CONFERENCE OF STATE BANK SUPERVISORS

# An Incremental Approach to Financial Regulation

## Right-Sized Regulations for Community Banks

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**About this Paper**

This paper discusses the importance of designing a federal regulatory framework that appropriately supervises and supports community banks. The paper notes that recent regulatory reform efforts are ill-suited to smaller institutions' relationship and portfolio-based lending business model, and ultimately undermine their ability to provide tailored credit products to consumers and small businesses. However, there are key instances in which federal regulators have tailored regulations to accommodate the community banking business model, and state supervisors encourage federal policymakers to use these as examples going forward.

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# An Incremental Approach to Financial Regulation

**As locally based and locally accountable regulators, the state banking regulators that comprise the Conference of State Bank Supervisors (CSBS) are committed to ensuring a diverse and competitive banking system and an effective system of state supervision and regulation.** Community banks are an integral part of this diverse system and help ensure economic development and accessible credit at the local level. CSBS formed the Community Bank Steering Group (the Steering Group) to analyze the long-term strategic challenges facing community banks and the state system of bank supervision and regulation.

**State supervisors recognize the importance of healthy, well-regulated community banks that provide the credit and services needed to support local economies.** The Steering Group focuses on issues facing these banks, and has pinpointed excessive regulatory burdens and regulations inappropriately applied to the community banking business model. Through this process, CSBS has developed a list of opportunities where federal regulators and Congress can appropriately tailor regulation and supervision to the risks of the community bank business model.

**The goal of this paper is to provide federal policymakers with actionable ideas to improve the community banking sector's ability to safely and soundly meet the needs of its communities.** The following pages describe the community bank business model, underscore its importance to the U.S. economy, highlight congressional and federal agency efforts to right-size regulation for community banks, and outline specific legislative and regulatory actions that Congress and federal regulators should take to build upon their existing efforts.

# EXECUTIVE SUMMARY

**Federal lawmakers and regulators have demonstrated the ability to distinguish between banks' business models and tailor supervisory and regulatory expectations.** By recognizing that Congress and federal regulatory agencies have the ability to design statutes and regulations to address risks inherent in large, complex organizations without crippling smaller, less sophisticated organizations, one can begin to envision a diverse and vibrant community banking sector that will continue to contribute to the economic vitality of the United States for decades to come. The Steering Group identified a need to develop future policy with an incremental approach that proactively tailors regulations to a bank's risk profile, size, and business model. Additionally, the Steering Group vigorously opposes the tendency to apply a "one-size-fits-all" supervisory model.

**Congress and federal bank regulators have acknowledged that broad regulatory reform efforts could harm community banks, and on numerous occasions have adjusted legislation and regulation to provide community banks with meaningful relief.** Above all, these tailored rulemakings demonstrate an important recognition that the very business model of community banking upholds the basic tenets of responsible lending and consumer protection. These efforts include:

- Shifting the Federal Deposit Insurance assessment base to larger institutions to better reflect the risks posed by their non-deposit funding practices.
- Designing a two-tiered payment system for interchange fees restrictions (Durbin Amendment).
- Preserving tier 1 capital treatment for trust-preferred securities held by small bank holding companies (Collins Amendment).
- Limiting the Consumer Financial Protection Bureau's (CFPB) examination authority to banks with more than $10 billion in assets.
- Granting federal agencies enough flexibility in their rulemaking authority to build out appropriate regulatory frameworks for community banks, such as the CFPB borrowing from the balloon loan qualified mortgage (QM) parameters within the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to create the Small Creditor QM.
- Excluding small banks from Basel III provisions designed for global institutions.

**Through efforts like these, Congress and federal regulators have recognized the natural alignment of interests in the community banking business model, from consumer protections in portfolio lending to flexible capital options.** By recognizing differences in portfolio lending business models and balance sheets for smaller institutions, policymakers have begun to incorporate the different cost structures and customer relationships that must be addressed when determining the risks facing community banks.

**Federal regulators are also addressing community banks' needs through new research, communication, and outreach efforts.** The Federal Deposit Insurance Corporation (FDIC) conducted a significant foundational research project on community banks that culminated in 2012. In addition, the FDIC has taken some steps to improve the pre-examination planning process, which was identified as an

area of weakness in community bank outreach efforts conducted by FDIC Chairman Martin Gruenberg during 2012. The FDIC and the Federal Reserve System have improved outreach to the community banking industry with numerous web resources, seminars, and newsletters. Both agencies now include prominent statements of applicability to banks with assets under $1 billion in all new communications coming from the agencies. Two recent agency efforts, the FDIC Advisory Committee on Community Banking and the Federal Reserve's Community Depository Institutions Advisory Council, have helped guide these agencies on policy issues that affect small banks and the communities they serve. State supervisors believe that such advisory groups have the potential for a significant long-term impact on the direction and approach to federal policy and that this type of feedback from the industry is critical. Federal officials have a responsibility to be responsive to the public, and these groups provide a critical vehicle for the agencies to hear from the industry as they work through policy issues.

**State supervisors and their federal counterparts are working together to chart the regulatory path forward for community banks.** CSBS and the Federal Reserve System co-hosted an inaugural community banking research conference at the Federal Reserve Bank of St. Louis in October 2013. Community bankers, regulators, and academics gathered to discuss current and future research on community banking. To prepare for the conference, banking commissioners from 28 states conducted 52 town hall meetings with more than 1,700 community bankers from around the country to gather on-the-ground reports about the opportunities and challenges that exist for community based institutions. The conference was a significant step toward developing more in-depth knowledge and research on the characteristics of the community bank model and the unique challenges these institutions face. State bank supervisors will continue to partner with fellow regulators, academics, and policymakers as they seek to build an argument and support for more tailored supervision and a better public policy outcome.

**Despite clear instances of regulatory relief, Congress and federal regulators must better support the community bank business model.** If there is recognition that rational, sensible regulation is possible, then there is an obligation to act. Congress and federal regulators can support community banks and the local economies they serve by taking the following actions:

- Design regulations and examination practices that properly account for community banks' relationship lending model, which small businesses and consumers rely heavily upon.
- Remove barriers to private capital investment for small bank holding companies.
- Grant all community banks' loans held in portfolio QM status, thereby encouraging home ownership in all communities, not just those served by the largest financial institutions.
- Provide community banks with regulatory clarity and transparency regarding fair lending requirements.
- Extend pass-through deposit insurance for small business payroll accounts.
- Eliminate the brokered deposit designation for reciprocal deposits.

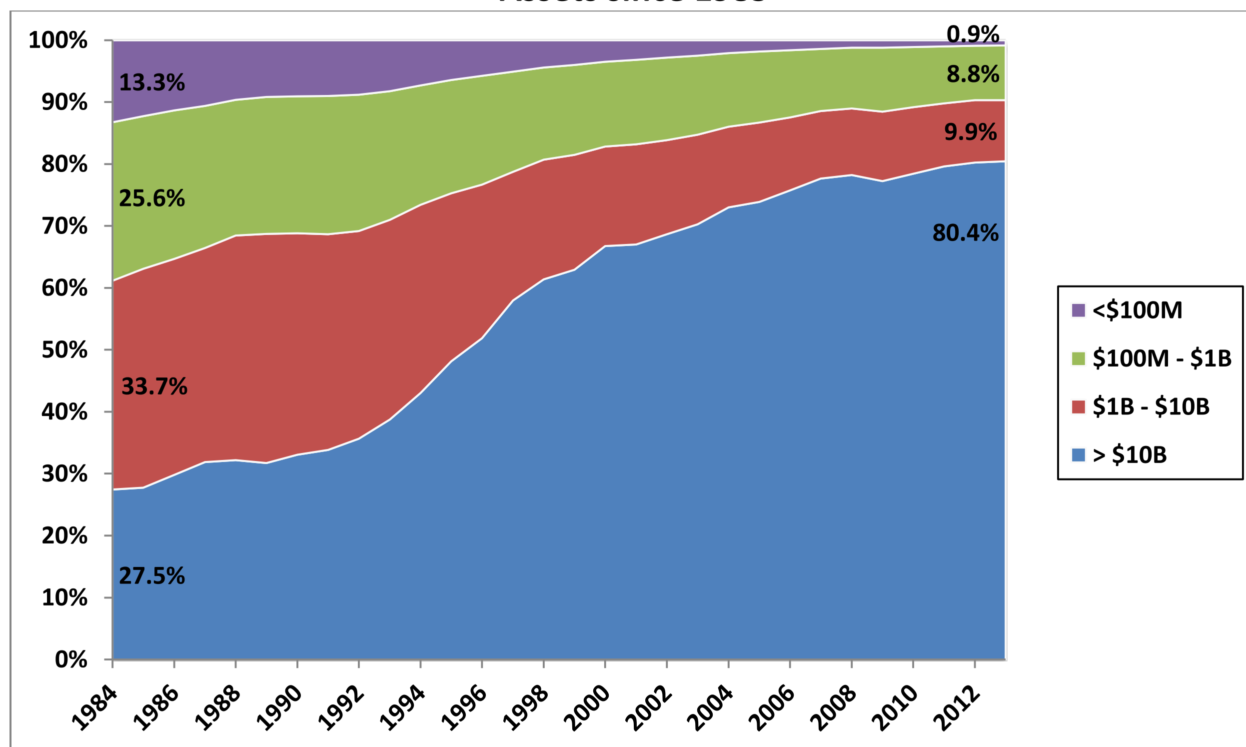
This paper follows the outline below:

- **Section I** details how regulatory priorities can significantly impact community banks.
- **Section II** explains the importance of community banks and their relationship and portfolio-based lending model.
- **Section III** provides examples of meaningful actions federal regulatory agencies have taken to appropriately accommodate the community bank business model.
- **Section IV** highlights the reasons why the fair lending debate offers federal agencies a unique opportunity to give community banks clear guidance on the examination process.
- **Section V** outlines additional measures federal regulators could take to promote strong community banks.
- **Section VI** closes the paper with a call for federal regulators and Congress to adopt a new approach to regulating community banks.

## SECTION I. REGULATIONS MATTER – POLICY PRIORITIES AND THEIR EFFECTS ON COMMUNITY BANKS

**Changes in regulatory priorities have altered the country's banking landscape, especially following the Riegle-Neal Act of 1994.** Deregulation became the policy priority of the 1990s, and ushered in an era marked by bank consolidation and stratification. Indeed, the FDIC's Community Banking Study notes that mergers and consolidations peaked in the years immediately following the passage of the Riegle-Neal Act in 1994.[1] This shift towards deregulation undoubtedly left a banking industry that looked little like it did only decades before, shrinking the number of smaller community banks and increasing the market share of larger institutions. Figure 1 illustrates the banking industry consolidation that has occurred since 1985. Community banks' share of industry assets has shrunk by nearly 30 percent since 1985, from 38.8 percent to just 9.7 percent. At the same time, banks with more than $10 billion in assets have almost tripled their share of industry assets over the same time period, from 27.5 percent to 80.4 percent.

**Figure 1. Banking Industry Consolidation, Percentage Share of Total Industry Assets since 1985**




Source: Bloomberg

[1] "FDIC Community Banking Study." Federal Deposit Insurance Corporation, December 2012, p. II. Available at: http://fdic.gov/regulations/resources/cbi/report/cbi-full.pdf

**Following the recent financial crisis, re-regulation of the banking industry has become the policy priority.** The shift in policy priorities from deregulation to re-regulation has been unmistakable. Major reform initiatives like the domestic Dodd-Frank Act and the international Basel III Accords have primarily focused on reducing the risks that large, internationally active and systemically important banks pose to the global economy.

**While the intent of this regulatory push has been to limit the type of financial activities that helped fuel the financial crisis, it has often failed to reflect the stratified nature of the U.S. banking system.** Small community banks typically engage in traditional banking services on a local level, and larger, U.S.-based financial conglomerates continue to expand into truly global operations. On balance, the size, sophistication, and business model of community banks precluded them from meaningfully engaging in the types of exotic and nontraditional financial activities that resulted in unprecedented systemic risk. As a result, the one-size-fits-all regulatory standards designed to capture the largest banks' activities are inappropriate and overly complex for smaller community banks.

**The complexity and quantity of uniform regulations also present a much more acute challenge for community banks.** The thousands of pages of rules written for large, complex financial institutions must still be understood by smaller institutions, despite the rules' irrelevance for how smaller institutions conduct business. Smaller institutions must direct resources toward understanding whether the regulations apply and away from serving the credit and deposit needs of their communities. Given the size and complexity of rules written for their larger counterparts, community banks are often forced to turn to third-party vendors to help them navigate regulatory compliance. Paradoxically, larger institutions have the capacity to shoulder additional compliance costs and the internal expertise to implement new regulatory standards.

**Community banks are already stretched thin in the post-crisis world, and regulatory costs only exacerbate existing business uncertainty.** Community banks continue to struggle with a stagnant economy, high unemployment, and a low interest rate environment. New regulatory standards only compound these challenges. Unlike larger financial institutions, they cannot rely on their scale and diverse revenue stream to support operations. The Federal Reserve Bank of Minneapolis quantified the costs community banks face when hiring additional full-time compliance staff to deal with new regulations, from the smallest institutions with less than $50 million in assets up to those with $1 billion in assets. Regulatory compliance weighs most heavily on the smallest institutions, whose return on assets decreases the most due to hiring staff to comply with additional regulations (Figure 2). According to the study, hiring one employee dedicated to regulatory compliance would make 13 percent of banks with less than $50 million in assets unprofitable, and would cause nearly 18 percent of these institutions' return on assets to fall below 40 basis points (Figure 3).

## Figure 2. The Impact of Additional Regulations on Staffing and Return on Assets

| Asset Range | Number of New Employees | New Employees as a % of the Median Number of Full-time Employees | Average Impact of New Hires on Bank ROA (bps) |
|---|---|---|---|
| <$50M | 1 | 11.1% | -27.8 |
| $50M-$100M | 1 | 5.3% | -11.0 |
| $100M-$250M | 2 | 5.3% | -10.5 |
| $250M-$500M | 2 | 2.5% | -4.9 |
| $500M-$1B | 3 | 1.9% | -3.8 |

Source: Federal Reserve Bank of Minneapolis[2]

## Figure 3. Profitability Reductions Due to Hiring Staff for New Regulations

| *Number of Newly Unprofitable Banks Due to Regulatory Change* | | | | | | |
|---|---|---|---|---|---|---|
| | Total Banks (5,457) | <$50M (739) | $50M-$100M (1,182) | $100M-$250M (1,970) | $250M-$500M (1,022) | $500M-$1B (544) |
| Number of Banks | *169* | 96 | 28 | 37 | 7 | 1 |
| % of All Newly Unprofitable Banks | - | 56.8% | 16.6% | 21.9% | 4.1% | 0.6% |
| % of Cohort | *3.1%* | 13.0% | 2.4% | 1.9% | 0.7% | 0.2% |
| *Number of Banks Whose ROA Falls Below 40 Basis Points Due to Regulatory Change* | | | | | | |
| Number of Banks | *347* | 132 | 70 | 110 | 21 | 14 |
| % of All Banks Whose ROA Falls Below 40 BPS | - | 37.9% | 20.1% | 31.8% | 6.2% | 3.9% |
| % of Cohort | *6.4%* | 17.8% | 5.9% | 5.6% | 2.1% | 2.5% |

Source: Federal Reserve Bank of Minneapolis[3]

**The complexities and costs of re-regulation may be an increasingly important driver of banking industry consolidation.** Though the first wave of consolidation was primarily sparked by changes in interstate and intrastate branching laws, the FDIC suggests that post-crisis regulatory initiatives could be pushing and exacerbating industry consolidation.[4] Official FDIC data supports this idea: since the end of 2008, the number of banks in the United States has decreased by 903 (excluding failed institutions).[5]

[2] Feldman, R., Heinecke, K., and Schmidt, J. "Quantifying the Costs of Additional Regulation on Community Banks: Economic Policy Paper 13-3." Federal Reserve Bank of Minneapolis, May 2013, pp. 7-11. Available at: http://www.minneapolisfed.org/pubs/eppapers/13-3/epp_13-3_community_banks.pdf

[3] Ibid.

[4] "FDIC Community Banking Study." Op. cit., p. II.

[5] "Statistics on Depository Institutions." FDIC, October 2013. Available at: http://www2.fdic.gov/SDI/

## SECTION II. THE IMPORTANCE OF COMMUNITY BANKS – PRESERVING RELATIONSHIP AND PORTFOLIO-BASED LENDING

**Community banks are best suited to provide local markets with customized credit products that benefit small businesses, farms, and homeowners.** A relationship and portfolio-based lending model allows community banks to meet the credit and financial product needs of customers who might not fit into the standardized credit products offered by larger financial institutions. However, product standardization in itself appears to be preferred by the federal agencies, which may not be in the best interest of consumers.

**Community banks serve geographically diverse communities and promote economic growth in both metropolitan and rural markets.** Community banks are nearly three times more likely to operate a branch outside of a metro area, and are the sole banking presence in nearly 20 percent of the United States' 3,238 counties. More than 6 million U.S. citizens across 629 counties would have no access to a physical bank branch or traditional banking services without community banks.[7] Recent research also proves the importance of community banks to local markets. Communities in which a community bank fails experience measurable drop-offs in economic performance, such as lower income and compensation growth, higher poverty rates, and lower employment.[8]

> *"Community banking is fundamentally a local, relationship-based business. Community bankers live in the localities they serve; their customers are their neighbors and friends. Their direct, personal knowledge of the local economy enables them to tailor products and services to meet their communities' needs. They can look beyond credit scores and other model-based metrics to make lending decisions in part based on more qualitative information that large regional or national financial institutions are less well suited to consider. Community bankers recognize that their own success depends on the health of the communities they serve, which is why so many community bankers contribute locally as citizens and leaders as well as in their capacities as lenders and providers of financial services."*
>
> *-Ben Bernanke*[6]

**Community banks are a primary, and oftentimes the only, source of credit for homeowners, small businesses, and farms whose needs may not be met by standardized, streamlined loan products at**

[6] Bernanke, B. "Brief Welcoming Remarks." *Community Banking in the 21st Century*, Conference Cosponsored by the Federal Reserve System and the Conference of State Bank Supervisors, St. Louis, October 2, 2013. Available at: http://www.federalreserve.gov/newsevents/speech/bernanke20131002a.pdf

[7] "FDIC Community Banking Study." Op. cit., pp. 3-4 & 3-5.

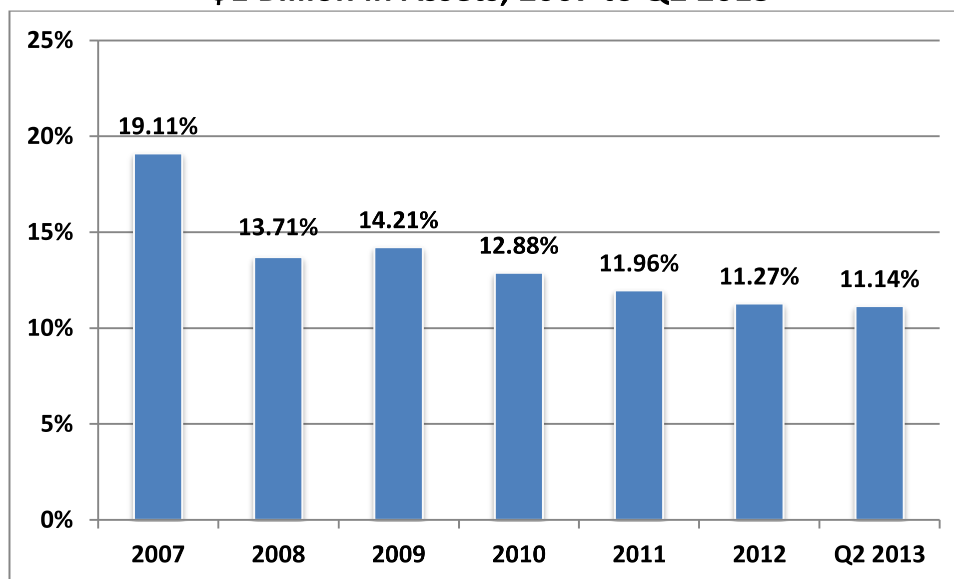
[8] Kandrac, J. "Bank Failure, Relationship Lending, and Local Economic Performance." Federal Reserve System and the Conference of State Bank Supervisors, September 2013. Available at: http://www.stlouisfed.org/banking/community-banking-conference/PDF/Kandrac_BankFailure_CBRC2013.pdf

**larger banks.** Based on the deep understanding of their local markets, community banks can tailor loans to meet the unique circumstances of their customers. They do so with an approach to lending that leverages their close community relationships, and they typically hold these loans in portfolio until maturity.

### *COMMUNITY BANKS AND RELATIONSHIP LENDING*

**Relationship lending is a foundational component of traditional banking.** In recent years, this form of lending has seen its overall market footprint diminish. The share of total industry net loans and leases originated by banks with less than $1 billion in assets has dropped by almost half since 2007, from nearly 20 percent to just over 11 percent (Figure 4). However, the recent decline does not render relationship lending obsolete. Fundamentally, the acute scope and specialization of community banking should remain an attractive and profitable strategy. Volume-driven models can reduce costs, eventually resulting in lower costs for consumers. However, customized relationship-based lending can also provide consumers with tailored products that are more consistent with their individual credit needs.

**Figure 4. Percentage of Total Industry Net Loans & Leases Held by Banks Under $1 Billion in Assets, 2007 to Q2 2013**




Source: FDIC[9]

**Relationship lending and volume-based lending are not mutually exclusive financial services.** The presence of both lending models provides a wider menu of options for consumers and their credit needs. The U.S. banking system reflects a country that is very economically diverse across its different regions. While the largest U.S. financial institutions are now capable of capitalizing on demand all over the world, over 90 percent of U.S. depository institutions still focus primarily on lending to the community members and local businesses from which they derive their deposits.

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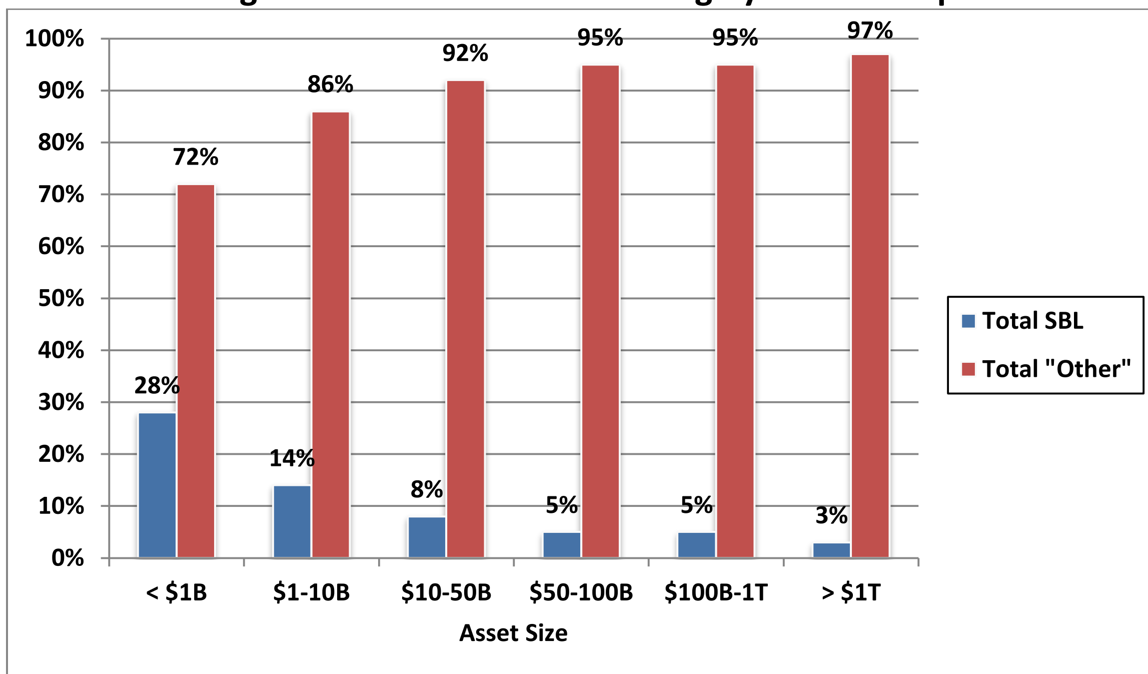
[9] "Statistics on Depository Institutions." Op. cit.

### *Relationship Lending and Small Business Credit Needs*

**Collectively, small businesses have a profound macroeconomic impact, and community banks are crucial providers of credit to these businesses.** According to official government data, small businesses account for 99.7 percent of U.S. employer firms, create 64 percent of net new private sector jobs, and employ 49.2 percent of the U.S. workforce.[10] Small businesses are a primary job engine in the United States, and community banks have an outsized role in providing them with credit and banking services. The FDIC Community Banking Study found that community banks hold 46 percent of the financial industry's small business and farm loans, while only accounting for 14 percent of all banking industry assets.[11] Figure 5 illustrates this fact. As a bank's asset size increases, the percentage of loans made to small businesses (Total SBL) out of total loans (Total "Other") decreases.

**Figure 5. Small Business Lending by Asset Group**




Source: FDIC[12]

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[10] "Frequently Asked Questions." Small Business Administration, September 2012, p. 1. Available at: http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf

[11] "FDIC Community Banking Study." Op. cit., p. 5-1.

[12] "Statistics on Depository Institutions." Op. cit.

## What Is a Community Bank Exactly?

A commercial bank, savings bank, or savings association with less than $1 billion in total banking assets is generally presumed to be a community bank. However, stakeholders have more recently recognized that a bright line threshold of $1 billion leaves out many institutions that, other than having more than $1 billion in total assets, meet the general criteria of a community banking institution. In fact, CSBS contends that institutions as large as $10 billion may be appropriately considered community banks. The FDIC has come to a similar conclusion. In the FDIC Community Banking Study, the agency used a more nuanced definition that ultimately covered 330 institutions above $1 billion.

CSBS uses the following attributes to define community banks:

- It operates primarily in a local market.
- It derives its funding primarily from a local market, specifically through deposits of members of the community in which it operates.
- Its primary business is lending out the deposits it collects to the community in which it predominately operates. Community banks often loan to local families, small businesses, and farms.
- Boards and management are members of the community constituting the bank's primary market.
- Board and management are not subject to authority or persons outside of the community.
- The lending model of these institutions is not volume driven or automated, but rather based on relationships and a detailed knowledge of the community and its members. During the underwriting process, these banks employ "soft" information about the community and its members.
- Community banks focus less on lowering costs and more on providing high-quality and comprehensive banking services to customers. The community bank business model is one more focused on quality delivery and provision of products rather than being volume-based.

Likewise, some specialty institutions with assets below $1 billion have business models that do not align with activities traditionally practiced by community banks. The following attributes likely would disqualify a bank from being considered a community bank:

- A niche charter.
- A large number of out-of-area branches.
- A concentration of out-of-area funding.
- A primary concentration of non-community focused business lines, such as credit card lending, auto financing, or out-of-area lending including syndicated loans and participations.
- A subsidiary of a large institution chartered to fulfill a specified business line.

**In fact, the majority of community banks qualify as small businesses themselves.** Figure 6 below shows that on average, community banks employ 53.1 workers, with the smallest community banks averaging only 16.3 employees. The Small Business Administration has recognized this fact, and in June 2013 increased their size thresholds for small banks from $175 million to $500 million in total assets.

## Figure 6. Average Employees and Average Assets per Employee at Community Banks, Q2 2013

| Asset Size | Average Number of Employees | Average Assets per Employee |
|---|---|---|
| Less than $100 million | 16.3 | $3.6 million |
| $100 to $300 million | 45.7 | $3.9 million |
| $300 to $500 million | 94.0 | $4.1 million |
| $500 million to $1 billion | 162.5 | $4.3 million |
| *All commercial banks $1 billion and below* | *53.1* | *$4.0 million* |

Source: FDIC[13]

**State supervisors encourage federal regulators to find more ways to provide community banks with regulatory relief based on their small business designation.** The Regulatory Flexibility Act requires federal agencies to analyze how prospective rules will impact small businesses. However, the federal banking agencies seem to employ inconsistent approaches and methodologies when assessing the impact of such rules. Therefore, a single rule analyzed by different agencies leads to inconsistent conclusions regarding its potential impact. State supervisors encourage the federal banking agencies to perform consistent, more robust analysis that adequately quantifies regulatory costs for community banks. This would go a long way in providing community banks with more certainty as they calculate compliance costs and undergo the capital planning process.

**There is a mismatch in the risk profiles of small businesses and larger banks' data-driven lending models, and this often makes it difficult for larger institutions to meet small business credit needs.** Small businesses often have uneven cash flows and unpredictable revenue, and small start-ups lack the hard financial data large banks use to underwrite loans. Small business borrowers' behavior and risk of default are hard to forecast with large banks' statistical assumptions and models.

**Community banks enhance start-up companies' chances of survival.** The closer a start-up business is to a community bank, the more likely it is to receive a personal loan to use for business purposes. On the other hand, the further away a start-up firm is from a local community bank, the more likely it will be to use more expensive business and personal credit cards. By extension, community banks play a critical role in fueling the higher rates of employment growth and job creation indicative of newer firms.[14]

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[13] "Bank Data & Statistics." FDIC, June 2013. Available at: http://www.fdic.gov/bank/statistical/

[14] Lee, Y. and Williams, S. "Do Community Banks Play a Role in New Firms' Access to Credit?" Federal Reserve System and the Conference of State Bank Supervisors. *Community Banking in the 21st Century*, October 2-3, 2013, Federal Reserve Bank of St. Louis. Available at: http://www.stlouisfed.org/banking/community-banking-conference/PDF/Lee_williams.pdf

**Community banks' deep roots in local markets provide them with an expertise that is lacking in automated underwriting.** Community banks are better able to identify promising lending opportunities in new and less-established businesses with an intuitive sense of the viability of the business, the market in which it will operate, and the quality of its leadership. Community banks are also more heavily invested in their local communities, meaning their own viability is more closely tied to the local markets in which they operate. In the end, community banks can appropriately use borrower-specific information as they weigh a small business loan decision, while large banking organizations' volume-based, model-driven lending approach would disqualify many small businesses.

> *"The local geographic focus of community banks makes them a natural clearinghouse for information that is valuable to small businesses, and the high-touch, relationship-based approach of community banks makes them effective at underwriting and monitoring loans to informationally opaque small businesses."*
>
> *-Robert DeYoung*[15]

### *Community Banks and Portfolio Lending*

**The traditional practice of portfolio lending stands in stark contrast to the originate-to-distribute model.** Over the past four decades, changes in technology and financial innovations have led to an unprecedented commoditization of loans. Mortgage loans were the assets most frequently securitized and sold off into the secondary market, with larger banks using an "originate-to-distribute" loan model. Still, not all residential lending is securitized, and many banks both large and small make these loans with the intention of holding them in portfolio (Figure 7). Portfolio lending is quite different from the originate-to-distribute model, as it inherently aligns the interests of borrowers with lenders who retain 100 percent of the risk of default – when the borrower defaults, portfolio lenders have every incentive to work with the borrower to resolve the problem.

**Portfolio lending allows community banks to tailor mortgage loans to consumers' individual credit profiles.** With a firsthand knowledge of their market's property and borrowers, community banks can also offer customized mortgages that might not qualify for the secondary market. This approach to mortgage lending has proven particularly resilient during times of great economic stress. For example, as the secondary mortgage market seized up in 2008, the amount of mortgages held in portfolio by community banks actually increased by $36 billion.[16] At a time when large lenders were pulling back and leaving homebuyers at the closing table, community banks continued to responsibly finance mortgages.

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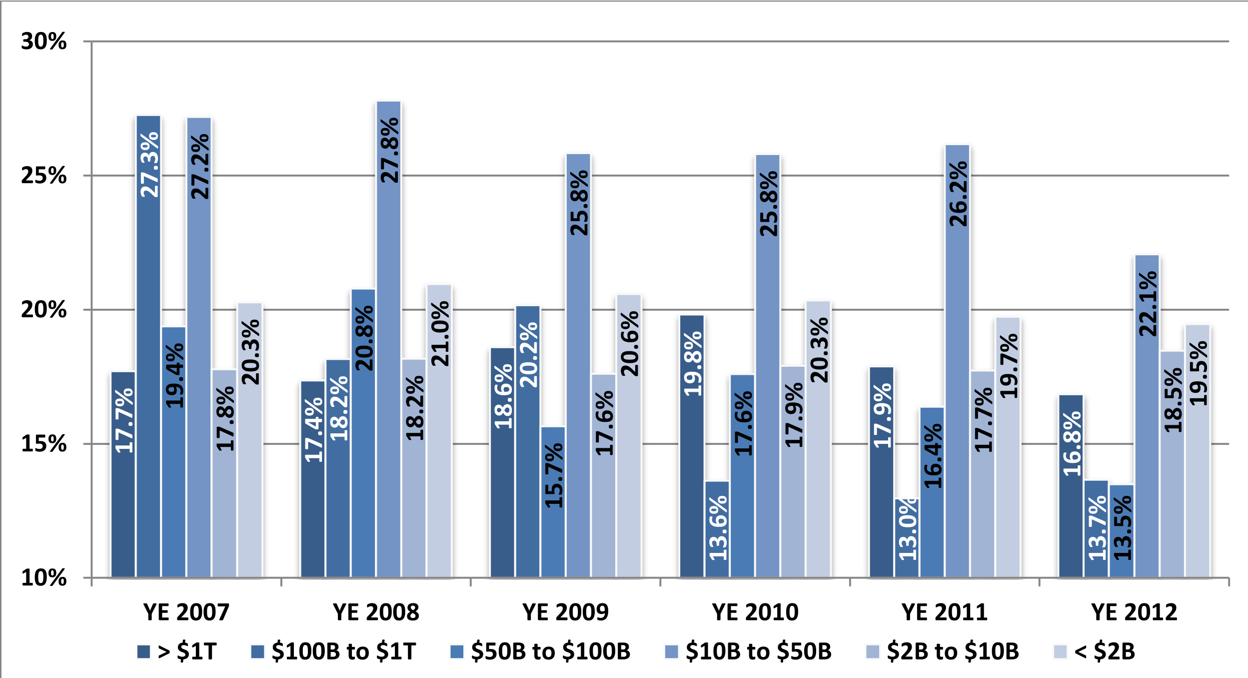
[15] DeYoung, R. "Whither the Community Bank? A Conference Summary." *Chicago Fed Letter*, Federal Reserve Bank of Chicago, May 2003. Available at:
http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2003/cflmay2003_189a.pdf

[16] "Statistics on Depository Institutions." Op. cit.

**Figure 7. 1-4 Family Loans Held in Portfolio as a Percentage of Total Bank Assets, 2007 to 2012**




Source: FDIC[17]

*"In the immediate aftermath [of the financial crisis], despite a substantial reduction in jumbo lending as a share of the overall mortgage market, the data indicate that the share of community bank jumbo mortgage lending held steady. Such lending actually increased at community banks that were not dependent on correspondent banking and at those that were sufficiently well capitalized and more profitable. And, by their sheer numbers and their central role in local communities, these banks are vital and competitive players in a highly diverse landscape for financial services. They often provide competitive options where none would otherwise exist, thereby lower borrowing costs for businesses and consumers."*

*- Sarah Bloom Raskin*[18]

[17] Ibid.

[18] Raskin, S. "Let's Move Forward: The Case for Timely Implementation of Revised Capital Rules." *Speech at the Ohio Bankers Day*, Columbus, June 6, 2013. Available at: http://www.federalreserve.gov/newsevents/speech/raskin20130606a.htm

## SECTION III. AREAS OF REGULATORY PROGRESS—ACCOMMODATING THE COMMUNITY BANK BUSINESS MODEL

**Community banks (and those who want to launch new banking ventures) need certainty, clarity, and a dedication to a regulatory environment that promotes the responsible provision of credit through relationship and portfolio-based lending.** While there seems to be a general recognition of the value of community banking, regulatory right-sizing may not be occurring quickly enough to help slow bank consolidation or to encourage new banking ventures. In the five years leading up to the financial crisis, an average of 156 new banks per year opened their doors. Since 2008, only 23 "new" banks have started, and it appears that all but one of these de novo charters were approved in order to buy existing, or failed, institutions.[19] In reality, Lakeside Bank in Louisiana has been the only true start-up bank to have emerged in the post-crisis banking industry to date.[20] Entrepreneurs who are willing to navigate the rapidly changing regulatory environment face the additional hurdle of heightened scrutiny by federal agencies. Federal regulators must arrest the consolidation trend, help existing community banks operate at profitable margins, and give entrepreneurs the confidence and opportunity to form new community banks.

**Still, federal regulators have certainly recognized the value of community banking – and their relationship and portfolio-based lending business model – and have adjusted several key proposals to limit their impact on community banks.** These encouraging developments demonstrate that the post-crisis regulatory system can allow community banks to flourish. These relief efforts have mainly taken the shape of size thresholds, but more logical and meaningful regulations can be achieved by accommodating the community bank business model.

### *RIGHT-SIZED REGULATIONS AND PORTFOLIO LENDING*

**One of the primary examples of regulatory relief has come from the CFPB's Small Creditor QM[21] rule.** It properly supports community banks' portfolio lending business model by conferring QM benefits on loans originated by institutions with less than $2 billion in assets and fewer than 500 annual mortgage originations. This regulatory right-sizing provides enormous benefits to the communities served by these small creditors – community bank portfolio lenders can continue making loans designed for borrowers who do not fit standardized credit profiles. The CFPB has taken a strong first step in appropriately tailoring regulations to the community bank business model, and there are other areas in

[19] Kline, A. "Bank Population Shrinks Rapidly Amid Lull in Startups." *American Banker*, September 5, 2013. Available at: http://www.americanbanker.com/issues/178_172/bank-population-shrinks-rapidly-amid-lull-in-startups-1061817-1.html

[20] Martin, A. "In Hard Times, One New Bank (Double-Wide)." *New York Times*, August 28, 2010. Available at: http://www.nytimes.com/2010/08/29/business/29bank.html?pagewanted=all&_r=0

[21] Qualified mortgages are loans that meet minimum underwriting criteria and borrower characteristics, which have been outlined by federal agencies to ensure quality underwriting practices.

which federal regulators could advance this model, including appraisals, escrow, and capital requirements.

**The CFPB has also recognized that the Dodd-Frank Act's restriction of balloon loans could disadvantage community banks.** As community banks typically retain these mortgages in portfolio, they have properly considered the borrower's ability to repay and are vulnerable to the high costs associated with default on such loans. The CFPB has provided a two-year window for community banks to continue making balloon loans held in portfolio, even if these customers are not in rural or underserved areas. The CFPB has built in this transition period to give regulators additional time to more thoroughly examine the impact a balloon loan restriction will have on community banks and their customers. It also provides Congress with an opportunity to confer QM status to balloon loans held in portfolio.

**Congress should grant Small Creditor QM status to all loans held in portfolio by community banks.** The CFPB's treatment of balloon loans was a step in the right direction, and demonstrated recognition of the unique nature of community banking and a different approach to regulating them. Congress should now extend this approach to all loans held in portfolio by community banks, which is the logical next step. Today's issue may be balloon loans, but tomorrow it could be another loan type. This approach would ensure community banks are properly supervised according to their actual risks and business practices, subjected to a simple regulatory framework, and authorized to lend using a model on which large areas of the country depend.

**If Congress fails to confer QM status to balloon loans held in portfolio, the CFPB should continue to provide community banks some measure of regulatory relief by addressing inconsistencies in the rural designation process.** Balloon loans are currently eligible for QM status if they meet the basic QM requirements and are originated in "rural" and "underserved" areas. However, many inconsistencies arise as regulators try to use one standard definition of "rural" in a country with over 3,794,000 square miles and 300 million people. Complications will arise from using the Urban Influence Code rural definition, and absent a statutory change, the CFPB should adopt a petition process for interested parties to seek rural designation for counties that do not fit the Urban Influence Code definition.

**Portfolio lending ultimately aligns economic incentives between borrower and lender in a way that causes local economies to thrive.** Federal policymakers should seek to advance this business model so community banks continue to provide their local communities with flexible credit products. The time tested practice of portfolio lending ensures consumers are benefitting from access to credit while banks lend in a safe, sound, and profitable manner. The CFPB's Small Creditor QM framework properly accommodates this portfolio lending model, and federal agencies should use it as a model for future reform initiatives.

## *Federal Agencies, Community Banks, and Basel III*

**During the Basel III rulemaking process, the federal regulatory agencies recognized that community banks should be granted certain exemptions based on their business model, size, resources, and risk**

**to the overall financial system.** Recognizing the scope of the Basel Committee's work – large, internationally active banks – they allowed community banks two key exemptions that were better tailored to their risk profile: the accumulated other comprehensive income (AOCI) opt-out, and the retention of the Dodd-Frank Act's Collins Amendment.

**The AOCI opt-out allows community banks to exclude most of its elements from regulatory capital.** In the original Basel III proposal, the regulators' rule would have required all unrealized gains and losses in AOCI, notably Available-For-Sale debt securities, to flow through a bank's common equity tier 1 capital. This would have applied to all banks, regardless of their size and the risks they posed to the overall financial system. Federal agencies saw that this provision would not have been meaningful or workable for community banks, mainly as it would have introduced significant volatility in capital ratios and would have potentially skewed these banks' capital positions both in times of crisis and in periods of stability. Taking this into account in the final Basel III rule, they provided non-advanced approach banking organizations with a one-time option to opt out of the requirement to include most AOCI components in the calculation of common equity tier 1 capital.

**Federal regulators also allowed community banks to continue using trust-preferred securities (TruPS) as tier 1 regulatory capital.** The proposed Basel III rule would have prohibited this practice, thus forcing community banks to raise additional capital to meet enhanced regulatory requirements. Regulators revised the Basel III proposed rule to ultimately include the Dodd-Frank Act's Collins Amendment, which allows community banks to continue using existing TruPS as tier 1 regulatory capital. Again, regulators recognized that community banks are more limited in their ability to raise capital than large banking companies, and saw that this would ultimately hurt both smaller banks and the communities they serve. By harmonizing the Basel III international standards with the Dodd-Frank Act, they provided community banks with regulatory relief and more certainty in their capital planning process.

### *Durbin Amendment: Interchange Fees*

**The Durbin Amendment, once actually feared as a potential impediment to small banks, has resulted in a regulatory system that more accurately reflects the disparity in size between institutions.** Community banks are earning nearly the same amount on debit interchange fees as they were prior to the financial crisis, and are actually making more than they were before the Dodd-Frank Act (51 cents now as opposed to 45 cents). Community banks are considered exempt debit card issuers under the Durbin Amendment, and exempt issuers have seen stronger gains in both market share and number of transactions compared to their non-exempt counterparts. Exempt issuers took in 48 percent of all interchange fee revenue in 2012, a 16 percent increase in fee income from the previous year. Additionally, exempt issuers also saw their number of transactions grow at a faster rate than that of non-exempt issuers, at 12.3 percent and 5.8 percent respectively.[22] The Durbin Amendment's two-tiered design has been a benefit to community banks.

[22] "Regulation II (Debit Card Interchange Fees and Routing)." Board of Governors of the Federal Reserve System. Available at: http://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm

## *Changes in the Deposit Insurance Assessment*

**Favorable changes to the Deposit Insurance assessment base appropriately shifted some of the overall assessment burden to the largest institutions, which rely less on domestic deposits for their funding and present greater risk to the Deposit Insurance system.** During the crisis, the resolution of community banks generally worked as it was designed. However, existing structures did not work for the large institutions because their funding practices did not rely as significantly on insured deposits. To more accurately reflect this reality, the Dodd-Frank Act redefined the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. This change has made large institutions more accountable for the share of risk they contribute to the financial system, and has provided some relief to community banks. In fact, aggregate premiums paid by banks under $10 billion in assets declined by one-third in the second quarter of 2011. The Dodd-Frank Act also permanently increased the deposit coverage limit to $250,000, which has helped community banks attract deposits.[23]

## *Agency Outreach and Congressional Support*

**Achieving right-sized regulations will require federal agencies to dialogue more frequently with community banks.** In particular, the FDIC has made great efforts to reach out to community banks. One example would be the steps the agency has taken to improve the pre-examination process, namely better scoping examinations, defining expectations, and improving examination efficiency. The FDIC has also launched communication initiatives with community banks to help explain changes in rules, provide community banks with training, and offer technical assistance through the exam and rulemaking processes.[24] The significant research project the FDIC undertook on community banks has also raised the visibility of community banking issues and provided a solid foundation for further research.

**Federal regulators' efforts to create a collaborative environment between regulators and the institutions they regulate benefit all stakeholders in the banking industry, including consumers.** Both the FDIC and Federal Reserve have also included prominent statements of applicability to banks under $1 billion, which result in greater clarification of supervisory expectations. Additionally, the CFPB has undertaken innovative outreach efforts to small institutions and the industry to aid implementation of the Dodd-Frank Act rules including Project Catalyst and the "Know Before You Owe" initiative. The FDIC Advisory Committee on Community Banking helps direct the agency's policy towards smaller institutions. A similar group at the Federal Reserve, the Community Depository Institutions Advisory Council, provides the same type of policy input and guidance. In October 2013, the Federal Reserve and CSBS jointly hosted a first-of-its-kind research conference completely dedicated to community banking issues. Such groups and initiatives provide a critical vehicle for the federal agencies to hear from the industry as they work through policy issues.

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[23] "Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation: Mitigating Systemic Risk Through Wall Street Reform." US Senate Committee on Banking, Housing, and Urban Affairs, July 11, 2013. Available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c1fcc9b5-ebf2-4326-a9e4-4edfe2b0097f

[24] Ibid.

# SECTION IV. REGULATORY CERTAINTY AND THE FAIR LENDING EXAMINATION PROCESS

### *INCREASING SUPERVISORY CLARITY AND TRANSPARENCY*

**Federal regulators should acknowledge the differences of the community bank business model during fair lending examinations.** Lending decisions made within community banks' relationship and portfolio-based lending model cannot be effectively analyzed through the same statistical models used to determine fair lending violations at banks with much larger sample sizes and automated pricing models. Federal regulators must move away from one-size-fits-all fair lending examination techniques that present compliance challenges for community banks, and should instead develop a flexible, streamlined approach to fair lending examinations for traditional community banks.

**Supervisory clarity is also crucial, as existing fair lending supervisory expectations fail to provide community banks with a clear understanding of what the law requires of them.** The supervisory process should be less reliant on opaque statistical models that fuel a zero-tolerance standard and inhibit regulators from exercising discretion when there is no pattern, practice, or intent to discriminate. Current supervisory methods launch a lengthy fair lending remediation process that imposes substantial costs to banks regardless of the impact of the violation. The costs of this remediation process often exceed the amount of compensation to the injured parties.

### *DIFFICULTIES IN THE CURRENT FAIR LENDING FRAMEWORK*

**While there is no question that overt discrimination or disparate treatment in lending should not be tolerated, there is significant debate over the propriety of the disparate impact analysis and the statutory authority of agencies to pursue claims based on such analysis.** The banking industry expected to find clarity through a Supreme Court ruling on *Mount Holly v. Mt. Holly Gardens Citizens in Action, Inc.*, a complex housing case involving disparate impact. The case's out-of-court settlement in November 2013 left the debate open on the validity of the disparate impact standard. However, there is no uncertainty that federal regulators will continue to look for disparate impact within their fair lending examination procedures.[25]

**Without a clear understanding of the disparate impact analysis, community banks may have less flexibility in meeting their customers' credit needs.** In the absence of clear guidance from federal regulators, lenders will reduce their lending or be forced to relax underwriting standards and accept

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[25] "CFPB Bulletin 2012-04 (Fair Lending)." Consumer Financial Protection Bureau, April 18, 2012. Available at: http://files.consumerfinance.gov/f/201404_cfpb_bulletin_lending_discrimination.pdf; "Implementation of the Fair Housing Act's Discriminatory Effects Standard; Final Rule." Department of Housing and Urban Development, February 15, 2013. Available at: http://portal.hud.gov/hudportal/documents/huddoc?id=discriminatoryeffectrule.pdf

higher risk customers to reduce inquiries into fair lending practices. The ultimate result could be higher rates for the borrowers the disparate impact standard aims to protect. Borrowers are also more likely to leave the banking system altogether for alternative delivery of products at higher costs if banks exit business lines due to fair lending risk.

**Continued ambiguity around the disparate impact analysis will also challenge community banks' relationship lending model.** Federal regulators point to the small number of fair lending referrals and settlements among community banks, using this as an argument that there is no need for broad policy change in this area. However, that argument fails to account for the uncertainty and fear surrounding the fair lending assessment process and the impact that uncertainty has on small institutions that extend credit based on soft information rarely captured by models. Relationship lending allows community banks to tailor product offerings to any customer, including disadvantaged groups in their markets.

## DISPARATE TREATMENT AND DISPARATE IMPACT – WHAT IS THE DIFFERENCE?

- According to the CFPB, **disparate treatment** is intentional. It "occurs when a creditor treats an applicant differently based on a prohibited basis such as race or national origin."[26]
    - *OCC Example* – A lender offers a credit card with a limit of $750 for applicants age 21 through 30 and $1,500 for applicants over age 30. This policy would violate the Equal Credit Opportunity Act's (ECOA) prohibition on discrimination based on age.[27]
- The CFPB explains that "**disparate impact** occurs when a creditor employs facially neutral policies or practices that have an adverse effect or impact on a member of a protected class unless it meets a legitimate business need that cannot reasonably be achieved by means that are less disparate in their impact."[28]
    - *OCC Example* – A lender has a policy of not making single family home loans for less than $60,000. This policy might exclude a high number of applicants who have lower income levels or lower home values than the rest of the applicant pool.[29]

[26] "CFPB Consumer Laws and Regulations: ECOA." Consumer Financial Protection Bureau, June 2013, ECOA 1. Available at: http://files.consumerfinance.gov/f/201306_cfpb_laws-and-regulations_ecoa-combined-june-2013.pdf. See also: 12 CFR Part 1002 Supp. I Sec.1002.4(a)-1; 12 CFR Part 1002 Supp. I Sec. 1002.4(a)-1

[27] "Consumer Protection: Fair Lending." Office of the Comptroller of the Currency. Available at: http://www.occ.gov/topics/consumer-protection/fair-lending/index-fair-lending.html

[28] "CFPB Consumer Laws and Regulations…" Op. cit. See also: 12 CFR Part 1002Supp. I Sec.1002.6(a)-2.

[29] "Consumer Protection: Fair Lending." Op. cit.

## *Clarity on Disparate Impact and Qualified Mortgage Rules*

**Lenders initially feared that the QM rules could lead to a disparate impact on protected classes, and therefore expose them to increased regulatory and legal risk.** In the summer of 2013, eight industry groups including the Mortgage Bankers Association, American Bankers Association, Consumer Bankers Association, and the Independent Community Bankers of America sent a letter to CFPB and the Department of Housing and Urban Development requesting written guidance in this area.[30] The industry groups expressed concern that adherence to the facially neutral requirements of the QM rules could result in fewer disadvantaged borrowers receiving home loans, thereby triggering disparate impact claims on behalf of these protected groups of borrowers. Publically available data show that a disproportionate share of minorities would have debt ratios over the 43 percent QM maximum when compared to non-minority borrowers.[31]

**The federal banking regulators provided some clarification regarding how exclusive adherence to the QM standard would not lead to disparate impact violations.** On October 22, 2013, federal regulators issued guidance to address industry concerns about the compatibility of the QM Rule with ECOA in order to dissuade fears that offering only QM loans would put lenders at risk for fair lending claims.[32] While the recent guidance is helpful, institutions that exclusively make QM loans may still have elevated fair lending risk based on “other factors” alluded to in the guidance.

## *Compliance Supervision – Focus on Corrective Action*

**Disparities, while harmful, can often be unintentional, and regulators should consider this fact as they examine community banks.** One such disparate impact case illustrates that good intentions can run afoul of fair lending requirements. A Maryland bank was hit with a fair lending enforcement action in March 2013 by the Office of the Comptroller of the Currency (OCC). The OCC alleged that the bank’s lending practices showed it had inadvertently charged higher loan rates for white men and married couples. The disparity resulted from a lending program created by the bank to specifically assist minorities, which placed a cap on the institution’s compensation at 2.5 percent of the loan amount for minority and women borrowers. This cap was not in place for white borrowers, resulting in higher

[30] American Bankers Association, et. al. “Request for Guidance and Clarity on Disparate Impact and Dodd-Frank Mortgage Standards.” Letter sent to CFPB and HUD, June 4, 2013. Available at: http://www.afsaonline.org/library/files/legal/comment_letters/Joint trade ltr re Disparate Impact.pdf

[31] Witkowski, R. “Blacks and Hispanics Likely to be Hurt by ‘Qualified Mortgage’ Rule.” *American Banker*, October 22, 2013. Available at: http://www.americanbanker.com/issues/178_204/blacks-and-hispanics-likely-to-be-hurt-by-qualified-mortgage-rule-1063055-1.html?zkPrintable=1&nopagination=1

[32] Guidance was issued on October 22, 2013, by the CFPB, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the National Credit Union Administration. Available at: http://files.consumerfinance.gov/f/201310_cfpb_guidance_qualified-mortgage-fair-lending-risks.pdf

charges for these borrowers.[33] Reverse discrimination allegations are unusual; however, the circumstances of this particular case reinforce bankers' fears of complying with the multitude of fair lending regulations facing their institutions.

**A corrective mindset that follows a traditional prudential supervisory model would help regulators and community banks remedy unintentional disparities.** Considering community banks' relationship and portfolio-based lending model, regulators' analysis of community bank loans should consider the differences and nuances of how and why certain loans were made, or why there may be a difference in loan terms. Additionally, the application of one-size-fits-all examination techniques and tools to community banks without regard for the use of judgment based on their close relationships with borrowers is inappropriate. A corrective examination framework would help allay banks' fears by providing them with the certainty they need when engaging in relationship lending.

[33] Witkowski, R. "Unusual OCC Order Hits Bank for Discriminating Against White Males." *American Banker*, May 7, 2013. Available at: http://www.americanbanker.com/issues/178_88/unusual-occ-order-hits-bank-for-discriminating-against-white-males-1058914-1.html

# Section V. Additional Areas of Regulatory Relief

## *Pass-Through Deposit Insurance for Small Business Payroll Accounts*

**Transaction accounts are crucial to community banks who work with small businesses across the country.** Small businesses, local governments, and other entities often use these accounts as a cash management tool. The FDIC's Transaction Account Guarantee (TAG) Program, as implemented through the Dodd-Frank Act, provided temporary unlimited deposit insurance for noninterest-bearing transaction accounts. On January 1, 2013, the Dodd-Frank Act changes to the definition of "insured deposit" expired, and deposit insurance returned to the $250,000 FDIC standard. When competing with large institutions with implicit government guarantees, options for community bankers seeking to retain customers with large deposits have been limited. Since the expiration of TAG, banks with less than $1 billion in assets have seen a 9 percent reduction in non-interest bearing deposits, while institutions with over $100 billion recorded only a 1 percent decline over the same period.

**The law would allow for the application of pass-through insurance for defined transaction accounts, which would help community banks compete with larger institutions in attracting commercial deposits.** CSBS has drafted a model rule that would apply pass-through insurance for defined transaction accounts. CSBS Counsel has concluded that the Federal Deposit Insurance Act, its implementing regulations, and FDIC interpretations provide a pass-through insurance legal theory that could be applied to a significant portion of the transaction accounts at issue. The FDIC uses three basic principles to determine whether pass-through insurance exists. First, a specified fiduciary relationship must exist whereby the account holder is acting on behalf of another. Second, the parties to the transaction must be explicitly named. Additionally, funds must be dedicated while in the account. Small business transaction accounts set up for payroll purposes satisfy these principles and should receive pass-through insurance of up to $250,000 for each beneficiary. If the FDIC were to adopt a rule, it would clarify the scope of pass-through insurance and provide a needed option to community banks seeking to keep or attract commercial deposits.

## *Remove Barriers to Raising Capital and Maintaining Liquidity for Community Banks*

**Federal regulators and Congress should not impede community banks' growth strategies based on concerns of setting precedent for larger institutions' mergers and acquisitions behavior.** Federal regulators often scrutinize mergers and acquisitions involving smaller banks through the lens of how larger banks might exploit those decisions by claiming such a merger set a particular precedent. However, regulatory restrictions on such strategic business ownership decisions have an outsized impact on small bank holding companies due to their inherent size, growth, and capital limitations. Community banks simply lack access to the diversity of funding sources available to larger banks. Community banks tend to require capital in amounts less than the optimal threshold attractive to institutional and other large investors, and this hampers their growth. Smaller banks would genuinely benefit from increased flexibility surrounding their strategic business ownership decisions, and would welcome a regulatory

environment that loosened restrictions around community bank growth. Congress should change federal law that states application decisions for banks below a specified size (perhaps $2 billion) do not establish a precedent for any institution designated as a systemically important financial institution. To further address the length of time regulators take to review these applications, the review and approval process for applications submitted by institutions below a certain size should be de-centralized with more final decision-making authority given to FDIC Regional Offices and the regional Federal Reserve Banks.

**With regulatory compliance costs significantly increasing for community banks, federal regulators should put in place commonsense rules that help community banks raise capital and provide easier access to cost-effective funding.** Better access to more funding sources would translate into increased lending throughout local markets, and would also attract more investors. Risk aversion in response to activities of large banks should not affect rules for smaller banks. When community banks take risk responsibly, it has a positive effect on the communities in which they operate. If they take too much risk, there is at least a proven system for their resolution.

### *Eliminate the Brokered Deposit Designation for Reciprocal Deposits*

**Federal regulators should encourage community banks to take responsible risks, and eliminating the brokered deposit designation for reciprocal deposits would promote healthy risk taking.** There is no doubt that excessive use of brokered deposits can be a precursor to problems; however, there are responsible, innovative products that enable community banks to take higher levels of acceptable risk. A key example would be that of reciprocal brokered deposits. These stable funding sources allow community banks to maintain their relationships with customers, attract new accounts, and responsibly collaborate with and share risk with a network of other banks. In a study on core and brokered deposits, the FDIC notes that there is no statistical correlation between reciprocal deposits and bank failure. Indeed, another study finds that banks that offer these products actually have lower quarterly failure rates on average, and also allow them to make more loans.[34] Products such as reciprocal deposits that help banks access low-cost funding responsibly and that augment their relationship business model should not be included in the definition of brokered deposits.

[34] Blinder, A. and Shastri, A. "Estimated Effects of CDARS Reciprocal Deposits on the Likelihood of Bank Failure." Promontory Interfinancial Network, January 3, 2011. Available at: http://www.fdic.gov/regulations/laws/federal/2010/10c21AD66rates.PDF

# SECTION VI. COMMUNITY BANKS IN THE 21ST CENTURY REGULATORY ENVIRONMENT

**Relationship and portfolio-based lending are proven, effective methods of supporting consumers' credit needs, and community banks should be able to continue these practices within an appropriately designed regulatory framework.** It is of great economic consequence that when regulating threats to 21st century financial stability, federal regulators preserve the centuries-old relationship between community banks and the communities they serve.

**Put simply, financial regulations designed to address the underwriting failures and systemic risks posed by the largest global banks should not be applied to community banks.** Doing so does not promote safe and sound business practices at community banks as it fails to capture their actual practices. It adds enormous compliance costs to institutions already struggling in a challenging economic environment. A one-size-fits-all regulatory approach ultimately inhibits many families and businesses from accessing credit.

**The United States has a diverse economy, and therefore needs a diverse banking system consisting of both large global banks and smaller community banks to fuel its growth.** In 2020, it would be unfortunate to look back at the wave of post-crisis regulations and conclude that they had a hand in eliminating this diversity by simply enshrining the originate-to-distribute model (albeit one more expensive for large banks than before the crisis), and cutting off the primary source of credit for large portions of the United States.

**Federal regulators and Congress have made some encouraging accommodations for community banks, but they must do more to ensure the community bank business model that underpins many local economies is allowed to flourish.** There are clear opportunities for federal regulators and Congress to promote regulatory certainty and clarity, and to show their commitment to traditional community-based lending. Right-sized regulations would free up community banks to better serve their local markets, and would help counter the consolidation trend by encouraging much needed de novo activity.

**Regulators must have a better vision for the future of the U.S. financial system, its supervision, and its role in the overall economy.** Financial regulators have spent the last few years building a regulatory framework that almost exclusively focuses on limiting the risks of large complex institutions, but the emerging supervisory system imperils community banks. Ill-designed regulations should never be the reason a small institution sells or self-liquidates, and it is now time for policymakers to design an appropriate regulatory model for community banks. Regulators must answer the challenge of saving the U.S. financial system's diversity, and promoting a banking industry comprising a full spectrum of institutions that fuel a vibrant national economy.