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Independent Community Bankers of America®

› WHITE PAPER

COMMUNITY BANK REGULATORY RELIEF: A Roadmap to Economic Growth & Prosperity

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COMMUNITY BANK REGULATORY RELIEF: A ROADMAP TO ECONOMIC GROWTH & PROSPERITY

As prepared for the U.S. Department of the Treasury in response to Executive Order 13772 on Core Principles for Regulating the United States Financial System

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ABOUT ICBA

The Independent Community Bankers of America® (ICBA), the nation's voice for more than 5,800 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. With 52,000 locations nationwide, community banks employ 760,000 Americans, hold $4.7 trillion in assets, $3.7 trillion in deposits, and $3.2 trillion in loans to consumers, small businesses, and the agricultural community.

For more information, visit ICBA's website at www.icba.org.

OVERVIEW

Community banks have served as America's engines of local economic growth since our nation's founding, and the United States remains the only country in the world served by a broadly based, vibrant community banking sector. As our economy and financial system continue to evolve, community banking must be preserved and strengthened. The empowerment of community banks is a sure route to rekindling America's economic vitality.

Today we have an opportunity to comprehensively rethink, restructure, and modernize the regulation of the American financial services industry to ensure that it promotes economic growth, prosperity, and job creation. Regulatory relief for community banks is a critical part of this effort.

The purpose of this paper is to describe what is unique about American community banks, survey the regulatory environment in which they operate, identify regulatory barriers, and recommend solutions that will allow them to serve as engines of economic growth and prosperity for generations to come.

THE COMMUNITY BANK BUSINESS MODEL: A STAKE IN THE COMMUNITY AND A MULTI-GENERATIONAL OUTLOOK

Community banks are locally operated and often closely held institutions with simple, conservative balance sheets and strong capitalization. Located in urban, suburban, and rural areas, they are funded primarily by local deposits and deeply rooted in their communities. Community banks have a vital stake in the success of their local economies because the fortunes of the local bank and the local economy are closely linked. Community banks thrive by cultivating long-term, cross-generational relationships with local families, small business owners, and farmers and by serving the full spectrum of their financial needs. The competitive advantage of community banks is offering customized underwriting, products, and services tailored to the unique needs and circumstances of borrowers. Individual-customer focus and customized offerings set community banks apart from larger, more transaction-focused institutions that offer cookie-cutter products and services based on automated underwriting.

> "We know that community banks serve many customers that large banks do not and provide services that are not offered by large banks in many communities. This circumstance is especially true in rural areas and other small communities, where community banks are sometimes the only retail financial institutions."[1]
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> *- Federal Reserve Chair, Janet Yellen*

[1] Remarks before the Third Annual Community Banking Research and Policy Conference. Sept. 30, 2015

COMMUNITY BANKS AND THE AMERICAN ECONOMY

The economic life of thousands of American communities depends on customized financial products and services that only community banks provide. According to a 2016 report by the Federal Deposit Insurance Corporation (FDIC), more than 20 percent of our nation's 3,100 counties are exclusively served 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] 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 playing a vital role in ensuring the economic recovery is robust and broad-based, reaching communities of all sizes and in every region of the country.

CHALLENGES FACING COMMUNITY BANKS

The flourishing of community banks is critical to American prosperity, but community banks face critical challenges.

Regulatory Burden

The onerous regulatory burden on community banks is growing both in volume and complexity, suffocating the true potential of community banks to spur economic growth and job creation in their communities and across the nation. These regulations are issued by a spectrum of federal agencies and run the gamut from Bank Secrecy Act to credit card regulation to the multiple code sections that govern mortgage lending and servicing.

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[2] https://www.fdic.gov/regulations/resources/cbi/conference/cbi-book12-19-16.pdf.
[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.

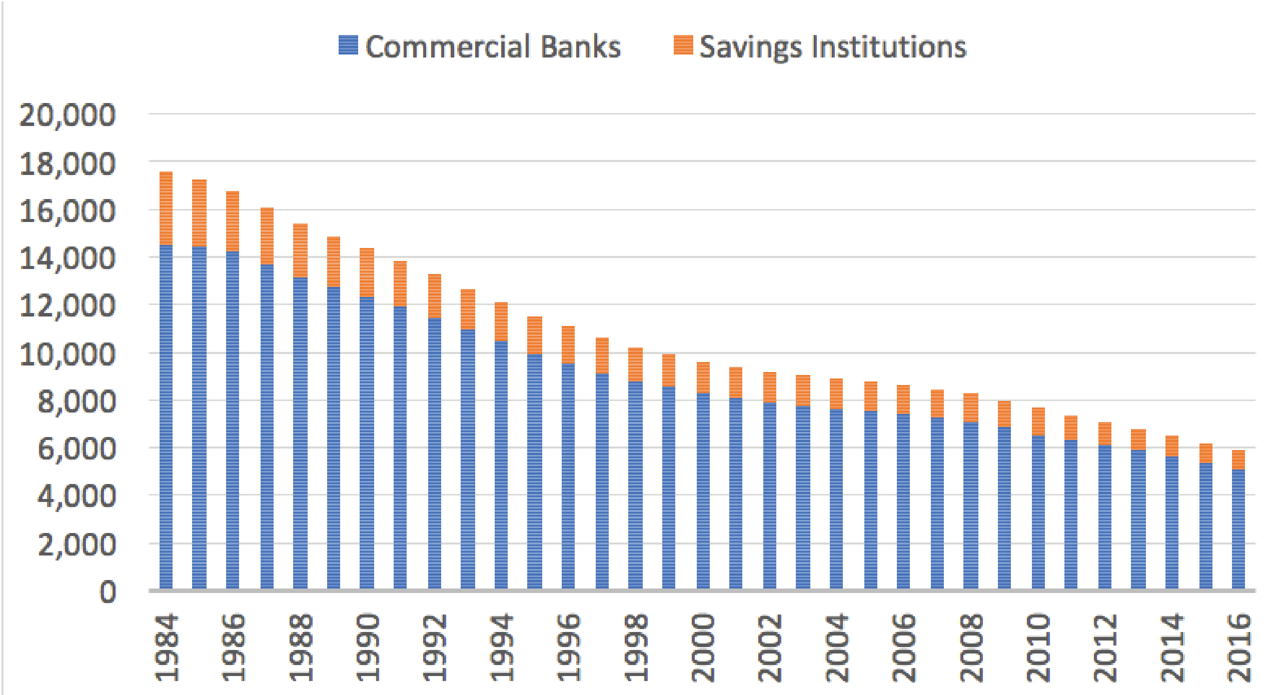
Even when a regulation does not apply to a particular bank, that bank must still evaluate it to determine to what extent its organization is impacted. Every change requires software updates, a lengthy process that includes a risk assessment, installation on a test network, testing, installation on a production network, more testing, procedural review, training, and audit. What's more, policy revisions require committee review and board approval. Compliance changes result in legal and audit expenses and sometimes the expense of printing and mailing new disclosures. But most significant is the drain on staff time. In contrast to larger banks, community banks have limited resources to devote to compliance. They must 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.

ICBA's 2014 Community Bank Lending Survey surveyed more than 500 community banks nationwide.[4] Seventy-eight percent of respondents reported they had increased the number of staff dedicated to lending compliance in the past five years. In a lightly staffed community bank, any additional hiring is significant. Hiring dedicated to compliance, rather than serving customers, is a deadweight loss that diverts resources from community lending. The survey clearly illustrated the negative impact new rules are having on credit availability and consumer choice.

Consolidation

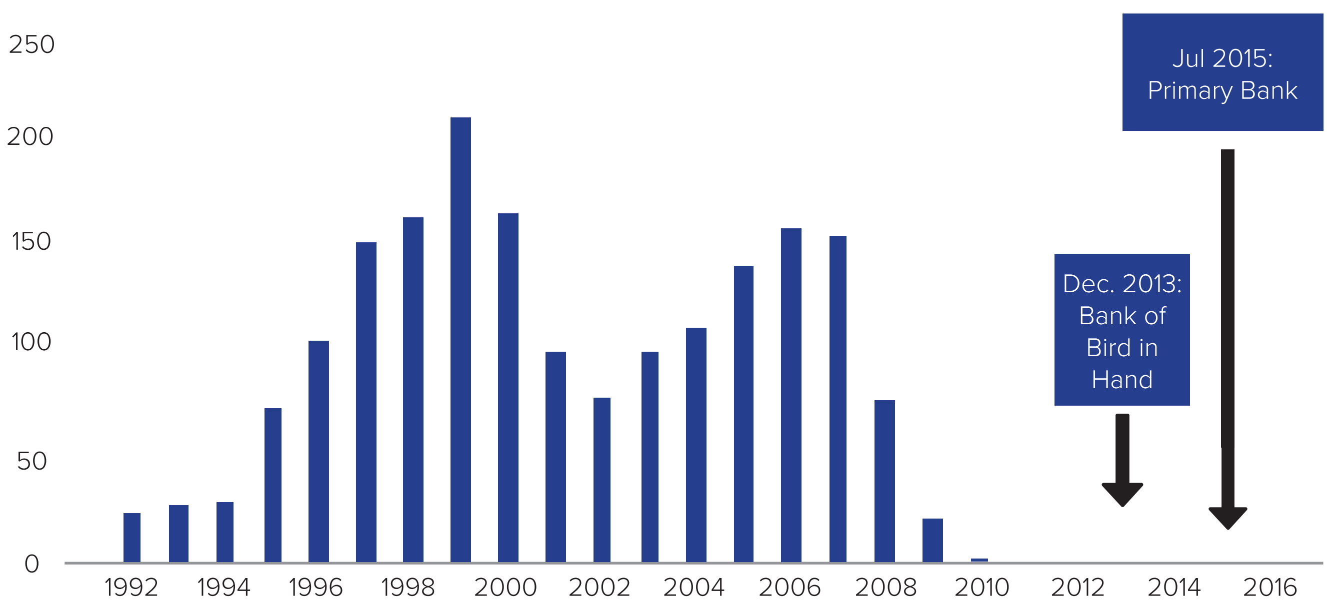
This increase in regulatory burden has contributed significantly to the rapid pace of consolidation in recent years. Banks need scale to amortize compliance costs. As these costs have grown dramatically in recent years, banks have acquired or merged with other banks to achieve this scale. As shown in the chart below, today there are 1,700 fewer community banks in the United States than there were in 2010. Regulation-driven consolidation has particularly reduced the ranks of the smallest community banks. The number of banks with assets below $100 million shrunk by 32 percent, while the number of banks with assets between $100 million and $1 billion fell by 11 percent.

[4] 2014 ICBA Community Bank Lending Survey. January 2015.



Source: FDIC

Of course, consolidation would be less of a concern if there were an influx of de novo charters to replenish lost banks. In the years before the financial crisis, de novo bank formation averaged over 170 per year. Even in the depths of the savings and loan crisis in the 1980s, when 1,800 banks and savings institutions failed, an average of 196 de novo banks and savings institutions were formed annually from 1984 through 1992. In recent years, by contrast, de novo formation has ground to a virtual halt. Only three new banks have opened for business since the financial crisis. The current regulatory and tax environment for community banks acts as a strong deterrent to potential de novo applicants.



Source: FDIC

What are the consequences of consolidation without the creation of de novo charters? More communities are stranded without a dedicated, locally based community bank to invest in their growth and prosperity. These communities will be challenged in the current economic recovery and in future economic cycles. In addition, there will be less competition in financial services in every American community. Less competition means lower rates paid on deposits, higher rates charged on loans, higher fees, and ultimately an erosion in the quality of service. The airline industry provides a vivid illustration of a potential future financial services industry with drastically fewer community banks. Flying today is a much different experience than it was 30 years ago. Consolidation in the airline industry has resulted in more and more seats per plane at the expense of passenger leg room, the disappearance of in-flight meals, and over-booking, among other practices that harm consumers. How would these practices translate into the financial services industry?

There are additional consequences to consolidation that must be considered. A financial system with fewer, larger banks is more vulnerable to the risk of another financial crisis. Consolidation makes the megabanks even larger, securing their implicit too-big-to-fail status, inducing risk taking, and ultimately leading to taxpayer bailouts.

For the sake of our communities and the stability of our financial system, it is imperative that we slow the pace of consolidation and restart the de novo process. There is a direct linkage from regulatory burden to consolidation to consumer harm, too-big-to-fail megabanks, and taxpayer bailouts. We must provide regulatory relief for community banks that will break this dangerous cycle. Regulation should be tiered and proportionate to the systemic and consumer risk posed by classes of banks.

While it struggles to absorb a dangerous new regulatory burden, the community banking industry also faces a growing competitive threat from tax-exempt credit unions, Farm Credit System lenders that leverage significant tax and regulatory advantages, and the emergence of non-depository fintech companies that are not subject to equivalent safety-and-soundness and consumer-protection regulation.

Below we survey the most onerous regulations afflicting community banks and inhibiting their ability to spur growth in their communities.

SECTION I: CHANGES NEEDED TO STRENGTHEN COMMUNITY BANK RESIDENTIAL MORTGAGE LENDING

Mortgage lending by community banks represents approximately 20 percent of the national mortgage market.[5] However, in small towns and rural communities, the local community bank is the main source of mortgage credit. These markets are often neglected by larger national mortgage lenders that are driven by volume and margins because the markets may not generate enough real estate lending activity.

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 be irregular in other ways. They frequently lie outside of city limits. These are not suburban properties, and for this reason they often lack adequate comparable sales 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. These loans have been made safely by community banks for decades.

For community banks, relationships and community reputation are paramount. Community banks have every incentive to make fair, common-sense, and affordable loans to preserve and enhance their most valuable asset — a reputation for fair dealing. They do not need prescriptive regulations to compel them to do so. Unnecessary regulatory burden drives community banks from the mortgage market and limits borrower choice.

Below we discuss regulatory barriers that obstruct or prevent community banks from providing mortgage credit in their communities and identify solutions that will preserve and strengthen community bank mortgage lending.

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[5] The Federal Reserve's analysis of Home Mortgage Disclosure Act (HMDA) data indicates that banks with assets under $10 billion account for 18 percent of home loan originations. See "Community Banks and Mortgage Lending," Remarks by Federal Reserve Governor Elizabeth Duke, November 9, 2012. However, HMDA data does not capture institutions that operate exclusively outside of metropolitan areas. Therefore, we estimate that the community bank mortgage market share is slightly larger than 18 percent.

Qualified Mortgage Rule Excludes Sound Loans to Creditworthy Borrowers

The Consumer Financial Protection Bureau's (CFPB's) ability-to-repay (ATR) rule creates a draconian legal liability for mortgage loans. At the same time, the rule creates a safe harbor for mortgages with rigidly prescribed underwriting, payment structures, and fee limitations. Loans that meet these standards are "qualified mortgages" (QM). Lenders have a strong disincentive to make non-QM loans. The liability for ATR violations includes enforcement actions by the CFPB and state attorneys general for up to three years following the violation, statutory damages and a private right of action potentially giving rise to class-action suits. Non-compliance with ATR could also serve as a defense to foreclosure if the loan is deemed not to be a QM loan. While non-QM products might make sense for certain large lenders, community banks simply do not have the legal resources to manage this degree of risk.

The problem is that many borrowers served by community banks and many types of loans offered by community banks do not meet QM standards. Examples include:

- Customers who relocate for a new job often fail to satisfy the QM income-verification requirements. Professionals with decades of experience in their fields who relocate to new areas are denied credit because they cannot produce enough pay stubs in their new job. A creditworthy borrower shouldn't have to rent, and possibly be forced into a 12-month lease, because they don't have enough paystubs to qualify for a mortgage.
- Community bankers must deny mortgage credit to small-business owners who cannot comply with the income-documentation requirements under the ability-to-repay rule, despite their excellent credit. The underwriting requirements of QM are inflexible and do not afford the lender discretion to use judgment or to weigh compensating factors, such as a high net worth, in making credit decisions.
- Low-dollar loans are typical in many parts of the country for purchase or refinance of residential properties. However, the fees on these loans, though low in absolute terms, often exceed the QM rule fee caps, which are based on a percentage of the loan amount.

There are additional examples of safe, legitimate loans that will fail the definition of QM, even under the broader terms available to "small creditors" (described below), and therefore not be made by community banks.

The CFPB has created accommodations for “small creditors” that meet two criteria: assets of less than $2 billion and fewer than 2,000 first-lien, closed-end mortgages originated and not sold in the secondary market in the past year. However, many banks that exceed either or both of these thresholds have all the attributes of authentic community banks, including deep roots in the community, local deposit funding, personalized service, and strong, conservative underwriting.

Solution

Community banks need a solution that will provide for more clarity and simplicity in QM designations without the tortuous analysis required under today’s rule. ICBA’s recommended solution would set down a bright line: QM status for any community bank loan held in portfolio. When a community bank holds a loan in portfolio, it holds 100 percent of the risk and has every incentive to ensure it understands the borrower’s financial condition and to work with the borrower to structure the loan properly and make sure it is affordable.

Escrow Requirements are Costly and Unnecessary

Escrow requirements for property taxes and insurance are an additional deterrent to community bank mortgage lending. The escrow requirement for higher-priced loans is unnecessary, impractical, and a significant expense for community banks, requiring investment in systems and software, employee training and legal fees. A community bank that escrows for 300 loans in portfolio would typically incur an expense of 300 man-hours annually. Many community banks do not have the resources to perform this service in-house, but outsourcing escrow services may not be an affordable option, either. For third-party servicers, it is simply not economical to offer escrow-only services, not packaged with other services, to low-volume lenders.

Solution

Loans held in portfolio by community banks should be exempt from escrow requirements. When loans are held in portfolio, lenders have every incentive to protect their collateral by ensuring that tax and insurance payments are current.

Costly Appraisal Requirements Create a Barrier to Lending

Appraisal standards have changed significantly over the past few years. First as a result of the Home Valuation Code of Conduct from Fannie Mae and Freddie Mac, and more recently as a result of the Dodd-Frank Act. These standards are well-intentioned, having been designed to prevent abuses by unregulated mortgage brokers that contributed to the collapse of the housing market. However, they have made it nearly impossible for community banks to use local appraisers. The use of an appraisal management company has become the only practical option for community bank mortgage lenders. The expense of employing these companies, coupled with new appraisal requirements, has substantially increased the cost of appraisals and the costs of credit for community bank customers. What's more, because appraisal management companies often use appraisers from outside the area, they produce poorer-quality appraisals.

Solution

Community banks should be permitted to use property evaluations completed by qualified bank staff in lieu of a full residential property appraisal for any residential mortgage that a community bank originates and retains in its portfolio. Community bank portfolio lenders have every incentive to ensure their collateral properties are accurately appraised.

The Mortgage Application and Closing Process

The TILA-RESPA Integrated Disclosure (TRID) rule, which governs the mortgage application and closing process, is unique in scope and complexity. Unfortunately, the new rule has unclear liabilities and significant new compliance expenditures that have caused some community banks to exit the mortgage market.

Solution

TRID should be reformed to:

- Make waiting periods waivable at the request of the consumer;
- Limit liability to violations that cause consumers actual, material harm;
- Permit creditors to cure errors and make consumers whole before allowing the consumer to file a lawsuit; and
- Exempt loans secured by large, mixed-use properties.

Mortgage Servicing

ICBA believes it is critical to retain and promote the role of community banks in mortgage servicing and adopt policies that will deter further consolidation of the mortgage-servicing industry. Community banks, which thrive on their reputation for customer focus and local commitment, promote a competitive mortgage-servicing industry that is less susceptible to abuses and avoidable foreclosures such as those that have impeded the housing recovery and led to the national mortgage settlement.

Community bank servicers know their communities and intervene early to keep mortgages out of default. Smaller portfolios and better control of mortgage documents also provide an advantage over large servicers. For these reasons, community banks have generally been able to identify repayment problems at the first signs of distress and work with borrowers one-on-one to keep them in their homes.

Requiring community banks to comply with the same resource-intensive mortgage-servicing requirements as the largest national servicers is driving community banks out of the marketplace. New servicing standards are overly prescriptive regarding the method and frequency of delinquent borrower contacts. They have reduced community bank flexibility to use methods that have proved successful in holding down delinquency rates. What's more, new regulation has approximately doubled the cost of servicing with a direct impact on the consumer cost of mortgage credit.

Compounding the impact of these costly and prescriptive new standards, Basel III punishes community bank mortgage servicers by severely lowering the threshold deduction for holding mortgage-servicing assets (MSAs) as well as almost tripling the risk weight assigned to MSAs when they are not deducted.

Solution

The CFPB's "small servicer" exemption limit should be increased from 5,000 loans to the higher of 30,000 loans serviced or $5 billion in total unpaid principal balance of mortgages serviced. Community banks above the 5,000-loan limit have a proven record of strong, personalized servicing and no record of abusive practices. This exemption limit would separate community bank servicers from regional and megabank servicers as well as non-bank servicers with large portfolios. To put the 30,000-loan limit in perspective, consider that the five largest servicers service an average portfolio of 6.8 million loans each and employ as many as 10,000 people each in their servicing departments. The five largest mortgage servicers each have more than $300 billion in unpaid principal balance on mortgages serviced.

The full benefit of increasing the small-servicer exemption limit cannot be realized without corresponding relief from the punitive capital treatment of MSAs under Basel III. (See Section III: Capital Regulation)

Home Mortgage Disclosure Act Reporting and Recordkeeping

Community bank mortgage lenders are subject to burdensome reporting and recordkeeping requirements under the Home Mortgage Disclosure Act (HMDA). The HMDA burden was sharply increased by a recent CFPB rule that more than doubled the number of data fields — from 23 to 48 — lenders must report for every loan application, forcing community banks to overhaul their systems and retrain staff at significant cost. Collection of the new data points begins on Jan. 1, 2018, and reporting of that data begins in 2019. Yet this new data, collected at significant expense, will likely provide little incremental benefit or insight over what is currently reported.

While HMDA does exempt certain lenders, the current exemption thresholds are far too low. Institutions with assets of less than $44 million (adjusted annually) and institutions with no offices in metropolitan statistical areas are exempt from reporting under HMDA. The new rule creates an additional exemption for small-volume mortgage lenders that originate fewer than 25 closed-end mortgages and fewer than 100 open-end lines of credit in each of the two preceding years.

This threshold exempts a maximum of 34,000 loans nationwide, according to a CFPB estimate, a miniscule fraction of the nearly 10 million annual mortgage applications reported through HMDA last year.

Solution

ICBA supports repeal of the Dodd-Frank authority for expanded HMDA reporting, which provides little additional usable information at significant expense to community bank mortgage lenders.

In addition, the loan-volume threshold for HMDA reporting should be increased to 1,000 closed-end mortgages and 2,000 open-end lines of credit. These higher thresholds would provide relief for many more small lenders without significantly impacting the mortgage data available to the CFPB or impairing the purpose of the HMDA statute.

SECTION II: COMMERCIAL LENDING: REGULATORY BURDEN DIVERTING CRITICAL RESOURCES

Community banks are prolific small-business and small-farm lenders. The longstanding partnership community banks enjoy with these borrowers is critical to local economic growth and job creation. Community banks consistently rank above other lenders in small-business borrower satisfaction ratings. The survey results below are from the 2016 Small Business Credit Survey: A Report on Employer Firms.[6] Similar results were found in the 2015 survey.

Successful applicants reported greatest satisfaction with small banks and credit unions.

Lender Satisfaction			
	SATISFIED	NEUTRAL	DISSATISFIED
Large Bank	61%	24%	15%
Small Bank	80%	15%	5%
Online Lender	46%	35%	19%
Credit Union	78%	19%	3%
CDFI	77%	22%	1%

Policymakers must leverage the already-strong community bank-small business partnership by creating a regulatory environment that allows community banks to dedicate sufficient resources to this critical activity. Below we note our concerns with specific commercial lending regulations.

Small Business Data Collection

Dodd-Frank Section 1071 requires the CFPB to implement rules for the collection and reporting of data on financial institutions' small-business lending under the Equal Credit Opportunity Act. When written, the rules will require the collection and reporting of data in connection with credit applications made by women- or minority-owned businesses of any size as well as all small businesses regardless of ownership. Twelve pieces of data will be required, including the race, sex, and ethnicity of the principal owners of the business. Section 1071 also gives the CFPB discretion to require the reporting of any additional information that would assist the bureau in fulfilling the purposes of the statute. The bureau's HMDA rule (see above), which included numerous data fields not required by statute, suggests that it would take a similarly expansive view of its authority under Section 1071.

[6] The Small Business Credit Survey is a national collaboration among the 12 Reserve Banks of the Federal Reserve System. https://www.newyorkfed.org/smallbusiness/small-business-credit-survey-employer-firms-2016

Small-business data collection and reporting will impose significant new burdens on community banks at a time when they are absorbing numerous other regulatory requirements and would likely have a chilling effect on community banks' small-business lending.

What's more, the data could be used to generate unfounded fair lending complaints, which are already a significant problem for community banks.

Solution

ICBA supports the full repeal of Dodd-Frank Section 1071. Repealing this provision before it is implemented would cut the red tape related to community banks' vibrant small-business loan portfolios and further spur economic development at the local level.

If legislative repeal of Section 1071 proves infeasible, ICBA urges the CFPB to use its authority under Dodd-Frank to exempt banks with less than $10 billion in assets from data reporting and to limit any regulation to data points required by statute.

Agricultural and Rural Credit

Thousands of community banks are located in rural areas. Approximately 2,500 community banks are classified as "agricultural" banks, and more than 3,000 community banks have agriculture-related portfolios of at least $5 million. Agricultural lending is a very specialized type of lending that requires extensive knowledge of farming, crops, and local conditions. For this reason, as noted above, community banks fund nearly 80 percent of all agricultural loans made by banks. Many banks in rural areas do not have economic choices beyond agriculture. For this reason, concentration limits are not suitable for agricultural lending.

Agricultural community banks are particularly challenged by the rapid growth of Farm Credit System (FCS) lenders, which unfairly leverage their tax and funding advantages over community banks.

Solution

To ease the application of concentration limits, regulatory agencies and bank examiners should not treat agency guidance on concentration limits as official agency rulemaking.

Congress should reform the FCS by equalizing tax treatment between community banks and FCS lenders, prohibiting FCS non-farm lending and loans to corporate borrowers, and changing the structure of the FCA board.

Commercial Real Estate Lending Guidance

Regulatory guidance can become very prescriptive. The banking agencies' 2006 "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" guidance is a good example. That guidance states that if a bank has total commercial real estate (CRE) exposure that exceeds 300 percent of its capital or total acquisition, development, and construction (ADC) exposure that exceeds 100 percent of capital, then the bank is subject to "further supervisory analysis." Unfortunately, that guidance has become a one-size-fits-all rule that no commercial bank can violate without risking a "matter requiring attention" (MRA) in an examination report or even an enforcement order from its regulator, even though in many cases it can be shown that CRE and ADC lending is not risky and results in few loan losses.

Solution

ICBA opposes any arbitrary regulatory concentration limits on lending, including those for CRE, agricultural or mortgage lending. Examiners should be trained not to treat guidance as a rule that cannot be exceeded except in unusual circumstances.

SECTION III: CAPITAL REGULATION INHIBITS COMMUNITY INVESTMENT

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. At its inception, Basel III was meant to apply only to the largest, most 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.

Aspects of Basel III that are of particular concern for community banks include:

Punitive Capital Requirements for Commercial Project Lending

Under Basel III, ADC loans are classified as high-volatility commercial real estate (HVCRE) loans and risk weighted at 150 percent for the determination of regulatory capital — compared to 100 percent before 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. This punitive risk weighting deters many creditworthy projects that would promote local economic development and job creation.

New development projects create jobs in construction and related services, which in turn boost consumer spending and create additional jobs. These projects include hotels, apartment buildings, shopping centers, hospitals, or other commercial projects — important sources of employment in themselves after construction has been completed.

The HVCRE rule sweeps in too many creditworthy developers who are well-established in local business communities — 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.

Community banks want to make every creditworthy loan possible — consistent with reasonable capital requirements and safety and soundness — to ensure the prosperity of their communities and the long-term viability of their banks. The HVCRE rule will force community banks 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 — small communities rely almost exclusively on community bank credit. Subjecting community banks to punitive capital treatment for HVCRE lending will hobble economic activity in thousands of communities across the country.

Capital Treatment of Mortgage Servicing Assets

Punitive Basel III provisions on mortgage-servicing assets (MSA) seem to be designed to drive community banks from the mortgage-servicing business. Basel III provides that the value of MSAs that exceed 10 percent of a bank's common-equity tier 1 capital must be deducted directly from its regulatory capital.[7] 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.

Basel III places 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 previous rule allowed banks to hold MSAs up to 100 percent of tier 1 capital (a broader measure of capital) and risk weight MSAs at 100 percent.

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 2.5 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. Subchapter S banks are "pass through" entities, taxed at the shareholder level. Shareholders are responsible for paying taxes on their pro-rata share of the bank's net income, regardless of whether that income is distributed. 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.

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

Investors expect returns on their investments, or at least deductible losses. What they do not expect is an unfunded tax bill in years when their investment had positive net income. This possibility makes it significantly more difficult for Subchapter S banks to solicit new shareholders or to raise additional capital from existing shareholders.

Solution

The simple solution to the capital problems identified above, among others, is an exemption from Basel III for non-systemically important financial institutions (non-SIFIs). A Basel III exemption would: (i) restore 100 percent risk weighting for ADC loans, treating these loans the same as other CRE loans; (ii) allow 100 percent of MSAs to be included in common-equity tier 1 capital; and (iii) remove dividend restrictions that have a chilling effect on potential equity investors, particularly for Subchapter S banks.

SECTION IV: OTHER SOURCES OF GROWTH-INHIBITING REGULATORY BURDEN

Consumer Financial Protection Bureau Rules

Community banks need relief from overly complex and prescriptive CFPB rules that prevent them from serving their customers and communities. These rules sap bank resources, drive providers from the market, and reduce the variety of products and services available to consumers.

The CFPB has issued an unprecedented number of new and revised consumer-protection regulations over the past several years. These new rules have touched virtually every consumer product and service community banks offer, with more change scheduled to come. CFPB rules often leave key compliance questions unanswered or ambiguous, and the bureau has been reticent to issue clarifications. For example, the CFPB was warned before its TRID rules became effective that the requirements would delay closings in some situations, but it has yet to issue clarifying regulations a year and a half after the rules were implemented.

Solution

The CFPB should be given more explicit statutory authority to exempt community banks from its rules and regulations.

In addition, as banks continue to consolidate — in large part driven by the increased costs of compliance — all depositories 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 regulations.

Bank Secrecy Act Reporting and Record Keeping

Community banks are committed to supporting balanced, effective measures that will prevent terrorists from using the financial system to fund their operations and prevent money launderers from hiding the proceeds of criminal activities. Community banks spend significant resources — in terms of both direct and indirect cost — complying with the Bank Secrecy Act and anti-money-laundering laws and regulations. However, the cumulative impact of these regulations places a burden on community banks that is often disproportionate to their size and resources. The current threshold for filing currency transaction reports (CTRs), $10,000, was set in 1970. It is significantly outdated and captures far more transactions than originally intended.

Solution

ICBA recommends raising the CTR threshold from $10,000 to $30,000 and indexing future increases on an annual basis for inflation. This higher threshold would produce more targeted, useful information for law enforcement.

The public sector should assume more responsibility for detecting and preventing financial crime. For example, the appropriate state and/or federal agency should collect beneficial ownership information for various legal entities at the time of incorporation and/or filing for taxpayer identification numbers. In addition, BSA compliance is fundamentally a governmental, law-enforcement function. As such, the costs should be borne by the government. ICBA supports the creation of a tax credit to offset the cost of BSA compliance.

Call Report Burden Diverts Critical Resources

The quarterly call report filed by community banks has grown dramatically in recent years and now comprises 61 or 80 pages, depending on the asset size of the bank. In ICBA's Community Bank Call Report Burden Survey, 86 percent of survey respondents said the total cost of preparing the quarterly call report has increased over the past 10 years. Thirty percent said it had increased significantly. A typical $500 million-asset community bank spends close to 300 hours per year of senior-level, highly compensated staff time on the quarterly call report. As recently as 15 years ago, such a bank would have filed a 30-page call report.

Only a fraction of the information collected in the call report is useful to regulators in monitoring safety and soundness and conducting monetary policy. The call report requires 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.

The Federal Financial Institutions Examinations Council (FFIEC) recently created a new 051 Call Report for banks with less than $1 billion in assets, with 61 pages instead of 80. Unfortunately, the 051 Call Report merely removes lines and schedules for complex activities not engaged in by community banks. Most community banks say the new report saves them no time at all.

Solution

ICBA believes regulators can supervise community banks with significantly less paperwork burden than they currently demand. 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.

Accountability in Examinations Must be Strengthened

The examination and supervision of community banks is unduly burdensome and a significant distraction for community bank management. In addition, the process is often perceived as unfair and lacking in accountability. Community bankers have limited options for challenging exam findings they disagree with. The current appeals process is arbitrary and frustrating. Bankers can seek review of exam findings internally or through the ombudsman's office. However, these appeals panels, or other processes, routinely lack the independence and market expertise necessary to reach a fair, unbiased decision and thus are not usually successful. Furthermore, community bankers often choose not to appeal out of fear of retaliation.

Solution

ICBA believes the best means of creating a more balanced exam environment is to create a workable appeals process. ICBA calls for the creation of an independent body 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.

Promote the Use of Reciprocal Deposits as a Stable Source of Funding to Support Community Lending

Reciprocal deposits allow community banks to accept a deposit that exceeds the $250,000 insurance limit by distributing it through a network of banks and receiving reciprocal deposits from other banks in the network. This solution allows large local depositors — such as local governments or foundations — to obtain insurance coverage while allowing banks to accept an equivalent amount of deposits to support local lending.

Unfortunately, reciprocal deposits have become caught up in the definition of "brokered deposit" in the Federal Deposit Insurance Act. Brokered deposits are disfavored and discouraged by the FDIC because they are not considered to be a stable source of funding. Brokered deposits could result in higher FDIC insurance premiums and a lower CAMELS rating.

Reciprocal deposits did not exist when the Federal Deposit Insurance Act was enacted, and reciprocal deposits do not act like the type of deposits the law was meant to cover. Studies have shown that reciprocal deposits act similarly to other core deposits: they are from local customers, earn the local interest rate, and are a stable source of funding. Because reciprocal deposits are wrongly governed by the law on brokered deposits, it is difficult for community banks to utilize their full potential.

Solution

ICBA recommends the creation of a statutory exception for reciprocal deposits from the definition of a brokered deposit, which would not compromise safety-and-soundness protections.

SECTION V: UNFAIR COMPETITION FROM TAX-EXEMPT CREDIT UNIONS

The credit union model has become outdated, and its charter, purpose and tax-exempt status should be reviewed by Congress and the administration.

The National Credit Union Administration (NCUA) has enabled many credit unions to grow their membership and their markets well beyond their statutory mission. In just the past four years, the total assets of federally insured credit unions have grown by nearly $70 billion and membership has grown by more than 10 million, while the total number of credit unions has declined by more than 1,000.

Credit unions are also aggressively expanding into business lending. According to the NCUA, total business lending by credit unions ballooned from $13.4 billion in 2004 to $56 billion in September 2015, an annualized growth rate of 14 percent. This increase in lending comes at the direct expense of taxpaying community banks.

Solutions

ICBA recommends the following to rein in the rogue credit union sector:

- Congress and the administration should review the credit union tax exemption, especially for the largest, multibillion-dollar credit unions.
- Credit unions must not be granted any further powers expansion, whether by legislation or regulation, as long as they remain exempt from taxation and the Community Reinvestment Act (CRA).

- Credit unions must not be allowed to raise supplemental capital and, in effect, cease being exclusively member-owned entities — a condition of their original tax exemption.
- Credit unions should be subject to CRA requirements comparable to and with the same asset-size distinctions as banks and thrifts.
- Credit unions must be allowed to convert to commercial banks without bearing greater regulatory conditions than required for national bank conversions to a state charter.

CLOSING

As illustrated in this paper, community banks operate in a suffocating regulatory environment that prevents them from reaching their full potential as catalysts for local economic growth and job creation. Without meaningful regulatory relief, industry consolidation will continue apace and fundamentally reshape the American financial services landscape to the detriment of consumers and small-business borrowers across the country. Financial services must not go the way of air travel. Timely regulatory relief for community banks is needed.

The regulatory solutions outlined above will empower community banks to jumpstart a sluggish economic recovery and create jobs and prosperity in our communities. ICBA urges the Department of the Treasury and Congress to champion and enact meaningful regulatory relief that will allow community banks to do what they do best — serve the unique borrowing needs of their customers.