STATEMENT OF

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on

REGULATORY RELIEF FOR COMMUNITY BANKS

before the

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Chairman Shelby, Ranking Member Brown, and members of the Committee, 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 I then will discuss the current interagency review to identify outdated, unnecessary, or unduly burdensome regulations. Next, I will describe how the FDIC strives on an ongoing basis to implement regulations and our supervision program in a way that reflects differences in risk profile among the 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] Our research is based on a definition of community banks that goes 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 they hold just 14 percent of all banking assets, community banks 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, the vast majority did not. Institutions that stuck to their core expertise weathered the crisis and are now performing well. 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.

The latest available community bank data[2], as of September 30, 2014, showed continued improvement in the overall financial condition of community banks and the industry as a whole. Further, the profitability gap between community banks and larger, noncommunity banks has narrowed in recent quarters. In the third quarter of 2014, community bank return on assets (ROA) rose to 0.97 percent -- the highest in more than seven years, and just 6 basis points less than the ROA of noncommunity banks.

Community banks earned $4.9 billion during the quarter, an increase of 11 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. A steepening of the Treasury yield curve in the year ending in September helped to lift the average community bank net interest margin (NIM) by 2 basis points from a

[2] Community bank is defined as FDIC-insured commercial banks and savings institutions meeting the criteria for community banks that were developed for the FDIC's Community Banking Study, published in December, 2012: http://fdic.gov/regulations/resources/cbi/report/cbi-full.pdf

year ago, even as the industry NIM was falling by 12 basis points. Close to 33 percent of the industry's annual growth in net interest income (up $3.2 billion) came from community banks. Meanwhile, community bank loan balances rose by 8 percent over the past year compared to 4.6 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 noncurrent loans down 20.3 percent from the third quarter of 2013.

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*[3] (EGRPRA) requires the Federal Financial Institutions Examination Council (FFIEC)[4] , the FDIC, the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC) to review their regulations at least once every ten years to identify any regulations that are outdated, unnecessary, or unduly burdensome. 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

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

[4] The FFIEC is comprised 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 comprised 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).

comprehensive plan for conducting its EGRPRA review that includes coordination with the other Federal banking agencies.[5]

As the primary federal regulator for the majority of community banks, 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. Therefore, the FDICs 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 those impacts.

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. The Agencies also are in the process of adopting for comment a second Federal Register notice, which was approved by the FDIC Board three weeks ago, addressing the banking operations, capital, and Community Reinvestment Act categories of regulations.

To date, the agencies also have held two regional outreach meetings in Los Angeles and in Dallas to get direct input as part of the EGRPRA review process.

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

Presenters included bankers, community groups, and consumer groups, and the events have been attended by agency principals and senior agency staff. Additional meetings are currently scheduled 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 focused on rural banks.

In response to what we heard in the first round of comments, the FDIC already has acted on regulatory relief suggestions where we could achieve rapid change. In November, we issued two Financial Institution Letters (FILs), our primary communication tool for policy and guidance to bankers.

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. Some EGRPRA commenters – and others – indicated that there was some confusion about the FDIC's existing policies and suggested that a clarification of existing policies 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.

The second FIL addressed new procedures that eliminate or reduce the need to file applications by institutions wishing 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 over 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 themes are emerging through the EGRPRA process that could affect community bankers, such as looking at 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 through the 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.

Tailored Supervisory Approach for Community Banks

The FDIC's supervision program promotes the safety-and-soundness of FDIC-supervised institutions, protects consumers' rights, and promotes community investment initiatives by FDIC-supervised institutions. 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 cadre 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) that were 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. For example, in adopting the implementing regulations for the Volcker Rule, the agencies recognized that, while the requirements of the implementing statute apply to all banking entities regardless of size, the activities covered are generally conducted by larger, more complex banks. Accordingly, the agencies designed the Volcker Rule to reduce the burden placed on banks that do not engage in proprietary trading activities or have only limited exposure to fund investments.

Under the Volcker Rule, a bank is exempt from all of the compliance program requirements, and all of the associated costs, if it limits its covered activities to those that are excluded from the definition of proprietary trading. This exemption applies to the

vast majority of community banks. For community banks that are less than $10 billion in assets but do engage in activities covered by the Volcker Rule, compliance program requirements can be met by simply including references to the relevant portions of the rule within the banks' existing policies and procedures. This should significantly reduce the compliance burden on smaller banks that may engage in a limited amount of covered activities.

The FDIC and other bank regulators also considered the burden on community banks in adopting regulatory capital rules. The FDIC recognizes that a number of the more complex requirements of our capital rules are not necessary or suitable for community banks. As such, 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 the 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.

Several areas of the proposed rule attracted significant comment and concerns from community bankers, namely, proposed changes to risk weightings for 1-to-4 family mortgages; the treatment of accumulated other comprehensive income (AOCI), trust preferred securities (TruPS) and mortgage servicing assets; and the applicability of the

conservation buffer to banking organizations organized under Subchapter S of the Internal Revenue Service Tax Code. After considering those comments and taking into account other safety and soundness factors, the banking agencies did not adopt certain of the proposed changes that caused concerns for community banks in the final rule, namely mortgage risk weightings and the treatment of AOCI and TruPS.

Notwithstanding our belief that the applicability of the conservation buffer to all financial institutions was important to achieving the safety-and-soundness goal of higher capital, last July we issued a FIL to FDIC-supervised institutions describing how we would treat certain requests from S corporation institutions under the new capital rules. 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. The FIL describes how the FDIC will consider requests from FDIC-supervised S corporation 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. We informed FDIC-supervised banks that we would generally approve those requests for well-rated banks, barring any significant safety and soundness issues.

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 capital rules, FDIC staff conducted face-to-face informational sessions with bankers in

each of the FDIC's six supervisory regions to discuss the revised capital rules most applicable to community banks.

Examination Program

The foundation of the FDIC's examination program is a highly trained and professional examiner cadre. 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. The vast majority of our field examiners in our 83 field offices nationwide are community bank examiners. These examiners live and work in the same communities served by the community banks they examine, ensuring that they are knowledgeable and experienced in local issues of importance to community bankers and can serve as a first line resource to bankers regarding supervisory expectations.

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, point-in-time 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 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 concomitantly reducing the regulatory burden on smaller, well-run institutions that do not pose an equivalent level of supervisory concern.

FDIC policy guides consumer compliance 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 upon 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 utilizes offsite monitoring programs to supplement and guide the onsite examination process. Offsite monitoring programs can provide an early indication that an institution's risk profile may be changing. The FDIC has developed a number of offsite monitoring tools using key data from banks' quarterly Reports of Condition and Income, or 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. Offsite monitoring also allows the FDIC to expand the examination cycle for certain lower-risk institutions, as described above.

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. Initial findings were presented 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 that face 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 their small size. 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 impacting 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, roundtable discussions were conducted 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 discussions with community bankers in these venues and through our routine outreach efforts, it became clear that community banks were concerned about keeping up with changing regulations and policy issues and were interested in assistance from us to stay informed. As a result, in 2013, the FDIC created a regulatory calendar that alerts

stakeholders to critical information as well as comment and compliance deadlines relating to new or amended federal banking laws, regulations and supervisory guidance. The calendar includes notices of proposed, interim and final rulemakings, and provides information about banker teleconferences and other important events related to changes in laws, regulations, and supervisory guidance.

In addition, in 2013, and based on community banker feedback, the FDIC restructured our pre-examination process to better tailor 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 and to ensure that only those items that are necessary for the examination process are requested from each institution to minimize burden.

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, in spring 2013, we issued six videos designed to provide new bank directors with information to prepare them for their fiduciary role in overseeing the bank. This was followed by the release of a virtual version of the FDIC's Directors' College Program that regional offices deliver throughout the year. 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.[6] We

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

issued the latest technical assistance video (on the Consumer Finance Protection Bureau's loan originator compensation rule) just last month.

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.[7] 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[8] to the chief executive officers (CEOs) of FDIC-supervised community banks containing 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 and programs 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 respond. Lists of reference materials where banks could obtain additional

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

information were also included. All of these resources can be found on the *Directors' Resource Center*, available through the FDIC's website.[9]

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, and we have also 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 Federal Financial Institutions Examination Council or FFIEC, we have engaged the industry in a dialogue about ways to improve Call Reports and the reporting process, and we will pursue several actions in the near term. For example, we have already conducted banker training calls regarding certain Call Report changes and plan to conduct additional calls going forward as needed. Additionally, we plan to propose certain burden-reducing changes in 2015 and implement a more robust process for bank agency users to justify retaining or adding items to the Call Report.

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

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Another example is actions taken by the FDIC to raise awareness of cyber risks and to work with community banks to encourage practices to protect against cyber threats. During 2014, the FDIC issued a list of free resources from which community banks could obtain cyber threat information and assisted financial institutions in identifying and shutting down "phishing" websites that attempt to fraudulently obtain and use an individual's confidential personal or financial institution, This year, the FDIC will add additional videos to the Cyber Challenge simulation exercise and work as a member of the FFIEC to implement actions to enhance the effectiveness of cybersecurity-related supervisory programs, guidance, and examiner training. The FDIC will continue to work with community banks to address this and other emerging threats.

Conclusion

The FDIC will continue to pursue regulatory burden reduction for community banks, while preserving safety and soundness goals. Strong risk management practices and a strong capital base are fundamental to the long-term health of community banks and their ability to serve their local communities. 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.

Reports by the General Accounting Office and the FDIC's Office of Inspector General (OIG),[10] and our own Community Banking Study have shown that banks – even those with concentrated asset portfolios - with sound risk management practices and strong capital have been able to weather crises and remain strong. Institutions that did not survive, according to these reports, 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. One of our IG reports also found that banks that heeded supervisory directives regarding risk management practices were more likely to survive.

We believe the evidence strongly supports the idea that the best way to preserve the long term health and vibrancy of community banks, and their ability to serve their local communities, is to ensure their core strength is preserved: strong capital, strong risk management and fair and appropriate dealings with their customers. We also believe our own supervision plays an important role in obtaining corrective action to address problems where this is needed, and that this also promotes the long term health of community banks. This being said, we remain alert to the importance of achieving the fundamental objectives of safety-and-soundness and consumer protection in ways that do not involve needless complexity or expense. Going forward, we continue to look for ways to improve our supervisory processes and reduce regulatory burden on the industry. We also stand ready to provide technical assistance regarding proposals that seek to

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[10] *Causes and Consequences of Recent Bank Failures* (January 2013), GAO-13-71 and *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (January 2013), EVAL-13-002

achieve the fundamental goals of safety-and-soundness and consumer protection in ways that are appropriately tailored for community banks.