of Regulations has Become Overwhelming

"Policymakers should take action to promote the strength and resurgence of America's banks—large, medium, and small—for the benefit of the customers and communities that rely upon them."

– Frank Keating, ABA President and CEO

American Bankers Association