TESTIMONY OF

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On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

“REGULATORY RELIEF FOR COMMUNITY BANKS AND CREDIT UNIONS”

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

Tuesday, February 10, 2015, 10:00 AM

538 Dirksen Senate Office Building

INTRODUCTION

Good morning, Chairman Shelby, Ranking Member Brown, and distinguished Members of the Committee. My name is Candace Franks. I serve as the Bank Commissioner for the State of Arkansas and I am the current Chairman of the Conference of State Bank Supervisors (CSBS). It is my pleasure to testify before you today on behalf of CSBS.

CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. State banking regulators charter and supervise more than 5,000 insured depository institutions. Additionally, most state banking departments also regulate a variety of non-bank financial service providers, including mortgage lenders, mortgage servicers, and money services businesses. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy. CSBS also provides training to state banking and financial regulators and represents its members before Congress and the federal financial regulatory agencies.

In my 35 years with the Arkansas State Bank Department, it has become abundantly clear that community banks are vital to economic development, job creation, and financial stability. I know this Committee shares my convictions, and I appreciate your efforts to examine the state of our country's community banks and regulatory approaches to smaller institutions.

State regulators have a long history of innovating to improve our regulatory and supervisory processes to better meet the needs of community banks, their customers, and our states. Because of our roles and where we fit in the broader regulatory framework, state banking departments are able to pilot programs at the local level based on our particular needs, especially in the area of bank supervision. This often leads to innovative practices bubbling up from individual states and expanding into other states. At the same time, each state has the authority to choose what works best in their local context.

This regulatory flexibility is a strength of the state banking system. After all, community banks in Arkansas might face local issues that my department should address in one manner, while another state's banking regulator might have a different set of supervisory challenges to address. The Appendix to my testimony highlights a few cases in which state regulators have proven to be particularly adept at developing and implementing flexible practices to better serve our smaller institutions.[1]

My testimony today will highlight the importance of community banks and their relationship-based business model, the shortcomings of our current community bank regulatory approach, and state regulators' vision for a new framework for community bank regulation. I will also discuss specific ways in which Congress and the federal banking agencies can adopt

[1] Also see: Vice, C. "Examining the State of Small Depository Institutions." Committee on Banking, Housing, and Urban Affairs. United States Senate. September 16, 2014. Available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6e89b188-c24a-40d5-99e9-754868914674

right-sized policy solutions for community banks and highlight state regulators' current outreach initiatives with community banks. Finally, my testimony will discuss the states' efforts to produce new and enhanced research to promote a better understanding among policymakers about the role of community banks and the impact they have upon our local, state, and national economies and communities.

COMMUNITY BANKS & RELATIONSHIP LENDING ARE ESSENTIAL

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

Community banks are essential to the U.S. financial system and economy. The Federal Deposit Insurance Corporation (FDIC) classifies nearly 93 percent of all U.S. banks as community banks, meaning there are 6,107 community banks embedded in local communities throughout the country.[2] The defining characteristic of a community bank is its relationship-based business model – a business model that relies on the bank's knowledge of its local market, citizens, and economic conditions. Community banks are able to leverage this personal, soft data in a way that large, model-driven banks cannot. This is why community banks have an outsized role in lending to America's small businesses, holding 46 percent of the banking industry's small loans to farms and businesses while only making up 14 percent of the banking industry's assets.[3] A community banker knows the entrepreneur opening a new business around the corner. A community banker also knows the local real estate market and the homebuyer seeking a mortgage loan. These relationships allow community bankers to offer personalized solutions designed to meet the specific financial needs of the borrower.

Community banks engage in relationship lending in the largest U.S. cities and the smallest rural markets. Their role in providing credit and banking services is just as vital as the largest financial institutions. In fact, many consumers, businesses, and farms are not served particularly well by standardized, model-driven lending. This is especially the case in rural areas, where the FDIC has found that community banks are three times more likely to operate a banking office outside of a metro area than their large bank counterparts.[4]

There are more than 600 counties – or one out of every five U.S. counties – that have no physical banking offices except those operated by community banks.[5] In my home state of Arkansas, there are 96 towns served by only one physical banking location, be it a bank's main office or branch. In fact, 66 of these communities have populations with less than 1,000 people. Community banks are the financial lifeblood of these small Arkansas communities. To these

[2] "Quarterly Banking Profile: Third Quarter 2014." FDIC. Available at: https://www2.fdic.gov/qbp/2014sep/qbp.pdf
[3] "FDIC Community Banking Study." FDIC, pp. 3-4 (December 2012). Available at: http://www.fdic.gov/regulations/resources/cbi/study.html
[4] Ibid.
[5] Ibid.

parts of the country, citizens do not differentiate between community banks, regional banks, or the largest banks in the world. For these small or rural towns, the community banking system is *the* banking system.

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

THE SHORTCOMINGS OF OUR COMMUNITY BANK REGULATORY FRAMEWORK

State regulators believe that policymakers in Congress, the federal banking agencies, and state banking agencies must rethink how we all approach regulating and supervising community banks. The statistics are clear – most banks are community banks that operate in local markets:

- Ninety percent of today's 6,589 banks have less than $1 billion in total assets.
- The 5,908 banks with less than $1 billion in assets hold less than 9 percent of the banking industry's total assets.
- The average community bank has $225 million in total assets, and employs 54 people on average.

On the other end of the industry spectrum, we find a very different type of bank:

- There are four U.S. banks that exceed $1 trillion in total assets, and two of these have more than $2 trillion in total assets.
- Four banks hold around 41 percent of the banking industry's total assets.
- These four institutions each average 188,100 employees.

The community bank and megabank business model are also radically different. Community banks serve local economies by tailoring their loans and financial services around the customers within their geographically limited markets. Conversely, the largest banks leverage economies of scale in order to offer standardized mortgage and consumer products across a diversity of U.S. and global markets, provide financial services to multinational corporations, and engage in extensive capital markets activity.

These are vastly different businesses, and policymakers must regulate and supervise these financial institutions differently based on their size, complexity, overall risk profile, and risk to the financial system.

Recent regulatory reform efforts have rightfully centered on addressing the problems posed by the largest, most systemically important banks. However, there is also widespread concern among policymakers and the banking industry that many of these new rules, in addition to existing regulatory requirements, pose an undue burden for community banks. To be sure, Congress and federal regulators have undertaken measures to provide community institutions with relief. While these regulatory relief efforts are positive, there remains a need for a more comprehensive approach based on a common and consistent definition of community banks. A

quick sampling of various asset thresholds for community bank regulatory relief purposes illustrates this point:

- Federal Reserve Small Bank Holding Company (BHC) Policy Statement – Exempts BHCs with assets less than $1 billion from the consolidated BHC capital guidelines and grants them simplified reporting requirements.
- Consumer Financial Protection Bureau (CFPB) Jurisdiction – The CFPB does not have direct supervisory authority over institutions that fall below $10 billion in assets.
- CFPB Small Creditor Definition – Residential mortgage loans are granted Qualified Mortgage status if the bank has less than $2 billion in total assets.
- CFPB Balloon Loan Qualified Mortgages – Residential mortgage loans are granted Qualified Mortgage status if the bank has less than $2 billion in total assets and the institution originates 50 percent or more of its mortgages in rural or underserved areas.
- CFPB Escrow Exemptions – Banks are exempt from escrow requirements if the bank has less than $2 billion in total assets and the institution originates 50 percent or more of its mortgages in rural or underserved areas.
- Treatment of Trust Preferred Securities (TruPS) Under the Collins Amendment – Grandfathers TruPS issued before May 19, 2010 into regulatory capital for BHCs with less than $15 billion in assets.
- Home Mortgage Disclosure Act (HMDA) Reporting Criteria – Banks with less than $44 million in assets are exempt from reporting HMDA data as required under Regulation C.

State regulators are concerned that an approach to regulatory relief that relies solely or primarily on asset thresholds falls short in granting small community banks real relief from regulations designed for their larger competitors. True regulatory right-sizing for community banks will require a holistic approach.

STATE REGULATORS SUPPORT A DEFINITIONAL APPROACH FOR RIGHT-SIZING COMMUNITY BANK REGULATION AND SUPERVISION

Regulatory right-sizing requires a process for determining how safety and soundness and consumer protection requirements can better reflect the community banking business model. To start this process, policymakers and regulators need to know which institutions should be the focus of our regulatory right-sizing efforts. To date, a consensus definition has eluded policymakers. CSBS is confident that regulators and policymakers can more accurately define the universe of community banks and tailor laws, regulations, and supervision for these institutions.

A definitional approach would provide the necessary foundation for a more appropriate regulatory framework for community banks. The definitional approach could be used as a basis for a broad range of regulatory right-sizing initiatives. Instead of crafting specific exemptions in law or leaning on boilerplate statements like “appropriate for the size and complexity of the institution,” there would be a clear process for defining a community bank. With a new process in place to identify community banks, Congress and regulators could then move forward in a holistic manner to provide regulatory and supervisory right-sizing for these institutions.

After all, the more than 6,100 institutions identified as community banks are not simply a number, but rather institutions that state regulators know, license, supervise, and work with on a regular and extensive basis. My banking department staff spends innumerable hours with community bankers in Arkansas, supervising them and helping them address today's banking challenges. This is the case for every regulatory agency at this table – we all know which institutions are in fact community banks, and we must begin to provide these institutions with real regulatory relief in a comprehensive, holistic manner.

Community banks are best identified by a set of principles that can be applied on a case-by-case basis, not by simple line drawing. CSBS is committed to getting this right, and my colleagues and I would be glad to work with Congress to create a process for community bank identification that is not solely based on asset thresholds, but takes qualitative criteria into account. For example, state regulators believe characteristics such as the following can help identify community banks:

- Operating primarily in local markets;
- Deriving funding primarily from a local market, specifically through deposits of members of the community in which it operates;
- Its primary business is lending out the deposits it collects to the community in which it predominately operates;
- The lending model is based on relationships and detailed knowledge of the community and its members, not volume-driven or automated;
- Focusing on providing high-quality and comprehensive banking services; and
- Locally based corporate governance.

Based on criteria such as these, I am confident we can identify the universe of community banks. This will provide the necessary framework for policymakers to move forward in a purposeful manner, designing statutes and regulations that are consistent with and foster a diverse economy and financial system.

SPECIFIC AREAS FOR COMMUNITY BANK REGULATORY RELIEF

As the effort to address regulatory burden has evolved over the last several years, state regulators have worked to identify specific recommendations that we believe would be meaningful for community banks. While these areas help to illustrate the inappropriate application of regulation and negative effect on community banks, the definitional approach presented earlier in this testimony would provide a foundation to address many of these issues. For state regulators, the objective is not necessarily less regulation, it is regulation and supervision that reflects and appreciates the community banking business model. The following represent specific actions that Congress and the federal banking agencies can undertake to promote right-sized regulations for community banks.

Study Risk-Based Capital for Smaller Institutions

The Basel Committee on Banking Supervision designed risk-based capital standards for internationally active banks. These standards are overly complex and inappropriate for

community banks and their business model. Indeed, research presented at the Community Bank Research Conference has shown that a simple leverage requirement would be equally, if not more, effective than risk-based capital requirements for community banks, and would be much less burdensome.[6]

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

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

Community banks that hold the full risk of default of a loan are fully incented to determine the borrower's repayment ability. Laws and regulations regarding mortgage lending should reflect this reality.

Qualified Mortgage Status for Mortgages Held in Portfolio

When a community bank makes a mortgage and holds that loan in portfolio, the interests of the bank and the borrower are inherently aligned, furthering the objective of safe and sound business practices that protect consumers. Yet, a national community bank survey and community bank town hall meetings conducted in conjunction with the 2014 Community Banking in the 21st Century research conference point to a problem: while many community banks' existing mortgage businesses are consistent with the Ability-to-Repay (ATR) and Qualified Mortgage (QM) requirements, complying with the regulations is not only creating an outsized regulatory burden but also curtailing lending. One solution that would tailor the requirement to the nature of community bank mortgage lending is to grant the QM liability safe harbor to all mortgage loans held in portfolio by a community bank. Congress explored this issue through hearings and CSBS-supported legislation during the 113th Congress. We encourage this Congress to pursue similar legislation to promote portfolio lending by community banks.

Improving the CFPB's Rural Designation Process

The Dodd-Frank Act's ATR requirement's restrictions on balloon loans and the CFPB's efforts to provide limited relief for balloon loans made by smaller institutions in rural areas illustrate the need for regulatory right-sizing and for a conscious effort to understand and adapt regulation to the community bank business model. When used responsibly, balloon loans are a useful source of credit for borrowers in all areas. Properly underwritten balloon loans are tailored to the needs and circumstances of the borrower, including situations where the borrower or property is otherwise ineligible for standard mortgage products. Because banks can

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[6] Moore, R., and M. Seamans. "Capital Regulation at Community Banks: Lessons from 400 Failures." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Capital_Regulation_at_Community_Banks.pdf.

restructure the terms of a balloon loan more easily than an adjustable rate mortgage, they are able to offer the borrower more options for affordable monthly payments, especially in a rising interest rate environment.

As a regulator, I prefer that lenders and borrowers in my state have flexibility and options when selecting consumer products and mortgages. Since the mortgage is held in portfolio, community banks must work to ensure that the product is tailored to take into consideration all risks associated with the credit in order to avoid default.

Community banks retain balloon mortgages in portfolio as a means of offering credit to individuals that do not fit a standard product but nonetheless can meet the monthly mortgage obligation. That is the logic behind the Dodd-Frank Act provision providing balloon loans with QM status if those loans are originated in rural or underserved areas by a small creditor. However, the CFPB's original approach to identifying such areas relied solely on the Department of Agriculture's Urban Influence Codes, producing many illogical and problematic outcomes for community banks.

CSBS raised this concern shortly after the original rule was proposed, and we worked with Congress to develop a petition process for interested parties to seek rural designation. We applaud Congress for its focus on this issue, and we appreciate the CFPB's recent efforts to improve its rural and underserved designation framework by adding rural census blocks as defined by the U.S. Census Bureau.

More fundamentally, portfolio lending is not a "rural" issue or an "underserved" issue; it is a relationship-based lending issue for all community banks. Eliminating the rural or underserved balloon loan limitations for qualified mortgages would go a long way in expanding the CFPB's Small Creditor QM framework to include all loans held in portfolio by community banks. Similarly, removing the rural or underserved requirements from the exception to mandatory escrow requirements for higher-priced loans would make right-sized regulations business model focused, not geographically focused.

Tailor Appraiser Qualifications for 1-4 Family Loans Held in Portfolio

Current appraisal regulations can curtail mortgage lending in markets that lack qualified appraisers or comparable sales. Congress should require regulations to accommodate portfolio loans for owner-occupied 1-4 family loans, recognizing the lender's proximity to the market and the inherent challenge in securing an accurate appraisal by a qualified appraiser.

Community Bank Fair Lending Supervision Must Acknowledge the Business Model and Be Applied Consistently

State regulators take the difficulties that many underserved borrowers have had in obtaining access to fair credit very seriously, especially in regards to mortgage lending and homeownership. State regulators are committed to enforcing institutions' compliance with the letter and spirit of our fair lending laws, but we are concerned about regulators' overreliance on opaque statistical models that use small samples to judge fair lending performance and

inconsistencies in federal regulators' approach to fair lending supervision. Many times it is not the statute that creates the problem, but the interpretation, guidance, and the examination techniques utilized. Federal agency leadership must commit to a more pragmatic and transparent approach to fair lending supervision.

Federal regulators should not use one-size-fits-all techniques and tools on community banks in fair lending examinations. A smaller institution makes case-by-case lending decisions based on local knowledge and local relationships. While statistical analysis plays a role in fair lending supervision, it is not the beginning and end of the analysis. Supervisors must utilize their flexibility to look beyond statistical models to take a more holistic view of the lending decision.

Despite assurances of consistent approaches from "headquarters" to "the field" and of continued collaboration to ensure consistency, state regulators have observed meaningful differences in how the three federal banking agencies treat community banks on fair lending issues and as well as a disconnect within the individual agencies. Federal agency leadership has the responsibility to make sure this is not the case, and they must be accountable for ensuring transparency and consistency.

The current approach to fair lending for community banks is having a chilling effect on credit availability, as banks, frustrated by the examination process, are curtailing or exiting consumer credit products. From a public policy perspective, we should want community banks doing this business. If there were only 66 banks that had compliance or Community Reinvestment Act problems in 2013,[7] and referrals to the Department of Justice are minimal, why are banks experiencing such in-depth and extensive reviews?

The Application Process for Community Banks Must Reflect the Business Model

Community bank applications submitted to federal banking agencies for transactions such as mergers and capital investments can take an extended time to process because the agencies have to ensure the decision will not establish a precedent that could be exploited by larger institutions. The approval of a merger, acquisition, or expansion of activities should be related to the overall size and complexity of the transaction, and community banks should not be unnecessarily penalized for the potential action of larger financial institutions. Federal law, an agency rule, or a clause in an approval letter could provide the necessary protection by stating that application decisions for community banks do not establish a precedent for systemically important financial institutions.

To further address the length of time the agencies take to review community bank applications, the application review and approval process for a defined subset of community institutions should be de-centralized with more final decision-making authority given to FDIC Regional Offices and the regional Federal Reserve Banks.

Federal Regulatory Agency Leadership and State Supervisory Representation

[7] "FDIC Annual Report 2013." FDIC. Available at: https://www.fdic.gov/about/strategic/report/2013annualreport/AR13section1.pdf

A key to the success of the dual banking system is robust coordination among regulators. Meaningful coordination in regulation and supervision means diversity at the highest governance levels at the federal regulatory agencies. The current FDIC Board does not include an individual with state regulatory experience as required by law.[8] The Federal Deposit Insurance (FDI) Act and congressional intent clearly require that the FDIC Board must include an individual who has worked as a state official responsible for bank supervision. As the chartering authority for more than 76 percent of all banks in the United States, state regulators bring an important regulatory perspective that reflects the realities of local economies and credit markets. State regulators were pleased to see bi-partisan legislation introduced last Congress in the Senate and the House that refined the language of the FDI Act to ensure that Congress' intent is met and that the FDIC Board includes an individual who has worked in state government as a banking regulator. We hope to see this proposal re-introduced this Congress.

We thank Congress for its efforts to require community bank or community bank supervisory representation on the Federal Reserve Board of Governors (the Board) through the Terrorism Risk Insurance Program Reauthorization Act of 2014. In 2013, CSBS released a white paper[9] on the composition of the Board of Governors and an infographic[10] that illustrates the background and experience of the members of the Board of Governors throughout the Board's history. The white paper highlights two key trends: Congress' continuing efforts to ensure the Board's composition is representative of the country's economic diversity, and the Board's expanding supervisory role. The infographic illustrates the growing trend of naming academics to the Board. Passage of Senator Vitter's provision reinforces Congress' consistent intent to bring together a range of perspectives on the Board, and reaffirms the important role of community banks in the financial marketplace.

Practical Privacy Policy Notice Requirements

State regulators firmly believe that financial institutions have an affirmative and continuing obligation to respect customer privacy. However, there are common sense practices for communicating privacy policies. If a bank's privacy policy does not change, the bank should not be required to repeatedly inform customers of the policy. Redundant notifications are costly and limit the effectiveness of important privacy communications with customers. Accordingly, CSBS supports any commonsense fix to the Gramm-Leach Bliley Act that exempts financial institutions from mandatory annual privacy policy mailings if the institution's privacy policy does not change.

[8] 12 U.S.C. § 1812(a)(1)(C).

[9] "The Composition of the Federal Reserve Board of Governors." CSBS. Available at: http://www.csbs.org/news/csbswhitepapers/Documents/Final%20CSBS%20White%20Paper%20on%20Federal%20Reserve%20Board%20Composition%20(Oct%2023%202013).pdf

[10] Available at: http://goo.gl/eCKVrS

State Regulators Are Engaging Community Banks

State regulators regularly and actively engage with community banks to try to reduce regulatory burden and to help meet the pressing needs these institutions face. State regulators are currently working to facilitate the Economic Growth and Regulatory Paperwork Reduction Act process. We are providing guidance to and conducting outreach with community banks to help them navigate cybersecurity threats.

Economic Growth and Regulatory Paperwork Reduction Act

The Federal Financial Institutions Examination Council (FFIEC) allows state regulators and our federal counterparts to better coordinate bank supervision, which helps reduce the supervisory burden for community institutions. State regulators are involved in the FFIEC through the State Liaison Committee, which is currently chaired by Massachusetts Banking Commissioner David Cotney.

One of the FFIEC's current major projects is the review of banking regulations mandated by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA).[11] State regulators, through our presence on the FFIEC, are committed to using this review as an opportunity to pinpoint regulations that may not be properly suited to the business model of community banks. We are excited to participate in this process through the FFIEC with our federal colleagues at the FDIC, Federal Reserve Board, and the Office of the Comptroller of the Currency.

State regulators are attending and participating in the regional outreach events. I am particularly pleased that there will be an event later this year focused on rural banks. Additionally, the feedback received during the outreach events and through the ongoing comment process will provide important input to the State Liaison Committee and state regulators as a whole as we continue to seek ways to minimize duplicative regulation and to make supervision of state-chartered banks more efficient.

The FFIEC and federal regulatory agencies are contributing significant time and resources to ensure the EGRPRA process is a fruitful endeavor. The federal regulators' commitment to this effort is evidenced by the attendance of Comptroller Curry, Federal Reserve Governor Powell, and FDIC Chairman Gruenberg at EGRPRA outreach meetings throughout the country. Their commitment shows that this will not merely be a check-the-box exercise, but a meaningful process of reducing regulatory burden.

While the comment process and outreach events have just begun, they are already yielding meaningful areas for us to consider changes, including burdens associated with the quarterly call report, other regulatory filings, and Bank Secrecy Act compliance. The industry is also building a reasonable case for extending the examination cycle for certain institutions. We also greatly appreciate Comptroller Curry's comments that there are changes we can start making now before we complete the EGRPRA process.

[11] 12 U.S.C. § 3311.

Executive Leadership of Cybersecurity

We appreciate Congress' ongoing efforts to address cybersecurity challenges. Cybersecurity is a national priority, and state regulators are fully engaging community banks on this vital issue. The persistent threat of cyber-attacks is a widespread problem facing all industries, especially the financial services industry. Through regular dialogue with our state-chartered financial institutions, state regulators have learned that the issue of cybersecurity can be daunting for small bank executives who often have limited resources and assets to dedicate to cybersecurity.

State regulators have heard from small bank executives that while they understand the harm cyber-attacks can cause to their financial institutions, the abundance of information available on cybersecurity is overwhelming and largely technical, making many bankers uncertain as to what information applies to their particular institution. This feedback from state-chartered banks prompted state regulators, through CSBS, to launch the Executive Leadership of Cybersecurity (ELOC) initiative in 2014.[12] The ELOC program seeks to raise awareness among bank CEOs that managing an institution's cybersecurity risks is not just a "back office" issue, but also an executive and board level issue. ELOC is part of a larger state and federal effort to help combat the threat of cyber-attacks in the financial services sector.

With the launch of the ELOC initiative, CSBS established a cybersecurity resources web page that, for over a period of nine weeks, served as a key resource for bank executives to receive comprehensive, non-technical, and easy-to-read information on cybersecurity tailored to community bank CEOs. By the conclusion of the web campaign, more than 500 community bankers had signed up to receive CSBS's exclusive *Cyber 101: A Resource Guide for Bank Executives*, a resource guide that compiles recognized industry standards for cybersecurity and financial services industry best practices into one document. The ELOC web campaign and resource guide provided community bank executives with the knowledge and necessary tools to better understand cyber threats at their institutions, better prepare for and protect against cyber threats, and to better understand their role as bank executives in managing cybersecurity risks at their banks.

The high level of community banker interest in the ELOC initiative sent a strong message to state regulators that community banks are looking for more leadership and clear guidance on how to address cybersecurity risks at their institutions. To that end, CSBS has made cybersecurity one of its highest priorities. In addition to the ELOC website and the cyber resource guide, CSBS will be working with state banking departments to host a series of cybersecurity industry outreach events throughout 2015. My department will take part in hosting one of these events in Arkansas this year.

These examples demonstrate the willingness of state regulators to seek innovative solutions and methods to provide comprehensive and effective supervision, while tailoring our efforts to the business models of banks. Banks should be in the business of supporting their

[12] "Executive Leadership of Cybersecurity." CSBS. Available at: http://www.csbs.org/cybersecurity

communities. We are working to enact supervision that ensures safety and soundness and consumer protection, while allowing state-chartered banks to serve their customers most effectively and contribute to the success of our local communities, our states, and our nation.

THE NEED FOR ROBUST COMMUNITY BANK RESEARCH

State regulators recognize that designing a right-sized regulatory framework requires us to truly understand the state of community banking, the issues community banks face, and the nuances within the community banking industry. Data-driven and independently developed research on community banks is sorely lacking when compared to the breadth of research dedicated to the largest financial institutions. To address the need for research focused on community banks, state regulators, through CSBS, have partnered with the Federal Reserve to conduct the annual Community Banking in the 21st Century research conference.[13] Bringing together state and federal regulators, industry experts, community bankers, and academics, the research conference provides valuable data, statistics, and analysis about community banking. Our hope is that community bank research will inform legislative and regulatory proposals and appropriate supervisory practices, and will add a new dimension to the dialogue between the industry and regulators.

The research conference represents an innovative approach to research. The industry informs many of the themes studied, providing their perspective on issues through a national survey and local town hall meetings. At the same time, academics explore issues raised by the industry in a neutral, empirical manner, while also contributing their own independent research topics. This approach ensures that three research elements – quantitative survey data, qualitative town hall findings, and independent academic research – all enhance and refine one another, year after year. The research conference's early success underscores the interest and need for community bank research: in 2014, more than 1,000 community bankers participated in the national survey, more than 1,300 bankers attended local town hall meetings, and more than 37 research papers were submitted by academics for consideration, a considerable increase from the number of papers submitted for the inaugural 2013 conference.

I would like to share some of the findings we have gathered through our community bank research conferences from academic research, the national survey of community banks, and our town hall meetings with community banks. I would also like to illustrate how our holistic approach to research can lead to better policy outcomes for community banks.

Academic Research on Community Banks

While there have only been two community bank research conferences thus far, we have already benefitted from valuable data and research findings that show the importance of community banks and the centrality of their relationship-based lending model. For example, we now know that community bank failures lead to measurable economic underperformance in local

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

markets.[14] Research also shows that the closer a business customer is to a community bank, the more likely the start-up borrower is to receive a loan.[15] Community banks also have a key advantage through "social capital," which supports well-informed financial transactions. This so called "social capital" is the basis for relationship lending and exists because community bankers live and work in the same communities that their banks do business. The success of the community bank is tied directly to the success of consumers and businesses in those communities. This is especially true in rural areas, where the community bank relationship-based lending model results in lower default rates on U.S. Small Business Administration loans than their urban counterparts.[16]

We are also discovering the extent to which governmental policies can impact community banks. For example, research shows that more than 80 percent of community banks have reported a greater than 5 percent increase in compliance costs since the passage of the Dodd-Frank Act.[17] Research has also informed us that the federal banking agencies' appeals processes are seldom used, inconsistent across agencies, and at times dysfunctional.[18] We can also see that macro-prudential regulation can have a meaningful impact on bank behavior, but that it may also cause unintended consequences.[19] We hope that findings like these will inform policymakers' work designing a right-sized policy framework for community banks.

National Survey of Community Banks

The community banker survey we conducted as part of the research conference provides us with crucial information straight from the industry.[20] For example, bankers have been very vocal about the compliance burdens associated with the new Ability-to-Repay and Qualified Mortgage rules. Our research finds that community banks continue to see residential mortgage lending as a meaningful business opportunity, but have a mixed view of making non-QM loans, with 26 percent of respondents indicating that they would not originate non-QM loans and an additional 33 percent only originating non-QM on an exception basis. Assessing the new ATR and QM mortgage standards against existing loans, 67 percent of bankers identified a low level of non-conformance, suggesting the two rules generally align with existing bank practices.

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[14] Kandrac, J. "Bank Failure, Relationship Lending, and Local Economic Performance." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Kandrac_BankFailure_CBRC2013.pdf.
[15] Lee, Y., and S. Williams. "Do Community Banks Play a Role in New Firms' Access to Credit?" Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Lee_Williams.pdf.
[16] DeYoung, R., et. al. "Small Business Lending and Social Capital: Are Rural Relationship Different?" Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/DGNS_2012_SBA_lending.pdf.
[17] Peirce, H., I. Robinson, and T. Stratmann. "How Are Small Banks Faring Under Dodd-Frank?" Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION3_Peirce_Robinson_Stratmann.pdf
[18] Hill, J. "When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION2_AndersonHill.pdf
[19] Bassett, W. and W. Marsh. "Assessing Targeted Macroprudential Financial Regulation: The Case of the 2006 Commercial Real Estate Guidance for Banks." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION2_Bassett_Marsh.pdf
[20] The survey data is available at: https://www.stlouisfed.org/bank-supervision/2014-community-banking-conference/2014-survey-data.

Community banks have long voiced concerns about increasing regulatory compliance costs, but these costs have been difficult to quantify historically. To encourage additional data and research in this area, the national survey sought to identify how increased compliance costs are realized in community banks' operations. Survey data show that rising compliance costs primarily take the shape of spending additional time on compliance, hiring additional compliance personnel, and increasing reliance on third-party vendors.

The survey also showed us that less than a quarter of respondents plan to add new products and services in the next three years. We must take this as an important red flag. Any industry that is not in a position to innovate while the world around it is innovating has questionable long-term viability.

Community Banker Town Hall Meetings

Community bankers in the town hall meetings were quite clear: the ATR and QM mortgage rules have required banks to make significant operational changes in order to comply. These changes have increased the cost of origination, the cost to the consumer, and have reduced the number of loans a bank can make.

Bankers also indicated that compliance burdens and security concerns are significant headwinds to launching new products and innovation. Similarly, bankers expressed that new regulations have changed how they approach serving their customers, shifting their mentality away from creating flexible products for customers and towards what regulations allow them to do.

Holistic Research Can Lead to Better Policy Outcomes

Looking at these research conference findings together should cause policymakers to ask serious questions about our approach to regulating community banks. In the context of the ATR and QM mortgage rules, if new requirements are generally consistent with most community banks' practices, should implementation of these rules result in increased costs and a reduction in credit availability? When we think about community banking products, should regulatory compliance burdens inhibit community banks from offering innovative products to their customers? These are not outcomes any policymaker should want, and we must be responsive to what the industry and empirical research are both telling us.

More importantly, this information can lead policymakers to better policy outcomes, if we let it. We are seeing more clearly the role and value that community banks play in our economies. This should inform and inspire us to not establish broad asset thresholds out of political pressure, but to craft a meaningful regulatory framework for a community banking business model that provides real value and presents limited risk to the financial system.

The 2015 Community Banking in the 21st Century research conference will be held this fall at the Federal Reserve Bank of St. Louis. We are pleased that Chair Yellen is planning on attending and addressing the conference. We have already issued a call for research papers and are planning our national survey and town hall events. State regulators have been encouraged by

the overwhelming demand for this conference. We have been pleased at the growing response to the call for papers over the past two years and expect the response and interest in the conference to continue to grow.

MOVING FORWARD

Congress, federal regulators, and state regulators must focus on establishing a new policymaking approach for community banks. We must do so by moving away from an inconsistent, piecemeal regulatory relief strategy that uses hard asset thresholds. We will need a new definitional framework based upon the easily identifiable attributes of a community bank. Only then will we be able to provide community banks with a regulatory framework that effectively complements and supervises their unique relationship-based lending model.

Policymakers are capable of right-sizing regulations for these indispensable institutions, but we must act now to ensure their long-term viability. CSBS remains prepared to work with members of Congress and our federal counterparts to build a new right-sized framework for community banks that promotes our common goals of safety and soundness and consumer protection.

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

APPENDIX

This Appendix highlights just a few cases in which state regulators have proven to be particularly adept at developing and implementing flexible practices to better serve our smaller institutions. Some of these examples are broad, historic initiatives that have significantly shaped the trajectory of U.S. banking regulation and supervision, such as the joint and coordinated bank examination framework. Other examples provide local snapshots highlighting the flexibility that individual states exercise on a regular basis. The significance that these are state-based solutions cannot be understated. States have the dexterity to experiment with supervisory processes in ways that the federal government cannot without applying sweeping changes to the entire industry. This is by design and a trademark of our dual banking system. As states develop these practices, CSBS has developed several vehicles for states to share techniques and best practices with one another, allowing for the speedy deployment of successful models nationwide and maximizing regulatory efficiency.

Joint Examinations of Multi-Charter Holding Companies

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

Before the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal), states like Iowa and Indiana were already coordinating with other state banking regulators to conduct joint state examinations for multi-charter holding companies. This approach eliminated regulatory duplication, reduced the regulatory burden on the individual banks and the holding company, and helped the regulators develop a holistic view of the entire holding company. Once Riegle-Neal was passed, states built upon their existing practices in order to coordinate with federal supervisors, crafting examination plans across state and agency lines. In 1996, the states formalized cooperative and coordination agreements, the Nationwide Cooperative Agreement[21] and Nationwide State-Federal Supervisory Agreement,[22] to facilitate the supervision of multi-state banks and to define the nature of state-federal supervision. These agreements set up a model centered on the examination team of the holding company or lead institution and, while close to 20 years old, still form the basis for state-federal supervisory interaction. These agreements foster effective coordination and communication among regulators and have led to a supervisory model that reduces burden and enhances responsiveness to local needs and interests in an interstate banking and branching environment.

This process ultimately leads to a more consistent examination experience for these community institutions. Rather than the holding company having to handle numerous

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

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

examinations throughout the year, regulators conduct coordinated examinations of all the holding company's institutions at the same time, satisfying state and federal supervisory requirements in a streamlined manner.

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

Arkansas Self-Examination Program

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

When an Arkansas bank volunteers to participate in the Self-Examination Program, it provides the Arkansas State Bank Department with roughly three pages of financial information each month. We use this information to spot problem areas and trends that may threaten the bank's safety and soundness. In exchange for this data, we provide participating institutions with reports that reflect the bank's month-by-month performance, a performance comparison with peer institutions, and early warnings that flag issues of concern. Both the information provided by the banks and reports generated by my staff remain confidential. While the program is not a replacement for examinations, it is an excellent supplement that benefits our agency and the bank.

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

Central Point of Contact

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

CSBS Loan Scoping Job Aid

In addition to coordination with the industry to make supervision more efficient, state regulators are increasingly turning to technology to enhance and streamline supervision. In 2012, CSBS published a Loan Scoping Job Aid (job aid) for examiners that encourages state regulators to consider institution-specific criteria that may lead to a smaller, yet more effective,

loan review methodology.[23] Loan review is the cornerstone of safety and soundness examinations, providing examiners the best avenue for determining a bank's health. The CSBS job aid provides methods for examiners to improve their loan scope by reviewing a different sample of loans than would otherwise be the case. This more thoughtful, risk-focused, yet surgical approach will help regulators identify new risks and provide community banks with more meaningful and useful examination results.

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