STATEMENT OF

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on

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Chairman Neugebauer, Ranking Member Clay, and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on regulatory relief for community banks. As the primary federal regulator for the majority of community banks, the FDIC has a particular interest in understanding the challenges and opportunities they face.

My testimony will highlight the profile and key performance information for community banks. I then will discuss the ongoing interagency review to identify outdated, unnecessary, or unduly burdensome regulations. Next, I will describe how the FDIC continually strives to implement both regulations and our supervision program in a way that reflects differences in risk profile among industry participants, while achieving our supervisory goals of a safe and sound banking system. Finally, I will touch on our continued work under our Community Bank Initiative to respond to requests we have received from community banks for technical assistance.

Community Bank Profile

Community banks provide traditional, relationship-based banking services to their communities, including many small towns and rural areas that would otherwise not have access to any physical banking services. Community banks (as defined in FDIC research[1]) make up 93 percent of all banks in the U.S. – a higher percentage than at any

[1] FDIC-insured commercial banks and savings institutions are defined to be community banks if they meet the criteria that were developed for the FDIC's Community Banking Study published in December 2012: http://fdic.gov/regulations/resources/cbi/report/cbi-full.pdf. These criteria go beyond asset size alone to account for each institution's lending and deposit-gathering activities, as well as the limited geographic scope of operations that is characteristic of community banks.

time going back to at least 1984. While community banks hold just 13 percent of all banking assets, they account for about 45 percent of all of the small loans to businesses and farms made by insured institutions. Although 448 community banks failed during the recent financial crisis, thousands of community banks -- the vast majority -- did not. Institutions that stuck to their core expertise weathered the crisis. The highest rates of failure were observed among non-community banks and among community banks that departed from the traditional model and tried to grow rapidly with risky assets often funded by volatile non-core and often non-local brokered deposits.

According to the latest available data, as of December 31, 2014, the overall financial condition of both community banks and the industry as a whole has continued to improve. Community banks earned $4.8 billion during the fourth quarter, an increase of 28 percent from a year ago. Higher net interest income, increased noninterest income, and lower provision expenses were the primary drivers of stronger earnings at community banks. Net interest income for community banks grew 6.4 percent over the year-ago quarter, outpacing the industry growth of 1.0 percent. Meanwhile, community bank loan balances rose by 8.6 percent over the past year compared to 5.3 percent for the industry. Community banks reported growth in all major loan categories, including residential mortgages and loans to small businesses, and asset quality showed continued improvement with the volume of noncurrent loans 19.1 percent lower at the end of the fourth quarter from a year earlier.

While the financial performance of community banks has continued to improve since the crisis, especially as compared to the industry as a whole, the FDIC is keenly aware of the impact that its regulatory requirements can have on smaller institutions, which operate with fewer staff and other resources than their larger counterparts. As the primary federal regulator for the majority of community banks, the FDIC pays particular attention to the impact its regulations may have on smaller and rural institutions that serve areas that otherwise would not have access to banking services, and the input community bankers provide regarding such impact.

EGRPRA Review and Progress to Date

The FDIC and other regulators are actively seeking input from the industry and the public on ways to reduce regulatory burden. The *Economic Growth and Regulatory Paperwork Reduction Act of 1996*[2] (EGRPRA) requires the Federal Financial Institutions Examination Council (FFIEC),[3] the FDIC, the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC) to review our regulations at least once every ten years to identify any regulations that are outdated, or otherwise unnecessary. EGRPRA also requires the agencies to eliminate unnecessary regulations to the extent such action is appropriate. The second decennial EGRPRA review is in process with a required report due to Congress in 2016. The FDIC has developed a comprehensive plan

[2] Public Law 104-208 (1996), codified at 12 U.S.C. § 3311

[3] The FFIEC is composed of the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Consumer Financial Protection Bureau (CFPB) and the State Liaison Committee (SLC), which is made up of representatives from the Conference of State Bank Supervisors (CSBS), the American Council of State Savings Supervisors (ACSSS), and the National Association of State Credit Union Supervisors (NASCUS).

for conducting its EGRPRA review that includes coordination with the other Federal banking agencies.[4]

On June 4, 2014, the Federal banking agencies jointly published in the *Federal Register* the first of a series of requests for public comment on regulations. The first request for comment covered applications and reporting, powers and activities, and international operations. The comment period for this request closed on September 2, 2014, and 40 comments were received and are being reviewed. On February 12, 2015, the agencies published the second request for public comment, focusing on regulations covering banking operations, capital, and the Community Reinvestment Act. The comment period for that set of regulations will close on May 14, 2015.

To date, the agencies have held two regional outreach meetings – one in Los Angeles and one in Dallas -- to receive direct input from the public as part of the EGRPRA review process. Presenters thus far have included bankers, community groups, and consumer groups, and the events have been attended by agency principals and senior agency staff. Additional meetings are scheduled currently for Boston on May 4, 2015; Chicago on October 19, 2015; and Washington, DC on December 2, 2015. The agencies also plan to hold an outreach meeting in Kansas City on August 4, 2015, that will be focused on rural banks. To increase public awareness of the EGRPRA process, the meetings can be viewed via live webcast, and transcripts and video recordings also are being made publicly available

[4] http://www.fdic.gov/EGRPRA/

I also would note that the agencies intend to solicit comment on all regulations that have been issued in final form up to the publication date of the last EGRPRA notice, which is expected by year end. The agencies will accept comment on any rules at the remaining public outreach meetings. The agencies will consider all comments received and will take action as warranted on suggested changes or provide recommendations to Congress if statutory changes are required.

In response to what we heard in the first rounds of comments, the FDIC already has acted on regulatory relief suggestions where we could achieve rapid change. We communicated these changes to bankers through two Financial Institution Letters (FILs), which are our primary communication tool for policy and guidance.

The first FIL released questions and answers (Q&As) about the deposit insurance application process to aid applicants in developing proposals for federal deposit insurance and to enhance the transparency of the application process.[5] Some EGRPRA commenters – and others – indicated that there was some confusion about the FDIC's existing policies and suggested that a clarification would be helpful. The Q&As address four distinct topics: the purpose and benefits of pre-filing meetings, processing timelines, initial capitalization requirements, and business plan requirements.

[5] https://www.fdic.gov/news/news/financial/2014/fil14056.html#continuation

The second FIL addressed new procedures that eliminate or reduce the need for institutions to file applications to conduct permissible activities through certain bank subsidiaries organized as limited liability companies, or LLCs, subject to some limited documentation standards. The prior procedures dated back to the time when the LLC structure was first permitted for bank subsidiaries. In the past ten years, the FDIC processed more than 2,200 applications relating to bank activities; the vast majority of these applications involved subsidiaries organized as LLCs. Commenters remarked, and we agreed, that an LLC is no longer a novel structure and does not create particular safety and soundness concerns. We are confident that the new procedures will result in a more streamlined process for the institutions we supervise – especially our community institutions – without compromising the FDIC's safety and soundness standards.

Several areas of focus are emerging through the EGRPRA process that could address community banker concerns. One such area involves the consideration of whether laws and regulations based on long-standing thresholds should be changed – for example, dollar thresholds requiring an appraisal or a currency transaction report. Along these same lines, commenters have expressed an interest in decreasing the frequency of examinations set forth in statute, increasing the size of the institutions eligible for longer examination intervals, or both. Commenters also have asked that we ensure that supervisory expectations intended for large banks are not applied to community banks and that we have open and regular lines of communication with community bankers. We look forward to continuing to receive comments during the EGRPRA process and our outreach sessions, and we intend to carefully consider comments received. It is our intention to continue looking for ways to reduce or eliminate outdated or unnecessary requirements as we move forward with this review, rather than wait until the end of the EGRPRA process.

<u>Tailored Supervisory Approach for Community Banks</u>

The FDIC has long tailored its supervisory approach to the size, complexity, and risk profile of each institution. This approach is embedded throughout our supervisory program, which includes issuing rulemakings and guidance, and maintaining a highly trained and professional examiner workforce to conduct periodic, on-site examinations and ongoing monitoring.

Rulemakings and Guidance

The FDIC considers the size, complexity, and risk profile of institutions during the rulemaking and supervisory guidance development processes and on an ongoing basis through feedback we receive from community bankers and other stakeholders. Where possible, we scale our regulations and policies according to these factors. The FDIC's policy statement on the development and review of regulations includes a goal of minimizing regulatory burdens on the public and the banking industry. Additionally, all of our FILs have a prominent community bank applicability statement so community bankers can immediately determine whether the FIL is relevant to them.

A number of recent FDIC rulemakings implemented provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) designed to benefit community institutions. For example, the assessment base for deposit insurance was changed from domestic deposits to average total assets minus average tangible equity, which shifted more of the deposit insurance assessment burden from smaller to larger institutions. As a result, aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately one-third in the second quarter of 2011, primarily due to the assessment base change. Under the Dodd-Frank Act, the deposit insurance coverage limit was permanently increased to $250,000, which particularly benefits small businesses and other depositors of community institutions. The Dodd-Frank Act also increased the minimum reserve ratio for the Deposit Insurance Fund (DIF) from 1.15 percent to 1.35 percent, with the increase in the minimum target to be funded entirely by larger banks.

In addition to issuing rules to implement the Dodd-Frank Act provisions that benefit community banks, the FDIC also has taken into account the unique characteristics of community banks in its rulemaking to implement other important reforms to the financial system. The FDIC recognizes that a number of the more complex requirements of the capital rules are not necessary or suitable for community banks. Therefore, many aspects of the revised capital rules do not apply to community banks. For example, the new capital rules introduce a number of provisions aimed only at large, internationally active banks. These provisions include the supplementary leverage ratio, the countercyclical capital buffer, and capital requirements for credit valuation adjustments and operational risk, to name a few. In addition, the revised capital rules contain large sections that do not apply to community banks. Most notably, the advanced approaches framework only applies to internationally active banks and the market risk rule only applies to banks with material trading operations.

The FDIC also addressed concerns about the application of the conservation buffer to S corporation institutions. In July 2014, we issued a FIL to FDIC-supervised institutions describing how we would treat certain requests from S corporation institutions under the new capital rules.[6] Many community banks are S corporation banks, and we issued this guidance because of feedback we heard from concerned S corporation banks and their shareholders. In the FIL, we informed FDIC-supervised banks that, barring any significant safety and soundness issues, we would generally approve requests from well-rated banks to pay dividends to their shareholders to cover taxes on their pass-through share of bank earnings when those dividends are otherwise not permitted under the new capital rules.

Examination Program

Every FDIC examiner is initially trained as a community bank examiner through a rigorous four-year program that teaches examination concepts, policies, and procedures. As a result, on the way to becoming commissioned examiners, they gain a thorough understanding of community banks. These examiners are knowledgeable and experienced in local issues of importance to community bankers and serve as a first-line resource to bankers regarding supervisory expectations.

[6] https://www.fdic.gov/news/news/financial/2014/fil14040.html

Our examiners conduct bank examinations using a risk-focused examination program, which tailors the supervisory approach to the size, complexity, and risk profile of each institution. Risk-focused examinations are based on core principles of safety and soundness, including risk identification and mitigation. Institutions with lower risk profiles, such as most community banks, are subject to less supervisory attention than those with elevated risk profiles. For example, well-managed banks engaged in traditional, non-complex activities receive periodic safety and soundness and consumer protection examinations that are carried out over a few weeks, while the very largest FDIC-supervised institutions are subject to continuous safety and soundness supervision and ongoing examination carried out through targeted reviews during the course of an examination cycle.

Our examination cycle is also tailored to the size and risk posed by a bank. The Federal Deposit Insurance Act requires regular safety and soundness examinations of state non-member banks at least once during each 12-month period. However, examination intervals can be extended to 18 months for well-run and well-rated institutions with total assets of less than $500 million. Most FDIC-supervised institutions have total assets less than $500 million. This longer cycle permits the FDIC to focus its resources on those segments of the industry that present the most immediate supervisory concern, while at the same time reducing the regulatory burden on smaller, well-run institutions that do not pose an equivalent level of supervisory concern.

FDIC policy guides consumer protection examination schedules, which also vary based on the institution's size, prior examination rating, and risk profile. Community Reinvestment Act (CRA) examination schedules conform to the requirements of the Gramm-Leach-Bliley Act, which established the CRA examination cycle for most small institutions. The FDIC also uses different CRA examination procedures based on the asset size of institutions. Those meeting the small and intermediate small asset-size threshold are not subject to the reporting requirements applicable to large banks and savings associations.

The FDIC uses off-site monitoring programs to supplement and guide the onsite examination process. Off-site monitoring allows the FDIC to expand the examination cycle for certain lower-risk institutions. Off-site monitoring programs also can provide an early indication that an institution's risk profile may be changing. The FDIC has developed a number of off-site monitoring tools using key data from banks' quarterly Reports of Condition and Income (Call Reports) to identify institutions that are experiencing rapid loan growth or reporting unusual levels or trends in problem loans, investment activities, funding strategies, earnings structure, or capital levels that merit further review.

Community Banking Initiative and Technical Assistance

FDIC Community Banking Study

Since late 2011, the FDIC has been engaged in a data-driven effort to identify and explore issues and questions about community banks. We presented our initial findings in a comprehensive FDIC Community Banking Study, published in December 2012. Our subsequent research has studied community bank consolidation, long-term developments in branch banking, the effects of rural depopulation on community banks, and the efforts of minority-owned and operated depository institutions to serve their communities. The FDIC's community bank research agenda remains active, and in 2015, we will be studying the challenges faced by small, closely held banks, such as raising external capital and ensuring management succession.

New Community Bank Quarterly Banking Profile

Last year, the FDIC introduced a community bank section in the FDIC's Quarterly Banking Profile. The QBP, as it is commonly known, is a long-standing tool that the industry, regulators, policymakers, investors, analysts, consumers, and other stakeholders use as a report card on the banking industry. We launched the Community Bank QBP to ensure that community bank performance was not obscured in the overall industry picture because of the small size of these institutions. The most recent analysis of that data was presented earlier in this testimony.

Community Bank Outreach and Technical Assistance

In 2009, the FDIC established its *Advisory Committee on Community Banking* to provide advice and guidance on a broad range of policy issues affecting small community banks and the local communities they serve. In February 2012, the FDIC sponsored a national conference to examine the unique role of community banks in our nation's economy. Later in 2012, we held roundtable discussions in each of the FDIC's regions that focused on the financial and operational challenges and opportunities facing community banks, and the regulatory interaction process. Additional roundtable discussions were held in each region in 2013 and 2014.

In 2013, based on community banker feedback, the FDIC restructured our pre-examination process to better tailor pre-examination activities to the unique risk profile of the individual institution. As part of this process, we developed and implemented an electronic pre-examination planning tool to ensure consistency nationwide. This tool also helps minimize burden by ensuring that only those items that are necessary for the examination process are requested from each institution.

We also instituted a number of outreach and technical assistance efforts, including more than 20 training videos on complex topics of interest to community bankers. For example, we issued six videos designed to provide new bank directors with information to prepare them for their fiduciary role in overseeing the bank, and a virtual version of the FDIC's Directors' College Program. We also have issued a series of videos, primarily targeted to bank officers and employees, providing more in-depth coverage of important supervisory topics with a focus on bank management's responsibilities.[7]

To assist bankers in complying with the revised capital rules, the FDIC conducted outreach and technical assistance designed specifically for community banks. In addition to the publication of a community bank guide and an informational video on the revised

[7] *Technical Assistance Video Program*: https://www.fdic.gov/regulations/resources/director/video.html.

capital rules, FDIC staff conducted informational sessions with bankers in each of the FDIC's six supervisory regions to discuss the revised capital rules most applicable to community banks.

We also hosted banker call-ins on topics such as proposed new accounting rules, new mortgage rules, and Call Report changes. The FDIC offers a series of Deposit Insurance Coverage seminars for banking officers and employees.[8] These free seminars, which are offered nationwide, particularly benefit smaller institutions, which have limited training resources.

In June 2014, the FDIC mailed an Information Packet[9] to the chief executive officers (CEOs) of FDIC-supervised community banks that contained resources and products developed as part of the FDIC's Community Banking Initiative, as well as documents describing our examination processes. In addition to an introductory letter to CEOs, the packet contained brochures highlighting the content of key resources, such as the FDIC's Ombudsman and Supervisory Appeals Review Committee; programs, including the technical assistance video series; and a copy of the FDIC's Cyber Challenge simulation exercise. Cyber Challenge was designed to encourage community banks to discuss operational risk issues and the potential impact of information technology disruptions. The exercise contained four videos that depict various operational disruptions and materials to facilitate discussion about how the bank would

[8] *Deposit Insurance Coverage: Free Nationwide Seminars for Bank Officers and Employees* (FIL-17-2014), dated April 18, 2014.
[9] See http://www.fdic.gov/regulations/resources/cbi/infopackage.html

respond. Lists of reference materials where banks could obtain additional information were also included. All of these resources can be found on the *Directors' Resource Center*, available through the FDIC's website.[10]

At the local level, we have enhanced communication efforts by having our community bank examiners contact supervised institutions between examinations to discuss and clarify supervisory and regulatory changes and the overall risk profile of the institutions.

Going forward, the FDIC intends to continue to be a resource for community banks regarding developing industry issues. One recent example involves Call Reports. We have received comments from institutions and others about the cost and burden of preparing Call Reports. We also have heard comments about the benefits of Call Reports, including their aforementioned use in extending examination cycles and the transparency they bring to the industry for investors, bankers, consumers, analysts, and other stakeholders. Working through the FFIEC, we have talked to the industry about ways to improve Call Reports and the reporting process, and we will pursue several actions in the near term. For example, we plan to propose certain burden-reducing changes this year and implement a more robust process for bank agency users to justify retaining or adding items to the Call Report.

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[10] See https://www.fdic.gov/regulations/resources/director/.

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Conclusion

Preserving the long-term health and vibrancy of community banks, and their ability to serve their local communities means preserving the core strengths of community banks: strong capital, strong risk management, and fair and appropriate dealings with their customers. Most community banks know how to manage the risks in their loan portfolios and have strong capital positions. And of course, community banks have a strong interest in retaining customers by treating them fairly. Serving the credit needs of their local communities, while managing the attendant credit risks, truly is the core expertise of many community banks.

Community banks with sound risk management practices and strong capital have been able to weather crises and remain strong. Institutions that did not survive crises were those with weaker or more aggressive risk management approaches, including imprudent loan underwriting and rapid growth often financed by wholesale funds or brokered deposits.

The FDIC will continue to look for ways to improve our supervisory processes and reduce regulatory burden on the industry. Our goal is to achieve the fundamental objectives of safety and soundness and consumer protection in ways that do not involve needless complexity or expense