Testimony
of
James D. MacPhee
CEO, Kalamazoo County State Bank

On behalf of the
Independent Community Bankers of America

Before the

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Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

Hearing on
"The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses"

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Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee, I am James MacPhee, CEO of Kalamazoo County State Bank in Schoolcraft Michigan and chairman of the Independent Community Bankers of America. Kalamazoo County State Bank is a state-chartered community bank with $77 million in assets. I am pleased to represent community bankers and ICBA's nearly 5,000 members at this important hearing on "The Effects of the Dodd-Frank Act on Small Institutions and Small Businesses."

We're grateful to you for convening this hearing. Community banks are the primary source of credit, depository, and other financial services in thousands of rural areas, small towns, and suburbs across the nation. As such, they will play an essential role in the recovery of our national economy. Regulatory and paperwork requirements impose a disproportionate burden on community banks thereby diminishing their profitability and their ability to attract capital and support their customers and communities. We appreciate your interest in the impact of the Dodd-Frank Act on community banks.

The Dodd-Frank Act was generational legislation and will permanently alter the landscape for financial services. Every provider of financial services – including every single community bank – will feel the effects of this new law to some extent. The community bank business model is based on the strength of our reputation in small communities and long-term customer relationships. Community banks don't engage in abusive consumer practices and did not cause the financial crisis, and we appreciate the support our industry received to shield us from some of the provisions designed to respond to the crisis.

What's the impact of the new law on community banks? A law this broad, disparate, and multi-dimensional cannot be easily characterized. Undeniably, the law will result in additional compliance burden for community banks and it will be challenging for them to cope with. The full and ultimate impact won't be known for years, depending on how the law is implemented and how the market adjusts to it. There's still an opportunity to improve negative provisions in the law – with the help of this committee and Congress – and provisions that could be helpful to community banks are still at risk of being weakened in the implementation.

It is also important to note that the Dodd-Frank Act was just one of a number of legislative and regulatory responses to the nation's financial crisis and resulting recession. The harsh examination environment and changes to credit card and overdraft protection rules, for example, have had a profound impact on community banks.
With those caveats, let me turn to the specific provisions of the Act, beginning with our concerns.

Debit Interchange

By a wide margin, the most troubling aspect of the Dodd-Frank Act is the debit interchange, or "Durbin," amendment. We're grateful to you, Chairman Capito, for dedicating a recent hearing to the Durbin amendment and the Federal Reserve's proposed implementing rule. The hearing substantiated the grave concerns we have with the law and the proposed rule, which would fundamentally alter the economics of consumer banking. In light of that hearing, for which we submitted a statement for the record, I'll be succinct in my comments here. But this point bears emphasis – community banks are not effectively carved out by the statutory exemption for debit cards issued by institutions with less than $10 billion in assets. Chairman Bernanke, the regulator charged with implementing the new law, conceded this point in a recent hearing before the Senate Banking Committee. Visa's planned two-tiered pricing system, however well intentioned, also will not work. Small issuers will feel the full impact of the Durbin amendment over time. It's too easy to focus on the large issuers and lose sight of the thousands of community bank issuers who will be harmed if the Federal Reserve proposal is implemented. Not only are small issuers not carved out, they would be disadvantaged relative to large issuers, and a likely consequence of the Federal Reserve's proposed rule, if implemented, is further industry consolidation, higher fees and fewer choices for consumers.

Why won't the carve-out work? The reasons are twofold. First, in addition to the interchange price-fixing provisions of the law and the Federal Reserve proposal, other less-discussed provisions shift control of transaction routing from the card issuer to the merchant. These provisions apply to all financial institutions, regardless of size, and negate the benefit, if any; small financial institutions would gain from the interchange price-fixing exemption. Granting retailers the ability to route debit card transactions over the network of their choice – where the card issuer currently designates the network on which its card is routed – will allow retailers to bypass the two-tier system. Further, large retailers will be able to incentivize customers to use the rate-controlled cards issued by the largest financial institutions, discriminating against community banks and their customers. Community bank cards will either be subject to the lower rate or their cards will be neglected by retailers.

There's a second way in which the carve-out fails to shield small issuers. In any two-tier system, the small issuer interchange rate, to the extent that small issuers actually receive it, will surely be lower than the current interchange rate. The payment card networks will be under considerable pressure from their clients with more than $10 billion in assets to narrow the gap between the two tiers.

For these reasons, a tiered system will not protect community banks. Over time, community bank interchange revenue will drop sharply with a direct impact on community bank customers.

What would happen if the Federal Reserve proposal were implemented? ICBA recently completed a survey of its members, and the results demonstrate that the Federal Reserve proposal would alter the economics of community banking and fundamentally and adversely change the nature of the relationship between a community bank and its customers. Among the survey results: Community banks would be forced to charge their customers for services that are currently offered for free and that customers have come to expect and value – debit cards, checking accounts, online or mobile banking.

Community banks will have difficulty offering their customers – both consumers and small businesses – competitive rates on deposits and loans. It will be harder to qualify for a debit card. Finally, 20 percent of survey respondents say they will have to eliminate jobs or halt plans to open new bank branches – extending the impact from individual consumers to communities. To use my bank as an example, in 2010 we had about 1600 debit cards outstanding and our profit on those cards for the year was a modest $4,800. If the Federal Reserve proposal goes into effect, I estimate that we would lose $20,000 on our debit card program – lost income that we would have to make up through higher fees on our products and services.

Our global payments system works so well that thousands of small community banks are able to stand toe-to-toe and offer services to consumers in direct competition with banks like Citigroup and Bank of America, while providing the quality of relationship service that only a community banker can give. The new law and the Federal Reserve proposal threaten the ability of community banks to compete with large issuers and would bring about further industry consolidation, to the detriment of consumers and small businesses in small town and rural America.

Our statement for the record for this subcommittee's February 17 hearing is a more complete consideration of this topic. The ICBA survey results clarify what is at stake. ICBA urges this committee to prevent the Federal Reserve proposal from going into effect.

Consumer Financial Protection Bureau

While we are pleased that the Dodd-Frank Act allows community banks with less than $10 billion in assets to continue to be examined by their primary regulators, ICBA remains concerned about CFPB regulations, to which community banks will be subject. ICBA strongly opposed provisions in the Dodd-Frank Act that excluded the prudential banking regulators from the CFPB rule-writing process. Bank regulators have long expertise in balancing the safety and soundness of banking operation with the need to protect consumers from unfair and harmful practices and provide them with the information they need to make informed financial decisions.

The Act gives the prudential regulators the ability to comment on CFPB proposals before they are released for comment and an extremely limited ability to veto regulations before they become final. This veto can only be exercised if, by a 2/3 vote, Financial Stability Oversight Council (FSOC) determines that a rule "puts at risk safety and soundness of the banking system or the stability of the financial system," an unreasonably high standard and one that should be amended. ICBA supports changing the standard so that FSOC is permitted to veto a CFPB rule that could adversely impact a subset of the industry in a disproportionate way. We believe that this standard would give prudential regulators a more meaningful role in CFPB rule writing.

Absent such legislation, ICBA encourages the CFPB to reach out to community banks as they contemplate rules – before proposed rules are issued – to better understand how proposed rules would impact community bank operations and community bank customers. In particular, any rules that privilege "plain vanilla" products (credit cards, mortgages, etc.) would adversely impact community banks, who are frequently the only providers who are willing to customize products to meet customer needs.

Any enhanced consumer protection laws should focus on the "shadow" financial industry which has been most responsible for victimizing consumers while avoiding serious regulatory scrutiny. This segment of the financial services industry should be brought under the same regulatory umbrella as commercial banks. ICBA supports a balanced regulatory system in which all financial firms that grant credit are subject to meaningful supervision and examination. Under Dodd-Frank, the CFPB has discretion in defining non-depository "covered persons" subject to CFPB rules, examination and enforcement. ICBA urges the CFPB to define "covered persons" broadly.

Community banks are already required to spend significant resources complying with voluminous consumer protection statutes. CFPB rules should not add to these costs. The Dodd-Frank Act gives the CFPB authority to exempt any class of providers or any products or services from the rules it writes considering the size of the entity, the volume of its transactions and the extent to which existing law already has protections. ICBA urges the CFPB to use this authority to grant broad relief to community banks and/or community bank products where appropriate.

Risk Retention

Community banks make commonsense mortgages supported by sound, conservative underwriting. As the banking regulatory agencies implement Section 941 of the Dodd-Frank Act, which requires mortgage originators to retain credit risk on non-qualified residential mortgages, ICBA strongly urges them not to define "qualified residential mortgage" too narrowly. An unreasonably narrow definition of QRM will drive thousands of community banks and other lenders from the residential mortgage market, leaving it to only a few of the largest lenders. Too narrow a definition will also severely limit credit availability to many borrowers who do not have significant down payments or who, despite high net worths, have relatively low incomes and high debt-to-income ratios. In ICBA's view, the definition of QRM should be relatively broad and encompass the largest portion of the residential mortgage market, consistent with the stronger underwriting standards called for by the Act. An unduly narrow definition of QRM will disadvantage community banks because they lack access to the increased capital needed to offset risk retention requirements, despite conservative underwriting. What's more, community banks operating in rural areas will be driven out of the market by Farm Credit System direct lenders who carry an exemption for the loans or other financial assets that they make, insure, guarantee or purchase.

Escrowing for taxes and insurance would be costly for small lenders

The Act's new mortgage escrow requirements will be costly to our members. Rural customers have unique credit needs, collateralized by rural properties, which do not lend themselves to securitization. As a result, community banks that serve rural customers tend to hold loans in portfolio, where the lender is exposed to the entire credit risk of the borrower for the full term of the loan. They not only have "skin in game," but bear the full risk of default. For this reason, portfolio lenders exercise special diligence in underwriting, and we believe that portfolio loans held by banks with assets of less than $10 billion should be exempt from the requirement that first lien mortgage lenders establish escrow accounts for the payment of taxes and insurance. There is a significant cost involved with establishing escrow accounts, particularly for community banks that have small lending volumes, must outsource their escrow services, and are not eligible for volume discounts. The costs are such that an escrow requirement could lead many community banks to sharply reduce or eliminate their mortgage businesses.

Community Banks Must Be Able to Rely on Credit Rating Agencies

The Dodd-Frank Act requires the regulatory agencies to replace all references to "credit ratings" with an "appropriate" standard for measuring creditworthiness. Community banks, lacking the resources to independently analyze credit quality, will be disproportionately affected by this provision.

As an alternative approach that addresses the legitimate concern with credit ratings, ICBA recommends amending Dodd-Frank to reintroduce the use of credit ratings, but also give the regulators the authority to confirm the credit ratings in those situations where additional credit analysis is warranted.

Community Banks Should Be Exempt From Derivatives Clearing Requirements

The Dodd-Frank Act includes provisions designed to create greater transparency and reduce conflicts of interests and systemic risks in the derivatives marketplace. ICBA agrees with these objectives but believes that new regulations by the SEC, the CFTC and federal banking agencies should not disadvantage community bankers in their use of derivatives, either in working with their borrowers or in hedging their interest rate risks.

Community banks typically use customized derivatives – basically interest rate swaps that match the characteristics of the underlying loans in order to be an effective hedge – that are not likely to be cleared by clearing houses due to their low volume and low notional values. For this reason and because they pose no financial or systemic risks to the financial markets, ICBA has urged the CFTC and SEC to exempt community banks from mandatory clearing requirements, based on their authority to do so in the Dodd-Frank Act. Due to the low risks involved, community banks' customized swaps also should not be subject to higher capital and margin requirements than the plain-vanilla swaps that will be cleared. In addition, the reuse of margin, or rehypothication, should not be prohibited because it is necessary for the functioning of the Over-The-Counter market. We need to ensure that community banks can continue to utilize low risk swaps to serve their customers. Otherwise, their customers will be driven to larger financial institutions whose derivatives were a source of systemic risk during the financial crisis.

ICBA-Supported Provisions

In representing our members during consideration of the Dodd-Frank Act, ICBA focused on making the Act workable for community banks. This meant seeking exemptions where appropriate. It also meant seizing the opportunity to advocate for long-sought community bank priorities. I will now turn to the provisions of the Act that ICBA supported and that we believe will strengthen community banks over the long term.

Tiered Regulation

First, the Act sets a precedent for tiered regulation of the financial industry. Community banks have little in common with Wall Street firms, mega-banks, or shadow banks and did not cause the financial crisis or perpetrate abusive consumer practices. Community banks have a much different risk profile because their business model is built on long-term customer relationships, and they cannot succeed without a reputation for fair treatment. For these reasons, ICBA believes it's appropriate to tier regulation of the financial services industry. Overly prescriptive regulation would only reduce community banks' flexibility in serving the unique needs of their customers. Moreover, regulation has a disproportionate impact on community banks because they have fewer resources to dedicate to compliance. We are pleased that Congress recognized these facts and our priority during the implementation phase is to press the regulators to carry through on the Act's clear preference for tiered regulation. We will also urge the regulators to use the flexibility they have under other statutes to implement a tiered regulatory system.

Too Big To Fail

ICBA has long expressed concerns about too-big-to-fail banks and the moral hazard they pose, well before the financial crisis. Community banks are more finely tuned to these concerns because we and our customers feel the direct impact. It's challenging for us to compete against mega-banks whose TBTF status gives them funding advantages. For this reason, we're pleased that the Act takes steps to mitigate TBTF.
ICBA supported the creation of the FSOC whose duties include identifying and responding to risks to financial stability that could arise from the failure of a large, interconnected bank or nonbank. We also support the FDIC's new resolution authority that will empower it to unwind large, systemically-risky financial firms. The government must never again be forced to choose between propping up a failing firm at taxpayer expense and allowing it to fail and wreak havoc on the financial system.

These and other provisions will help level the financial services playing field.

Regulation of “Shadow” Bank Competitors

ICBA is pleased that non-banks will be subject to federal examination and enforcement for the first time. The “shadow” financial industry has been most responsible for victimizing consumers while avoiding serious regulatory scrutiny. This segment of the financial services industry should be brought under the same regulatory umbrella as commercial banks. As I mentioned earlier in this testimony, under Dodd-Frank, the CFPB has discretion in defining non-depository “covered persons” subject to CFPB rules, examination and enforcement. ICBA urges the CFPB to define “covered persons” broadly.

Deposit Insurance

ICBA was a leading advocate for the deposit insurance provisions of the Act, including the change in the assessment base from domestic deposits to assets (minus tangible equity), which will better align premiums with a depository’s true risk to the financial system and will save community banks $4.5 billion over the next 3 years. The deposit insurance limit increase to $250,000 per depositor and the two-year extension of the Transaction Account Guarantee (TAG) Program, which provides unlimited deposit insurance coverage for non-interest bearing transaction accounts, will both help to offset the advantage enjoyed by the too-big-to-fail mega-banks in attracting deposits.

SOX 404(b) Relief

The Act permanently exempts public companies with capitalization of less than $75 million from the auditor attestation requirements of SOX 404(b). ICBA has led the fight for this exemption since SOX was enacted in 2002 and was very pleased to see this included in the Act.

Communities First Act

The legislative ideas highlighted in this testimony will be included in the Communities First Act, legislation which ICBA is working on with members of both chambers of Congress. We hope it will be introduced in the near future. In addition to Dodd-Frank Act amendments, the Communities First Act will include other provisions that would offer regulatory and tax relief to community banks. I hope that this committee will consider the Communities First Act.

Closing

Thank you again for the opportunity to testify today. Like most pieces of legislation, especially those that run to 2,300 pages, the Dodd-Frank Act is a mixed outcome for community banks. I hope that my testimony, while not exhaustive, helps to clarify some of the concerns as well as the bright spots in the Dodd-Frank Act for community banks. No legislation of this breadth and ambition can be got right the first time. We hope to work with this committee to improve the law and to ensure that it is implemented in a way that will impose the least burden on community banks.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
James Douglas MacPhee	Kalamazoo County State Bank Schoolcraft, Michigan (CEO) Independent Community Bankers of America (Immediate Past-Chairman)

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature: James D. MacPhee

Please attach a copy of this form to your written testimony.