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TESTIMONY OF

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On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

FOSTERING ECONOMIC GROWTH: REGULATOR PERSPECTIVE

Before the

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

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Introduction

Good morning, Chairman Crapo, Ranking Member Brown, and distinguished members of the Committee. My name is Charles Cooper, and I am currently serving in my ninth year as the Commissioner of the Texas Department of Banking (DOB), which is responsible for the supervision, regulation, and examination of 273 state-chartered banks with aggregate assets of approximately \$275.3 billion.¹ Additionally, DOB supervises trust companies, money service businesses, and foreign bank agencies and branches. I have more than 47 years of experience in the financial services industry – 12 as an FDIC bank examiner, 26 as a banker in both community and large banks, and the last nine years as the Texas Banking Commissioner. Most recently, I am the immediate past Chairman of the Conference of State Bank Supervisors, and continue to serve on the Executive Committee. It is my pleasure to testify before you today on behalf of CSBS and state regulators.

CSBS is the nationwide organization of banking regulators from all 50 states, American Samoa, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. CSBS supports the state banking agencies by serving as a forum for policy and supervisory process development, and facilitates state implementation of policy through training, educational programs, and production of examiner tools and job aids. Additionally, CSBS represents its members before the federal financial regulatory agencies and Congress.

State regulators' unique perspective is informed by supervision of a diverse field of financial firms and their activities within local communities. States are the chartering authority and primary regulator for 78% of the nation's banks, a figure that represents 4,572 institutions with over \$5.3 trillion in assets. These banks vary in asset size, from large and complex institutions that have been categorized as global systemically important banks (G-SIBs) with assets of more than \$200 billion,² to large regional banks, to smaller institutions that offer products tailored to community needs. In addition to supervising most of our country's banks, the states are the primary regulators of over 20,000 non-depository financial service providers. This category includes residential mortgage lenders and servicers, money service businesses and money transmitters, debt collectors, consumer and small dollar loan lenders, and emerging and established financial technology companies.

State regulators' knowledge of local markets and institutions lends itself to identifying and addressing emerging risks to consumers, and in many instances, bringing those risks to national attention. This on-the-ground perspective, informed by implementation of federal and state law and regulations, contributes to an understanding of how standards can be tailored to not only ensure safety and soundness, but promote responsible innovation and economic growth.

State regulators thank Chairman Crapo, Ranking Member Brown, and the Committee members for your continued efforts to understand how complex, national regulation affects

¹ FDIC Bank Data as of Q1 2017.

² Bank of New York Mellon and State Street are both state chartered institutions that have been identified as global systemically important banks (G-SIBs) by the Financial Stability Board (FSB), in consultation with the Basel Committee on Banking Supervision (BCBS). See <http://www.fsb.org/2016/11/2016-list-of-global-systemically-important-banks-g-sibs/>

regional credit communities. By observing local and national trends, state regulators have found evidence that community banks are disproportionately burdened by regulation that is inappropriate for their size, business model, or activities. I appreciate the opportunity to bring this perspective to the Committee's hearing today.

My testimony today focuses on community banks. At the state level, regulators are focused on ensuring that borrowers – wherever they live – have broad, safe access to an array of credit and banking services. Community banks are central to this mission. Collectively, community banks are responsible for 45% of small loans to businesses in the United States, and upwards of three-fourths of agriculture lending. Moreover, in roughly 600 counties across the nation, a community bank is the only physical banking presence.

As someone who works outside of the beltway, I am optimistic that we have a realistic opportunity to appropriately calibrate our regulatory approach, especially for community based institutions. I believe it is possible for us to maintain a strong and effective regulatory program that ensures safety and soundness, protects consumers, and meets the economic needs of local communities without undue burden on the institutions that we supervise.

As policy makers pursue this important task, we are fortunate to have two bodies of work from which to extract ideas. Earlier this year, the Federal Financial Institutions Examination Council (FFIEC) issued its report under the Economic Growth and Paperwork Reduction Act (EGRPRA). The report is the result of a multi-year effort by the FFIEC member agencies to identify areas where regulation can be more efficient and the industry can be relieved of unnecessary burden. The states were active participants in this work. The report offers numerous opportunities for improvement, some of which have already been implemented.

Last week, the Treasury Department also issued its first report in response to the President's Executive Order 13772 on Core Principles for Regulating the United States Financial System. The report, focused on banks and credit unions, makes a powerful case for significant changes to our regulatory approach if we hope to serve the economic needs of local communities.

With nearly 100 recommendations in the Treasury report and 440 pages of comments and recommendations in the EGRPRA report to Congress point to one undeniable fact – we have a problem with the volume, complexity, and overall approach of our regulatory framework. How or why we got to this point is not as important as how we to come together to address it. There are meaningful recommendations in both reports that identify opportunities for both Congress and regulators to act. Today, we are presented with a tangible opportunity to positively impact the banking industry and the economies they serve.

To support the economic growth fueled by small business and agriculture, it must be a priority to reverse the hollowing out of community banking. In this endeavor, regulation plays a key role. My testimony today highlights regulations that disproportionately burden smaller institutions, stalling economic growth and product innovation. Several of these topics have been

raised through the EGRPRA³ process and in the recent Treasury Department report regarding Executive Order 13772, but warrant continued attention. In particular, my testimony discusses the following opportunities for regulatory relief aimed at bringing economic growth to local communities:

- The adoption of a uniform, activities-based definition for community banks;
- The simplification of the revised capital regime and its treatment of certain activities;
- Granting community banks relief from QM mortgage rules and HMDA reporting requirements; and
- Ensuring that state regulators and local communities are represented in the national policy development process.

I plan to discuss several other issues of concern to state regulators, including: the current use of the Herfindahl-Hirschman Index (HHI) in competitive analyses, a lack of clarity surrounding methodologies and models used in consumer compliance examinations, and the ongoing appraiser shortage in many areas of the country.

Aggregate Performance Data Does Not Reflect Regional Trends in Profitability

If profitability is the only metric used to analyze the entirety of the banking market, then it could be argued that the community banking industry is not in decline. However, because of their local perspective, state regulators know that an appropriate analysis of community bank performance is more nuanced. When one goes beyond national numbers to look at community bank performance data on a regional or state-by-state basis, community bank performance varies significantly. Median return-on-asset (ROA) is relatively high in states with dominant agricultural sectors, with community banks in Oklahoma, South Dakota, North Dakota and Iowa all maintaining an ROA above 1.2. However, there is a significant gap between the profitability indicators of those markets and regions where community bank performance is struggling – North Carolina, Florida, Maryland, Massachusetts, New Hampshire, Connecticut and New Jersey all have a median ROA below .6. Finally, consolidation of smaller institutions reflects that small community banks are struggling to survive in many states.

Despite Resilience of Community Bank Business Model, Consolidation Continues

Small, local banks continue to consolidate across the country, leaving many communities without access to financial services. An astonishing 1,715 community banks have disappeared since 2010, and this trend continues with 54 banks exiting the market in 2017.⁴ By contrast, only three community banks have closed due to failure in 2017. Consolidation leaves consumers with less choice, and diminishes healthy competition within the market.

Recent research from the Federal Reserve Bank of Minneapolis has found that there is little correlation between economic recession and trends in bank numbers, highlighting the

³ USC 12 3311

⁴ See FDIC Quarterly Financial as of 3/31/2017.

resiliency of community bank business models.⁵ However, the study notes that there has been a marked increase in community bank consolidation after major regulatory legislation like the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) or the Dodd-Frank Act (DFA) were implemented.⁶ However, in previous instances, this consolidation is also met with new bank formation. We have yet to see that occur in the post Dodd-Frank era. As *Figure 1* illustrates, the banking industry continues to consolidate as the largest banks increase their overall share of assets.

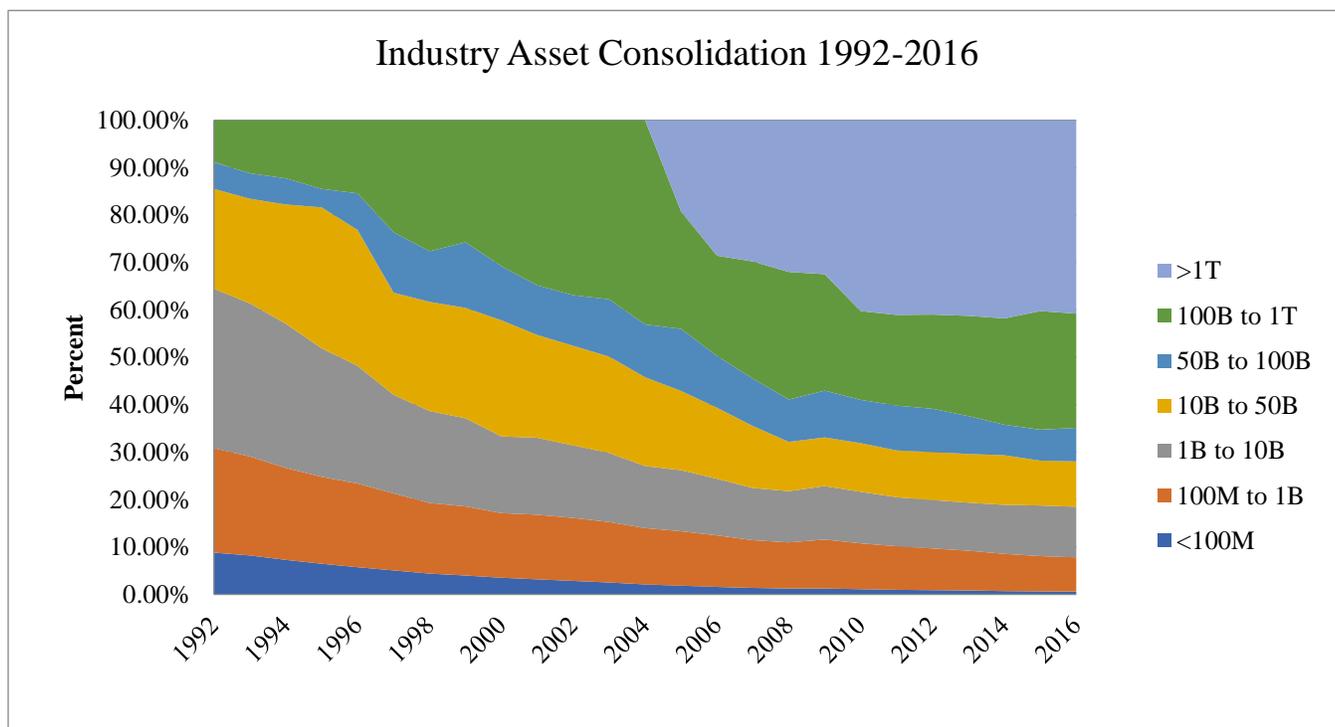


Figure 1 Source: FDIC SDI Data

In Texas, the banking market has lost 159 state-chartered institutions since 2010. Additionally, community banks that exit the market are not being replaced – de novo applications for new bank charters are at all-time lows. There have been only five de novo charters granted since the passage of Dodd-Frank. Further consolidation and lack of de-novo applications could have drastic effects on credit availability. As discussed above, one out of every five U.S. counties have no physical banking offices except those operated by community banks.⁷

In addition to providing fundamental financial services, smaller and less complex banks regularly tailor products to meet local needs. Whether servicing the agricultural markets of the Midwest or the startup communities of Silicon Valley, local banks adapt to their markets. The ability to tailor products to consumer needs is illustrated through the rate at which community

⁵ See <https://www.minneapolisfed.org/research/economic-policy-papers/assessing-community-bank-consolidation> . *Assessing Community Bank Consolidation*, (Schreck and Feldman, 2014).

⁶ See *id.*

⁷ See <https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf> *FDIC Community Banking Study* (2012).

institutions lend to small, local businesses. Despite smaller asset size, community banks' proximity to and familiarity with local economies has driven small business growth – a 2016 survey of small businesses by the Federal Reserve Bank of New York found that small business loan applicants were more likely to be approved at a small bank than an online lender, large bank, or credit union. Additionally, applicants were 20% more likely to be satisfied with a small depository lender than a large bank, further emphasizing the necessity to update regulation to match the evolving role of small institutions in the financial marketplace.⁸

The current pace of consolidation cannot be sustained for much longer. This rapid rate of consolidation, in combination with a lack of de novo institutions, threatens community banking, a franchise that contributes greatly to the economy. Regulatory relief for community banks has been a topic of discussion for quite some time, and it is time to take practical steps to reform existing laws and regulations. CSBS and I urge Congress and my federal regulatory colleagues to act swiftly to further reduce the regulatory burden on community banks before they are gone.

A Uniform, Activities-Based Definition of Community Banks Allows for Effective Supervision

Policymakers have often approached bank regulatory requirements based on an institution's asset size. However, this has led to a fragmented and arbitrary regulatory framework that negatively impacts community banks. *Figure 2* shows a sample of current regulations and their applicability based on asset size, illustrating just how inconsistent this regime can be.

State regulators are concerned that the current approach to applicable regulation falls short in providing a tailored and reasonable approach to community bank regulation, which in turn harms these institutions and the communities they serve. For example, Commissioners have seen community banks approaching the \$10 billion asset mark choose to acquire another institution to quickly achieve a size well beyond \$10 billion (rather than organically grow) to absorb the increased costs of direct supervision by the Consumer Financial Protection Bureau (CFPB or Bureau). Furthermore, according to results from *CSBS 2016 National Survey of Community Banks*, regulatory burden is the primary reason that community banks exit a specific product or service.⁹

Simply put, our current framework may not be creating the appropriate incentives for the long-term financial stability of the industry and economic opportunities for communities. The recently released Department of the Treasury report regarding Executive Order 13772 similarly recommends that specific asset thresholds for increased regulatory requirements create “innappropriate incentives,” and that one-size-fits-all regulatory approach undermines the diversity of our banking markets.¹⁰

⁸ See <https://www.newyorkfed.org/smallbusiness/small-business-credit-survey-employer-firms-2016> *New York Federal Reserve Bank Small Business Credit Survey* (2016).

⁹ 36.87% of respondents cited regulatory burden as their reason for exiting an activity, and only 26.98% of respondents cited profitability as reason for exiting an activity.

¹⁰ See <https://www.treasury.gov/press-center/press-releases/Documents/Apercent20Financialpercent20System.pdf> pp. 40

The Many Asset Thresholds for Dodd-Frank Act Regulations and Exemptions

ASSET THRESHOLD:	< \$500 Million	\$500M to \$1B	\$1B to \$2B	\$2B to \$10B	\$10B to \$15B	\$15B to \$50B	\$50B to \$250B	More than \$250B
REGULATION		APPLICABILITY						
Supplementary Leverage Ratio								
Liquidity Coverage Ratio								
Large Bank/SIFI Assessment								
Comprehensive Capital Analysis & Review (CCAR)								
Collins Amendment - TruPs								
Dodd-Frank Act Stress Testing (DFAST)								
Fed Dividend Reduction								
CFPB Supervision								
Durbin								
Enhanced Prudential Standards for BHC's								
CRA Reporting								
Overdraft Reporting								
Audit Requirement								
HMDA Data Collection								
Volcker Rule								
EXEMPTION		ELIGIBILITY						
AOCI* Opt-out								
Swap Clearing Exemption (CFTC)								
Small Creditor - QM								
Small Bank Holding Company								
18 Month Exam Cycle								
<small>*Accumulated Other Comprehensive Income (AOCI)</small>								
LEGEND								
Covered by Rule			Eligible for Exemption			Streamlined Compliance		

Figure 2 Source: CSBS

CSBS believes policymakers could use a set of factors and measures other than asset thresholds that better reflect the true character of a community bank, such as the Federal Deposit Insurance Corporation’s (FDIC) research definition, introduced in 2012. CSBS believes the FDIC research definition of a community bank – which considers an institution’s business activities, funding characteristics, and geographic footprint – provides a good foundation on which to build a more rational regulatory and supervisory framework for community banks. State regulators believe there could be other criteria that policymakers use to help identify community banks, such as:

- Operating primarily in local markets;
- Deriving funding primarily from these local markets, specifically through deposits of members of the communities in which a bank operates;
- Focusing on lending out the deposits a bank collects to the communities in which it predominately operates;
- Having a lending model based on relationships and detailed knowledge of the communities and its members, not one that is volume-driven or automated;
- Focusing on providing high-quality and traditional banking services; and
- Having locally based corporate governance.

Approximately 92% of all banks in the United States are considered community banks under the FDIC's research definition, meaning roughly 5,500 community banks are embedded in local communities throughout the country. More than 93% of all state-chartered banks also meet the FDIC's definition of a community bank. In 17 of the 24 states represented on the Senate Banking Committee, more than 90% of the banks in the state are considered community banks under this definition. Recognizing that the community banking business model has both a quantitative and qualitative aspect, CSBS proposes that this definition be coupled with a petition process. This would allow institutions to petition their chartering authority for community bank designation. State supervisors recommend that, to facilitate the petition process, chartering authorities conduct analyses that examine the criteria outlined above, but also provide for additional regulatory judgment and discretion.

Whether Congress uses the FDIC community bank research definition or other measures, state regulators urge you to create a process for community bank identification that is not solely based on asset thresholds, but takes activity-based criteria into account. A more holistic definition of community banks could be used as a basis for a broad range of regulatory right-sizing initiatives. With a new approach in place to identify community banks, Congress and state regulators, in collaboration with their federal regulatory counterparts, could move toward right-sizing a more appropriate regulatory and supervisory approach for these institutions. Creating a right-sized regulatory environment will empower community banks to better serve their local markets, thus, promoting economic growth.

Capital Simplification is Necessary to Ensure that Local Communities Have Access to Financial Services

State regulators continue to support high quantities of quality capital. However, the effect of unwieldy application of federal rules is illustrated by the impact that Basel III standards have had on community banks. The current capital standards, promulgated by the Basel Committee on Banking Supervision (BCBS) regarding risk-based capital, leverage, and liquidity (otherwise known as Basel III) were designed for internationally active, complex organizations. Federal prudential regulators (the Federal Reserve Board, Office of the Comptroller of the Currency, and FDIC) have implemented Basel standards through formal rulemaking, and community banking organizations became subject to the final Basel III rule in 2015. Although the final rule included key changes that federal regulators designed to provide relief to community institutions, the current capital regime introduces unnecessary reporting complexity and costs, which impact community banks' ability to participate in certain activities. The recent Treasury Report regarding Executive Order 13772 similarly recommends that a simplification of the overall capital regime for community banks is necessary, as the complex U.S. capital rules implementing Basel III standards are not appropriately tailored.

The Complexity of the Capital Rules is Reflected in Call Report Preparation

Throughout the EGRPRA process, community bankers commented that the revised capital rules have placed undue burdens on small institutions, with little discernable benefit to safety and soundness. The capital rules are designed for much more complex and interconnected

institutions, and small banks often need to dedicate staff to regulatory reporting, pulling employees away from serving customer needs. The complexity of the capital rules is reflected in Call Report preparation – Schedule RC-R (Regulatory Capital) requires significant resources to interpret lengthy, complicated instructions, and to collect the data required for the schedule. Indeed, of the 61 pages on the new FFIEC 051 (small bank Call Report), no less than 14 pages are for the capital section. One observes a similar challenge with the instructions, with 113 pages of the total 538 pages (21%) dedicated to capital rules alone. Many data items require manual entry, and as a result, community institutions divert staff resources that could otherwise be used to serve their customers. With the simplification of capital rules, the complexity and difficulty of Call Report preparation can be eased, allowing community institutions to focus on their customer base.

HVCRE Definition Is Overly-Complex & MSA Risk-Weighting is Prohibitive

The capital rules' treatment of certain assets – such as High Volatility Commercial Real Estate (HVCRE) and mortgage servicing assets (MSAs) – have disproportionately affected small bank activity. Under the current capital rules, HVCRE is defined as all acquisition, development, and construction (ADC) commercial real estate loans with a loan to value ratio (LTV) less than or equal to the regulatory agencies' real estate lending standards, with exemptions.¹¹

In addition to raising the risk weight applied to HVCRE to 150%, the complex nature of the HVCRE definition has left community lenders unsure as to how to classify CRE loans. Since the classification's introduction in 2011 and implementation in 2013, the agencies have released several pieces of guidance. However, the EGRPRA report listed several comments emphasizing that both the definition of HVCRE and associated exemptions are unclear. State regulators recommend that that HVCRE definition and exemptions be simplified.

Additionally, the revised capital rules' treatment of mortgage servicing assets has affected local credit markets. Under the revised capital rules, MSAs are limited to 10% of a bank's common equity Tier 1 capital, and MSAs in excess must be deducted. Any portion of a bank's MSAs that are not deducted from the calculation of common equity Tier 1 will be subject to a 250% risk weight. Because of the risk weight applied to MSAs and associated compliance costs, community banks will most likely not enter the mortgage servicing space. The prohibitive risk weighting applied to MSAs could potentially limit community bank mortgage servicing, a potential income stream used to manage interest rate risk and maintain valuable customer

¹¹ All loans and credit facilities used for ADC loans of real property are to be reported as HVCRE unless **one** of the following is met: 1) the loan is secured by one-to-four family residential projects, 2) the loans is secured by a property that would qualify as an investment in a community development project, or 3) is secured by agricultural land and is used for the purchase or development of land that will or can be used for agricultural purposes. Additionally, all loans and credit facilities are to be reported as HVCRE unless **all the following** criteria are met: the project's LTV is less than or equal to the maximum supervisory loan to value limits set forth in applicable regulations, the borrower has contributed capital to the project prior to the advance of funds in the form of cash, unencumbered readily marketable assets, land to be contributed to the project purchased with cash, or certain out-of-pocket development expenses, where the aggregate of such capital contributions is at least 15 percent of the real estate project's "as completed" appraised value; and Borrower-contributed capital is contractually required to remain throughout the life of the project, i.e., until the loan is converted to permanent financing or the debt is paid in full.

relationships. This restriction of MSA activity, in combination with restrictions on hedging implemented by the Volcker Rule, limits available options for community banks to manage interest rate risk.¹²

The 2017 EGRPRA Report included a statement from the FFIEC federal member banking agencies that a proposal is under development to simplify the regulatory capital rules for community institutions.¹³ This statement highlights the impact that the treatment of HVCRE and MSAs has on local project development and banking relationships, but more important, CSBS sees a need for broader capital simplification for community banks.

Federal Mortgage Rules & Reporting Requirements Are Impeding Community Bank Residential Lending Activity

State regulators continue to observe the effect that recent mortgage regulation has had on community bank residential lending activity. Each year, as part of the CSBS-Federal Reserve *21st Century Research and Policy Conference*, CSBS surveys community banks across the country to gain insight into relevant issues affecting community institutions. Among the 974 bankers from 39 states that participated in the *CSBS 2015 National Survey of Community Banks*, only 69% listed mortgage as a primary product line, which represented a significant drop of 8% from the prior year's survey. The 2016 survey results indicated that mortgage lending activity at community banks continues to decline. Community bankers have also identified QM mortgage rules and HMDA requirements as presenting significant regulatory burden in both their complexity and implementation.

Smaller and less complex institutions have reported that stringent documentation requirements to obtain safe-harbor status from qualified-mortgage (QM) rules have made mortgage lending increasingly unprofitable, and recent research indicates that discontinuation of residential mortgage origination by community banks is on the rise.¹⁴ The CFPB's QM rule and the ability to repay (ATR) requirements,¹⁵ both made effective in 2014, have had a demonstrable effect on community bank residential lending activity.¹⁶ State supervisors find this to be a disconcerting trend, as community banks are the primary source of mortgage credit in many of our communities.

State regulators recommend that lenders that retain mortgages in portfolio should be subject to more flexible underwriting practices, as they are fully incentivized to ensure the borrower can meet the monthly obligations of a mortgage. Specifically, state regulators

¹² The Volcker Rule, or, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, OCC, Fed, FDIC, December 10, 2013, limits bank investment in structured products and restricts hedging activity.

¹³ 12 USC 3311

¹⁴ See: https://www.communitybanking.org/~media/files/communitybanking/2014/session3_peirce_robinson_stratman.pdf. How Are Small Banks Faring Under Dodd-Frank? (Peirce, Robinson, Stratman)

¹⁵ 1026.43(c), 1026.43(e)(2)

¹⁶ See <https://www.federalreserve.gov/boarddocs/SnLoanSurvey/201305/default.htm>. April 2013 Federal Reserve Senior Loan Officer Opinion Survey.

recommend granting QM status to all loans held in portfolio by community banks. This approach reflects the alignment of interest between the bank and the borrower, tailoring regulatory requirements to the relationship-based nature of community bank mortgage lending.¹⁷

The recent expansion of Home Mortgage Disclosure Act (HMDA) reporting requirements has placed a disproportionate burden on smaller and less complex institutions, potentially restricting mortgage lending. In 2018, the number of data points required to comply with HMDA reporting standards is set to double, further increasing compliance costs for smaller institutions. Despite changes to the institutional coverage of HMDA that will provide limited relief to depository institutions that report fewer than 25 loans (over the previous two calendar years), state regulators are concerned that the new reporting requirements will impose a disproportionate cost burden on small reporters that exceed the 25-loan threshold.

State regulators recommend the Bureau institute a threshold of at least 100 covered loans for depository institutions, and implement a tiered approach to HMDA reporting. By establishing a tiered approach to institutions covered under HMDA, it would reduce the burden on smaller institutions and provide value to large bank evaluations. For example, the tiered approach could consist of a tier for those institutions originating less than 100 loans; those institutions would be considered exempt from HMDA reporting. Each tier would represent larger origination volume, and would have corresponding data-reporting requirements commensurate with the volume of the institution. Institutions originating less than 100 loans annually are likely not operating in a regional or national capacity. These entities are likely to be small lenders or brokers, with limited sophistication in both systems and personnel. Because institutions with larger loan origination volume comply with additional HMDA data points, a tiered approach would not only reduce burden on small banks, but make data for all tiers more targeted and meaningful.

In addition to the increased compliance burden imposed by expanded reporting requirements, state supervisors have observed a lack of transparency in the way that HMDA data is evaluated by the various federal agencies that analyze HMDA reporting. Given that this information is a primary lens through which federal regulators determine violations of the Equal Credit Opportunity Act (ECOA) and other fair lending laws, it is critically important that the process of HMDA data collection and validation be transparent, and the data is used appropriately in the fair lending examination process.

Empower Community Banks to Continue Serving Small Businesses' Credit Needs

According to the Federal Reserve's *2016 Small Business Credit Survey*, small banks are a primary source of credit for small businesses, and successful small business loan applicants are most satisfied with small banks. Community banks have an outsized role in small business

¹⁷ See https://www.communitybanking.org/~media/files/communitybanking/2013/dgns_2012_sba_lending.pdf. Small Business Lending and Social Capital: Are Rural Relationships Different? (DeYoung, Glennon, Nigro, Spong, 2013).

lending – despite smaller asset size, community banks make 45% of all small loans to businesses in the US.¹⁸ In fact, small business startups with assets under \$1 million are most likely to be approved for financing at community banks. Small banks’ small business lending activity levels the playing field, allowing for small firms to gain a foothold in the local market.

Access to affordable and flexible mortgage credit is not simply about advancing homeownership, but also small business growth. Small business owners often rely on home equity as a significant credit source, and the overly rigid ATR standard can inhibit community banks from extending this type of credit to worthy borrowers. Empowering community banks to fulfill their role as a primary credit provider to small firms and startups will level the playing field for new entrants into our economy, continuing economic growth.

As discussed above, HMDA reporting requirements have presented significant challenges to community institutions. Recently, the CFPB has released a request for information (RFI)¹⁹ regarding the small business lending marketplace, with a focus on lending activity to women-owned and minority-owned businesses. The Bureau’s request is statutorily mandated pursuant to Dodd-Frank Section 1071, and amends ECOA to require that certain data be collected and maintained regarding small business loan applications, including:

- The number of the application and application date;
- The type and purpose of the loan or credit applied for, including the amount approved;
- Census data regarding business location;
- The gross annual revenue of the business; and
- The race, sex and ethnicity of the principle owners of the business.

State regulators firmly believe that lending should be fair, and that small business owners of minority status should be provided with access to available credit. However, state regulators are concerned that, like HMDA, data collection requirements pursuant to Section 1071 will continue to expand, with no corresponding public policy benefit.

Unlike mortgage lending, which has primarily become a commodity business, small business loans are often tailored to the borrower’s unique needs. The CFPB’s recent RFI included a request that bankers describe the data points used to make lending decisions to small business borrowers. What the Bureau will surely find, and what state regulators have been aware of for quite some time, is that community banks tailor small business lending products for the borrower’s specific needs. Any set of data points and associated reporting requirements cannot be rigid – the nature of small business lending activity simply doesn’t lend itself to an inflexible set of data points. Further, utilizing data on small business lending activity to determine ECOA compliance is a point of concern for state supervisors. The definition of small business loan differs on a nearly borrower-by-borrower basis, and attempting to use a generalized data-set to

¹⁸ FDIC Quarterly Banking Profile, Q22016. See: <https://www.fdic.gov/bank/analytical/qbp/2016jun/qbpcb.html>

¹⁹ See: <https://www.consumerfinance.gov/about-us/blog/request-information-small-business-lending/>

determine fair-lending violations will most likely be ineffective. State regulators urge the Bureau to employ an approach that considers the varying needs of small business borrowers, and products that are tailored to those needs.

The relationship lending model employed by community banks is essential in this space – often, small startups and firms do not have long operational histories, but still require funding to expand business in the local market. Because of their proximity to the community and familiarity with the borrower, community banks lend to small firms that may have otherwise been refused funding. Community banks are more likely to approve loans to small firms seeking expansion than large banks, credit unions or online lenders.²⁰ Community bank small business lending is a major driver of the economy, as new firms are a principal source of net job creation.²¹ The uncertainty associated with potential use of HMDA-like reporting for small business lending could discourage community banks from supporting local economies.

Small businesses are the cornerstone of our economy, and community banks continue to serve startups and established small businesses, allowing for a more diverse and competitive marketplace. As regulators, we understand the role and value of data to ensure that institutions are complying with the law and that credit needs are being met. However, Congress and regulators must evaluate the burdens created by new and/or expanded data collection requirements against the goal of ensuring that mandatory data collections are not stifling the very lending that we want our regulated institutions to do.

Providing Relief from Appraisal Requirements Will Address Delays in Local Home Purchase Process

State supervisors continue to observe the delays that a lack of credentialed appraisers impose on the home purchase process, particularly in rural and underserved markets. Several factors influence the ongoing shortage, including: appraisal regulation thresholds, educational requirements for licensed and certified appraisers, and a lack of clarity regarding options for relief.

The appraisal regulation thresholds established by the federal agencies to implement FIRREA²² are outdated. State regulators continue to be concerned that outdated thresholds may unnecessarily impede credit availability, particularly in rural and underserved urban markets. The current threshold of \$250,000 for both residential and nonresidential (commercial) real estate transactions has not been adjusted since 1994.²³ Real estate loans over the dollar threshold must be supported by an appraisal performed by a licensed or certified appraiser, while loans

²⁰ See <https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf>. 42% of small businesses rely exclusively on their owners' personal credit scores to secure debt, another 45% use both the owner's personal scores and business credit scores. Firms under \$1 million are most likely to use a personal guarantee as collateral to secure outstanding debt. Despite applying to large and small banks at similar rates, small firms were most likely to gain approval at small banks.

²¹ See http://www.hbs.edu/faculty/Publicationpercent20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf. Harvard Business School, *The State of Small Business Lending* (Mills & McCathy, 2016).

²² See 12 CFR 34.43

²³ See 12 C.F.R. 323.3(a)(1)

below the threshold may have the market value of the property determined by an evaluation²⁴ that conforms to published regulatory guidelines.²⁵ Evaluations do not require a credentialed appraiser, but the evaluation preparer should be knowledgeable of the market and property values.

The Appraisal Regulatory Thresholds Should be Adjusted to Reflect Inflation

In many instances, the costs associated with an appraisal on a relatively small real estate loan are high in comparison to the property's purchase price. Further, the lack or limited number of qualified appraisers in numerous markets throughout the country can lead to even higher appraisal costs and delays in the real estate transaction process.

Although the most recent EGRPRA Report stated that the agencies are developing a proposal to raise the thresholds for commercial real estate loans from \$250,000 to \$400,000, state supervisors recommend that the agencies also consider raising the threshold for residential real estate loans to reflect inflation. As part of state regulators' participation in the EGRPRA review, the State Liaison Committee (SLC) sent a letter to their fellow FFIEC member agencies urging an indexing of both commercial and residential thresholds to account for changes in real estate value over time. A reasonable increase in the threshold level does not present an undue threat to the safety and soundness of institutions. In addition, state regulators believe that real estate evaluations²⁶ conforming with regulatory guidance provide reasonable support for market values as well as protection for consumers.

Higher Education Requirements Limit Entry to Appraiser Profession

The Dodd-Frank Act requires that all appraisers, regardless of State Appraiser Regulatory Agency, conform to standards and qualifications issued by the Appraiser Qualifications Board, or AQB.²⁷ The AQB is overseen by the Appraisal Subcommittee (ASC) of the FFIEC, which was established pursuant to Title X of FIRREA. The AQB most recently published proposed changes to the *Real Property Appraiser Qualification Criteria*, which included the requirement

²⁴ See 12 C.F.R. 323.3 (b). An evaluation provides an estimate of the property's market value but does not have to be performed by a state licensed or certified appraiser.

²⁵ See <https://www.fdic.gov/news/news/financial/2010/fil10082a.pdf> and <https://www.fdic.gov/news/news/press/2016/pr16017a.pdf>. Regulatory expectations for evaluations are detailed within the December 10, 2010 Interagency Appraisal and Evaluation Guidelines, and the March 4, 2016 Interagency Advisory on Use of Evaluations in Real Estate-Related Financial Transactions.

²⁶ An evaluation is defined in the Interagency Appraisal and Evaluation Guidelines as "A valuation permitted by the Agencies' appraisal regulations for transactions that qualify for the appraisal threshold exemption, business loan exemption, or subsequent transaction exemption." Evaluations must be consistent with safe and sound banking practices, support the institution's decision to engage in the transaction, provide a reliable estimate of the collateral's market value as of a stated effective date prior to the decision to enter into the transaction, be based on a valuation method that is appropriate for a transaction rather than the method that renders the highest value, lowest cost, or fastest turnaround time; address the property's physical condition and characteristics, address the economic and market conditions that effect the estimate of the collateral's market value, and not be based on unsupported assumptions, such as an assumption that the property is in average condition, the zoning will change, or the property is not affected by adverse market conditions.

²⁷ Public Law 111-203, 124 Stat. 1376.

for a Bachelor's degree for appraisers holding a Certified Residential and Certified General Appraiser credential.²⁸ Further, the changes adopted in 2015 also require that Licensed Residential Appraisers hold thirty semester credit hours of college-level education.

State supervisors see the requirement of a Bachelor's degree and college credit hours as being an unwarranted barrier to entry into the appraiser profession, and recommend that the shortage will only continue if educational standards are not adjusted.²⁹ It is not demonstrably clear whether a Bachelor's degree is necessary to complete the requisite duties of an appraiser, and the AQB has previously proposed removing the requirement.³⁰ State regulators recommend that the educational requirements be amended, allowing for more appraisers to be credentialed, and ultimately shortening the delay caused by appraiser shortages.

The Process for Title XI Waiver from Appraisal Requirements is Unclear

Although a waiver-based option for relief is available, state regulators note that the process for attaining a waiver from appraisal requirements is not clear. Title XI of FIRREA authorizes the ASC to grant temporary waivers of any requirement relating to certification or licensing of individuals to perform appraisals in states where there is a shortage of appraisers leading to significant delays. Through the EGRPRA process and a recent public financial institution letter (FIL),³¹ the federal financial agencies have listed which entities can make requests, including:

- A state appraiser certifying or licensing agency;
- A federal bank regulatory agency;
- A regulated financial institution; or
- Other persons or institutions with demonstrable interest in appraiser regulation.

The last category is vague, and does not offer clarity as to who or what "other persons or institutions" would be eligible. Further, although the public FIL listed requirements for waiver application submission such as evidence of a demonstrable scarcity of appraisers, the publication does not detail the methodology that should drive a determination. Other process oriented details like where to send the submission, how to format it, and submission examples are not included. State supervisors appreciate the steps the FFIEC member banking agencies have taken to make interested parties aware of the waiver option; however, more clarity and guidance regarding the process is needed. Without further details or guidance, the waiver option risks being largely unused.³² State supervisors request that the FFIEC member banking agencies issue more

²⁸ See: <https://www.asc.gov/ResourcesFor/RealEstate-Appraisers/AQBRealPropertyAppraiserQualificationCriteria.aspx>

²⁹ See Appraisal Institute Comment Letter, Re: Potential Changes to the Real Property Appraiser Qualification Criteria: http://www.appraisalinstitute.org/file.aspx?Document=AI_on_2016_Exposure_Draft-3-31.pdf

³⁰ See Third Exposure Draft of proposed changes to the Real Property Appraiser Qualifications Criteria, March 15th, 2017.

³¹ See <https://www.fdic.gov/news/news/financial/2017/fil17019.html>

³² 58 FR 551 Vol. 58, No. 3 Wednesday, January 6th, 1993. *The Appraisal Subcommittee; Interim Order Granting Commonwealth of the Northern Mariana Islands Emergency Temporary Waiver Relief and Request for Comments.*

substantive and detailed guidance related to the waiver option under Title XI, in addition to exploring further options for relief from appraisal requirements.

Implementation of a Loan Basket Program Would Provide Relief to Community Banks

State regulators recommend that the agencies employ an approach like what was implemented through the *Interagency Policy Statement on Documentation for Loans to Small and Medium-sized Businesses and Farms*, or what is commonly referred to as having a “loan basket.”³³ Through the program, well or adequately capitalized institutions with a satisfactory supervisory rating are permitted to identify a portion of their portfolio of small and medium sized business and farm loans, and those loans are exempt from examiner criticism of documentation. Applying the “loan basket” policy to a portion of residential mortgage loans held in portfolio would present significant regulatory burden for smaller and less complex institutions that make and retain a small number of residential mortgage loans. This would significantly streamline the home purchase process, especially for markets with an appraiser shortage, with little cost to safety and soundness.

Re-Evaluating the Use of the Herfindahl-Hirschman Index Serves Consumer Preference in Local Markets

State supervisors continue to observe how the Herfindahl-Hirschman Index (HHI), employed in evaluations of market concentration, may not accurately represent market competitiveness, leading to out of market acquisition and entry of competitors unfamiliar with local consumers. This topic was heavily discussed at the Federal Reserve Bank of Kansas City EGRPRA Outreach meeting, but not substantively addressed in the final EGRPRA Report to Congress.

The HHI serves as the principle measure of market concentration used by federal banking regulators, and its efficacy is highly dependent upon both the definition of the market and the products or services considered in determining market share. Unless specified on a case-by-case basis, non-depositories’ market influence is not factored into HHI calculations, and credit union deposits must fulfill specific conditions to be included, albeit often at a lower weight.³⁴ The *CSBS 2016 National Survey of Community Banks* data indicated that credit unions present significant competitive pressure in local markets,³⁵ and credit union market presence continues

³³ See <https://www.fdic.gov/regulations/laws/rules/5000-3400.html>. Federal Deposit Insurance Corporation. Interagency Policy Statement on Documentation for Loans

³⁴ See: <https://www.federalreserve.gov/bankinforeg/competitive-effects-mergers-acquisitions-faqs.htm#faq16> . Credit unions are typically included in these calculations if two conditions are met: (1) the field of membership includes all, or almost all, of the market population, and (2) the credit union's branches are easily accessible to the public. In such instances, a credit union's deposits will generally be given 50 percent weight. Commercial bank deposits are weighted at 100 percent, and deposits of thrifts are weighted at 50 percent. Thrifts may receive 100 percent weight under certain conditions.

³⁵ See <https://www.communitybanking.org/~media/d217da4200ab482a868c9d9cdc8dbccc.ashx>. Conference of State Bank Supervisors, *Community Banking in the 21st Century* (2016). 52.2 percent of community bankers perceive credit unions as the biggest current competitors in the consumer lending space, and 49.6 percent of

to grow.³⁶ Additionally, in many markets where agricultural lending is the dominant industry, the Farm Credit System (FCS) presents significant competition – in fact, survey data indicates that the FCS exerts the most competitive pressure on community banks in those specific markets.³⁷ However, because the FCS is comprised of non-depository lenders,³⁸ it is left out of competitive analyses, despite holding 40% of total farm credit market share.

In other words, the current use of the HHI may inaccurately portray local markets as more concentrated and less competitive, because only those deposits reported by depository institutions are considered. We have seen cases where a high HHI figure -- indicative of a noncompetitive market -- tends to be followed by a decrease in banking concentration, often through out-of-market acquisition or entry of a competitor unfamiliar with the local market.³⁹ This highlights the importance of meaningful HHI calculations – if a banking market’s competitiveness is portrayed inaccurately, consumer needs may be ill-served by eventual market entry of a large, deposit holding institution.

The HHI’s reliance on deposit market-share to determine market concentration is problematic, as credit unions and members of the FCS, despite exerting obvious competitive pressure, are not considered. The Federal Reserve’s explanation of the reliance on deposit-level data is that

“Deposits are a reasonable indicator of a level of activity or output of a depository institution, because deposit accounts are widely held by consumers and small businesses and are held in combination with other commercial banking products.”⁴⁰

There are numerous examples of nonbanks that regularly provide services like that of commercial banks, despite a lack of deposit market-share. Because of its reliance on deposits as a proxy for activity, the HHI does not consider the market share of a wide breadth of financial firms, including: specialty lenders in mortgages and credit cards, commercial lending finance companies, accounts receivable finance companies, and money market mutual funds for deposits. As currently employed, the HHI could disadvantage in-market mergers of peer institutions and result in the entry of a large, deposit-gathering branch of a nationwide institution. In-market

community bankers indicated that credit unions present future competitive pressure regarding consumer loan activity.

³⁶ See <https://www.cuna.org/Research-And-Strategy/Credit-Union-Data-And-Statistics/>. Credit Union National Association, *Credit Union Data and Statistics* (April 2017). Credit union total memberships grew .4 percent during April of 2017.

³⁷ See <https://www.communitybanking.org/~media/d217da4200ab482a868c9d9cdc8dbccc.ashx>. Conference of State Bank Supervisors, *Community Banking in the 21st Century* (2016). 56.3 percent of community bankers experience the greatest current and future competitive pressure from FCS in the agricultural lending space.

³⁸ The Farm Credit System (FCS) is comprised of retail nonbank lenders referred to as Farm Credit Associations, or FCAs.

³⁹ See <http://www.frbsf.org/economic-research/publications/economic-letter/2003/october/good-news-on-twelfth-district-banking-market-concentration/#subhead4>. Research from the San Francisco Federal Reserve Bank indicates that when concentration is high enough to begin with, it does tend to be followed by decreases in concentration in the long run; moreover, the higher the initial concentration, the larger the decreases.

⁴⁰ See <https://www.federalreserve.gov/bankinforeg/competitive-effects-mergers-acquisitions-faqs.htm>

acquisitions better serve consumer preference, as the majority would rather seek financial services from a community bank.⁴¹

Reform the Consumer Compliance Exam Process, and Bring Transparency to Models & Methodologies

Effective fair lending enforcement is key to ensuring that financial institutions serve the communities in which they operate. State regulators are committed to consumer protection, and the enforcement of federal and state fair lending laws. However, state regulators see a supervisory approach to these issues that lacks transparency, and is more punitive than corrective.

Community banks sometimes experience a “zero tolerance” approach to compliance issues that leaves no opportunity for institutions to correct internal practices, or for examiners to provide guidance and follow-up steps on how to improve compliance. Even if an institution self-reports an issue and takes independent steps to remediate concerns, state regulators have witnessed situations in which banks are subject to unexpected enforcement actions that can persist for years at a time. For compliance examinations to fulfill their purpose and guarantee that institutions are lending to local consumers, state supervisors recommend the following:

- Federal regulators should adopt stringent expectations regarding the duration of exams. Compliance examinations in which fair lending issues are identified can span multiple years from the start of an examination through completion, often resulting in confusion for the institution and an inability to continue normal operations while a compliance issue is further analyzed at the regional office or Washington, D.C.
- Federal regulators should be more transparent regarding fair lending methodologies, namely models and underlying assumptions. We note that the Treasury Report calls on greater regulatory transparency around models and methodologies. Greater transparency of the compliance process will allow institutions to clearly understand the standards and assumptions being used, learn from each examination experience, and develop more effective compliance programs.
- To further this transparency, federal regulators should define what constitutes a pattern or practice when determining if compliance-related violations exist in a dataset. State regulators are concerned that federal regulators’ interpretation of ECOA’s referral provisions has the effect of automatically transforming a single occurrence or a very small set of occurrences into a “pattern or practice.”
- Additionally, a regulatory review process (like that of the EGRPRA process) should be implemented to ensure that community banks are not held to a higher standard than larger institutions.

For institutions to meet market demand for credit, industry must have insight into what regulatory expectations are, and how they work. A lack of information can discourage lending –

⁴¹ See: https://www.bancvue.com/custom/bancvue/pdf/CBI_Executive_Summary-KBV-2015.pdf. BancVue, *2015 Consumer Insights Study* (2015). Per the 2015 Consumer Banking Insights Study, if everything were equal, 66 percent of U.S. adults would rather bank at a community bank or credit union than a larger competitor.

without an understanding of what constitutes a compliance violation, banks may be reluctant to expand lending volume, limiting economic growth.

Modernize the Bank Service Company Act (BSCA) to Continue Legacy of Community Bank Innovation

Community banks have innovated to meet customer needs with great success, delivering financial services that have stimulated economic growth, oftentimes through partnership with technology service providers (TSPs). To support this innovation and to ensure that we, as bank regulators effectively carry out our supervisory responsibilities, effective oversight of these third parties is crucial.

State regulators have authority under state law to examine bank TSPs, and have gained valuable experience in observing how third party relationships affect local banks and consumers. Federal banking regulators' authorities are set out, primarily, in the Bank Service Company Act (BSCA).⁴² However, the BSCA contains no reference to state regulators, complicating the supervisory process for third-party service providers who work with state-chartered banks. While the BSCA does not bar state regulators from participating in exams with federal regulators, the law's failure to include state regulators has been interpreted as a barrier to information sharing and regulatory coordination. As a result:

- Federal and state banking regulators are not fully able to share information encompassing vital areas of how banks should conduct their business; and
- Because of this information gap, state and federal regulators encounter challenges in coordinating TSP exams, resulting in duplicative and inefficient supervision.

State supervisors urge Congress to amend the BSCA to include state supervisors, who are well-positioned to understand how TSP relationships affect local banking relationships. Allowing states to supervise the local effects of innovation will not only strengthen industry accountability, but also tailor product innovation to local markets. Amending the BSCA to clearly and explicitly synchronize the authorities of state and federal regulators on TSP exams will enhance coordination, improve information security, and reduce burden on both the regulators and the industry, promoting economic growth.

Without the Perspective of State Supervisors, the National Policy Process Is Incomplete

State supervisors contribute a practical and locally accountable perspective to the development of federal rulemaking and supervisory processes. Given that state regulators are involved in supervising each segment of the financial services industry, a key priority for state regulators has been to ensure state supervisory representation at every level within federal banking agencies. Since 2006, state banking regulators have been voting members of the FFIEC. Additionally, state banking regulators have been non-voting members of the Financial Stability Oversight Council (FSOC) since its creation.

⁴² 12 U.S.C. 1867

The Federal Deposit Insurance Act has long required that one member of the FDIC Board have state bank supervisory experience – in other words, at least one member of the FDIC Board must have worked as a state official supervising banks.⁴³ The legislative history surrounding this provision clearly shows that this requirement calls for an individual who worked in state government supervising banks. State regulators are concerned that the composition of the FDIC Board has not met this requirement for several years and have sought legislation clarifying the language of the Federal Deposit Insurance Act to ensure that this requirement is met. State regulators urge the Administration to follow the letter and spirit of the law in filling vacancies on the FDIC Board.

Additionally, CSBS worked with Congress recently to make a change to the Federal Reserve Act requiring that at least one member of the Federal Reserve Board of Governors have experience working in or supervising community banks.⁴⁴

A recurring theme in the Treasury Report is the importance of improving regulatory coordination. The dual banking system is premised on state-federal coordination and on the benefits for regulators and industry of efficient regulatory coordination. Federal policy tends to address issues found throughout the entire banking industry, while state supervisors bring a more local perspective and local accountability for economic growth. To achieve this regulatory balance, CSBS recommends that the Administration consider individuals who understand the impact that Washington decisions have at the local level, and are committed to regulatory coordination in identifying federal banking agency leadership.

State Regulation Continues to Keep Pace with Innovative Financial Services

The state system has served our nation over nearly two centuries, and has remained consistently steadfast through both crises and economic prosperity. State regulation continues to evolve with the financial services space, and state supervisors are actively seeking ways to streamline and modernize supervision. States regulators encourage community banks to share resources to maintain compliance, expand customers' access to products and services, and improve operational efficiency.⁴⁵ In addition to encouraging community-based banks to enter shared resource agreements, state regulators are crafting broader initiatives to modernize state supervision.

Introduced in May of 2017, CSBS' Vision 2020 promises that state supervisors will continue to strengthen our financial system by streamlining and simplifying licensing requirements, and harmonizing state supervision of non-banks. Vision 2020 also promises to address both bank and non-bank concerns by addressing de-risking due to regulatory uncertainty, allowing banks to provide services to non-banks, and for banks to easily partner with third party service providers. The states will continue to leverage an on-the-ground perspective to spot emerging risks, support innovation, and encourage coordination with federal regulators. As part

⁴³ USC 12 1812(a)

⁴⁴ 12 USC § 241

⁴⁵ See: <https://www.csbs.org/news/presentations/annualreports/Documents/Shared%20Resource%20Arrangements%20Whitepaper%20FINAL.pdf> Conference of State Bank Supervisors, *Shared Resource Arrangements: An Alternative to Consolidation* (2016).

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of Vision 2020, state regulators will collaborate with industry and gain insight into points of friction in licensing and multi-state regulation. However, for the local economies that comprise our national community to thrive, the burden of federal regulation on smaller institutions must be addressed.

Conclusion

Myself and the state regulators I represent appreciate the opportunity to present issues of importance to local credit communities. Community banks are vital to the economic health of local markets that are too often excluded from the federal policy development process.

The perspective of the states offers a nuanced, specific approach to policy. Although macro approaches to issues that affect the entire banking market are necessary, they simply cannot function if they do not take smaller and less-complex banks, which comprise most our country's institutions, into account.

Thank you for your time and continued attention.