INDEPENDENT COMMUNITY
BANKERS of AMERICA®

June 9, 2016

The Destructive Impact of Regulatory Burden on Rural Communities

On behalf of the more than 6,000 community banks represented by ICBA, we thank Chairman Huelskamp and Ranking Member Chu for convening today's hearing entitled: “"Bearing the Burden: Over-regulation's Impact on Small Banks and Rural Communities." ICBA is pleased to submit this statement for the record describing the destructive impact of regulatory burden on rural community banks and the customers and communities they serve. ICBA's “Plan for Prosperity,” which is attached to this statement, provides a road map for needed regulatory relief.

America is mired in an anemic economic recovery, with GDP growth of a mere 0.5 percent at an annualized pace in the first quarter of 2016. America must do better to sustain our prosperity or the next generation will experience a starkly different way of life. What's worse, new business creation, a critical engine of economic growth and job creation, has been highly concentrated in a small number of urban areas in the current economic recovery. According to new research by the Economic Innovation Group, half of new business in the current recovery have been located in just 20 U.S. counties.[1] Rural counties have seen more businesses disappear than created. Similarly, in the current recovery, rural counties account for just 1 in 10 newly created jobs.

Access to bank credit – predominantly provided by community banks -- is critical to reversing this trend and revitalizing rural America. As an FDIC Community Banking Study showed, in one out of every five counties in the United States, the only physical banking offices are those operated by community banks.[2] Collectively, community banks provide nearly 50 percent of all small business loans in the country and 77 percent of all agricultural loans, according to a study from Harvard's Kennedy School.[3]

Regulatory relief for community banks is critically important to ensuring continued access to the credit in rural America. In recent years, community banks have experienced a sharply increasing regulatory burden. The nature of community banking has changed from lending and investing in local communities to compliance with ever-increasing rules and guidance. But the real crisis is

---

[1] “The New Map of Economic Growth and Recovery,” The Economic Innovation Group. May 2016.
[2] FDIC Community Banking Study. December 2012.
[3] “The State and Fate of Community Banking.” Marshall Lux and Robert Greene. Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School. February 2015.

1615 L Street NW, Suite 900, Washington, DC 20036 ■ 202-659-8111 ■ Fax 202-659-9216 ■ www.icba.org

the customer impact. Simply put, regulatory burden is cutting off access to credit to credit worthy borrowers, especially in rural America.

The economic life of rural America depends on customized financial products and services that only community banks provide. Residential properties in small and rural communities are typically unique. They may sit on a large plot of land, be mixed-use in nature, or irregular in other ways. They are frequently outside of city limits. These are not suburban, tract-like properties and for this reason they often lack adequate comparables and don't fit the inflexible requirements of the secondary market. In addition, the borrowers may be farmers or small business owners whose debt-to-income ratios fall outside of secondary market parameters, despite their personal net worth and means to repay the loan. Community banks specialize in serving such borrowers, often with balloon payment or other non-conforming loans held in portfolio. Balloon payments protect the lender from the significant interest rate risk of a 30 year, fixed-rate loan. They have been made safely by community banks for decades.

Small business lending in rural communities presents a similar story. Community banks extend credit based on their first-hand knowledge of the borrower, the community, and the local economy. A bank based outside the community simply cannot match this type of underwriting. As the Harvard study noted, in certain lending markets, there is no effective substitute for the "skills, knowledge, and interpersonal competencies" of a community bank. Agricultural lending in particular is a very specialized form of lending that requires extensive knowledge of farming, crops, and local conditions.

Community banks are disproportionately impacted by regulatory burden because they have a much smaller asset base over which to spread regulatory costs. Without dedicated legal and compliance departments, community banks have to divert valuable staff from other duties, including serving customers, to implement new rules and other changes, a process that can take weeks or months depending on the complexity of the change and the bank processes impacted. If consolidation continues apace and rural community banks disappear under the weight of regulatory burden, millions of rural customers – including farmers, small business owners, families and individuals – will be cut off from credit.

Attachment: ICBA's Plan for Prosperity

1615 L Street NW, Suite 900, Washington, DC 20036 ▪ 202-659-8111 ▪ Fax 202-659-9216 ▪ www.icba.org

INDEPENDENT COMMUNITY BANKERS of AMERICA

One Mission. Community Banks.®

Plan for Prosperity

A Pro-Growth Agenda to Reduce the Onerous Regulatory Burden on Community Banks and Empower Local Communities

2016

Plan for Prosperity: An Agenda to Reduce the Onerous Regulatory Burden on Community Banks and Empower Local Communities

America's more than 6,000 community banks are critical to the prosperity of the U.S. economy. Providing more than half of all small business loans under $1 million, as well as customized mortgage, consumer, and agricultural loans suited to the unique characteristics of their local communities, community banks serve a vital role in sustaining robust economic growth in communities of all sizes and in every region of the country.

In order to reach their full potential as catalysts for entrepreneurship, economic growth, and job creation, community banks must be able to attract capital in a highly competitive environment. An end to the exponential growth of onerous regulatory mandates is critical to this objective. Regulation is suffocating nearly every aspect of community banking and changing the very nature of the industry away from community investment and community building to paperwork, compliance, and examination. A fundamentally new approach is needed: Regulation must be calibrated to the size, lower-risk profile, and traditional business model of community banks.

ICBA's Plan for Prosperity ("Plan") provides targeted regulatory relief that will allow community banks to thrive by doing what they do best – serving and growing their communities. By reducing unsustainable regulatory burden, the Plan will ensure that scarce capital and labor resources are used productively, not sunk into unnecessary compliance costs, allowing community banks to better focus on lending and investing that will directly improve the quality of life in our communities. Each provision of the Plan was developed with input from community bankers nationwide and crafted to preserve and strengthen consumer protections and bank safety and soundness.

The Plan is a set of detailed legislative priorities positioned for advancement in Congress. Four Plan provisions were signed into law in 2015. A subset of these priorities is specifically dedicated to strengthening community bank viability by creating new options for capital raising and capital preservation. A number of regulatory relief measures would be tiered. The recommended thresholds are based on existing levels and statutory provisions, which may vary by provision.

ICBA is committed to advancing and enacting the provisions of the Plan with all due vigilance and the aggressive use of every resource at our disposal. The Plan is a flexible, living document that can be adapted to a rapidly changing regulatory and legislative environment to maximize its influence and likelihood of enactment. Provisions are described below.

ACCESS TO CAPITAL: CREATING NEW OPTIONS FOR THE CREATION AND PRESERVATION OF COMMUNITY BANK CAPITAL

ICBA is proposing a set of options to strengthen community bank viability by enhancing access to capital.

Basel III Amendments: Restoring the Original Intent of the Rule. Basel III was originally intended to apply only to large, internationally active banks. ICBA supports a full exemption from Basel III for non-systemically important financial institutions (non-SIFIs). If a full exemption is not possible, ICBA proposes the following amendments:

- *Exemption from the capital conservation buffer.* The new buffer provisions impose dividend restrictions that have a chilling effect on potential investors. This is particularly true for Subchapter S banks whose investors rely on dividends to pay their pro-rata share of the bank's tax. Exempting non-SIFIs from the capital conservation buffer would make it easier for them to raise capital.
- *Full capital recognition of allowance for credit losses.* Provide that the allowance for credit losses is included in tier 1 capital up to 1.25 percent of risk weighted assets with the remaining amount reported in tier 2 capital. This change would reverse the punitive treatment of the allowance under Basel III. The allowance should be captured in the regulatory capital framework since it is the first line of defense in protecting against future credit losses.
- *Amend risk weighting to promote economic development.* Provide 100 percent risk weighting for acquisition, development, and construction loans. Under Basel III, these loans are classified as high volatility commercial real estate loans and risk weighted at 150 percent. ICBA's proposed change would treat these loans the same as other commercial real estate loans and would be consistent with Basel I.

More Accurate Identification of "Systemic Risk." The current threshold of $50 billion for the identification of "systemically risky financial institutions" (SIFIs) under Title I of the Dodd-Frank Act is too low. It sweeps in too many banks that pose no systemic risk and should not be subject to higher prudential standards. A higher threshold and a more flexible "SIFI" definition under Title I would more accurately identify those institutions that impose systemic risk to our banking system.

Additional Capital for Small Bank Holding Companies: Modernizing the Federal Reserve's Policy Statement. Require the Federal Reserve to revise the Small Bank Holding Company Policy Statement – a set of capital guidelines that have the force of law. The Policy Statement, which makes it easier for small bank and thrift holding companies to raise additional capital by issuing debt, would be revised to increase the qualifying asset threshold from $1 billion to $5 billion. Qualifying bank and thrift holding companies must not have significant outstanding debt or be engaged in nonbanking activities that involve significant leverage.

Relief from Securities and Exchange Commission Rules. ICBA recommends the following changes to SEC rules which would allow community banks to commit more resources to their communities without putting investors at risk:

- Provide an exemption from internal control attestation requirements for banks with assets of less than $1 billion. The current exemption applies to any company with market capitalization of $75 million or less. Because smaller bank internal control systems are monitored continually by bank examiners, they should not have to sustain the unnecessary annual expense of paying an outside audit firm for attestation work. This provision will substantially lower the regulatory burden and expense for small, publicly traded banks without creating more risk for investors.

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

TARGETED REGULATORY RELIEF

Supporting a Robust Housing Market: Mortgage Reform for Community Banks. Provide more community banks relief from certain mortgage regulations, especially for loans held in portfolio. When a community bank holds a loan in portfolio, it has a direct stake in the loan's performance and every incentive to ensure it is properly underwritten, affordable, and responsibly serviced. Relief would include:

- Providing "qualified mortgage" safe harbor status for loans originated and held in portfolio by banks with less than $10 billion in assets, including balloon mortgages.
- Exempting banks with assets below $10 billion from escrow requirements for loans held in portfolio.
- An exemption from the higher risk mortgage appraisal requirements for loans of $250,000 or less provided they are held in portfolio by the originator for a period of at least three years.
- Information reporting requirements under the Home Mortgage Disclosure Act (HMDA) should not apply to banks that originate a modest volume of mortgages. A new HMDA rule exempts lenders that originate fewer than 25 closed-end loans or fewer than 100 open-end lines in each of the two preceding calendar years. These exemption thresholds should be significantly increased.

Preserve Community Bank Mortgage Servicing. The provisions described below would help preserve the important role of community banks in servicing mortgages and deter further industry consolidation, which is harmful to borrowers:

- Increase the "small servicer" exemption threshold to 20,000 loans (up from 5,000). To put this proposed threshold in perspective, the average number of loans serviced by the five largest servicers subject to the national mortgage settlement is 6.8 million. An exemption threshold of 20,000 would demarcate small servicers from both large and mid-sized servicers.
- For banks with assets of $50 billion or less, reverse the punitive Basel III capital treatment of mortgage servicing rights (MSRs) and allow 100 percent of MSRs to be included as common equity tier 1 capital.

Strengthening Accountability in Bank Exams: A Workable Appeals Process. The trend toward oppressive, micromanaged regulatory exams is a concern to community bankers nationwide. An independent body would be created to receive, investigate, and resolve material complaints from banks in a timely and confidential manner. The goal is to hold examiners accountable and to prevent retribution against banks that file complaints.

Reforming Bank Oversight and Examination to Better Target Risk. ICBA makes the following recommendations to allow bank examiners to better target their resources at true sources of systemic risk:

- A two-year exam cycle for well-rated banks with up to $2 billion in assets would allow examiners to better target their limited resources toward banks that pose systemic risk. It would also provide needed relief to bank management for whom exams are a significant distraction from serving their customers and communities.
- Non-systemically important financial institutions (non-SIFIs) should be exempt from stress test requirements.
- Community banks should be allowed to file a short form call report in the first and third quarters of each year. The current, long form call report would be filed in the second and fourth quarters. The quarterly call report now comprises some 80 pages supported by almost 700 pages of instructions. It represents a growing burden on community banks without being an effective supervisory tool.
- The Community Reinvestment Act (CRA) asset thresholds should be modernized. The "small bank" threshold should be raised from $305 million to $1.5 billion, and the "intermediate small bank" should be raised from $1.221 billion to $5 billion. While no bank is exempt from CRA, asset thresholds are used to determine how a bank is assessed. The current asset thresholds do not reflect consolidation in the community banking industry. In addition, the threshold for determining how often a bank is assessed should be increased. Banks with assets up to $1 billion (up from $250 million) and an overall CRA rating of "outstanding" should be evaluated every five years, and those with an overall rating of "satisfactory" should be evaluated every four years. Community banks prosper by reinvesting local deposits and serving all customers in their communities. Too frequent or intrusive CRA exams unnecessarily expend resources that could otherwise be dedicated to serving customers.

Risk Targeting the Volcker Rule. Exempt non-systemically important financial institutions (non-SIFIs) from the Volcker Rule. The Volcker Rule should apply only to the largest, most systemically risky banks. Proposals to apply the rule to non-SIFIs carry unintended consequences that threaten to destabilize segments of the banking industry.

Balanced Consumer Regulation: More Inclusive and Accountable CFPB Governance. The following changes would strength CFPB accountability, improve the quality of the agency's rulemaking, and make more effective use of its examination resources:

- All banks with assets of $50 billion or less should be exempt from examination and enforcement by the CFPB and instead be examined and supervised by their prudential regulators for compliance with consumer protection regulation; and CFPB backup (or "ride along") authority for compliance exams performed by a bank's primary regulator should be eliminated.
- Change the governance structure of the CFPB to a five-member commission rather than a single Director. Commissioners would be confirmed by the Senate to staggered five-year terms with no more than three commissioners affiliated with any one political party. This change will strengthen accountability and bring a diversity of views and professional backgrounds to decision-making at the CFPB.

- The Financial Stability Oversight Council's review of CFPB rules should be strengthened by changing the vote required to veto a rule from an unreasonably high two-thirds vote to a simple majority, excluding the CFPB Director.

Eliminate Arbitrary "Disparate Impact" Fair Lending Suits. Amend the Equal Credit Opportunity Act and the Fair Housing Act to bar "disparate impact" causes of action. Disparate impact describes differential results that arise despite the use of practices that are facially neutral in their treatment of different groups. In June 2015, the U.S. Supreme Court limited the application of disparate impact theory under the Fair Housing Act so that statistical data alone is not sufficient to establish liability: a plaintiff must also cite a specific practice that results in disparate impact. Despite this limitation, lenders still have to consider factors such as race and national origin in individual credit decisions to protect themselves from fair lending regulatory enforcement actions and lawsuits. Moreover, the Supreme Court's decision does not extend to the Equal Credit Opportunity Act. Legislation is needed to eliminate disparate impact and ensure lenders that uniformly apply neutral lending standards are not subject to unnecessary regulatory enforcement actions or frivolous and abusive lawsuits under the Equal Credit Opportunity Act or the Fair Housing Act.

Ensuring the Viability of Mutual Banks: New Charter and Capital Options. A new charter for mutual national banks would allow institutions to choose the charter that best suits their needs and the communities they serve. Mutual institutions should be authorized to issue mutual capital certificates, an additional option for raising capital. Existing federal savings associations chartered under the Home Owners' Loan Act should be able to elect to have the rights and privileges of a national bank without changing charters.

Rigorous and Quantitative Justification of New Rules: Cost-Benefit Analysis. Provide that financial regulatory agencies cannot issue notices of proposed rulemakings unless they first determine that quantified costs are less than benefits. The analysis must take into account the impact on the smallest banks which are disproportionately burdened by regulation because they lack the scale and the resources to absorb the associated compliance costs. In addition, the agencies would be required to identify and assess available alternatives including modifications to existing regulations. They would also be required to ensure that proposed regulations are consistent with existing regulations, written in plain English, and easy to interpret.

Cutting the Red Tape in Small Business Lending: Eliminate Burdensome Data Collection. Exclude banks with assets below $10 billion from new small business data collection requirements. This provision, which will likely require the reporting of information regarding every small business loan application, will fall disproportionately upon smaller banks that lack scale and compliance resources.

Incentivizing Credit for Low and Moderate Income Customers and American Agriculture. ICBA supports the creation of new tax credits or deductions for community bank lending to low and moderate income individuals, businesses, and farmers and ranchers in order to offset the competitive advantage enjoyed by tax-exempt credit unions and Farm Credit System (FCS) lenders. Credit unions were initially created and granted a generous exemption from federal, state, and local tax for the specific purpose of serving people of modest means with a common bond. However, independent studies show that community banks do a better job of serving low and moderate income customers than credit unions. The tax subsidies granted to FCS lenders – often large, multi-billion dollar institutions serving the same customers served by much smaller community banks – distort the marketplace. The revenue loss associated with the credit union and FCS tax exemptions serves no public purpose. The creation of targeted tax credits or deductions for community banks would help to sustain and strengthen lending to low and moderate income customers and America's farmers and ranchers.

Modernize Subchapter S Constraints. Subchapter S of the tax code should be updated to facilitate capital formation for community banks, particularly in light of higher capital requirements under the proposed Basel III capital standards. The limit on Subchapter S shareholders should be increased from 100 to 200; Subchapter S corporations should be allowed to issue preferred shares; and Subchapter S shares, both common and preferred, should be permitted to be held in individual retirement accounts (IRAs). These changes would better allow the nation's 2,200 Subchapter S banks to raise capital and increase the flow of credit.

Limited Liability Corporation Option for Community Banks. In addition to modernization of Subchapter S for banks (as described above), ICBA supports the creation of a limited liability company (LLC) option for community banks. The LLC election would allow pass-through tax treatment for community banks without the limitations of Subchapter S organization.

Update Bank Qualified Bond Issuer Limitation. Since 1986, the tax code has provided a special incentive for banks to purchase bonds issued by municipalities, school districts, sanitation districts, and other public entities provided the issuer expects to issue no more than $10 million of bonds annually. These are known as "bank qualified bonds." Because the $10 million limitation has been severely eroded by inflation, today only a small number of issuers are eligible to take advantage of lower interest rates by issuing bank qualified bonds. The limitation was temporarily increased to $30 million by the American Recovery and Reinvestment Act of 2009. ICBA supports a permanent increase in the limitation to $30 million to be indexed prospectively. A higher limitation would allow local bank deposits to support needed, local public infrastructure investments at a lower interest rate, as originally intended by the 1986 Tax Reform Act.

Five-Year Loss Carryback Supports Lending During Economic Downturns. Banks with $15 billion or less in assets should be allowed to use a five-year net operating loss (NOL) carryback**.** The five-year NOL carryback is countercyclical and will support community bank capital and lending during economic downturns.

The Independent Community Bankers of America®, the nation's voice for more than 6,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. For more information, visit www.icba.org.