Testimony of

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On behalf of the

Independent Community Bankers of America

Before the

United States Senate
Committee on Banking, Housing and Urban Affairs

Hearing on

"Bank Capital and Liquidity Regulation Part II: Industry Perspectives"

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Opening

Chairman Shelby, Ranking Member Brown, and members of the Committee, my name is Rebeca Romero Rainey, and I am Chairman and CEO of Centinel Bank of Taos, a $215 million asset bank with 48 employees headquartered in Taos, New Mexico. I'm a third generation community banker. Centinel was founded by my grandfather, Eliu E. Romero, in 1969 after he was denied a loan to finance his start-up law practice. I'm proud to carry on his legacy of service to our community by providing access to credit on an equitable basis to all responsible borrowers.

I am also Chairman of the Independent Community Bankers of America (ICBA), and I testify today on behalf of the more than 6,000 community banks we represent. Thank you for convening this hearing on bank capital and liquidity regulation. A great deal is at stake in these regulations. They have the power to promote or to stifle community bank lending, and can make or break a community. It is critically important that we get them right.

Changes are urgently needed to community bank capital regulation. In particular, ICBA urges the support of this Committee for an exemption from Basel III for banks with assets of less than $50 billion. More on that later in this statement.

At the outset, I would like to thank the members of this committee for your leadership in securing inclusion of community bank regulatory relief in the FAST Act, which was signed into law last December. FAST Act relief includes expansion of the exam cycle for highly rated banks, broadening of accommodations under the CFPB's "ability to repay" rule, the long-sought elimination of annual privacy notices when a bank has not changed its privacy policies, and other important provisions. We encourage this committee to build on that record by enacting additional regulatory relief measures for community banks.

I would also like to thank the members of this committee who contacted the bank regulators during their consideration of the Basel III rule to express their concern about the impact of the rule on community banks. Your influence was critical to securing notable improvements in the final rule, though, as explained below, the rule continues to pose a significant threat to consumers and small businesses seeking credit.

Basel III

With the implementation of the Basel III Capital Rule, which began in 2015, bank capital regulation became significantly more complex and punitive, especially for community banks. Do we really need four definitions of regulatory capital, plus a capital conservation buffer, and complex rules governing capital deductions and adjustments? More fundamentally, why does the rule apply to community banks at all?

At its inception, Basel III was meant to apply only to the largest, interconnected, internationally active and systemically important institutions. Community banks, with their simple capital structures and conservative funding and lending practices, have nothing in common with these larger institutions.

Applying Basel III to community banks in a one-size-fits-all manner harms the consumers and businesses that rely on community bank credit. The impact will be especially harsh in small communities and rural areas not served by larger institutions. This is why 17,000 community bankers signed a petition calling for an exemption from Basel III for community banks.

Aspects of Basel III that are of particular concern for Centinel Bank and other community banks include:

High Volatility Commercial Real Estate (HVCRE)

My community of Taos has yet to fully recover from the last recession and continues to experience high unemployment. New development projects would create jobs in construction and related services, which would in turn boost consumer spending and create additional jobs. These projects might include hotels, apartment buildings, shopping centers, hospitals, or other commercial projects – important sources of employment in themselves after construction has been completed.

Unfortunately, such projects would be defined as high volatility commercial real estate (HVCRE) under Basel III – unless the borrower can contribute at origination 15 percent of the projected appraised value of the project upon its completion in cash or readily marketable assets. The borrower must also commit to tying up that capital for the life of the project. HVCRE loans are subject to punitive risk weighting for the determination of regulatory capital: 150 percent compared to 100 percent before Basel III. I now have to allocate 50 percent more capital in order to finance a loan that my community desperately needs.

The HVCRE rule sweeps in too many credit worthy developers who are well established in our local business community, developers who exercise due diligence in planning projects with manageable risk but simply do not have the resources to tie up a 15 percent cash contribution for the life of a multi-year construction project. Such a developer might have an equity stake in land that will serve as the site of a project. But, under the HVCRE rule, any appreciated value of land equity does not count toward the required 15 percent contribution.

At Centinel Bank, we want to make every credit worthy loan that we possibly can – consistent with reasonable capital requirements and safety and soundness – to ensure the prosperity of our community and the long-term viability of the bank. The HVCRE rule will force us to make difficult trade-offs in lending to promising development projects. The result will be reduced credit availability and higher costs for potentially job-creating projects. Rural communities will be particularly hard hit. While urban and suburban communities have access to non-bank options for project finance – lenders and investors not subject to regulatory capital requirements – communities such as mine rely almost exclusively on community bank credit. Subjecting community banks to punitive capital treatment for HVCRE lending will hobble the economic recovery in Taos, New Mexico and in thousands of communities across the country.

ICBA is grateful to members of Congress who have written to the heads of the banking regulatory agencies to express their concerns about the impact of the HVCRE rule.

Introduced Legislation

ICBA strongly supports the Community Bank Access to Capital Act (S. 1816), sponsored by committee member Senator Mike Rounds and Senator Roy Blunt, which would, among other provisions, direct the bank regulatory agencies to issue a regulation exempting community banks with assets of less than $50 billion from Basel III.

Complex New Reporting Requirements

Another troubling aspect of Basel III is its contribution to the volume and complexity of our quarterly call report – which had already become a nearly unmanageable burden. Today's call report consists of 80 pages of forms and more than 670 pages of instructions, with one new schedule alone taking up 134 pages. Centinel Bank's last call report was 93 pages long and its preparation consumed 2-1/2 weeks of full time equivalent hours. That's over a month of FTE hours each year. This is unfortunately typical of the staff burden the call report imposes on a community bank.

It hasn't always been this way. The call report is so named because it used to be called in by phone. Unfortunately, the report has grown since that time out of all proportion to its value in monitoring safety and soundness, and Basel III has only amplified it growth. As recently as 2006, before Basel III, the call report instructions were 45 pages long, roughly half of what they are now.

Only a fraction of the information collected is actually useful to regulators in monitoring safety and soundness and conducting monetary policy. The 80 pages of forms contain extremely granular data such as the quarterly change in loan balances on owner-occupied commercial real estate. Whatever negligible value there is for the regulators in obtaining this type of detail is dwarfed by the expense and the staff hours dedicated to collecting it. To put things in perspective, consider this contrast: the largest, multi-billion-dollar credit unions filed a less than 30-page call report in the first quarter of 2016. Surely, regulators can supervise community banks with significantly less paperwork burden than they currently demand.

In September 2014, nearly 15,000 community bankers representing 40 percent of all community banks nationwide signed an ICBA petition to the regulatory agencies calling for more streamlined quarterly call report filings.

ICBA's recent Community Bank Call Report Burden Survey empirically demonstrates this problem. Eighty-six percent of survey respondents said the total cost of preparing the quarterly call report has increased over the last 10 years.[1] Thirty percent said it had increased significantly. A typical $500 million asset community bank spends close to 300 hours a year of senior level, highly-compensated staff time on the quarterly call report.

For this reason, ICBA is calling on the agencies to allow highly-rated community banks to submit a short form call report in the first and third quarters of each year. A full call report would be filed at mid-year and at year-end. The short form would contain essential data required by regulators to conduct offsite monitoring, including income, loan growth, changes in loan loss reserves, and capital position. In the recent survey noted above, community bank respondents overwhelmingly agreed that instituting a short-form call report in certain quarters would provide a great deal of regulatory relief. Seventy-two percent of respondents indicated the relief would be substantial.

Introduced Legislation

A number of bills introduced in the House and Senate would provide for short form call reports, notably the Clear Plus Act (S. 927), introduced by Senators Jerry Moran and Jon Tester.

The Capital Conservation Buffer and Subchapter S Community Banks

In addition to establishing higher minimum capital ratios and new risk weights, Basel III also establishes a capital conservation buffer of 2-1/2 percent. Banks that do not exceed the buffer face restrictions on dividends and discretionary bonuses.

The capital conservation buffer is a concern for all banks, but it poses a special challenge for the more than 2,000 community banks – one third of all community banks – organized under Subchapter S of the tax code, including Centinel Bank.

Subchapter S banks are "pass through" entities, taxed at the shareholder level. Shareholders are responsible for paying taxes on their pro-rata of the bank's net income, whether that income is distributed or not. When a Subchapter S bank falls short of the capital conservation buffer and is restricted in full or in part from making distributions, shareholders are required to pay taxes on the bank's net income out of their own pockets. Investors expect returns on their investments, or at least deductible losses. What they do not expect is an unfunded tax bill in year when their investment had positive net income.

This possibility makes it significantly more difficult for a subchapter S bank to solicit new shareholders or to raise additional capital from existing shareholders. While FDIC and the Federal Reserve have stated that they would consider waiving dividend restrictions on a case-by-case basis, this is hardly reassuring to current or potential investors. A better solution is needed, such as a community bank exemption from Basel III, or at a minimum, a provision to allow a distribution of at least 40 percent of a

[1] 2104 ICBA Community Bank Call Report Burden Survey. http://www.icba.org/files/ICBASites/PDFs/2014CallReportSurveyResults.pdf

Subchapter S bank's net income, regardless of the capital conservation buffer. This would ensure that a bank can distribute at least enough to cover its shareholders' taxes.

Capital Treatment of Mortgage Servicing Assets

The punitive new capital provisions of Basel III pose a real threat to community bank mortgage servicing. ICBA believes it is critical to retain and promote the role of community banks in mortgage servicing and to adopt policies that will deter further consolidation of that industry. Community banks thrive on their reputation for customer focus and local commitment. Their involvement in mortgage servicing promotes industry competition and deters future abuses and avoidable foreclosures such as those that impeded the housing recovery and led to the national mortgage settlement. Despite this, the Basel III mortgage servicing asset (MSA) provisions seem to be designed to drive community banks from the mortgage servicing business.

Basel III provides that the value of mortgage servicing assets (MSAs) that exceed 10 percent of a bank's common equity tier 1 capital must be deducted directly from its regulatory capital.[2] In addition, MSAs that are below the 10 percent threshold must be risk weighted at 250 percent once Basel III is fully phased in. Expressed in terms of capital ratios, MSAs shrink the numerator or capital (when they exceed the 10 percent threshold) and inflate the denominator or assets, resulting in a lower regulatory capital ratio. As if this were not enough, there's a third limitation on MSAs: When MSAs combined with deferred tax assets and investments in the common stock of unconsolidated financial institutions exceed 15 percent of common equity tier 1 capital, the excess must also be directly deducted from regulatory capital. Many banks that do not exceed that 10 percent MSA threshold are caught by the 15 percent combined threshold.

The Basel III rule is a drastic change from the previous rule which allowed a bank to hold MSAs up to 100 percent of tier 1 capital (and broader measure of capital) and risk weight MSAs at 100 percent. Any change in policy with such a broad adverse impact should have been clearly supported by data and analysis. But regulators offered no data or empirical analysis whatsoever to suggest that MSAs destabilized banks during the recent financial crisis.

Introduced Legislation

ICBA supports bills introduced in the House and Senate that would require the federal banking agencies to study the impact of the Basel III capital treatment of mortgage servicing assets, including Chairman Shelby's Financial Regulatory Improvement Act (S. 1484).

[2] MSAs represent the future value of servicing mortgage loans owned by third parties.

Capital Treatment of TruPS Investments

ICBA urges this committee to support capital relief for community banks, many of them rural-based, that invested in trust preferred securities (TruPS) issued by other community banks. Under the Basel III rule, these investments are subject to the same punitive capital treatment as MSAs: TruPS investments that exceed 10 percent of a bank's common equity tier 1 capital must be deducted directly from its regulatory capital. A capital deduction for their TruPS investments will directly reduce their capacity to provide credit in their communities.

Basel III provides an exemption for community banks that *issued* TruPS prior to May 19, 2010: These banks continue to count the proceeds of their TruPS issuances as Tier 1 capital. A comparable exemption should be provided to community banks that *invested* in TruPS. Parity between issuers and investors in the same securities will create a more equitable outcome and will provide a direct benefit to the communities they serve.

Disincentive for De Novo Charters

I ask you to consider the cumulative impact of the Basel III capital rule, numerous additional bank regulations that have gone into effect in recent years, and others that are in statute but have not yet been implemented. The complexity and volume of new regulation is a strong disincentive for de novo bank charters. I doubt that Centinel Bank or many other community banks would have been chartered if they had been faced with the daunting regulatory cost and complexity that exists today.

The FDIC has approved only two applicants for deposit insurance in the past four years, a dramatic shift from many years of de novo bank formation averaging over 170 per year. Community bank consolidation, coupled with the dearth of new charters, will leave many communities without a local bank or access to local credit. I urge this committee to consider legislation that will incentivize much needed de novo bank formation.

<u>Other Proposals That Would Support Community Bank Capital</u>

Modernize the Federal Reserve's Small Bank Holding Company Policy Statement

Addressing the punitive capital regulation of Basel III is a priority for community banks. Short of an outright exemption for community banks, or at least targeted relief, from Basel III, I encourage this committee to consider measures that would help us to meet our higher capital requirements under the new rule and better serve our customers and communities.

ICBA supports legislation that would raise the consolidated assets threshold for the Federal Reserve's Small Banking Holding Company Policy Statement (Policy Statement) from $1 billion to $5 billion. I would like to thank the members of this committee for their efforts and leadership in the adoption of legislation at the end of the 113th Congress which raised the Policy Statement asset threshold from $500 million to $1 billion. That change has provided relief for nearly 650 bank and thrift holding companies.

ICBA has long held the position that the threshold should be significantly higher to recognize the higher average asset size of today's community banks and bank and thrift holding companies. Approximately 415 additional bank holding companies would obtain capital relief if the Policy Statement were raised to $5 billion.

The Policy Statement is a set of capital guidelines with the force of law that allows qualifying holding companies to raise and carry more debt than larger holding companies and potentially downstream the proceeds to their subsidiary banks. The Policy Statement plays an important role in capital formation for smaller bank and thrift holding companies that have limited access to equity markets. A higher threshold will help more community banks meet their higher capital requirements under Basel III.

The Policy Statement contains safeguards to ensure that it will not unduly increase institutional risk. These include limits on outstanding debt and on off-balance sheet activities (including securitization), a ban on nonbanking activities that involve significant leverage, limitations on dividends, and a requirement that each depository institution subsidiary of a small bank holding company remain well capitalized.

Introduced Legislation

ICBA is very pleased that H.R. 3791, which would raise the Policy Statement threshold to $5 billion, passed the House in April of this year. The bill is sponsored by Rep. Mia Love.

New Capital Options for Mutual Banks

ICBA supports the creation of a new capital option to strengthen the long-term viability of mutual banks. Mutual banks should be authorized to issue Mutual Capital Certificates that would qualify as Tier 1 common equity capital.

Mutual institutions were established and are maintained for the benefit of their communities, depositors and borrowers. They are well-run financial institutions that provide local service and investment to improve the quality of life in their local communities. In addition, mutual community banks are among the safest and soundest financial institutions. They remained strong during the financial crisis and continued to provide financial services to their customers.

Introduced Legislation

The Mutual Bank Capital Opportunity Act of 2015 (H.R. 1661), sponsored by Rep. Keith Rothfus, would authorize Mutual Capital Certificates as described above.

Closing

ICBA thanks this committee for convening this important hearing and for the opportunity to present the views of the community banking industry.

As I stated at the outset, capital regulation has the power to make or break credit availability in thousands of rural communities and small towns across America such as Taos, New Mexico. We urge this committee to support changes that will support vital community bank lending.