

Statement for the Record

On behalf of the

American Bankers Association

before the

Financial Institutions and Consumer Protection Subcommittee

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate



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Chairman Brown, Ranking Member Corker, and members of the Subcommittee, the American Bankers Association appreciates the opportunity to submit this statement for the record on ways to enhance safety and soundness in the aftermath of the financial crisis. The ABA represents banks of all sizes and charters and is the voice of the nation's \$13 trillion banking industry and its two million employees.

The topic of this hearing is very important. In an effort to deal with the aftermath of the financial crisis, the response by Congress and the regulators has been to drive out *all* the risk from the system in the name of safety and soundness. This has meant that good loans that could and should be made are left unfunded. The pendulum has swung too far in favor of tighter regulation, micro-management, and second-guessing. This has made the daily efforts of banks to make credit and financial services available much more difficult. Combined with hundreds of new regulations expected from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional community banks, handicapping their ability to meet the credit needs of communities across the country.

Congress must be vigilant in overseeing regulatory actions that unnecessarily restrict loans to creditworthy borrowers. Holding oversight hearings like this one is critical to ensure that banks are allowed to do what they do best – namely, meet the credit needs of their communities.

For banks to be successful and meet the needs of their customers, they need to be profitable. ***There is no better assurance of safety and soundness than a healthy, profitable industry.*** Once again, Congress and the regulators have acted to reduce sources of income, made it much harder to

raise capital, and threaten to drive some banks completely out of business lines, such as acting as municipal advisors or making residential mortgage loans.

One of those very important sources of income that will be significantly diminished is a direct result of the Durbin Amendment in the Dodd-Frank Act that imposes severe restrictions on interchange prices. The ABA and the thousands of banks we represent were deeply disappointed with the outcome of Senate vote last week. Failure to approve the bi-partisan amendment sponsored by Sens. Tester (D-Mont.), Corker (R-Tenn.) and others to address the serious concerns over the interchange amendment marks a dark day for every bank that issues debit cards and for consumers that have come to rely on them.

American consumers will now have to pay more for basic banking services, while big-box retailers go off and count their unjustified profits. Community banks – the backbone of local communities – will suffer the most. They will see a reduction in a key source of revenue that allows them to offer low-cost banking services to everyday consumers and supports lending and fraud protection measures. Key banking regulators – including Federal Reserve Board Chairman Ben Bernanke and FDIC Chairwoman Sheila Bair – have unequivocally stated that small banks will be harmed by the implementation of the Durbin Amendment. While a majority of Senators supported the Tester/Corker amendment, it is simply unconscionable that the Senate will not complete the work and protect community banks from this destructive effect.

It is within the Federal Reserve's power to mitigate the disastrous consequences that are sure to come from this policy initiative, and we urge the Fed to take all necessary action to do so.

The entire banking industry thanks Senators Tester and Corker – and the other 52 senators that stood up for debit card customers – for their extraordinary effort to address this serious problem in a constructive and deliberate way.

The remainder of this statement focuses on several key issues:

- Driving all the risk out of the system means slower economic and job growth;
- Access to new capital for community banks is problematic; and
- Restrictions may drive banks out of some lines of business altogether.

I. Driving All the Risk Out of the System Means Slower Economic and Job Growth

ABA believes that it is a mistake for policymakers to apply the most restrictive approach to every bank. By swinging the pendulum too far in the direction of minimizing risk, the Dodd-Frank Act risks choking off important banking activity that can and should be done by banks – particularly by banks that had no hand in creating the financial crisis. It is important to keep that pendulum close to the center in order to encourage diversity and innovation.

The health of the banking industry and the economic strength of the nation’s communities are closely interwoven. ABA strongly believes that our communities cannot reach their full potential without the local presence of a bank – a bank that understands the financial and credit needs of its citizens, businesses, and government. This model will collapse under the massive weight of new rules and regulations. The vast majority of banks never made an exotic mortgage loan or took on excessive risks. They had nothing to do with the events that led to the financial crisis and are as much victims of the devastation as the rest of the economy. These banks are the survivors of the problems, yet they are the ones that pay the price for the mess that others created.

Managing this mountain of regulation will be a significant challenge for a bank of any size. For the median-sized bank with only 37 employees this burden will be overwhelming. The new rules create more pressure to hire additional compliance staff, not customer-facing staff. They mean more money spent on outside lawyers to manage the risk of compliance errors and litigation. They mean more money to hire consulting firms to assist with the implementation of all of the changes, and more money to hire outside auditors to verify there are no compliance errors. They mean more risk of regulatory scrutiny, which can include penalties and fines. All of these expenditures take away precious resources that could be better used serving the bank’s community.

The consequences are real. Costs are rising, access to capital is limited, and revenue sources have been severely cut. It means that fewer loans get made. It means a weaker economy. It means slower job growth. With the regulatory over-reaction, piles of new laws, and uncertainty about government’s role in the day-to-day business of banking, meeting local community needs is difficult at best. Without quick and bold action to relieve regulatory burden we will witness an appalling contraction of the banking industry.

II. Access to New Capital for Community Banks is Problematic

Banks have to be profitable and provide a reasonable return to investors. If they do not, capital quickly flows to other industries that have higher returns. Capital is critical as it is the foundation upon which all lending is built. Having sufficient capital is critical to support lending and to absorb losses when loans are not repaid. In fact, \$1 worth of capital supports up to \$10 in loans. Most banks entered this economic downturn with a great deal of capital, but the downward spiral of the economy has created losses and stressed capital levels. Not surprisingly, when the economy is weak, new sources of capital are scarce.

The timing of the Dodd-Frank limitations on sources of capital could not have been worse, as banks struggle to replace capital used to absorb losses brought on by the recession. While the market for trust preferred securities (which had been an important source of capital for many community banks) is moribund at the moment, the industry needs the flexibility to raise capital through various means in order to meet increasing demands for capital. Moreover, the lack of readily available capital comes at a time when restrictions on interchange and higher operating expenses from Dodd-Frank have already made building capital through retained earnings more difficult.

These limitations are bad enough on their own, but the consequences are exacerbated by bank regulators piling on new requests for even greater levels of capital. Many community banks have told us that regulators are pressing banks to increase capital-to-assets ratios by as much as 4 to 6 percentage points – 50 to 75 percent – above minimum standards. For many banks, it seems like whatever level of capital they have, it is not enough to satisfy the regulators. This is excess capital not able to be redeployed into the market for economic growth.

Thus, to maintain or increase capital-to-assets levels demanded by the regulators, these *banks have been forced to limit, or even reduce, their lending*. The result: the banking industry becomes smaller while loans become more expensive and harder to get.

While more capital certainly can improve safety and soundness, it ignores the fundamental fact that banks are in the business of taking risk – every loan made runs the risk of not being repaid. Ever-increasing demands for more capital are dragging down credit availability at the worst possible time for our nation's recovery. Moreover, it works at cross purposes with banks' need for the strong and sustainable earnings that will be the key to addressing asset quality challenges.

Therefore, anything that relieves the increasing regulatory demands for more capital will help banks make the loans that are needed for our nation's recovery.

III. Regulatory Risk and Uncertainty Are Rising, Reducing Incentive to Lend

Businesses – including banks – cannot operate in an environment of uncertainty. Unfortunately, Dodd-Frank increases uncertainty for banks, and as a consequence, raises credit risks, raises litigation risks and costs (for even minor compliance issues), leads to less hiring or even a reduction in staff, makes hedging risks more difficult and costly, and restricts new business outreach. All of this translates into less willingness to make loans. In fact, banks' biggest risk has become regulatory risk. Four examples help to illustrate this increase in regulatory risk and uncertainty:

First, the nature and extent of rules from the Consumer Financial Protection Bureau are unknown, but uncertainty about the potential actions creates potential litigation risk as actions taken today may conflict with the changes in rules devised by the Bureau. The expectation of significant new disclosures, for example, translates into less willingness to lend (and therefore less credit extended overall), and higher costs to borrowers that still have access to credit to cover the added risks and expenses assumed by banks.

A second important example of uncertainty and unease created by Dodd-Frank arises from the provisions regarding preemption. Congress *explicitly* preserved in the Dodd-Frank Act the test for preemption articulated by the United States Supreme Court for deciding when a state law is preempted by the federal laws that govern national banks' activities. Nevertheless, any mention of the preemption standard in a statute is likely to generate lawsuits from those who argue that the standard somehow has changed. The Dodd-Frank Act preemption provisions will affect *all* banks, including state-chartered banks and thrifts that benefit from wild-card statutes. State attorneys general will have greater authority to enforce rules and regulations, specifically including those promulgated by the Consumer Financial Protection Bureau. The potential changes and risk of litigation necessarily reduce the willingness of banks to lend to any business or individual with less than a stellar credit history.

Third, government involvement in price controls – such as the Durbin Amendment on interchange fees – sets a dangerous precedent, suggesting that financial institutions may be subject to future, unknowable price controls on other financial products and services, undermining important free-market principles. Banks have always accepted the operational, reputational, and

financial risk associated with developing new products and services and making them available to millions of consumers. Now financial institutions risk losing their investments of billions of dollars into improvements of existing products and services, and the creation of new ones, through government price controls. Why would any business invest in an innovative product knowing the government *ex post facto* will interfere by imposing price controls? The Durbin Amendment serves as a strong disincentive for innovation and investment by financial institutions in other emerging payment systems and financial products and services. In the end, it is the American public who suffers.

The fourth uncertainty relates to the implementation of the swap rules. Banks do not know yet how the swaps exchanges will operate, what impact the clearing requirements will have on banks' ability to customize swaps, or even which banks and transactions will be subject to each of the new rules. For example, while other end users will be exempt from complex and costly clearing requirements, we are waiting to find out if our community banks will receive the same treatment. If not, then these banks might not be able to use swaps and the end result would be reduced lending, increased risk for banks, and higher costs for customers if banks cannot hedge the risk.

We urge Congress to actively oversee the Commodity Futures Trading Commission (CFTC) and SEC as they implement the new swaps requirements to be sure there are no adverse effects on lending or competition for U.S. banks. *We also encourage Congress to enact legislation explicitly granting small banks the same exemption from swaps clearing requirements that is available to other end users.*

IV. Restrictions May Drive Banks Out of Some Lines of Business Altogether

Safety and soundness is best protected when banks are able to meet the credit needs of their customers. This is what is so disturbing about the implementation of some rules under Dodd-Frank that would effectively drive banks out of lines of businesses altogether. This not only hurts the customers, but also means less income – and less diversified sources of income – that forms the base of financial health for any bank. New rules on registration as municipal advisors and on mortgage lending are two particularly problematic provisions.

Proposed SEC municipal advisor rules could limit banking options for state and local governments

ABA believes that Dodd-Frank intended to establish a regulatory scheme for unregulated persons providing advice to municipalities with respect to municipal derivatives, guaranteed investment contracts, investment strategies or the issuance of municipal securities. Most community banks do not deal in bonds or securities. But banks do offer public sector customers banking services and are regulated closely by several government agencies.

The Securities and Exchange Commission has proposed a very broad definition of “investment strategies” that would cover traditional bank products and services such as deposit accounts, cash management products and loans to municipalities. This means that community banks would have to register as municipal advisors and be subject to a whole new layer of regulation on bank products for no meaningful public purpose. The result of this duplicative and costly regulation is that banks may decide not to provide banking services to their local municipalities – forcing these local and state entities to look outside of their community for the services they need. This proposal flies in the face of the President’s initiative to streamline federal oversight and avoid new regulations that impede innovation, diminish U.S. competitiveness, and restrain job creation and economic expansion.

We urge Congress to oversee this implementation and ensure that the rule addresses *unregulated* parties and that *neither* Section 975 of Dodd-Frank nor its implementing regulation reaches through to traditional bank products and services.

New proposed mortgage rules likely to drive many community banks out of mortgage lending

ABA has grave concerns that the risk retention proposal issued by the regulators will drive many banks from mortgage lending and shut many borrowers out of the credit market entirely. Responding to widespread objections from consumer groups, banks, and Senators and Congressman, the regulators extended the comment period from June 10th to August 1st. While more time for commenting on such a far reaching regulatory proposal is welcome, what is really necessary is for the rule to be withdrawn in its current form and substantially reconsidered.

It is true that the proposal’s immediate impact is muted by the fact that loans sold to Fannie Mae and Freddie Mac while they are in conservatorship escape risk retention. However, once the rule’s requirements are imposed broadly on the market (should they be adopted) they would likely shut out many borrowers entirely and act to destabilize the housing market once again. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of

Fannie and Freddie, it is important that risk retention requirements be rational and non-disruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

Therefore, ABA urges Congress to ensure that the regulators revise the risk retention regulation before it is imposed on the mortgage market broadly. Specifically we recommend:

- ***Exemption from risk retention provisions must reflect changes in the market already imposed through other legislative and regulatory change.***

In the Dodd-Frank Act, Congress determined that some form of risk retention was desirable to ensure that participants in a mortgage securitization transaction had so-called “skin in the game.” The goal was to create incentives for originators to assure proper underwriting (e.g., ability to repay) and incentives to control default risk for participants beyond the origination stage. There have already been dramatic changes to the regulations governing mortgages. The result is that mortgage loans with lower risk characteristics – which include most mortgage loans being made by community banks today – should be exempted from the risk retention requirements – regardless of whether sold to Fannie Mae and Freddie Mac or to private securitizers.

Exempting such “qualified residential mortgage” loans (QRM) is important to ensure the stability and recovery of the mortgage market and also to avoid capital requirements not necessary to address systemic issues. However, the QRM as proposed is very narrow and many high-quality loans posing little risk will end up being excluded. This will inevitably mean that fewer borrowers will qualify for loans to purchase or refinance a home. Instead, the QRM definition should more closely align with the proposed QM definition promulgated by the Federal Reserve Board. The QM definition (as proposed) focuses on a borrower's ability to repay and allows originators to measure that ability with traditional underwriting tools. The proposed QRM rule, in contrast, takes most underwriting decisions away from originators in favor of rigid loan to value and other targets.

For example, for the loan to qualify for QRM status, borrowers must make at least a 20 percent down payment – and at least 25 percent if the mortgage is a refinancing (and 30 percent if it is a cash-out refinance).

Certainly loans with lower loan-to-value (LTV) ratios are likely to have lower default rates, and we agree that this is one of a number of characteristics to be considered. However, the LTV should not be the only characteristic for eligibility as a “Qualified Residential Mortgage,” and it should not be considered in isolation. Setting the QRM cutoff at a specific LTV without regard to other loan characteristics or features, including credit enhancements such as private mortgage insurance, will lead to an unnecessary restriction of credit. To illustrate the severity of the proposal, even with private mortgage insurance, loans with less than 20 percent down will not qualify for the QRM.

ABA strongly believes that creating a narrow definition of QRM is an inappropriate method for achieving the desired underwriting reforms intended by Dodd-Frank.

- ***The Risk Retention Requirements as proposed will inhibit the return of private capital to the marketplace and will make ending the conservatorship of Fannie Mae and Freddie Mac more difficult.***

The proposal presented by the regulators will make it vastly more difficult to end the conservatorship of Fannie and Freddie and to shrink FHA back to a more rational portion of the mortgage market. As noted above, under the proposed rule, loans with a federal guarantee are exempt from risk retention – which includes that of Federal government. FHA loans (as well as other federally insured and guaranteed loan programs) are also exempt. Since almost 100 percent of new loans today being sold are bought by Fannie and Freddie or insured by FHA – and as long as these GSEs can buy loans without risk retention – it will be dramatically more difficult for private securitizers to compete. In fact, the economic incentives of the proposed risk retention strongly favor sales of mortgages to the GSEs in conservatorship and not to private securitizers. Thus, this proposal does not foster the growth of private label securitizations that would reduce the role of government in backing loans.

Equally important is the fact that the conservatorship situation is unsustainable over the long term. That means that eventually, these highly narrow and restrictive rules would apply to a much, much larger segment of the mortgage market. That means that fewer borrowers will qualify for these QRM mortgage loans and the risk retention rules make it less likely that

community banks will underwrite non-QRM – but prudent and safe – loans. Some community banks may stop providing mortgages altogether as the requirements and compliance costs make such a service unreasonable without considerable volume. Driving community banks from the mortgage marketplace would be counterproductive as they have proven to be responsible underwriters that have served their borrowers and communities well. Instead of exempting the GSEs from risk retention, the QRM should also factor in the underwriting requirements of the GSEs. If a loan meets those requirements (which we anticipate will evolve to conform with any new QM definition) and is thus eligible for purchase by the GSEs, it should also be exempt from risk retention requirements. More closely conforming the QM, QRM and GSE standards will set the foundation for a coherent and sustainable secondary mortgage market.

The imposition of risk retention requirements to improve underwriting of mortgage loans is a significant change to the operation of the mortgage markets and must not be undertaken lightly. ABA urges Congress to exercise its oversight authority to assure that rules adopted are consistent with the intent of the statute and will not have adverse consequences for the housing market and mortgage credit availability.

Conclusion

Safety and soundness is best protected by creating an environment where banks can make good business decisions and take prudent risks. Unfortunately, the pendulum has shifted too far in favor of driving out risk entirely and constant second-guessing of banks' decisions.

Ultimately, it is consumers that bear the consequences of government imposed restrictions. The loss of interchange income will certainly mean higher costs of using debit cards for consumers. Greater mortgage restrictions and the lack of certainty on safe harbors for qualified mortgages means that community banks may no longer make mortgage loans or certainly not as many. Higher compliance costs mean more time and effort devoted to government regulations and less time for our communities. Increased expenses often translate into layoffs within the bank.

This all makes it harder to meet the needs of our communities. Jobs and local economic growth will slow as these impediments inevitably reduce the credit that can be provided and the cost of credit that is supplied. Fewer loans mean fewer jobs. Access to credit will be limited, leaving many promising ideas from entrepreneurs without funding. Capital moves to other industries,

further limiting the ability of banks to grow. Since banks and communities grow together, the restrictions that limit one necessarily limit the other.

Lack of earning potential, regulatory fatigue, lack of access to capital, limited resources to compete, inability to enhance shareholder value and return on investment, all push community banks to sell. The Dodd-Frank Act drives all of these in the wrong direction and is leading to consolidations. The consequences for local communities are real.

The regulatory burden from Dodd-Frank and the excessive regulatory second-guessing must be addressed in order to give all banks a fighting chance to maintain long-term viability and meet the needs of local communities everywhere.