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THE EFFECT OF DODD–FRANK ON SMALL FINANCIAL INSTITUTIONS AND SMALL BUSINESSES

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THE EFFECT OF DODD–FRANK ON SMALL FINANCIAL INSTITUTIONS AND SMALL BUSINESSES

Wednesday, March 2, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Royce, Westmoreland, Luetkemeyer, Huizenga, Duffy, Renacci, Canseco; Maloney, Watt, and Scott.

Chairwoman CAPITO. Thank you. This hearing will come to order.

As many of you know, we have pending votes that are supposed to begin at any moment. Flexibility is the key here. What we would like to do is go ahead and get started and get our opening statements, and then we may have to adjourn the meeting and come back after our votes. So, to our witnesses, I apologize for the inconvenience in advance.

I would like to thank the members of the Financial Institutions Subcommittee for joining me today in today's hearing entitled, "The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses."

As the House and Senate worked through financial regulatory reform, there was a constant theme: small institutions should be exempted from the provisions of this Act. In theory, I think we can all agree on this point. But, despite the efforts of many to carve out small financial institutions with less than $10 billion in assets, this is not the case. Now that Dodd-Frank is being implemented, we are hearing concerns about additional regulatory burden from the very institutions that were supposed to be exempted.

The most notable carve-out in the Dodd-Frank Act is the exemption of small institutions from supervision by the newly-created Consumer Financial Protection Bureau (CFPB). In January, the Financial Services Committee heard testimony from Charles Maddy, a friend of mine and a community banker from West Virginia. Despite operating an institution that is below $10 billion in assets, Mr. Maddy is very concerned that small institutions like his will

be subject to the rules that the Bureau creates even when they are not subject to their supervision.

What does this mean for a small institution? They will have to hire more compliance staff, which puts additional cost pressures on their ability to cooperate. Higher compliance costs, combined with uncertainty about capital standards, will have a direct result on small institutions' ability to serve their small business clients.

Our economy relies on the growth and innovation of small business and entrepreneurs. Some of these entrepreneurs are fortunate enough to have startup capital, but many are not. They are often dependent on small financial institutions for loans to start their companies. We must make sure that overburdensome regulations on small institutions do not have the spillover effect of stifling economic growth and small business development.

I look forward to hearing from our two panels today.

I would like to recognize the ranking minority member, the gentlelady from New York, Mrs. Maloney, for the purpose of making an opening statement.

Mrs. MALONEY. Thank you very much.

I thank Chairwoman Capito and, on the Democratic side, Congressman Scott from the great State of Georgia for being with us for this important meeting.

I am very proud of the work that we did to enact financial regulatory reform last summer in the wake of one of the deepest recessions in my lifetime. We did a number of critical things in that bill to put investors on an equal playing field with financial institutions, to provide consumers with a new bureau that will regulate predatory financial products, to end "too-big-to-fail," to regulate the derivatives market, and to ensure that systemically important firms are adequately supervised and regulated.

We are still in the early days of the implementation of this reform effort, and there will still be some uncertainty about how the rules will affect financial institutions going forward. But, throughout our effort, we were mindful of the impact that these reforms would have on smaller financial institutions. Because we all agree that small financial institutions did not cause the financial crisis, we all agree that small financial institutions were absolutely critical to ensuring that capital would continue to flow to small businesses, and we all agree that small financial institutions function very differently than larger institutions.

With all of this in mind, we enacted a number of important things in Dodd-Frank with small institutions in mind, and I would like to highlight a few of them.

First, we changed the formula for deposit insurance in assessments so small institutions, including community banks and credit unions, will pay significantly less in premiums. We did this by putting forward a formula that better reflects the risks an institution poses to the Deposit Insurance Fund using total consolidated assets minus tangible equity, rather than simply domestic deposits. This will ensure that larger institutions engaged in riskier activities will then be required to pay more, and lower assessments will mean more room for smaller institutions to lend to small businesses.

Second, we made the $250,000 deposit insurance limit permanent, which will increase public confidence and help smaller financial institutions continue to serve their communities.

Third, we leveled the playing field for small financial institutions and credit unions so that they can compete with nonbank institutions for the first time. Nonbank institutions such as mortgage brokers and payday lenders were playing by a different set of rules, and now these institutions will have a new regulator, the CFPB, to ensure that they are regulated in the same manner as financial institutions are regulated.

We also exempted institutions under $10 billion from the fee caps in our interchange rule.

Finally, we exempted smaller institutions from CFPB supervision so they will continue to have a single Federal regulator for safety and soundness under either the OCC, the FDIC, or the Fed.

I will be very much interested in hearing from the witnesses today what you see as the challenges going forward. I look forward to your testimony, and we appreciate the positive role that you have played in our economy. We want to make sure that you continue playing that positive role.

Thank you, and I yield back. And I guess we have time for other people to comment?

Chairwoman CAPITO. Yes. I would like to recognize the gentleman from California, Mr. Royce, for 2 minutes for an opening statement.

Mr. ROYCE. I thank the chairwoman; and I do, Madam Chairwoman, want to recognize Bill Cheney from California, who is one of the witnesses here today.

I want to say that there is agreement on both sides of the aisle on the fact that smaller institutions did not cause this crisis. Where we have some disagreement is the concern that we have on our side of the aisle, a concern many economists have pointed out is that, as a result of Dodd-Frank, we have now put smaller institutions at a structural competitive disadvantage because of the legislation. As time goes on, how we treated small institutions in this legislation becomes clear, and I would like to point out three things.

The first would be what we did really compounds "too-big-to-fail," and it divides our financial system really between those who are going to have the implicit government backstop. The FDIC tells us the advantage of doing this, a lower borrowing cost, 100 basis points for the institutions that are large and, of course, for their smaller competitors, the "too-small-to-save" competitors, this is an issue.

The second issue is it adds another layer of regulations through the new CFPB and then it restricts the ability to recover costs through the interchange fee. Even the head of the Federal Reserve, the agency tasked with implementing the rule, says the small issuer exemption may not be workable; and I think these are issues that we have to examine at this hearing.

Thank you.

Chairwoman CAPITO. Thank you.

I would like to recognize the gentleman, Mr. Scott, for 4 minutes for an opening statement.

Mr. SCOTT. Thank you very much, Madam Chairwoman, and thank you for this important hearing on the Dodd-Frank financial reform legislation and how it is impacting small businesses and small banks.

The original intent of the Dodd-Frank legislation was to increase oversight and enforcement of existing protections for consumers while at the same time putting a stop to reckless behavior by Wall Street that helped cause the financial crisis.

The law continues to promote transparency and accountability that was lacking in the financial sector so the consumers who are constituents are protected against predatory lending practices and excessive risk-taking. In the Dodd-Frank legislation, we also move to protect community banks. We exempted many of them from many of the bill's provisions so that they could continue to compete with large banks and serve the local communities.

Our small community banks form the heart and soul of our local communities in terms of financial arrangements. Despite these protections for small institutions, there is one aspect of the financial legislation that remains a major point of concern to me and that issue is a limit on interchange fees. This was approved by a Durbin Senate amendment but was never considered by the House of Representatives.

These interchange fees, whether restricted or not, are a contentious subject within the realm of finance and business, both large and small. The current rule proposed by the Federal Reserve would cap interchange fees at 12 cents, which is around 10 percent lower than the average fee on such transactions last year and a very drastic reduction from the current level of around 44 cents, a decrease of 78 percent.

I was happy to participate in a hearing in this subcommittee 2 weeks ago where the primary topic was interchange fees, and I am pleased we have an opportunity to discuss this issue again.

Earlier today, I put the question to Federal Reserve Chairman Bernanke and I was pleased to get his response that there is concern that we make sure we move on this issue judiciously, very carefully so that we do what is in the best interest of the consumer and the retailer as well as our financial institutions and especially credit unions and the smaller banks that were not consulted in the initial survey.

The intended purpose of interchange fees is to protect consumers who rely on debit cards for daily purchases. However, if the unintended consequence of this limit is a strain on consumers and on the smaller institutions, then we must revisit this issue.

I look forward to a vibrant discussion on this critical issue, and I hope we can find a solution that both protects the consumer as well as our retailers and our smaller financial institutions from additional fees in this already challenging economic climate. Our small businesses and the smaller banks form the heart and soul of our economic system, creating most of the jobs and providing the way out of the economic difficulties we are in today; and that is why this hearing is so very, very important and timely.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I would like to recognize the gentleman from Georgia for 1 minute for an opening statement.

Mr. WESTMORELAND. I thank the chairwoman.

As you know, I am keenly aware of the impact that government regulations have had on our community financial institutions and small businesses. Georgia has had 59 bank failures since 2008, including 6 failures already in 2011. When a community institution closes, millions of dollars in community wealth are lost.

Unfortunately, the reality is the Dodd-Frank Act protections for small community institutions will not shield the backbone of our communities from the overreaching government regulations, despite its sales pitch. Failed banks are one of the top threats to the small business entrepreneurship and job growth in Georgia, and these overbearing regulations stemming from Dodd-Frank are a major threat to small businesses and job growth across the country.

When small banks have employed more compliance officers than tellers or loan officers, we need to take pause and assess what we, the government, have done to put them under such a burden for their business and all their customers. I look forward to hearing from all of the witnesses, hopefully with a solution other than more regulation.

I would like to thank the chairwoman for yielding.

Chairwoman CAPITO. Thank you.

I would now like to recognize Mr. Luetkemeyer for 1 minute for an opening statement.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman, and thank you for holding this hearing.

As a former community banker, I have very serious concerns with the effect of Dodd-Frank, what it would have on small institutions and businesses. I am afraid that we are creating uncertainty among these institutions that are heading down a very slippery regulatory slope with many of the provisions of this bill.

The Durbin amendment on interchange fees, for example, allows the Federal Reserve to set price caps on financial products. While many maintain that small institutions with less than $10 billion in assets will be carved out of this rule, I am concerned by the potential for discrimination and the potential for merchants to come back to Congress when they decide that institutions under $10 billion are charging what they deem to be unfair fees.

Dodd-Frank also created the Consumer Financial Protection Bureau, a self-regulated body funded outside the congressional appropriations process that may even be unconstitutional that promises to promulgate rules to regulate every single financial product available. This agency puts consumer protection above safety and soundness, our financial system, causing great concern and further uncertainty in the marketplace. It is the uncertainty that is most damaging to our system.

Across America, small businesses that could be growing and reinvesting in their customers are being forced to hire staff to deal exclusively with the increased regulatory burdens they face. I hear it from every business person who walks in my office, from banks and credit unions to utility companies and insurance agents and farmers. We are regulating ourselves out of an economic recovery, and legislation intended to help the situation will only make it worse.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Our final opening statement will be from Mr. Huizenga, who would also like to make an introduction.

Mr. HUIZENGA. Thank you, Madam Chairwoman. I appreciate that.

I know our votes clock has started, so we will make this quick, and you will see everybody rush out to go take care of our business.

But I appreciate you having this hearing. This is an important hearing as we are moving forward on Dodd-Frank.

The Congressional Research Service has estimated that there are 300 rules made by 10 different agencies regarding these rulemakings. And I can tell you that it also has stated that companies under 20 employees—there is over a $10,000 per employee estimation for just complying with Federal regulations. As a gentleman who owns a small gravel company with 2 employees, that means I have over $20,000 a year just for compliance on those things. And with an 11-year-old loader, which is the key to my business, I desperately could use that cash in my business.

But I look forward to hearing your testimony from you all today regarding the effects of the Dodd-Frank.

More importantly, I am pleased and honored to welcome one of the witnesses who is an important constituent of Michigan's 2nd District, John Buckley. He is from a great little town called Fremont. If you have ever eaten Gerber Baby Food, that is the home of it, and we are very proud of that.

Mr. Buckley is the president and CEO of Gerber Federal Credit Union located in Fremont. He has a long and impressive resume both in community banks and now with credit unions. He earned his BA in economics from Notre Dame, an MBA from the University of Illinois, and he is a graduate of the banking school of the University of Wisconsin. So you pretty much run the entire Big 10 there.

And like most community leaders, he is very active in the area; and I think that is a key as we are looking at this. These are people who are very active in their communities.

As a small business owner, I know that there are some universal principles of success that Congress needs to work on to grow this economy again. For government, that means creating an atmosphere for success for small business that does not include a burdensome regulatory environment.

I believe, Madam Chairwoman, that my time is up. But I appreciate you all being here today and informing this committee. Thank you.

Chairwoman CAPITO. Thank you.

As you can hear, the bell is going off and probably some distractedness. We have three votes, which should probably bring us back here in half an hour. Again, I apologize. I will then introduce the witnesses, and we will have the testimony.

Thank you. We are in recess.

[recess]

Chairwoman CAPITO. The hearing will come back to order.

I am pleased to welcome—and again, excuse us for our little gap in the proceedings—the first panel. I will just introduce you right before you speak individually, if that is all right.

Our first panelist is Mr. Albert C. Kelly, president and chief executive officer of Spirit Bank, on behalf of the American Bankers Association. Mr. Kelly, you are recognized for 5 minutes. I ask that you all keep your statements to 5 minutes. We have your larger statements for the record and we can ask some questions. Yes, sir.

STATEMENT OF ALBERT C. KELLY, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SPIRITBANK, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION (ABA)

Mr. KELLY. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, my name is Albert Kelly. I am president and CEO of SpiritBank in Bristol, Oklahoma, and chairman-elect of the American Bankers Association.

Thank you for the opportunity to testify today. These are very important issues for the thousands of community banks that work hard to serve our communities every day.

The health of banks and the economic strength of our communities are closely interwoven. A bank's presence is a symbol of hope, a vote of confidence in a town's future.

This connection is not new. Most banks have been in their communities for decades. SpiritBank has served our community for 95 years. In fact, 2 out of every 3 banks have served their communities for more than 50 years and one of every three has been in business for more than a century. These numbers tell a dramatic story about banks' commitment to the communities that they serve.

Just to illustrate this commitment, my bank contributed over $550,000 last year and our 330 employees have logged thousands of hours of service to schools, charities, and community organizations throughout our area in a year when our investors saw no return.

Banks are working hard every day to make credit available. Those efforts are made more difficult by the hundreds of new regulations expected from Dodd-Frank and the constant second-guessing by bank examiners. Managing the tsunami of regulation will be a challenge for a bank of any size, but for the medium-sized bank with only 37 employees, it is overwhelming. Let me give a few examples of how Dodd-Frank will negatively impact community banks.

First, the cumulative burden of hundreds of new regulations will lead to massive consolidation in the banking industry. Of particular concern is the additional compliance burden expected from the Bureau of Consumer Financial Protection. This new bureaucracy will impose new obligations on community banks that have a long history of serving consumers fairly in a competitive environment.

One claim is that community banks are exempt from the new Bureau, but community banks are not exempt. All banks, large and small, will be required to comply with all rules and regulations set by the Bureau. Bank regulators will enforce these rules as aggressively as the Bureau.

The Bureau should focus its energies on supervision and examination of nonbank financial providers. This lack of supervision of

nonbanks contributed mightily to the financial crisis. We urge Congress to ensure that this focus on nonbanks is a priority of the Bureau.

Second, the government has inserted itself in the day-to-day business of banking, which will mean less access to credit and banking services. The most egregious example is the price controls on interchange fees which will devastate retail bank profitability, stifle innovation, and force some people out of the protection of the banking system.

Some will say the so-called carve-out for community banks from the Fed's interchange rule will protect community banks. Nothing could be further from the truth. Having two different prices for the same exact product is not sustainable. The result for small banks is a loss of market share and loss of revenue that support products like free checking.

It is imperative that Congress take immediate action to stop the Fed's interchange rule. I urge you to suspend implementation until a full understanding of the consequences is known.

Third, some rules under Dodd-Frank will drive banks out of some business lines. For example, the SEC rules on municipal advisors, if done improperly, will drive community banks out of providing basic banking products to the local and State governments. Similarly, the mortgage risk retention rules, if done improperly, will drive community banks out of mortgage lending.

ABA urges Congress to use its oversight authority to ensure that the rules adopted will not have adverse consequences for municipalities and mortgage credit availability. Ultimately, it is the consumers who bear the consequences of government restrictions. The loss of interchange income will raise the cost for consumers of using their debit cards. The lack of a true safe harbor for low-risk mortgages means that community banks will make fewer mortgage loans or none at all. More time spent on government regulations mean less time devoted to our communities.

The consequences for the economy are severe. These impediments raise the cost and reduce the availability of credit. Fewer loans mean fewer jobs, and fewer jobs mean slower economic growth. Since banks and communities grow together, limits on one mean limits on the other.

The regulatory burden from Dodd-Frank must be addressed in order to give all banks a fighting chance to maintain long-term viability. Each bank that disappears from a community makes that community poorer. It is imperative that Congress take action to help community banks do what they do best, namely, meet the credit needs of their communities.

Thank you for the opportunity to present the views of the American Bankers Association. I would be happy to answer any questions that you may have.

[The prepared statement of Mr. Kelly can be found on page 100 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. Kelly.

Our next witness is Mr. John Buckley, president and chief executive officer of Gerber Federal Credit Union, on behalf of the National Association of Federal Credit Unions. Welcome.

STATEMENT OF JOHN P. BUCKLEY, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, GERBER FEDERAL CREDIT UNION, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS (NAFCU)

Mr. BUCKLEY. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, my name is John Buckley, and I am testifying this afternoon on behalf of the National Association of Federal Credit Unions. I serve as the president and CEO of Gerber Federal Credit Union in Fremont, Michigan. Gerber has more than 13,400 members, with assets totaling $114 million.

NAFCU and the entire credit union community appreciate the opportunity to discuss the impact that regulatory restructuring under the Dodd-Frank Act is having and will have on credit unions.

Credit unions were not the cause of the financial crisis. This point was reiterated last month by the cochairman of the congressionally-established Financial Crisis Inquiry Commission during testimony before the House Financial Services Committee. In fact, credit unions helped blunt the crisis by continuing to lend to creditworthy consumers during difficult times. Yet, they are still firmly within the regulatory reach of several provisions contained in the Dodd-Frank Act. The additional requirements in Dodd-Frank have created an overwhelming number of new compliance burdens which will take credit unions considerable time, effort, and resources to resolve.

We applaud recent efforts by the Administration and Congress to tackle excessive regulations that hamper the ability of our industry to create jobs and aid in the economic recovery. With a slew of new regulations emerging from the Dodd-Frank Act, such relief from unnecessary and outdated regulation is needed now more than ever by credit unions.

First and foremost, the Durbin amendment on debit interchange included in the Act and the Federal Reserve's proposed rule are disastrous for credit unions and the 19 million members we serve. We believe that the exemption for financial institutions under $10 billion in assets will not work. In recent testimony before the Senate Banking Committee, Federal Reserve Chairman Ben Bernanke reinforced that belief when he stated that the small issuer exemption will not be effective in the marketplace.

We believe the purported exemption actually creates a negative impact on small institutions like mine as the Federal Reserve only surveyed large, nonexempt institutions to determine the price cap. When small issuers receive the lower capped interchange rate, that rate will be twice as difficult for small issuers to manage because the fee is based not on their own costs but on the costs of larger, more complex institutions with better economies of scale. Consequently, the so-called small issuer exemption will create the perverse effect of providing a significant competitive advantage to large issuers. In order to compensate for this, credit union members may lose free checking, face new fees for debit cards, and some may even lose access to debit cards.

At Gerber, we estimate we will lose $210,000 annually under the proposed rule, and as a not-for-profit, this lost income will come directly out of our members' pockets. To put this in perspective, such

a loss would have put us significantly in the red last year. I am dismayed that our members will shoulder tremendous financial burden and still be on the hook for fraud loss, while large retailers receive a giant windfall at the hand of the government with no obligation to lower prices for consumers.

Today, on behalf of credit unions and their 92 million members, I am asking Congress to take action to stop the Federal Reserve's proposed rule from going into effect this July. This issue should be studied further to examine the true impact. And if Congress decides further action is needed, a new fair process for rulemaking must be established.

While debit interchange is the industry's immediate concern, the creation of the new Consumer Financial Protection Bureau is also potentially problematic as the Bureau will have rule-writing authority over credit unions of all sizes.

Additionally, the CFPB was granted examination and enforcement authority for credit unions with more than $10 billion in assets. We already protect consumers, our member owners, and have consistently opposed efforts to include credit unions in any unnecessary regulatory scheme. I cannot emphasize enough how burdensome and expensive unnecessary compliance costs can be to credit unions. My employees already spend countless hours updating disclosure booklets and Web sites, retrofitting facilities for new regulations, and rewriting documents to comply with changes to regulations. The time and costs spent on this compliance burden are resources lost that could be used to help members purchase a new car or buy their first home.

We believe that Congress can help ease some of these new regulatory burdens by taking the following steps: first, strengthen the veto authority of the Financial Stability Oversight Council in reviewing proposed rules of the CFPB; second, extend the transition time for many of the new compliance burdens of the Dodd-Frank Act; third, annually index for inflation all monetary thresholds in the bill; and fourth, provide credit unions parity with the FDIC and insurance coverage for IOLTAs.

Finally, as outlined in my written testimony, NAFCU urges Congress to enact a series of additional fixes to the Dodd-Frank legislation to help relieve the new regulatory burdens on credit unions.

I thank you for the opportunity to appear before you today on behalf of NAFCU and would welcome any questions that you may have.

[The prepared statement of Mr. Buckley can be found on page 50 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. Buckley.

Our next witness is Mr. O. William Cheney, president and chief executive officer on behalf of the Credit Union National Association.

STATEMENT OF O. WILLIAM CHENEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CREDIT UNION NATIONAL ASSOCIATION (CUNA)

Mr. CHENEY. Thank you.

Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you very much for the opportunity to tes-

tify. My name is Bill Cheney, and I am president and CEO of the Credit Union National Association, which represents nearly 90 percent of America's 7,700 State and federally chartered credit unions and their 92 million members.

Credit unions support reasonable safety and soundness rules, as well as meaningful consumer protection laws. However, credit unions are already among the most highly regulated financial institutions in the country. Credit union executives and volunteers are concerned that the mountain of regulation will only grow under the Dodd-Frank Act.

Credit unions concern with regulatory burden is not motivated by a desire to avoid the intent of consumer protection legislation. Because credit unions are owned by their members, they already face very strong incentives to treat consumers well. Consumer protection rules hardly ever require changes in credit union business practices. However, compliance with those rules is often very expensive.

The combination of existing rules and new burdens is a prime consideration when credit unions think about consolidation. It is becoming a crisis of creeping complexity. The steady accumulation of regulatory requirements over the years eventually adds up until a straw breaks the camel's back.

Twenty years ago, there were over 12,000 credit unions with under $50 million in assets. Today, there are approximately 5,500. Many of these smaller credit unions found it untenable to continue as standalone operations, often because of the employee time required to comply with numerous regulatory requirements.

Credit unions are concerned that these creeping regulatory burdens also stifle innovation. It is critical that Congress provide diligent oversight to ensure that new regulation is not overly burdensome and redundant. My written testimony goes into detail regarding the overall regulatory burden facing credit unions.

With respect to the Dodd-Frank Act, I would like to highlight two key areas of the law that are very significant to credit unions.

The first is Section 1075 regarding interchange fees, which is why we oppose the Dodd-Frank Act. Last month, CUNA testified before this subcommittee regarding the Fed's debit interchange regulation. While Congress exempted all but three credit unions, we believe this statutory carve-out is rendered essentially meaningless by market forces created by a rule that excludes many of the costs of providing debit at large issuers and by the Fed's proposed rule that does not enforce the exemption.

Further, the network exclusivity and routing provisions are very problematic. Credit unions are not exempt from these provisions, which, as Federal Reserve Chairman Bernanke has indicated, will likely put downward pressure on small institutions' interchange fees. Ultimately, interchange regulation will make it more expensive for consumers to access their checking accounts. This is not what Congress intended.

A legislative remedy is necessary to fully realize the intent of one of the sponsors who said small institutions would not lose any interchange revenue that they currently receive. We urge Congress to intervene to ensure small issuers are protected as Congress promised.

The second area I call your attention to are the two provisions of the Act which are designed to reduce regulatory burden. The first provision directs the Bureau to ensure that outdated, unnecessary, and unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens. The second provision directs the Bureau to consider the impact of proposed rules on credit unions and community banks with less than $10 billion in assets.

It is widely expected that the Bureau will engage in a comprehensive regulatory review process. Quite frankly, credit unions and others fear that at the end of this process, the overall regulatory burden will have increased. You cannot simplify regulation by creating new rules. Outdated regulations must be peeled back.

These provisions offer credit unions hope that the Bureau will take steps to reduce regulatory burden and that it will fully consider the impact of its rules on credit unions. The Bureau staff has acknowledged this concern, and congressional oversight of this process is critical.

My written testimony describes several other impediments to credit union member service beyond the scope of the Dodd-Frank Act. We ask Congress to increase the statutory member business lending cap, which would permit creditors to lend an additional $10 billion to small businesses in the first year, helping them create over 100,000 new jobs at no cost to the taxpayers. We also encourage Congress to enhance safety and soundness by permitting credit unions to count supplemental forms of capital as net worth. This would permit credit unions to more quickly recover from the financial crisis and position them to continue to be a source of stability to their members in the future.

Madam Chairwoman, thank you for the opportunity to testify at today's hearing. I am pleased to answer any questions that the members of the subcommittee may have.

[The prepared statement of Mr. Cheney can be found on page 83 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. Stinebert. He is president and chief executive officer of the American Financial Services Association. Welcome.

STATEMENT OF CHRIS STINEBERT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN FINANCIAL SERVICES ASSOCIATION (AFSA)

Mr. STINEBERT. Thank you.

My name is Chris Stinebert. I am president and CEO of the American Financial Services Association. AFSA is a national trade association. I represent the consumer credit industry. I am happy to report that the Association will celebrate its 100th year 5 years from now, and its 370 member companies include consumer and commercial finance companies.

First, I would like to say that I certainly agree with my colleagues here and their concerns about regulatory costs and compliance type issues. Certainly we agree in many of the areas with mortgage concerns and debit interchange fees.

Madam Chairwoman, you and the members of the committee are probably more familiar with AFSA's bigger members, which include many banks, bank subsidies, and large captive auto finance companies. But AFSA's roots lies with the local finance companies that have been serving communities for many generations. Today, I am testifying on behalf of these small financial institutions, finance companies who provide personal loans to people in their communities, like the carpenter who needs to repair a transmission on his truck or somebody who needs to buy a washer or dryer.

The Department of Defense, in its recent policymaking on credit for military families and dependents, described installment loans as a beneficial product and specifically cited the differences between installment loans and payday loans. I should note that we do not represent the payday lenders.

Each loan, installment loan is individually underwritten for affordable and sensible debt. Equal installments of principal and interest support repayment over, on average, from 9 to 12 months with no balloon payments due. Lending and consumer service, customer service are provided by real people in local bricks and mortar offices. Customers are constantly monitored for their capacity to repay, and performance is reported to the credit bureaus.

The FDIC recently reported in its small dollar loan pilot program that loans up to $2,500 were too costly for depositories to achieve much acceptance of future participation, except perhaps in cases where government taxpayer subsidies could be applied and/or saving accounts were mandatory or additional bank products could be sold.

Finance companies are certainly not afraid to be regulated, but we do not want to be regulated like depositories, because they simply are not banks. Unlike banks, when a finance company makes a loan, its customers' deposits are not at risk and the government and the taxpayers do not insure its capital. The only entity harmed by poor underwriting and defaults is the finance company because it is their money they are lending, certainly not yours or mine.

Prior to enactment of the Dodd-Frank Act, finance services' regulation has been dominated by oversight of the depositories, banks, thrifts, and credit unions. Therefore, regulators have a very good, I think, understanding of the Federal banking model.

For decades, nonbanking finance companies have worked effectively with State regulators in complying with both State and Federal consumer protection loans. These nonbank finance companies have been successful in providing credit and other products and services in communities in which they operate in part because of the oversight of these State regulators that have often been the first to identify emerging practices and products that they deem need further examination.

ASFA's finance companies are concerned that the wealth of experience and knowledge will be lost on Federal regulators with their emphasis on bank-centric experience that they have. Nonbank finance companies want to make sure that they are not regulated to the point they can no longer make sustainable loans.

The U.S. Small Business Administration study shows that the expense for small firms to comply with Federal rules is 45 percent greater than it is for larger business competitors, and almost 90

percent of the country's 26 million small businesses use some form of credit. As part of the Dodd-Frank Act, the CFPB is required to comply with the Small Business Regulatory Enforcement Fairness Act panel process. That panel study and the potential impact must be studied, and we encourage this committee to make sure and clear that the CFPB has a full complement of small institutions represented on that panel. Consumers and the economy need to expand installment lending.

The only thing I can close in saying is that preserving and expanding access to affordable credit should be the goal of every legislator and regulator, Federal and State. But it must also acknowledge that the uncertainty and the fear of excess regulation is an ever-present anchor on meeting this goal.

Again, AFSA appreciates the opportunity to testify to the subcommittee, and I am happy to take any questions.

[The prepared statement of Mr. Stinebert can be found on page 175 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. James MacPhee. He is chairman of the Independent Community Bankers of America. Welcome.

STATEMENT OF JAMES D. MACPHEE, CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. MACPHEE. Thank you, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee.

I am Jim MacPhee, CEO of Kalamazoo County State Bank in Schoolcraft, Michigan, and chairman of the Independent Community Bankers of America. Our bank is a State-chartered community bank with $85 million in assets, 40 employees, and 103 years of continuous business to our community. I am pleased to represent community banks and ICBA's nearly 5,000 members and 18,000 locations and 270,000 employees at this important 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 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 ability to attract capital and support their customers, including small businesses. Every provider of financial service, including every single community bank, will feel the effects of this new law to some extent.

By a wide margin, the most troubling aspect of Dodd-Frank is the debit interchange amendment. We are grateful to you, Chairwoman Capito, for dedicating a recent hearing to the debit interchange amendment and the Federal Reserve's proposed 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 will be brief in my comments here. But this point bears emphasis: Community banks were not effectively carved out by the statutory exemption for debit cards issued by institutions with less than $10 billion in assets. Small issuers will feel the full

impact of the Federal Reserve proposal over time. To use my bank as an example, in 2010, we had 1,600 debit cards outstanding and our profits on those cards for the year was a modest $4,800.

If the Federal Reserve proposal goes into effect, I estimate that we will lose $20,000 on that debit card program, lost income that we would have to make up through higher fees and other products and services.

Another source of concern is the CFPB. While we are pleased that Dodd-Frank allows community banks with less than $10 billion in assets to continue to be examined by their primary regulators, we remain concerned about the CFPB regulations to which community banks will be subject. In particular, the CFPB should not implement any rules that would adversely impact the ability of community banks to customize products to meet customers' needs. Because bank regulators have long expertise in balancing the safety and soundness of banking operations with a need to protect consumers, ICBA supports amending the law to give prudential regulators a more meaningful role in CFPB rule writing.

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

ICBA was the leading advocate for the deposit insurance provision 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 save community banks $4.5 billion over the next 3 years. The deposit insurance limit increase to $250,000 per depositor and the 2-year extension of the transaction account 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.

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

Thank you for the opportunity to testify today on behalf of the ICBA and its members. Like most pieces of legislation, especially those that run 2,300 pages, Dodd-Frank offers 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 Dodd-Frank for community banks. Legislation of this magnitude cannot be gotten 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.

I would be happy to answer any further questions. Thank you, Madam Chairwoman.

[The prepared statement of Mr. MacPhee can be found on page 116 of the appendix.]

Chairwoman CAPITO. Thank you.

Our final witness is Mr. Skillern, executive director of the Community Reinvestment Association of North Carolina. Welcome.

STATEMENT OF PETER SKILLERN, EXECUTIVE DIRECTOR, COMMUNITY REINVESTMENT ASSOCIATION OF NORTH CAROLINA

Mr. SKILLERN. Thank you very much, Chairwoman Capito and Ranking Member Maloney, for the opportunity to testify today. I am Peter Skillern, executive director of the Community Reinvestment Association of North Carolina.

Small financial institutions are facing long-term trends of consolidation and competition from mega-banks and unregulated financial institutions. The Dodd-Frank Act will help to create baseline rules for all lenders which will help small banks by providing a more level playing field such as an example of mortgage origination rules.

Small businesses are facing a tougher credit market and slower recovery. The Act makes an extraordinary effort to do no harm to small businesses and to help them through increased transparency in credit decisions. Most importantly, Dodd-Frank provides a more stable financial system for small banks and businesses by mitigating the systemic risks and abuses that catalyzed the financial crisis. This legislation stands up for the little guy in the financial marketplace—small institutions, small businesses, and families.

Nationally, the number of banks with under $100 million in assets dropped by more than 5,400 from 1992 to 2008. In North Carolina, of 146 institutions, the bottom 100 hold only 10 percent of the deposits, while the top 6 hold 76 percent. Yet small banks remain essential components of local financial services lending and civic engagement. Many areas of the country would not have banking services if it were not for the small institution.

By contrast, the consolidation of assets and market share of mega-banks has increased. In 1995, the top banks had 11 percent of the deposit shares. By 2009, they had nearly 40 percent. In the last half of 2010, 3 lenders conducted 50 percent of mortgage activity.

The challenges that small financial institutions face are not from the Dodd-Frank Act but from long-term trends of capital concentrations and consolidation. The Dodd-Frank Act primarily focuses on large financial institutions that operate in the capital markets. Its focus is on reducing systemic risk, creating a means for the resolution of failed giant institutions, prohibiting proprietary trading, regulating derivatives, and reforming the regulatory system itself. These are not primarily the concerns of small banks, other than whether the system itself is stronger and more stable in which they operate.

The creation of the Consumer Financial Protection Bureau, in our opinion, will benefit banking by consolidating and simplifying rule writing for all financial institutions. It will supervise 2 percent of deposit institutions. The remaining 98 percent will be supervised by their prudential regulators. And, ironically, the efforts to reduce

the CFPB's ability to regulate mega-banks and non-depository institutions will mean that small banks will again be regulated by their prudential regulators, while the bad practices are allowed to drive out the good ones that they model.

There will be costs related to regulatory reform, and there is uncertainty in change. We agree that the unique needs of small institutions need to be considered as rules are written and implemented. We, too, urge simplicity, paper reduction, and cost savings. We want our money back in the community, not in paperwork. But that is not an argument that rules and reforms are not merited. The CFPB will benefit the financial system and small banks.

Given the record number of small bank failures, foreclosures, and mega-bank collapses, we support Dodd-Frank's emphasis on safety and soundness, yet we urge that the rulemaking does not overly restrict credit or disadvantage small institutions in lending. As an example, the rulemaking to define the Qualified Residential Mortgage, QRM, exemption from capital retention could adversely impact small lenders and consumers. Capital risk retention should be targeted towards non-conventional risky loans. If the definition is overly restrictive, such as having high downpayments or not utilizing mortgage insurance, small lenders will be sidelined by capital requirements and first-time home buyers will have an unnecessary hurdle to homeownership.

Small businesses are currently faced with constriction of credit availability. Loans to small businesses in 2009 were only 44 percent of those in 2008, and the decline in outstanding balances to small business continued in 2010.

The Dodd-Frank Act makes explicit protections to protect small businesses from unintended consequences of regulation. Section 619 prohibitions on proprietary trading do not apply to small business investment corporations, allowing for banks to invest in SBICs. Section 1027 explicitly excludes merchants, retailers, and other sellers of nonfinancial goods and services. Subtitle C, Section 1031, specifically allows for small business income to be considered in loan underwriting. Subtitle G, Section 1071, which requires new data collection, will better ensure lending to small business is done without bias. Three different sections—1099, 1424, and 1474—all require studies to ensure that credit costs are not increased for small businesses through this regulation.

As I read it, the Dodd-Frank Act is small-business friendly. Small banks, small businesses, and families will be well served by the Dodd-Frank Act and Consumer Financial Protection Bureau.

Thank you.

[The prepared statement of Mr. Skillern can be found on page 169 of the appendix.]

Chairwoman CAPITO. Thank you. I appreciate all of the testimony, and I am going to begin the questioning. It appears as though we are going to have votes again at 3:45. So my plan is, as the Chair, I will shorten my questions and try to get as many as we can in and dismiss the first panel, if that is all right with the rest of the committee.

Our final witness gave us a contrast. But I want to go back to what Mr. Kelly mentioned when we are talking about contracting

credit and accessibility to the smaller institutions in the different communities.

You listed three ways. You mentioned interchange. You also said that your banks could be out of certain business lines, and that with the mortgage risk retention provisions, which I guess is in the qualified mortgage, those are three pretty significant issues. We did have the hearing on interchange, So if you could talk a little bit more about the latter two. What kind of business lines are you concerned that you might fall out of under this regulatory regime? And, also, let us talk about the mortgage risk retention and how that will influence credit to the little guy.

Mr. KELLY. Thank you, Madam Chairwoman.

The mortgage risk retention, to speak of that first, our bank provides a retail mortgage product of about $20 million a month in mortgages. We also provide warehouse funding for over 900 locations across the Midwest, which make all prime, no subprime, mostly government-insured loans of one manner or another.

Because of the really unknown nature of what the risk retention is, the title of that risk retention is drawn, the more difficult it is going to be for a bank of our size or smaller or really any moderate-sized bank to have the capital to retain 5 percent of every mortgage that they make. So if that rule is drawn narrowly, we are concerned that we and others will be out of the mortgage business and thereby the mortgage business will move away from community banks and we will not be able to be competitive in that particular market.

Chairwoman CAPITO. Let me just clarify here so I make sure I understand exactly. This provision does not exempt any community banks or certain asset level—it corrects across every financial institution that is in the mortgage business; is that correct?

Mr. KELLY. Yes, Madam Chairwoman, that is correct.

We are also concerned about the competitiveness of the supposed two-tier system relative to the debit cards, and I realize that was one that you said we have already had some discussion on. But, likewise, that will require us to examine our fees and look to see how those fees could be made up that we will no longer be getting from the debit cards.

As an example, the fact that we have to retain—all banks retain the fraud risk of a transaction such as that. In our particular instance, we actually lost during one month when we had a scam that was in the area, a debit card scam resulted in a $143,000 loss for our bank. There is no way that 12 cents makes up the fraud loss, much less that it makes up and allows us to make any money.

From the standpoint of being able to lose business lines, we are concerned about the municipal advisor provision of the SEC rule or the SEC attempted position because we believe that while in our communities—and we cut across many communities in Oklahoma. We have many school districts. We have all sorts of municipal-type companies that we bank. We believe that those rules, if construed the way that we understand the SEC is attempting to construe them, will not only require us to register my teller and my new accounts and CD clerk, but it will also give the SEC the ability to come in and examine us for those things, one more examination, a regulatory scheme that we will have to put up.

Yes, ma'am.

Chairwoman CAPITO. Have you all made comments or been asked to weigh in on the formulation of that rule?

Mr. KELLY. Have we made comments? Yes. Our bank did make an extensive comment, and the ABA likewise has made comments. We have had a number of banks that have made comments on that, and we tried to point that out.

We believe that we provide marvelous service to the municipalities and the school boards and the like across the State of Oklahoma. We merely warehouse their money or put their money into an instrument. We are not serving as a "municipal advisor." Yet, the requirement is for us to go into the municipal deposit rulemaking and register, as well as with the SEC, both of which will be very onerous.

Chairwoman CAPITO. Thank you.

I am going to turn this over to Mrs. Maloney for questions.

Mrs. MALONEY. I want to thank all of you and to underscore what has been said many times in your testimony: The crisis was not caused by smaller institutions. If anything, you were a rock on which to lean during the crisis for communities and continue to be a rock for available liquidity and loans across America. You are a big part of the solution to the recession that we are experiencing.

One of the things that we tried to do after safety and soundness and restoring stability to our markets was to level the playing field for smaller institutions so that you could compete and win in an easier way, and one way that we tried to do that was to say that all nonbank financial companies should be brought to the same level as any financial institution.

Many people were going to mortgage brokers because there was no requirements. And many banks had all kind of regulatory requirements. And the financial crisis in many ways was not with the regular banking system that was regulated. It was for the nonbank financial institutions and new exotic products that were not regulated.

So I would like to ask, does this help bringing in mortgage companies, payday lenders, private student lenders, and other large players in sort of the shadow banking system? We tried to bring them into the same regulations as smaller institutions. And I believe that this will be a benefit to smaller institutions.

But I would like someone to answer me, does it not help the competition in bringing the shadow financial industry under the same regulation?

Mr. CHENEY. Ranking Member Maloney, thank you very much for the question. As I said in both my oral testimony and the written testimony, credit unions are already the most highly regulated financial institutions. We have additional restrictions that don't exist, even in the traditional banking sector. So we are not in favor of additional regulation for other financial institutions.

However, I do think that there are parts of the financial services system that are not currently regulated that could benefit from some oversight. Certainly, credit unions—we have a unique business model in that our business interests and our members' interests are completely aligned because the members own the institution. So it is a little different business model. But we are not op-

posed to additional regulation for other people who are providing similar products and services.

Mr. KELLY. Ranking Member Maloney, if I might, in my testimony, I said we urge Congress to ensure the focus on those nonbanks. And we thank you for that. The shadow banking industry is in need of that type of supervision. And we believe that the CFPB would be something that would be quite adequate to do that. Our urging is that banks are already so regulated by our existing prudential regulators that the focus of the CFPB should be on those that have, as you described, no regulation today.

Mrs. MALONEY. Certainly, one of the things that we wanted to accomplish was to reduce the regulatory burden. And one of the ways that we did that was creating a single form for federally required mortgage disclosures, simplifying the process for financial institutions and consumers alike, and reducing compliance costs. And I, for one, would like to continue to work in any way to reduce a duplication or regulatory burden.

Possibly there is a way you could computerize the requirements that are required from various regulators and have that go out quarterly. There may be other ways that we could make it less onerous on people. I specifically would like to hear from any of you how you think the regulatory burden could be reduced while preserving safety and soundness necessary, obviously.

Mr. CHENEY. As I mentioned in my oral testimony, we can't simplify regulation just by creating new regulations. We have to peel back decades of outdated and overly burdensome regulation. The mission of the Consumer Financial Protection Bureau is to do that. But I think it is critical that as new regulations are even being considered, much less promulgated, they look at what currently exists.

You mentioned the mortgage form, a 1-page form. Anybody who has ever closed a mortgage loan knows how onerous that is, not only on the financial institution but on the consumer; how difficult it is to understand. But if all we do is create a new form and we don't get rid of the stacks and stacks of conflicting forms, we really haven't simplified anything.

And I know that wasn't the intent of the legislation. It is just important that as the Bureau implements the legislation, they make sure that they remove that outdated regulation.

Mr. STINEBERT. Speaking on behalf of the nonbank participants up here on this panel, I should note that leveling the playing field is basically increasing regulations on another entity. I think for the nonbanks that are certainly here, if you look at the total auto sector and you look at the small loan sector and others, they didn't cause any of the problems that we are talking about. We are really talking about specifically mortgage that cut across all lines that created the crisis.

And as we start talking about regulation, we want to make sure that regulations are truly going to protect the consumer and that are smart, that are good; not necessarily creating additional supervision, additional examinations that perhaps are unnecessary.

We have been talking about the level of regulation now. And burdening another sector with increased regulations is not always the way to go.

Chairwoman CAPITO. Thank you.

Mr. Westmoreland.

Mr. WESTMORELAND. Thank you, Madam Chairwoman.

Mr. Skillern, have you ever heard of a recording artist by the name of Alan Jackson?

Mr. SKILLERN. No, sir.

Mr. WESTMORELAND. He is a country recording artist, and he has a song out called, "Here in the Real World." I suggest you buy it and listen to it for a little bit.

Mr. MacPhee, I continue to hear from both banks and builders in my congressional district—and I come from a building background, a real estate background—that the examiners are turning some of this regulatory guidance on commercial real estate into assuming that if a builder has a qualified presale, somebody who comes in who is a qualified buyer, a presale, a lot of banks are saying—regulators are saying, "You're at 100 percent of your commercial real estate exposure, so, therefore, you cannot make a loan to this builder to build this presale house even though he has a qualified buyer."

Are you getting any of that from some of your banks? I know in Georgia, we have had more bank failures than I guess any other State, 59 total, and 6 in this last year. So this is a problem that we are having, that banks are not being able to do what they do to make money, and that is to loan money.

Mr. MACPHEE. Thank you for the question, Congressman.

I have heard that from a number of community banks within the ICBA family around the Nation. And it depends on the geographic area as to how serious or what level the examiners do criticize any new commercial loan activity. I think there are areas, like Texas as an example, where the economy is pretty strong. They don't seem to be criticized too heavily there.

But I can tell you, coming from Michigan, with the highest unemployment in the Nation for a number of years, if I were a bank on the east side of Michigan doing a commercial loan, I would be heavily criticized for that.

Mr. KELLY. Congressman Westmoreland, may I? Could I respond?

Mr. WESTMORELAND. Sure. Absolutely.

Mr. KELLY. I might give you a real world example when we talk about this. For our bank, the guidelines are 300 percent of capital. And CRE is also—a component of that is construction and development, which are not supposed to be, as you stated, over 100 percent. We are at 150 percent, and we were over that when the guidance became a rule, so to speak, so we have yet to get down below that, even though our total concentration is below 300 percent.

We had the real world example of a company that wanted to build their headquarters building in Oklahoma, about a $10 million headquarters building, and the problem was they came to us for the construction loan, and we went up the chain of the regulatory ladder and were told, "Well, even though they are going to be occupying it and even though once they occupy it, it will be owner-occupied, and outside the CRE, no one occupies it during that construction, so you can't make that loan." And so, to my knowledge, that loan has not been made. That building has not been constructed, and that headquarters isn't in Oklahoma.

The same is true for all of our custom builders. You may have a custom house to build, but the owner doesn't live there until it is finished. So you technically can't build it without raising your CRE. To me, that is counterintuitive, but that is the rule.

Mr. WESTMORELAND. Yes, sir, it is counterintuitive. And until the construction business is able to come back, I would say that 60 percent of the people who are unemployed in this country right now are former construction workers. So we have to do something to help the housing market come back.

The other thing is the regulation about writing down toxic assets, nonperforming assets, to zero or to some amount, when this asset is really performing; it is a performing asset. Somebody is paying their interest every month. They are making the calls at renewal periods. But yet the regulator comes in and says, "You have to write this loan down." And the people who can't bring in any more equity—they can't even get their equity out of the some of the stuff they have now. That is what, to me, is causing a lot of the bank failures. Would you agree from both the banking ends of it?

Mr. KELLY. Congressman, I think you have hit exactly on the head the issue, and that is that we all know that when you have a robust economy and you make a loan, even though it is performing, if that robust economy then falls and the value of that collateral falls with the potential of saying, we expect you to reappraise that. And once that is reappraised, you now have an impairment on the loan, which conceivably could go to zero or could be a very large impairment, which immediately becomes a hit to capital.

In the case of Georgia, as you are well aware, what happens when those banks close and the regulators then dispose of the property at a lower price, I may have a good loan that is well capitalized—or, excuse me, well collateralized, but when the assets are sold by the regulator to be rid of them, now my loan that was good gets a low appraisal and, whoa, all of a sudden, I have an impairment. It becomes almost a self-fulfilling prophesy, and it becomes kind of the death spiral. So the suspension of that type of an appraisal requirement to go in and immediately write it down and immediately impair capital is a serious problem.

Mr. WESTMORELAND. Whatever the level of the playing field, we have a steeper slope for businesses.

Chairwoman CAPITO. Thank you.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Madam Chairwoman.

First of all, let me start with you, Mr. Cheney. We have somewhat of a clear understanding of how this rule would affect our larger banks. How would this rule affect credit unions, the interchange fee rule?

Mr. CHENEY. We are concerned that the interchange rule will have a dramatic effect on credit unions. All but three credit unions are exempt in terms of the asset size limit. However, there is nothing in the rule that enforces the exemption. There is nothing that requires a two-tiered system. There is nothing that enforces honor all cards. And so we are concerned that what we are talking about here is a $1.5 billion annual impact on credit unions and, more importantly, the impact on consumers.

Credit unions, as I said earlier, serve 92 million Americans, millions and millions of debit cards. The two-tiered system—even if there is a two-tiered system, because there is no enforcement of honor all cards, market forces we know will drive those rates down even at smaller issuers, and ultimately the cost, especially at a credit union, which is a cooperative institution, has to be passed on to consumers. And that drives people out of the banking system. It raises costs for the people who can least afford it.

We are concerned that this is a train wreck for consumers. But we can stop it before it happens if we can take action quickly.

Mr. SCOTT. And if you had to put some dollar figure on where we are now, where it is basically recommended of a 73 percent decrease, from 45 to around 12, in terms of economic impact and in particular dealing with the credit unions, what are we talking about in loss of revenue?

Mr. CHENEY. The numbers that you mentioned in your opening statement and you just repeated, from 44 or 45 cents a transaction down to 12 cents a transaction, if the exemption doesn't work, it is a $1.5 billion a year for the credit union movement for not-for-profit credit unions. And, more importantly, ultimately that will have to be passed on to the consumer.

Mr. SCOTT. Now let me go to you—the banker. Mr. Kelly. I had it written here.

You are the president and CEO of a small bank. Small banks were not covered in the survey that were done. How do you think that has skewed the results of that survey by you all not being involved in that survey?

Mr. KELLY. I think both the survey and some of the instructions certainly were skewed against the community banks. We don't have the economies of scale that a very, very mega-bank would have. We have a lot of costs that have to be consolidated as we offer those debit cards to our customers. And so when we talk about, in our case, Congressman, one of the things that we have gone and evaluated is we believe that the cost, exclusive of fraud, will be about a million dollars to our bank. That is just a guess based on this pricing at twelve cents. The thing that, again, the Federal Reserve study did not take into account was they said you can take into account fraud prevention, but it was not anything as far as fraud cost.

Our estimate is that fraud cost is about those 12 cents. So whether you are right or wrong about that, it is going to be a fairly massive loss for banks across the scale that are community banks. You can do the index on it, but it will be a very, very large loss, depending on the number of debit cards.

Mr. SCOTT. Now we are concerned about small businesses. Would this affect your ability to lend to small businesses?

Mr. KELLY. The ability that we have to lend to small businesses obviously is directly proportional to your ability to both take a risk and have a risk appetite and also have the ability to fund the necessary positions to cover all of the necessary lending function that there is.

As far as the ability to lend to small businesses, I don't think this is going to counter our ability to lend to small businesses. I think, though, it will reduce significantly, absent finding a way to

increase our cost, I think it will reduce significantly the dollars that we have at our disposal to reinvest.

Mr. SCOTT. Now how would it affect your customers' access to existing benefits, like free checking?

Mr. KELLY. I believe that the debit card income that we have seen and we see across our industry is used by banks to offset some of the loss leaders that we have, free checking and other things such as that. Those products would have to have some type of cost to the consumer. I can't tell you exactly what those costs would be, but we would have to make up some of that loss somewhere in order to fund the additional compliance requirements that we are going to have out of the Dodd-Frank Act and in order to just make up for the loss that we are currently carrying relative to the debit cards themselves.

Mr. SCOTT. Thank you.

Chairwoman CAPITO. Thank you. We are on a tight timeframe here. What I am going to do is call on Mr. Renacci, and then if we have any time left, I am going to give it to Mr. Royce. Then, if it is okay with the other members, I am going to dismiss the first panel. So when we come back from voting, we will start up with panel two.

Mr. Renacci.

Mr. RENACCI. Thank you, Madam Chairwoman.

Just a couple of quick questions for Mr. Buckley and Mr. Cheney. This is in regard to credit unions. Can you tell me what percentage of your customer base is low- or moderate-income customers? And also, I am trying to frame this in total. What is the total impact of the Dodd-Frank regulations on the credit unions to raise capital? I know that is a broad question. And knowing that the credit unions raise capital through earnings only, which is an issue, and then what is the impact of the loss of this capital or earnings, if that potentially is the case, because of these regulations on the sustaining of credit unions in the marketplace in the future?

Mr. BUCKLEY. Congressman, in Newaygo County, where we primarily operate, I would estimate that fully 40 to 50 percent of our membership would be classified as low- to moderate-income folks. Again, this gets back to the historical nature of employer-based credit unions and their service to people of low or modest means.

With respect to the impact of Dodd-Frank and the raising of capital, our concern is that we are now pitting safety and soundness concerns against the regulatory environment, which by its nature is more costly than the current environment.

So as regulations change or are modified and we then incur costs to change documentation, to put out new disclosures, that is every dollar of additional cost is a dollar out of my members' pocket. That comes right out of our bottom line and out of our capital. We don't have the means of raising capital through mezzanine financing or the like that some of my fellow financial institutions on the panel might have.

Mr. CHENEY. Just to comment, if I might, Mr. Buckley is exactly right: Every dollar that credit unions lose in revenue or every dollar that they have to spend on compliance is a dollar that comes out of the bottom line. The bottom line of credit unions is retained

earnings is the only way they can build capital in this environment. We talked about the possibility of supplemental capital.

But I think at $1.5 billion in potential lost revenue, that is the difference for many credit unions, if you get down to the local level, that is the difference between a continued recovery out of this economic crisis, a crisis that credit unions didn't create, and continued losses. It is a very, very severe impact in this environment.

Mr. RENACCI. Or the sustainability of a credit union.

Mr. CHENEY. Or the sustainability, absolutely.

Mr. RENACCI. For Mr. Kelly and Mr. MacPhee, this goes over to the small financial institutions. Again, I think everybody would agree that as regulations increase, costs go up. My concern again would be for the low- and the moderate-income families who use your small institutions. And as these costs go up, what is going to be the ability to maintain checking accounts for the low- and moderate-income and also the ability to maintain branches, small branches in areas where there is low- and moderate-income, as your costs continue to increase? If you agree, and again, I have had a number of conversations with small bankers who said these regulations are going to drive up costs.

Mr. MACPHEE. I couldn't agree more, Congressman.

We are in a small community where we know our customer pretty well. Our products aren't plain vanilla in our communities. We make loans to people, and we have to fashion them to their needs. And when you get something as ominous as the interchange bill, as an example, that ratchets up your costs to a point where, as an example, I only make $2.28 on the transaction on each of my 1,600 cards. It is not a get-rich-quick program. So when I lose just even that $5,000 a year in income, it is significant to our little bank, and it does affect my customers.

Mr. KELLY. Congressman, I think that in Oklahoma, the counties that we are in are mostly low- to moderate-income areas. And so we have a tremendous concern and also respect for the people who make up that population. This debit card—certainly, the debit card situation the way that it is today has the potential to impact them. It is either going to impact their ability to afford an account or it is going to impact our ability to bring more money in to reinvest in our communities and do other things. We have been very mindful of trying to be sure that those folks do have banking services. And so the banks that do that, and they do traditionally do that, will have to make the decision, are we going to go ahead and reduce our ability to invest in other things like more compliance officers and eat those charges, or are we going to have to charge those people who are in those accounts?

So I would hope that we are able to keep them in the bank. But it will require the banks to sacrifice more of their revenue to do so.

Chairwoman CAPITO. I think in the interest of time—we have 3 minutes before we need to vote. I had told Mr. Royce that he could have a minute or two, but it looks like we are down to the wire here. So I want to thank the panel for attending.

I would note that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for mem-

bers to submit written questions to these witnesses and to place their responses in the record.

Thank you very much. Thank you for your patience.

We will return after votes.

[recess]

Chairwoman CAPITO. Ranking Member Maloney said we could go ahead. I am really pleased that you are here, and I look forward to your testimony. I will introduce each of the panelists before you speak and ask that you speak for 5 minutes. We have your written statements in the record.

So our first speaker is Mr. Jess Sharp, executive director for the Center for Capital Markets Competitiveness, with the U.S. Chamber of Commerce.

Thank you.

STATEMENT OF JESS SHARP, EXECUTIVE DIRECTOR, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. SHARP. Thank you, Chairwoman Capito, Ranking Member Maloney, and distinguished members of the subcommittee. I am Jess Sharp, executive director for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector, and region. We appreciate the opportunity to testify before the subcommittee today on behalf of the businesses that the Chamber represents.

I am going to focus my testimony this afternoon on the potential impact of the Consumer Financial Protection Bureau, called the CFPB, on America's small businesses. First, I want to say the Chamber firmly supports sound consumer protection regulation that weeds out fraudulent and predatory actors and ensures consumers receive clear and concise disclosures about financial products. However, we also want to work with the CFBP to ensure that in doing this work, the Bureau avoids sweeping policies that would impose duplicative regulatory burdens on small businesses, and perhaps even more importantly, policies that would prevent small businesses from obtaining the credit they need to expand and create the new jobs that our economy so desperately needs.

The CFPB has broad authority to regulate consumer financial products and services of banks and nonbank financial institutions. So credit cards, mortgages, and student loans, for instance. The Dodd-Frank Act, however, also gives the CFPB the authority to regulate a number of activities that are fairly common to businesses outside the financial services sector, sort of the financial services mainstream; for example, merchants that extent credit to customers. While there is sort of an exemption, at least in principle in the statute, it is very, very complicated, and I think it is a five-part test to ensure that you actually can qualify for that exemption as a business extending credit.

In addition to casting this very wide net of coverage, the Dodd-Frank Act also gives the CFPB a very broad standard to enforce: the prevention of unfair deceptive or abuses acts or practices. While unfair and deceptive practices have been proscribed for

years, with decades of case law to guide compliance and enforcement, the new abusive standard will require immediate interpretation by the Bureau that will likely continue to evolve into the future.

Together, these standards are very vague and give the CFPB tremendous power to interpret its own mandate and give the regulated community, including small businesses, very little guidance to follow as we approach the July 21st transfer date. The full universe of covered entities is unknown, and the standards by which those entities will be judged compliant or noncompliant have yet to be written.

So our two main concerns about the CFPB relative to small business are these. First, as I sort of alluded to at the top, small businesses may be subject directly to the CFPB'S regulation and other oversight because they engage in one of these 10 activities laid out in the statute or are service providers to one of those companies. Under current law, most of these companies, if not virtually all of them, are already subject to some sort of oversight by the Federal Trade Commission. So the Chamber fears that overlap and duplication of efforts and sort of double jeopardy will be inevitable as the Federal agency sorts out lines of jurisdiction and responsibility. And to some extent, those are the growing pains of the new agency as we have here, but it is something we want to be mindful of and caution against.

Second, CFPB regulation—and I think we heard a little bit of this on the first panel—may possibly decrease the availability or increase the cost of the forms of credit small businesses rely on to provide working capital. According to research conducted by the Small Business Administration's Office of Advocacy, 80 percent of small firms use nontraditional sources of funding, including owners' loans, and personal and business credit cards, while 60 percent use traditional types of loans, such as credit lines, mortgage loans, and others. In fact, 47 percent of all small businesses use personal credit cards rather than business credit cards.

So, in regulating consumer products, it is fair to say there will be an indirect effect on the availability of credit to small businesses as a result of that.

Yesterday, the Chamber and a number of other trade associations sent a letter to Secretary Geithner laying out a series of recommendations to guide the Bureau's development in some of the early decision-making. I am just going to work through a quick summary of that. If you would like, I will provide a full copy of that for the record.

We have some structural recommendations, one of which we are happy to see that the CFPB has already incorporated, and that is the creation of a COO position. So often with new regulatory agencies and even with existing regulatory agencies, there can be an inability to see the whole field. So a COO position that kind of cuts across the silos, we think is a good idea, and we are happy they are ahead of us on that.

As I said at the top as well, empowering consumers by rationalizing disclosure requirements should be, we believe, the primary focus of the CFPB's work, and we think they can add a lot of value there, and we look forward to working with them to do

that. We are hoping they will prevent duplicative and inconsistent regulation to Main Street businesses. As I said, some of that will have to be negotiated, I think, between the CFPB and the Federal Trade Commission and the attorneys general and the prudential regulators, but we understand that is a work in progress.

As I said, we want them to preserve small business access to credit, and we want to ensure they are coordinating with potential regulators; that is very critical. And last, what we have asked is that the Secretary of the Treasury, in the event that there is a period of time between the transfer date and the confirmation of a director, what we have asked is that there not be any attempts to regulate or take enforcement actions that would interpret the new authorities under the statute.

With that, thank you very much. I am happy to answer questions.

[The prepared statement of Mr. Sharp can be found on page 161 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. Robert Nielsen, chairman of the board, National Association of Home Builders.

Welcome.

STATEMENT OF ROBERT NIELSEN, CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

Mr. NIELSEN. Chairwoman Capito, Ranking Member Maloney, and members of the Subcommittee on Financial Institutions and Consumer Credit, I am pleased to appear before you today on behalf of the National Association of Home Builders to share our views on the effect of the Dodd-Frank Act on small financial institutions and small businesses and to highlight the existing regulatory obstacles to housing production credit.

My name is Bob Nielsen. I am the 2011 National Association of Home Builders chairman of the board and a home builder from Reno, Nevada.

The housing sector is an industry made up of mostly small businesses. Over 85 percent of the NAHB builders members reported building fewer than 25 homes per year in both 2008 and 2009. And over 95 percent have receipts less than $15 million. Thus, the typical home builder easily qualifies as a small business. And these small businesses depend almost entirely upon commercial banks and thrifts for housing production credit.

Indeed, small community lenders account for over 90 percent of residential land acquisition, development, and residential construction, that is AD&C, loan originations. With no alternative source of housing production credit for most firms in the home building industry, NAHB is extremely interested in how the rulemakings required by the Dodd-Frank Act will impact the ability of small community banks to service our industry in the coming months and years.

Federal banking regulators are now entering an intense period of rulemaking on key components of the Dodd-Frank law. NAHB will be examining and commenting on these crucial rulemakings, not only for their potential to impact the already struggling home building industry but also for the additional uncertainty that the

sheer weight of new regulation will have on the ability of small builders to obtain much-needed housing production credit. Additional burdensome and unnecessary regulatory excesses will be sure to have a negative impact on small homebuilding companies and thus for the entire economy.

NAHB is concerned that the forthcoming credit risk-retention rules required by Dodd-Frank Act may result in an unduly narrow definition of the important term "qualified residential mortgage," which could forestall recovery of the housing market by making mortgages unavailable or unnecessarily expensive. This could occur, for example, if the rules required home buyers to make large downpayments. A move to a larger downpayment standard at this juncture would cause renewed stress and uncertainty for borrowers who are seeking or are on the threshold of seeking affordable sustainable, homeownership. Moving forward, NAHB recommends the broadest criteria possible when defining the qualified mortgage exemption without interfering with the safety and soundness requirements of the Dodd-Frank Act.

While the possible effects of ongoing Dodd-Frank regulations on community lending institutions are concerning, small builders have already been significantly impacted by existing regulatory requirements. Community banks are under intense regulatory pressure that has resulted in a severe lack of credit to home builders for AD&C loans. Such short-term loans are the life blood of our industry.

Unfortunately, I continue to hear from my fellow builders that it is extremely difficult if not impossible to obtain new AD&C loans. Additionally, builders with outstanding loans are experiencing intense pressure as a result of requirements for additional equity, denials on loan extensions, and demands for immediate repayment. This is a major impediment to the housing recovery and an increasing threat to the ability of many home builders to survive the economic downturn.

Of concern to NAHB is that lenders often cite regulatory requirements or examiner pressure that banks shrink their AD&C loan portfolios as the reason for their actions. While Federal bank regulators maintain that they are not encouraging institutions to stop making loans or to indiscriminately liquidate outstanding loans, reports from my fellow members and their lenders suggest that bank examiners in the field are adopting a significantly more aggressive posture.

To address this situation, NAHB has presented banking regulators with specific instances of credit restrictions. To date, these efforts have not produced any tangible result. It is clear that congressional action is now needed. As my written statement outlines, NAHB is offering a formal legislative blueprint focusing on fixing specific instances of regulatory excesses. NAHB stands ready to work constructively with this subcommittee to find prudent and workable solutions to both the current and ongoing regulatory constraints that are impacting the ability of the home building industry to fully participate in our Nation's economic recovery. Thank you.

[The prepared statement of Mr. Nielsen can be found on page 125 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. John Schaible, chairman of Atlas Federal Holdings.

Welcome.

STATEMENT OF JOHN M. SCHAIBLE, CEO, CHAIRMAN, AND FOUNDER, ATLAS FEDERAL HOLDINGS

Mr. SCHAIBLE. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, my name is John Schaible. I am the chairman, founder, and CEO of Atlas Federal Holdings. I want to begin by commending the committee for holding this hearing on Dodd-Frank, and I want to thank you for providing me the opportunity to share my opinions and hopefully what amounts to insights.

I am a businessman and an entrepreneur. I founded a company called NexTrade, which was one of the first electronic exchanges to compete directly with the New York Stock Exchange. I founded another company called Matchbook FX, which was the first spot foreign currency electronic exchange. I also founded a company called Anderen Financial, which is a Florida State-chartered bank and brokerage firm. Anderen remains today one of the best capitalized banks in the country.

To the success of my firms, I have employed, contracted thousands of Americans and been responsible for facilitating billions of dollars of economic activity, all of it generated from scratch. In the simplest sense, my business has been about inventing better ways for other businesses to access capital and distribute risk.

From this level, I submit to you that business in America needs certainty. And Dodd-Frank undermines that certainty. To make matters worse, Dodd-Frank is aimed at the financial services industry, which is the fuel pump for capital formation for all other businesses. At the core of the legislation, there is a philosophy inherently opposed to capital formation: the concept that regulation should be maximally flexible. To an entrepreneur like me, flexible regulation is a euphemism for arbitrary regulation, and it deters investment.

Dodd-Frank is massive, but there are three provisions in particular I want to reference that give me the most uncertainty. The first is Title X, which creates the Consumer Finance Protection Bureau. The reach of the CFPB does not seem to be limited in any material way for any firm engaged in finance. In addition, Congress has seen fit to abdicate the entire construction of the body of rules of the agency to the agency itself. For the business entrepreneur considering entering the field of finance, the entrepreneur has no way of forecasting the costs of this new rulemaking body and, therefore, has no real way to convince someone to put capital into them.

The secondary provision of concern is Title II, under which Dodd-Frank creates the orderly liquidation authority. The powers extended to the government during an orderly liquidation are practically limitless. While the vocalized intent is that the authority will seldom, if ever, be utilized, the reality is that it can occur. And potential investors and financial services have to look at two distinct scenarios: The first scenario is the possibility that their firm

that they are investing in gets placed under OLA. The second scenario, which is more likely, is that one of the firms that they contract with or are a customer of gets placed into OLA.

I will give you an example of a firm, like Bank of New York, which handles over $24 trillion in custody and administration services. They clear for over 1,150 other brokerage firms, and they provide services to what is roughly 45 percent of all exchange-traded funds. Bank of New York is one of the preferred places for small firms like mine to go to for services that we need. Our fear is that, under the OLA, what happens to our investors if such a bank like that gets seized?

We are faced with the cold reality that our contracts that we have with them can be canceled, or worse, forced to stay in place even though this firm is now recognized because of the seizure as a credit risk.

The OLA not only strips firms under resolution of certain rights, but it also otherwise can strip innocent and otherwise solvent end customers of their rights. To me, this is not even remotely American, very scary, and a severe deterrent to future capital formation.

The third section that gives me great concern is Title VI and, specifically, the Volcker Rule. The unintended consequences of the Volcker Rule can be very broad. Without the liquidity that bank-owned dealers provide, there can be some substantial negative effects for business formation in general. There will be higher funding and higher debt cost for U.S. companies, there will be a reduced ability of households to build wealth through the participation in liquid securities. Hopefully, if we learned anything during the recent crisis, it is the importance of liquid markets. The reduced willingness of investors to provide capital for new financial service firms because of the illiquidity and the higher trading costs in general will probably impact investors.

We have to realize that we face very strong competition from overseas capital markets and a prescriptive rule set that precludes liquidity support from some of largest capitalized players will substantially drain liquidity and important trade and products, and move jobs and wealth offshore.

In conclusion, I think that the passage of Dodd-Frank was definitely made with the best intentions, but I am concerned that we are trading prosperity for political expedience. I think we have a misunderstanding as to what caused the crisis. I think it is in fact a cause of government intervention and a very ill-defined regulatory rule set that tends to drive good business into small margins and allows what I call the "cockroaches of the industry" to survive in the dark margins and even thrive.

So, to that extent, when we understand that government intervention and bad rule sets are the cause of the problem, I think that Dodd-Frank probably is just one more Band-Aid and not a good solution.

Thank you.

[The prepared statement of Mr. Schaible can be found on page 140 of the appendix.]

Chairwoman CAPITO. Thank you.

Our final panelist is Mr. David Borris of the Main Street Alliance.

Welcome.

STATEMENT OF DAVID BORRIS, MAIN STREET ALLIANCE

Mr. BORRIS. Thank you. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for the invitation to testify regarding the impact of the Dodd-Frank financial reform law on small business.

My name is David Borris, and I serve on the Executive Committee of the Main Street Alliance, a national network of small business owners. Our network creates opportunities for small business owners to speak for themselves on matters of public policy that impact our businesses.

I have been a small business owner for over 25 years. My wife and I opened a gourmet carryout food store in 1985, and over the years have expanded into a full-service catering company with 25 full-time employees and up to 80 part-time and seasonal workers. We take pride in what we do.

I think it is important to understand the vital connection small businesses share with the communities we serve. Unlike big corporations, Main Street business owners see our customers every day, in our businesses, at the local grocery store, at school bus stops. We share close personal relationships and equally close economic ties. Policies that impact the economic health of our customer base reverberate quickly to our bottom lines.

Much attention has been paid to the severe tightening of credit markets. And this is certainly a serious issue for small business. But to blame Dodd-Frank for this credit crunch makes little sense. Credit dried up and has remained frozen because of the financial crisis itself, which could have been averted or mitigated had the stabilizing measures contained in Dodd-Frank been in effect at the time. To blame Dodd-Frank for the credit crunch confuses cause and effect, especially as the new law has not even been implemented yet.

When it comes to new capital requirements, leading financial experts dismiss the claim of a negative impact on lending. Professor Anat Admati from the Graduate School of Business, Stanford University, and her colleagues have looked carefully at the topic. They conclude that better capitalized banks will find it easier to raise funds for new loans and, further, that new capital requirements can help address biases in the current risk-weighted system and increase incentives for traditional lending.

The real reasons why small institutions and small businesses are having difficulties with credit lending are the underlying uncertainties in the economy: high unemployment; stagnant consumer demand; and the lingering foreclosure crisis. The great recession cost this economy 8 million jobs and eroded the small business customer base severely. Those customers have yet to return. Uncertainty in the foreclosure market continues to hang like an albatross around the neck of consumer demand as the unwillingness of big lenders to write down principal lingers as a drag on lending markets on economic growth. It should be noted, too, that efforts to rewrite Dodd-Frank even before it is implemented only add to that uncertainty.

New data on bank reserves reinforce the conclusion that the credit problem doesn't stem from regulatory requirements. According to last Friday's Wall Street Journal, U.S. bank reserves have swelled to $1.3 trillion, a figure the Journal describes as eye-popping. Those excess reserves represent money that could be out circulating in the economy on productive loans instead of sitting at the Fed.

Yes, we are in a credit crunch. The banks slashed their small business lending by $59 billion between June of 2008 and June of 2010, but the current levels of excess reserves could fill that lending gap 20 times over. The $150 billion in reserve at small institutions is 2.5 times the amount necessary to restore small business lending to 2008 levels.

While Dodd-Frank is hardly responsible for drying up credit, it does include a number of provisions that will provide real help for small business. The new Consumer Financial Protection Bureau will benefit small business in three ways: first, directly, because we are financial consumers also; second, by protecting people from bad credit arrangements and helping them keep money in their pockets to spend in the real economy at our Main Street stores; and third, by promoting a level playing field in lending.

Meanwhile, the law's proprietary trading limits will encourage banks to restore the focus on economically productive lending, and that will boost commercial lending. And the law includes provisions that should restore some parity to credit and debit contracts and debit interchange fees, an important area for many small businesses.

For me, as a small business owner, the bottom line is trust. Small businesses across America succeed by earning the trust of our customers. The financial sector lost sight of this basic principle of business, and we have all paid a very steep price. That is why we need these new rules of the road for the financial sector to engender trust, inspire confidence, and decrease uncertainty.

Small businesses like mine are counting on Dodd-Frank to succeed so we can go back to doing what we do best, creating jobs, building vibrant economies, and serving local communities across America.

Thank you.

[The prepared statement of Mr. Borris can be found on page 46 of the appendix.]

Chairwoman CAPITO. Thank you.

I want to thank all of the witnesses. We will begin the question portion. I am going to begin.

First of all, Mr. Sharp, you raised an issue that I have great concern about as well in terms of the development of the CFPB in terms of the timing. We are at the beginning of March. We have no nominee for a director. We are going up against a timeline here. And I think there are some very fundamental questions as to what is going to happen in the short term if a situation should arise that there is not a nominee or the nominee hasn't been confirmed, etc., etc. So I thank you for raising that issue. I think it is very real and certainly leads, again, to more uncertainty, which I think we are trying to, in all facets of our economy, trying to create and bring about more certainty so that we can get moving again.

I would like to ask Mr. Nielsen a couple of questions. Small home building companies, how will you be affected by the rules requiring banks to retain a portion of the credit risk associated with the mortgage loan? Is this a great concern for you all?

Mr. NIELSEN. Yes, it is. In fact, that could have a dampening effect on the ability of mortgage creators to create mortgages, and it would reduce the number of home builders that would qualify for a mortgage.

Chairwoman CAPITO. What would you say is the most common reason now that banks are giving to home builders for denial of credit? Mr. Westmoreland was here for the last questioning, and I think he was hitting on this very topic. Is it regulatory guidance? Is it lack of confidence in the economy? Is it real estate prices? Is it all of the above?

Mr. NIELSEN. Two different issues there. The first issue is to the consumer who is trying to buy a home. And, certainly, the tightening of FHA regulations, the tightening of banking regulations in terms of scores, credit scores, and that kind of thing are an issue for someone trying to purchase a home today. The other piece is for home builders trying to get financing, trying to access capital to be able to build, which the regulators have absolutely shut down. And that is the reason why we believe there needs to be a legislative response to that kind of a problem.

We have talked to the regulators. We have said bankers need to be able to make well underwritten loans in reasonable markets like Tulsa, Oklahoma, or North or South Dakota and parts of Texas, where home building can still be done. In fact, the regulators say, we encourage that with our examiners. But when you go out and talk to the community bankers, as you heard in your first panel, the examiners aren't telling them. So if the examiners are telling them to reduce their real estate lending book, they are going to do that, because they have to do that.

So that is the concern. It is twofold: one on the consumer side; and one on the production side.

Chairwoman CAPITO. All right. Thank you.

This is really for anybody. It will be my final question. President Obama recently announced an initiative to reassess regulations in light of their effectiveness and their effort and their effect on economic growth and jobs. I am curious to know, have you all or has anybody in the course of your businesses, have you ever been the beneficiary of reduced regulation and—not oversight, but it seems to me we are piling more regulation upon more regulation. Are any of your regulations going away to ease the business moving forward?

Mr. NIELSEN. I can guarantee you, Madam Chairwoman, we have seen no reduction in regulations. In fact, we see additional regulations at this point. I guess you have to give them time to do that. But we certainly see no move at this point to reduce regulations that affect our builders.

Chairwoman CAPITO. Does anybody else have a comment on that?

Mr. Sharp?

Mr. SHARP. I would just agree with what my colleague here said. I haven't seen a reduction anywhere.

Chairwoman CAPITO. Thank you.

Mrs. Maloney.

Mrs. MALONEY. Thank you. And I want to thank all the panelists for being here and for what you do every day to create jobs and be part of our economy.

I do want to share that at the last hearing of this Joint Economic Committee, Dr. Hill, who was appointed by former President Bush to head the Bureau of Labor Statistics, testified that this recession was the first one that wasn't just economic factors but was a failure of the financial system. And when you look at the failures that took place, it was highly unregulated, risky products that got us into the mess that we are digging our way out of.

It is estimated we lost $13 trillion in profits or value in our economy, 8 million jobs. It has been a devastating impact on all of us. Certainly, to respond to Mr. Nielsen and others who raised access to credit, there has been a dual story going on where the regulators and bankers will come in and say, oh, we are getting all the credit out into the community. And then you talk to the community and the community cannot find access to capital. And you are not going to grow, you are not going to invest until you have access to capital.

So, in the last Congress, we passed a bill that would create in Treasury a $300 billion fund for small banks, for communities, to get the capital out in the community to get the building of small businesses going. That is the Small Business Lending Fund. And it is just beginning to provide the necessary liquidity to small businesses.

The panel before you was a lot of smaller financial institutions, which I would say in this financial crisis have been the true heroes and heroines. They have been in the community. They have gotten the capital out. They have been well managed. They did not take risks. It was the old way of not handing out a loan unless people could pay for it. It got so bad during the heyday that the joke in New York was, if you can't afford your rent, go out and buy a home. Because there just wasn't any oversight. You didn't have to put anything down. You didn't have to have any credit. It was called no-doc loans. It really went overboard. And we are suffering.

We are working very hard in New York to really handle the foreclosure process, but in some States, our colleagues literally are having brand new homes bulldozed down and destroyed because there is nobody there to buy them.

I think one of the challenges, and I think Mr. Nielsen hit on it, is that there are some places where the economy is rebounding, where you need to be able to get these loans where they could presell their homes and really prove that there is a demand and get it moving.

I think one of the things that is confronting us, I believe it was Mr. Zandi, a private-sector economist who works for Moody's, which means that if he is not right in his forecast, he gets fired. But he was estimating that housing was 25 percent of our economy. It is huge. If it is 25 percent of our economy, when you look at all of the aspects of it, with the home building, the contractors, the construction workers—and construction workers have been

hardest hit in this downturn—I don't see how we really rebound in a positive way until we get housing moving again.

Earlier today, Chairman Bernanke testified that the recession was over and that we are not falling, but we are not climbing out of it. We are not even creating enough jobs to equal the number of people going into the workforce, which is roughly 150,000.

So my question, I guess, to Mr. Nielsen is, realistically, what can we do to get the housing moving? There are certain areas in the country where there is still a backlog of buildings that have been built. I would say that is true here in the Arlington, Virginia/Washington, D.C., area. There is a backlog of having built enough things that they can't even sell them.

It is hard to build new things when there is a backlog there. So I just think it is a huge challenge, because I do think there are some piecemeal areas in the country, some in Florida, I would say some in New York, where the demand is there and you could move forward. But still the fact that the backlog is so deep and strong has everybody concerned.

And I just want to put out there that the intent of this bill—government doesn't like to get involved with the private sector. But if the banks are closing and you are on the verge of a Great Depression and your entire financial community would have crumbled without the intervention of a Federal Reserve, that is why people came in. And, as I said, it was the deregulated areas that took the derivatives, moved them off the exchanges so no one knew what was going on with them.

There is a movie out—actually, it won an Academy Award, a documentary called, "Inside Job." But it was about the whole meltdown of the financial industry where all regulation was moved off the charts. We are now trying to put transparency back in so the consumers can see those areas.

So I guess my question to you, Mr. Nielsen, or anybody else who wants to answer it, is what can we do to get the housing market moving again? And is the demand even out there? If you could build the houses, is there anyone there to buy them?

As I said, we now have this lending fund that will be there if you can prove that, in fact, someone can pay for it. We are stopping the area of building things that people can't pay for and then leaving the taxpayer with the tab. And some people say that is too much regulation.

I think it is smart not to give someone a house that they can't afford that is going to be foreclosed on and the taxpayer is going to have to pay for. I think that is a dumb public policy. So what we were trying to do is put some balance in it. But anything that could get housing moving if the demand is there.

Number one, do you think the demand is there? And just your comments on it, because I don't believe we are going to ever get past the sort of treadmill area that we are in until housing, 25 percent of our economy, starts moving again.

Mr. NIELSEN. Absolutely correct. I love hearing you say that housing is what could lead this economy out of the recession.

Clearly, housing is still in a huge recession, unless you want to call it a depression. Unfortunately, the small business bill that you spoke of expressly precludes home builders from accessing that. In

fact, we had a fix-it bill that almost made it through in the last Congress but didn't. So we don't have access to those funds. That is part of the problem.

You are right that there are segments of the country that are beginning to come back. As I said in my testimony, Tulsa, Oklahoma, the Dakotas, and parts of Texas and, actually, specific areas of even Florida are starting to come back.

But if builders are precluded from having capital to be able to fund their business, they can't come back; and that is what we are experiencing. Some of the very largest builders, the biggest builders have direct access to Wall Street and don't have that problem. But our members, 165,000 of them, are small builders. They are community builders. They are people who build less than 25 homes. And unless we can create capital flow to them, which we believe a piece of legislation that we are crafting right now will do, they are not going to get back and be building. And, without that, they won't be hiring the people, as you pointed out, that we need to hire for that.

Mrs. MALONEY. The $300 billion precludes home builders. What about a home buyer? Can a home buyer access that $300 billion?

Mr. NIELSEN. I don't think that is for mortgages. At least, I don't believe it is.

Chairwoman CAPITO. Thank you.

I would like to ask for unanimous consent to insert into the record statements from the National Association of REALTORS, the National Association of Small Business Investment Companies, and the Retail Industry Leaders Association.

Without objection, it is so ordered. We will now go to Mr. Luetkemeyer for questioning.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Mr. Nielsen, let us continue with your discussion here. You hit on an interesting problem here and one that I hear all the time as I go back and talk to my local folks in the district. And that is the one where—especially with the builders and contractors and developers where there is a huge disconnect between the regulatory officials here in D.C. and what is going on in the district where it affects the people who make the livings and get our economy going from the standpoint that they are forcing the local examiners, the ones in the field are forcing the banks to restrict credit, call notes that really—there is nothing wrong with them, other than the fact that the market is kind of flipped upside down with regards to the values they have been performing and have never been past due and yet they are being called. It is a huge problem, and I am glad to hear your testimony along that fact.

If you can just again confirm what is going on out there. One of the questions I have is, what is the present inventory of homes that is sitting there ready to be purchased that people have moved out of? Or how big is the inventory and how long would it take to get rid of it?

Mr. NIELSEN. That is a very fluid question, and I am certainly not an economist and couldn't give you a number. But I can tell you that the overhang is huge.

But what you were talking about earlier, the banks calling—performing loans is what really concerns me, too. Because a lot of our

builders have land that is ready to build at this point that they are holding. But because banks are, in essence, reappraising that land and they are forcing home builders or owners of that land to put additional equity into the—pay the bank, additional equity to keep the loan in balance. And if they can't do that, they are foreclosing on that.

When they foreclose on it, the bank then sells that at a distressed value and reduces the value of every other piece of property around it because an appraiser has to look at that when they appraise a property, which is another problem, the appraisal problem.

Both of those are addressed in our legislation.

Mr. LUETKEMEYER. I had a situation where I had a developer that was so big, he had four different banks involved, and they all foreclosed on him because he was bankrupt. But if they all foreclosed on him, it would drive all the prices in the whole area down to a level that everybody would lose everything else. All the good loans would suddenly be worthless. That is how big and how bad the situation can get.

Mr. NIELSEN. Right. And we will get you the number of foreclosed houses on that.

Mr. LUETKEMEYER. Mr. Schaible, you hit on a couple of points there that are of interest to me, saying that the CFPA and the whole bill as a whole, Dodd-Frank really undermines the certainty of what businesses need in order to be able to continue to operate. And as I go out and talk to my folks, over and over again, the key word is certainty. They can't go anywhere because they are not certain of the laws, not certain of the regulations, not certain of taxes, not certain—if you get to manufacture, not certain of trade policy.

You used the word "arbitrary" regulation. I kind of like that. That is kind of a neat way to put what is going on here. They come in and they arbitrarily seem to, without any sort of documentation or real problem there, all of a sudden they are arbitrarily imposing rules and regulations on things.

And you made a comment in your testimony with regard to them being able to come in and take away some of the businesses and come in and repossess or close down. Would you elaborate on it just a little bit? Because I think this is a very important point that we make here.

Mr. SCHAIBLE. From my reading of the order of liquidation authority, they can seize certain enterprises when they feel that the enterprise is in trouble of potentially going under. And what is interesting is that they chose not to fall back on bankruptcy provisions or really any form of due process. They just kind of arbitrarily make that decision.

If you are on the other side of that as a customer of one of these larger firms, you can depend on these customers for clearing, for settlement, for stock loans, for a whole variety of services that are critical to your business. But the downside is the contracts that you have, even if you put provisions in your contracts to get away from them if they go bankrupt, they have specifically nullified that. And from what I have seen and that, from my perspective, if I am on the other side of that situation and my service provider has suddenly been randomly seized, I cannot break my contracts and I can't go someplace else unless the FDIC for a period of 90 days

gives me authority. And as a small firm dealing in trading, 90 days or 9 days, it doesn't matter. You will be out of business. It is a very scary situation.

Mr. LUETKEMEYER. I was talking to somebody today, and their comment was that it may be even unconstitutional to do this sort of thing. Because it is pretty arbitrary about where there they are doing it, and there is no basis there for them to be able to go in and basically take over a company without some sort of due process, which is basically what they are doing here.

Just very quickly—my time is about out—with regards to interchange fees. Mr. Borris, I believe it is, I am just kind of curious, how many businesses do you have in your Alliance?

Mr. BORRIS. We have about 8,000 businesses.

Mr. LUETKEMEYER. Do you know roughly what amount of the business transacted uses debit cards?

Mr. BORRIS. I don't know that. I can get that for you, though.

Mr. LUETKEMEYER. I am just kind of curious from the standpoint that, if debit cards go away, how impactful is it going to be to your merchants?

Mr. BORRIS. If debit cards were to disappear?

Mr. LUETKEMEYER. Yes.

Mr. BORRIS. Implying that debit cards will disappear by bringing those debit card fees more in line with what can be afforded?

Mr. LUETKEMEYER. By breaking the folks who can no longer afford to provide the service without being able to be paid for it. That is my question. If they can't pay for it, where are they going to—and they will pull the service or go someplace else to find other moneys to be able to continue to provide service free.

Mr. BORRIS. I think they indeed may go someplace else to try to find some of that money.

Mr. LUETKEMEYER. My question is, how impactful that will be to businesses? I am kind of curious. You are asking for the government to come in here and you seem to be approving this, to be able to set a price. How would you like to have somebody come in and set the prices on the products that you sell?

Mr. BORRIS. Right. What I can say is that, in my experience with my business, in my experience with other merchant businesses, we have sort of been at the mercy and still conduct our business at the mercy of credit card interchange fees, which have changed dramatically over the last several years both in transaction fees as well as in discount rates, the difference between nonqualified cards and qualified cards and swipe cards. I think that it is time for us to get some sort of fairness and justice in the marketplace for merchants.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Renacci.

Mr. RENACCI. Thank you, Madam Chairwoman.

Thank you to all the panelists there.

After listening to all of you speak, the one thing that you all agree on is that we need certainty and predictability to move forward. But the one thing that you disagree on, and Mr. Borris especially, is the effects of Dodd-Frank. I want to go to Mr. Borris, some of your comments.

You made the comment that—and again, I was a small business owner for 28 years. So I understand what it takes to run a small business, and I understand what certainty and predictability in a marketplace and how necessary that is. But it is interesting because you made the comment that the Consumer Financial Protection Bureau would bring certainty and predictability. And I am just intrigued by that comment because I know in my business background, after 28 years, I was never really comfortable about certainty and predictability when there was a new bureau coming in to oversee what I was doing. Can you kind of elaborate on that?

Mr. BORRIS. Sure. I think that part of what happened to our business, and what happened to business across America over the last 2 years is that the demand disappeared as jobs were lost and as people had all of the equity sucked out of what they thought they had equity in, their homes. So as that demand disappeared and the money flowed strictly to a very narrow band of extraordinarily profitable—as it turned out because of taxpayer bailouts—extraordinarily profitable investment banking firms and loan originators who didn't have to hold on to any of their loans. So what I believe that the Consumer Financial Protection Agency will do is protect consumers from getting involved in predatory lending, bad mortgages that have no prayer of ever becoming repaid, and keep money in their pockets where it will be spent in our local communities. So that is where it will give some certainty to what is happening in the economy.

Mr. RENACCI. Mr. Schaible, do you believe that? I know you commented about that same organization.

Mr. SCHAIBLE. Do I agree with what he said?

Mr. RENACCI. Yes. Do you agree that having another bureau coming in is going to bring you certainty and predictability?

Mr. SCHAIBLE. No. I completely disagree.

Mr. RENACCI. Mr. Nielsen, in your organization, in the homebuilding industry, any more oversight, would that bring you certainty and predictability?

Mr. NIELSEN. No, it doesn't. I think that what we are looking at is additional regulation which, unless really watched very carefully, is going to be difficult for any of our guys to deal with.

Mr. RENACCI. Mr. Sharp?

Mr. SHARP. As I said, at this point it is not clear who is covered by the CFPB and what the rules of the road are going to be. So, again, it is a tremendous amount of uncertainty for our members.

Mr. RENACCI. More uncertainty and more unpredictability.

How about regulations? As a small business owner—again, I would just like for all four of you to comment. Do you believe regulations drive up costs? And in a business, if a regulation drives up costs, what are some of the things you have to start looking at? Would payroll, employment be one of those things? Will regulations drive up costs?

We will go back to Mr. Borris first.

Mr. BORRIS. I would answer that this way. There is regulation and there is undue regulation, right? So, no, do I want an authority saying to me that chicken salad has to be priced at $8.95 a pound no matter what your cost of producing chicken salad is? No, I would agree that is wrong. But do I want somebody stamping the

meat that comes in my door so that I know that it is valid and that it works? Do I want reasonable regulation for workplace environments so that we don't have a situation like we had before Upton Sinclair wrote, "The Jungle"?

I think that there are some big-picture issues that are significant and need to be talked about. If you and I were having a conversation right now about what is—should we have a 50-hour workweek, if there were no overtime provisions right now in law, I think it would be a very difficult conversation to have. And yet we wind up with a more productive society.

Mr. RENACCI. I guess it is more of a simple question. Because I do believe some regulations. I understand that. The question is, do overburdensome regulations increase your costs and reduce your ability to have people on the payroll?

Mr. BORRIS. I don't think it is a fair question. It is like saying, if I put a 120 hitter up at the cleanup spot, is my team going to be less productive? If I am forced to do that, then, yes. So if we are taking it as a supposition that all regulation is overburdensome, then, yes, you are correct. But I think you and I agree that there is proper and good regulation that levels playing fields and gives everybody equal access and opportunities to succeed.

Mr. RENACCI. I am really trying to stick to the Dodd-Frank regulations coming forward, though, not the meat packing regulations.

Mr. BORRIS. I don't see Dodd-Frank as overburdensome.

Mr. RENACCI. The other three panelists, just a quick answer.

Mr. SCHAIBLE. I don't know. I do think that it is going to be overburdensome, and it raises a great deal of uncertainty. And part of your question is, how do we respond to that? I think when you are in businesses that can migrate anywhere because of a virtual economy, you start to look at other jurisdictions that can allow you to compete. Because if you don't have a competitive playing field, you are going to go out of business.

Mr. NIELSEN. I would say that regulations in general are always burdensome. However, as some of the other witnesses have said, some regulations are necessary. But they have to be based on sound science. They have to have a reason why they are there. And if that is the case, then we can deal with it. But regulations in general are always costly and always burdensome and reduce the ability of small business to hire people.

Mr. SHARP. And I would essentially echo what Mr. Nielsen said. Regulation is always a tradeoff. And, of course, we always hope that the benefits of the regulation exceed, hopefully by a good deal, the cost of those regulations. So there is still a lot to be written at this point about the Dodd-Frank regulations. So many of them are yet to come. But, again, there is a lot of fear out there about regulators not moving cautiously and understanding the tradeoffs bound up in each of these rules.

Mr. RENACCI. A lot of uncertainty and predictability. I will end it there. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I want to thank the panelists certainly for your patience and for the great information that you provided for this committee.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing.

Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record. This hearing is adjourned. Thank you.

[Whereupon, at 5:38 p.m., the hearing was adjourned.]

A P P E N D I X

March 2, 2011

Small businesses and the community banks that finance them are the lifeblood of the economy in many parts of the country. The 23rd district of Texas, which I represent, is home to many small towns that depend heavily on small banks to finance ranching, agriculture, construction, and other vital functions that make our economy run. It is these banks that we must focus special attention on protecting from onerous regulations. Dodd-Frank has not only taken aim at large institutions, but small banks as well, and sent them scrambling to find a way to survive in its wake. This has serious implications for our economy.

One major focus of the Dodd-Frank bill was "consumer protection" – while this is a noble and worthwhile goal, the bill missed the mark and will result in higher prices and less choices, all in the name of protecting consumers. In a free and open economy, there is no greater way to advocate for the consumer than ensuring they have choices when it comes to finding a bank that is willing to extend a loan to a small business that will in turn create jobs and grow our economy.

I look forward to hearing from our panel today on what we in this Congress can do to help their businesses turn this ship around.

OPENING STATEMENT OF REP. BILL HUIZENGA

House Financial Services Subcommittee on Financial Institutions and Consumer Credit

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

March 2, 2011

Good morning, and thank you Chairman Capito and Ranking Member Maloney for holding this important hearing today.

Last year, we saw enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was the largest overhaul of the financial services sector since the Great Depression. According to the Congressional Research Service, with its enactment also came more than 300 rulemakings by 10 different federal agencies. As you know, the devil is always in the details and many large and small businesses across the country are anxiously awaiting those details. Not to mention that this regulatory implementation and uncertainty has had a detrimental effect on small businesses across the country.

Both sides of the aisle agree that small businesses are the backbone and engine of the U.S. economy and provide more than two-thirds of American jobs. As a small business owner, I know firsthand how federal regulations can choke small businesses. The average small business with less than 20 employees faces an annual cost of $10,585 to comply with myriad federal regulations per worker they employ. For my small gravel company that employs two full time workers, that equates to more than $21,000 that I have to spend toward compliance - money I could be using to invest in much-needed new equipment.

Today, I look forward to hearing testimony from all the witnesses regarding the effects of the Dodd-Frank Act on smaller financial institutions. More importantly, I am pleased and honored to welcome one of the witnesses, who is an important constituent of Michigan's Second District, John Buckley. Mr. Buckley is the President and CEO of Gerber Federal Credit Union located in Fremont, Michigan, and has a long and impressive resume with both the community banks and now credit unions. Like most community leaders, he is very active in the area.

As a small business owner, I know there are some universal principles of successful businesses that Congress could work towards to grow our economy again. For government, that means creating an atmosphere for success for small businesses that does not include a burdensome regulatory environment. Last year, the executive branch issued more than 3,000 new rules and regulations which their own Small Business Administration reports cost small businesses more than $1 trillion. This is unacceptable and as a newly-elected member of the 112th Congress, and member of this important committee, I look forward to addressing this.

Ms. Chairwoman, thank you for holding this important hearing and I look forward to hearing from the witnesses today.

Statement of David Borris, Main Street Alliance Executive Committee Member and Business Owner For House Financial Services Committee, Subcommittee on Financial Institutions & Consumer Credit Hearing on "The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses" Wednesday, March 2, 2011

Chairman Capito, Ranking Member Maloney, and members of the committee,

Thank you for the invitation to testify regarding the impact of the Dodd-Frank financial reform law on small businesses.

My name is David Borris and I serve on the Executive Committee of the Main Street Alliance, a national network of small business owners. Our network creates opportunities for small business owners to speak for ourselves on matters of public policy that impact our businesses, our employees, and the communities we serve.

I've been a small business owner for 25 years. My wife and I opened a homemade food store in 1985 and over the years we expanded into a full service catering company with about 25 full-time employees and up to 80 more part-time and seasonal workers. We take great pride in what we do.

For today's discussion on the financial reform law and its impact on small institutions and small businesses, I think it is important to understand the vital connection small businesses share with the communities we serve. Unlike large national or multinational corporations, Main Street business owners see both our customers and our employees every day – in our businesses, at the local grocery store, on the soccer fields and at school bus stops – and the public policies that impact the health of our customer base and our workforce reverberate to our bottom lines and the health of our businesses.

The financial crisis and its aftermath have taken a serious toll on America's small businesses. According to a report by London-based Capital Economics, during this recession small business job losses were responsible for about two-thirds of the employment decline in the U.S. as of late 2009. Between March 2008 and March 2009, small business bankruptcies nearly doubled. While bailouts were being handed out on Wall Street, Main Street small businesses have continued to pay the price in a "double squeeze" of a decimated customer base on the one hand and frozen credit markets on the other.

The Dodd-Frank Law and Small Business Access to Credit

There has been much attention to the severe tightening of access to credit since the onset of the financial crisis. This is certainly a serious issue for small business owners who are positioned to expand, and for the nation's economic recovery. But to blame the Dodd-Frank law for this credit crunch makes little sense.

Credit dried up – and has remained so frozen – because of the financial crisis itself, which could have been averted or at least mitigated had the stabilizing measures contained in Dodd-Frank been in effect. To blame Dodd-Frank for the crisis-induced credit crunch confuses cause and effect, especially

as the new law is not yet even implemented. A proper reckoning of cause and effect is needed in order to move forward with pragmatic policies that clear the path for small businesses to flourish.

When it comes to new capital requirements under Dodd-Frank, financial experts dispute the claim of a possible negative impact on productive lending as unfounded. As Professor Anat Admati from the Stanford Graduate School of Business and her colleagues write in a letter published in the Financial Times in November 2010:

> "These warnings are misplaced. First, it is easier for better-capitalized banks, with fewer prior debt commitments hanging over them, to raise funds for new loans. Second, removing biases created by the current risk-weighting system that favor marketable securities would increase banks' incentives to fund traditional loans. Third, the recent subprime-mortgage experience shows that some lending can be bad for welfare and growth."

The real reasons why small institutions and small businesses are having difficulties with credit and lending are the underlying uncertainties in the economy – high unemployment, sluggish demand, and the lingering foreclosure crisis. The Great Recession cost the U.S. economy 8 million jobs and eroded the small business customer base severely. Those customers have not yet returned in sufficient numbers to restore lending to better terms. Uncertainty in the foreclosure market continues to hang like an albatross around the neck of consumer demand as the unwillingness of big lenders to write down foreclosures lingers as a drag on lending markets and economic growth. (It should be noted too that efforts to re-write Dodd-Frank even before it is implemented also add to uncertainty and confusion about the direction of lending and financial sector practices.)

New data on bank reserves reinforce the conclusion that the credit problem stems not from regulatory requirements (either current or pending), but from the lingering hangover that remains from the financial meltdown. According to last Friday's *Wall Street Journal*, U.S. bank reserves have swelled to $1.3 trillion, a figure the *Journal* described as "eye-popping." That includes $1.2 trillion in excess reserves – reserves beyond the amounts required by law – a number that has swelled by $225 billion since the start of this year.

Those excess reserves represent money that could be out circulating in the economy on productive loans, including loans to small businesses. Instead, those excess reserves are sitting at the Fed and the banks are collecting 0.25 percent interest for holding more money out of the economy.

Yes, small businesses are in a credit crunch – the banks slashed their small business lending by $59 billion between June 2008 and June 2010 – but the excess reserves the banks are sitting on could fill that lending gap 20 times over.

Even focusing narrowly on small institutions, Fed data indicates that about $150 billion of that reserve figure comes from small institutions. That alone is more than two and a half times the amount that would be needed to restore small business lending to the level of summer 2008.

The Dodd-Frank Law's Benefits for Small Businesses
While Dodd-Frank is hardly responsible for drying up credit, it does include a number of provisions that weigh in on the positive side of the ledger for small businesses.

Consumer Financial Protection Bureau
The new Consumer Financial Protection Bureau will benefit small businesses from three perspectives:

- First, small businesses are financial consumers, too – we've been harmed directly by deceptive financial products, and we'll benefit directly as abusive lending practices are curtailed.
- Second, people need to have money in their pockets to go out and spend in local small businesses. When people get trapped in bad mortgages or deceptive credit arrangements, it saps their disposable income. By guarding against this, the CFPB will help keep money in people's pockets to spend in the real economy.
- Third, the consumer bureau will promote a level playing field in lending by regulating shadow lenders, reining in abusive but profitable practices (propagated mostly by larger institutions), and allowing small banks and credit unions to compete on more equal terms.

In the *Main Street Policy Pulse* report the Main Street Alliance released in January 2010, based on a survey of over 1,200 small businesses across 13 states, 67 percent of responding business owners supported the creation of the consumer bureau, and only 12 percent opposed it.

Restoring the Focus on Traditional Lending Through Limits on Proprietary Trading
Dodd-Frank law's limits on proprietary trading will also benefit small businesses. The basic function of banking – to pool deposits and offer loans to build and grow productive enterprises – should be reliable and predictable. With the boom in proprietary trading by banks, more and more attention and resources were turned toward casino-style trading and its big payouts, and less and less toward traditional lending. This was bad news for small businesses seeking loans. The Dodd-Frank law's proprietary trading limits will encourage banks to restore the focus on their traditional mission of economically productive lending.

Reforming Credit/Debit Contracts and Debit Interchange Fees
The Dodd-Frank law also includes provisions that should restore some parity to credit and debit contracts and debit interchange fees. These include returning to business owners the freedom to make decisions about forms of payment, and establishing a rules process for ensuring that debit interchange fees are set at reasonable and proportional levels. While we would have liked to see a similar requirement for credit card interchange, these provisions represent important positive steps for small businesses.

In addition to these specific measures, there remain the overarching benefits to small businesses and local economies of increasing overall economic stability as the Dodd-Frank framework seeks to do.

Conclusion
The bottom line for me, as a small business owner, has to do with trust. My business and small businesses across America are built on trust. When you walk in my door, a handshake is a commitment. We succeed by earning the trust of our customers, again and again. The financial sector lost sight of this basic principle of good business, and we've all paid a very steep price.

That's why we need the new rules of the road for the financial sector included in the Dodd-Frank law – to engender trust, inspire confidence, and decrease uncertainty. Small businesses like mine are counting on Dodd-Frank to help put the economy back on solid ground and make sure we don't get the rug pulled out from under us again. We need Dodd-Frank to succeed so we can go back to doing what we do best: creating jobs, building local economies, and serving local communities across America.

National Association of Federal Credit Unions

Testimony of

John P. Buckley, Jr.
President & CEO
Gerber Federal Credit Union

On Behalf of

The National Association of Federal Credit Unions

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

Before the

House Financial Services Subcommittee on Financial Institutions and Consumer Credit

United States House of Representatives

March 2, 2011

Introduction

Good afternoon, Chairman Capito, Ranking Member Maloney and Members of the Subcommittee. My name is John Buckley and I am testifying this afternoon on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the President and CEO of Gerber Federal Credit Union in Fremont, Michigan. Gerber FCU has more than 13,400 members with assets totaling $114 million. With two branches in Fremont, one in Newaygo, Michigan, and one in Fort Smith, Arkansas, we strive to improve the well-being of our member-owners each and every day.

NAFCU is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU member credit unions collectively account for approximately 64 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to discuss the profound impact that regulatory restructuring under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* [P.L. 111-203] is having, and will continue to have, on credit unions.

Historically, credit unions have served a unique function in the delivery of essential financial services to American consumers. Established by an Act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom may otherwise have limited access to financial services. Congress established credit

unions as an alternative to banks and to meet a precise public need – a niche that credit unions fill today for more than 92 million Americans.

Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While over 75 years have passed since the Federal Credit Union Act (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain wholly committed to providing their members with efficient, low-cost, personal financial service; and,

- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

Credit unions are not banks. The nation's approximately 7,400 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. Furthermore, unlike their counterparts at banks and thrifts, federal credit union directors generally serve without

remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions have grown steadily in membership and assets, but in relative terms, they make up a small portion of the financial services marketplace. Federally insured credit unions had approximately $884.7 billion in assets as of year-end 2009. By contrast, institutions insured by the Federal Deposit Insurance Corporation (FDIC) held $13.1 trillion in assets. The average size of a federal credit union is $107.4 million compared with $1.725 billion for banks. Over 2,800 credit unions have less than $10 million in assets. The credit union share of total household financial assets is also relatively small, just 1.5 percent as of December 2009.

Size has no bearing on a credit union's structure or adherence to the credit union philosophy of service to members and the community. While credit unions may have grown, their relative size is still small compared to banks.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the Credit Union Membership Access Act (CUMAA – P.L. 105-219) a little over a decade ago. In the "findings" section of that law, Congress declared that, "The American credit union movement began as a cooperative effort to serve the productive and provident credit

needs of individuals of modest means ... [and it] continue[s] to fulfill this public purpose."

While the lending practices of many other financial institutions led to the nation's subprime mortgage debacle, data collected under the Home Mortgage Disclosure Act (HMDA) illustrates the value of credit unions to their communities. The difference between credit unions and banks is highlighted when one examines the 2007 HMDA data for loans to applicants with household incomes under $40,000. According to the pre-collapse 2007 HMDA data, banks had a significantly higher percentage of mortgage purchase loans (14.7 percent) charging at least 3 percent higher than the comparable Treasury yield for all low-income applicants with household income under $40,000. Credit unions, on the other hand, had only 3.7 percent of their loans in that category. To be clear, credit unions and other community based financial institutions were not the root cause of the housing and financial crises. As the Subcommittee is aware, this point was recently reiterated by the co-chairmen of the congressionally established Financial Crisis Inquiry Commission during testimony before the House Financial Services Committee on February 16, 2011.

Credit unions have always been some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital. There are many consumer protections already built into the Federal Credit Union Act, such as the only federal usury ceiling on financial institutions and the prohibition on pre-

payment penalties that other institutions have often used to bait and trap consumers into high cost products.

Despite the fact that credit unions are already heavily regulated, were not the cause of the financial crisis, and actually helped blunt the crisis by continuing to lend to credit worthy consumers during difficult times, they are still firmly within the regulatory reach of several provisions contained in the Dodd-Frank Act. The additional requirements in Dodd-Frank have created an overwhelming number of new compliance burdens, which will take credit unions considerable time, effort, and resources to resolve.

We applaud recent efforts by the Obama Administration and the House of Representatives to tackle excessive regulations that hamper the ability of an industry to create jobs and aid in the economic recovery. With a slew of new regulation emerging from the Dodd-Frank Act, such relief from unnecessary or outdated regulation is needed now more than ever by credit unions.

Regulatory Reform and Debit Interchange

Section 1075 of the *Dodd-Frank Act*, as prescribed by an amendment offered by Senator Richard Durbin, requiring the Federal Reserve to establish standards for determining whether a debit interchange fee is "reasonable and proportional" to the actual cost incurred by the issuer or payment card network with respect to the transaction is disastrous for the credit union industry and the 92 million members they serve. NAFCU strongly opposed Senator Durbin's amendment which, in the eleventh hour, was changed

on the Senate floor to include a toothless handwritten exemption for financial institutions under $10 billion in assets.

Just two weeks ago while testifying in front of the Senate Committee on Banking, Housing, & Urban Affairs about the proposed debit interchange rule issued by the Federal Reserve, Chairman Ben Bernanke expressed the very real possibility that the small issuer exemption "will not be effective in the marketplace." Chairman Bernanke pointed to two factors to support this assessment – first, that merchants will reject more expensive cards from smaller institutions, and second, that networks will not be willing to differentiate the interchange fee for issuers of different sizes. These comments only reaffirm the validity of arguments that NAFCU member credit unions have been making since the Durbin amendment was first proposed and then inserted into the Dodd-Frank Act.

NAFCU strongly opposes the Federal Reserve's proposed rule that, with price caps for debit interchange, doesn't fairly compensate issuers for the costs involved in processing debit card transactions [see appendix A for a copy of NAFCU's letter to the Federal Reserve outlining these comments]. First, there should have been more consideration given to fraud losses and data security concerns when drafting this proposed regulation. Credit unions have suffered steep losses in recent years due to the direct and indirect costs of data breaches. Credit unions are forced to charge-off fraud losses and incur additional expenses in making their members whole again, much of which stem from the failure of merchants to protect sensitive financial information about their customers.

Such costs include, but are not limited to, the re-issuance of new cards, creation of new personal identification numbers, and fraud insurance. These were not factored into the Federal Reserve's proposal.

Several other significant costs associated with maintaining a debit card portfolio were also ignored. Network fees, licensing fees, personnel training, regulatory compliance, and the technology needed to operate a debit card program all add up to real money and become a serious burden for small financial institutions.

The Federal Reserve only surveyed issuers with more than $10 billion in assets during the rulemaking process because the Durbin amendment "exempted" smaller institutions. Thus the proposed cap of 7 – 12 cents only accounts for the costs of large issuers who have greater economies of scale, and further disadvantaged smaller credit unions like mine. On the one hand, small issuers will likely ultimately receive the lower, capped interchange rate. However, on the other hand, that rate will be twice as difficult for small issuers to manage because the fee is based not on their own costs but on costs of larger, more complex institutions with better economies of scale. Consequently, the small issuer exemption, which singled out issuers with less than $10 billion in assets for protection, will instead create the perverse effect of providing a significant competitive advantage to large issuers.

Congress and the Federal Reserve have interjected themselves into a free market system between two industries that works successfully for the American public. The government

has clearly picked winners - mega-retailers who stand to gain billions of dollars while automatically transferring risk to financial institutions with each swipe of a debit card. The government has also picked losers - credit unions, community based financial institutions and the millions of Americans that they provide financial services to everyday. NAFCU-member credit unions have indicated that the implementation of the proposed rule threatens a 35 basis point hit on a credit union's bottom line.

Recent NAFCU surveys of our membership found that nearly 65% of responding credit unions are considering eliminating free checking to help mitigate lost revenue from the debit interchange rule and 67% are considering imposing annual or monthly fees on debit cardholders. Implementation of this rule could also lead to lower dividends and higher costs of credit, as 52% of respondents may consider reducing rates on deposit accounts and 25% will consider increasing rates on loans. Furthermore, it may lead to job losses, as nearly 19% of responding credit unions will consider reducing staff at their credit unions and nearly 21% will consider closing existing branches or postponing plans to open new ones if the capped rate becomes the default rate for all issuers.

At Gerber Federal Credit Union, we estimate we will lose $210,000 annually under the proposed Federal Reserve rule. Because credit unions are unable to raise revenue elsewhere, it is a foregone conclusion that this lost income will come directly out of our members' pockets. In addition, drastically lowering capital at each credit union with a debit card portfolio will increase risk to the credit union system as a whole. In short, I am appalled that our members will shoulder tremendous financial burden and still be on the

hook for fraud loss while large retailers receive a giant windfall at the hands of the government. It is also worth noting that, under the law, retailers have no obligation to lower prices for consumers.

Today, on behalf of credit unions and their 92 million members, I am asking Congress to take action to stop the Federal Reserve's proposed rule from going into effect this July. This debit interchange amendment was not studied in a single Congressional hearing before its enactment and deserves serious consideration by Congress and its members to avoid unintended consequences for small financial institutions and consumers everywhere.

Regulatory Reform and the Consumer Financial Protection Bureau

While debit interchange is the industry's immediate primary concern, the creation of the new Consumer Financial Protection Bureau (CFPB) is also potentially problematic as the Bureau will have rule writing authority over credit unions of all size. Additionally, the CFPB was granted examination and enforcement authority for credit unions with over $10 billion in assets. NAFCU has consistently opposed efforts to include credit unions, regardless of size, under this new regulatory scheme.

While we were pleased to see the Financial Stability Oversight Council (FSOC) granted some "veto" ability over some proposed CFPB rules if they are deemed to create safety and soundness concerns, we would urge Congress to strengthen the ability of the FSOC to act in this capacity to "veto" proposed rules that may go too far.

NAFCU has long recognized the need for additional consumer protection in the financial services arena. From the moment the Obama Administration released its white paper in June 2009 calling for the creation of a CFPB like entity, NAFCU supported additional regulation for bad actors on Wall Street. NAFCU also supported the NCUA's establishment of an office dedicated for consumer protection. Given that credit unions were not part of the shadow banking system that helped lead to the financial crisis, it's perplexing that they were ultimately placed under the jurisdiction of the CFPB.

With new information about the focus of the CFPB surfacing, it appears that credit unions will likely face a new set of regulatory hurdles regarding credit card portfolios, in mortgage disclosure procedures under the Truth in Lending Act, and many other areas. I cannot emphasize enough how burdensome and expensive unnecessary compliance costs can be to credit unions. At Gerber FCU employees already spend countless hours updating disclosure booklets and Web sites, retrofitting facilities for new regulations, and constantly rewriting documents to comply with the never ending changes to regulations. The time and costs spent on this compliance burden are resources lost that could be used to help members purchase a new car or start a new small business.

The Dodd-Frank Act included a section (Section 1100G) that says it must evaluate as part of its regulatory flexibility analysis the impact that its actions have on "small entities" (which includes "small organizations"). We believe the credit unions meet the definition of a "small organization" as defined in Title 5, Section 601 of the U.S. Code as "any not-

for-profit enterprise which is independently owned and operated and is not dominant in its field..." We would urge Congress to make sure that the CFPB abides by this Congressionally-mandated standard, and does not try to narrow the definition of "small entity" in order to strengthen its authority over credit unions.

Moving forward, NAFCU believes that the CFPB must have a Senate confirmed director before it becomes an official stand alone federal agency on July 21, 2011. Lawmakers, their constituents, and every entity under the CFPB deserve a fair and open process in which candidates that may head the new agency are properly vetted. After Senate confirmation, the new director should routinely testify before Congress about the CFPB's work. This will be especially important in the agency's infancy while credit unions and others adjust to a new regulatory framework, and the credit union prudential regulator, the NCUA, works to ensure that new protection plans don't create unintended safety and soundness concerns.

Additional Credit Union Concerns Stemming from Dodd-Frank

NAFCU member credit unions have several other concerns they would like to express to the committee as the Dodd-Frank Act is implemented across the board. We would urge Congress to take action to make the following additional changes to the act:

- Transition Time: Credit unions are already dealing with a multitude of new legislative regulatory requirements. The additional requirements imposed by Dodd-Frank have created an overwhelming number of new compliance burdens, which will take credit unions considerable time and effort to resolve. A slightly longer period for full implementation of Dodd-Frank—up to 24 months for some

areas—would help alleviate some of these burdens and give credit unions more time to comply.

- Inflation Adjustment: An important omission in Dodd-Frank is the indexing for inflation of all monetary thresholds in the bill annually. This is important to keep the intent of the legislation intact over time. $10 billion in assets today will not be the equivalent of $10 billion in assets next year, and NAFCU is concerned that more and more institutions will find themselves crossing this arbitrary line and becoming subject to new and unintended requirements.

- Interest on Lawyers Trust Accounts (IOLTA): To the extent the FDIC is required to fully insure IOLTA accounts, it is essential for the NCUA's share insurance fund to be treated identically in order to maintain parity between the two federal insurance programs. Congress passed a change to the Dodd-Frank law late last year to clarify the FDIC's ability in this area, but failed to provide parity to credit unions in its last minute action. We urge Congress to take action to correct this failure and ensure continued parity. IOLTA accounts often contain funds from many clients, some of whom may have funds in excess of the standard $250,000 share insurance limit. IOLTA funds are constantly withdrawn and replenished with new funds from existing and new clients. Accordingly, it is impractical to require attorneys to establish multiple IOLTAs in different credit unions to ensure full share insurance coverage.

- Unified Mortgage Loan Disclosure: Although Dodd-Frank calls for a joint HUD-RESPA rule concerning mortgage loan disclosures, the bill provides an important exception—it leaves the CFPB with the final say on whether a new rule is needed. A combined disclosure rule is critical to avoiding some of the confusion and overlap that currently exists during the mortgage loan transaction process, easing the compliance burden on financial institutions and reducing confusion for borrowers.

- Definition of "Remittance Transfer": NAFCU also remains concerned that the overly broad definition of a "remittance transfer" in the bill imposes new disclosure requirements on all international electronic transfer of funds services, and not just transmissions of money from immigrants in the U.S. to their families abroad—which are in fact conventional remittances. The new regulatory and disclosure requirements would impose significant compliance obstacles for non-remittance services, and we ask that the definition be narrowed accordingly.

- CFPB Document Access: While Dodd-Frank excludes financial institutions with $10 billion or less in assets from the examination authority of the CFPB, the new agency is provided with unlimited access to financial reports concerning covered persons issued by other regulators. Since the reports are drafted by federal agencies as part of their examination procedures, access by the CFPB to the reports essentially amounts to an examination in itself, even for those institutions with assets of $10 billion or less. NAFCU does not believe that this is the result Congress was seeking to achieve, and asks that this broad language be narrowed appropriately.

- Appraiser Independence: Section 1472 of the Act imposes mandatory reporting requirements on credit unions and other lenders who believe an appraiser is behaving unethically or violating applicable codes and laws, with heavy monetary penalties for failure to comply. These provisions would impose a significant burden on each credit union to essentially serve as a watchdog for appraisers violating their own professional practices, and should therefore be optional. If reporting continues to be compulsory, NAFCU asks that Congress amend the severe penalties of up to $10,000 or $20,000 per day which we believe to be excessive.

In addition, there are a number of issues arising from previous legislation that the Committee has not yet had the chance to address and resolve as needed. We ask that the

Committee take advantage of any opportunity to ease regulatory burdens from the Dodd-Frank Act to also attend to the following matters of high importance for credit unions:

- Risk-Based Capital: We ask that Congress amend current law to make all credit unions subject to risk-based capital standards, and direct the National Credit Union Administration (NCUA) to consider risk standards comparable to those of FDIC-insured institutions when drafting risk-based requirements for credit unions. Credit unions need this flexibility to determine their own risk and ability to lend. NAFCU supports amending the Federal Credit Union Act (FCUA) to permit the inclusion of certain uninsured capital instruments in a credit union's net worth. NAFCU strongly believes in the mutual model for credit unions and believes that all capital, including alternative capital, should come from membership, or in very limited circumstances, the NCUA. This change will enable credit unions to keep their mutuality, yet better manage their net worth levels under varying economic conditions.

- Member Business Loans: Credit unions have a 12.25% asset cap on their business lending, with loans of $50,000 or less exempt from this cap. Passed in 1998, this arbitrary threshold is severely outdated, and has not increased with inflation and economic fluctuations. We believe that this asset cap should be raised to at least 27.5%. At the very least, we ask that this *de minimis* exclusion be increased to exempt loans under $100,000, to allow credit unions to continue to lend to small business owners in dire need of credit during this difficult economic time.

- E-SIGN Act Requirements: Passed in 2000, the E-SIGN Act requires financial institutions to receive consumer consent *electronically* before e-statements can be selected. Credit unions cannot accept their members' consent to receive e-statements over the phone or in person, but must instead send them back to their computers to confirm electronically, inevitably dissuading them from doing so

along the way. This outdated provision is a burden for financial institutions and a nuisance for consumers, and should be stricken.

- SAFE Act Definition of "Loan Originator": The S.A.F.E. Mortgage Licensing Act of 2008 required financial institutions to register any "loan originator." While the intent was to record commissioned originators that perform underwriting, regulators have interpreted the definition very broadly to include any employee accepting a loan application, and even call center staff. NAFCU asks that Congress narrow the meaning of what it means to "take" an application and to "offer" or "negotiate" terms, which would help prevent credit unions from going through a burdensome process to unnecessarily register individuals not involved in underwriting loans.

- Community Charter Conversions: In cases where a common-bond federal credit union (such as an employee group) wishes to convert to a community credit union charter, there may be groups within the credit union's existing membership located outside of the new charter's geographic boundaries that wish to remain members of the credit union. Most recently, this resulted in a federal credit union serving the military overseas having to divest itself of the overseas bases that it served, a result not desired by either the credit union or the Department of Defense. NAFCU asks that Congress amend the FCUA to give NCUA the power to determine whether an existing member group can continue to remain within the credit union's field of membership once it is outside of the new community. This is of particular concern to Gerber FCU, for while we serve Gerber employees and others in West Michigan, we also serve Gerber plant employees in Fort Smith, Arkansas. If we were ever to become a community-charter in Michigan, we would be forced to cut services to those Gerber employees in Arkansas.

- Credit Union Governance: the FCUA currently requires a two thirds vote to expel a member who is disruptive to the operations of the credit union, at a special meeting at which the member in question himself has the right to vote. NAFCU

does not believe that this is in line with good governance practices, and asks that the FCUA be amended to provide federal credit union boards flexibility to expel members based on just cause (such as harassment or safety concerns).

- SEC Broker-Dealer Exemption: while the Gramm-Leach-Bliley Act allows for an exemption for banks from broker-dealer and investment adviser registration requirements with the SEC, no similar exception for credit unions is included, even though federal credit unions are permitted to engage in securities-related activities under the FCUA as regulated by NCUA. We ask that credit unions be treated similar to banks under these securities laws. This would ensure they are not dissuaded from providing services that consumers demand, thereby putting their members at a disadvantage.

Conclusion

In conclusion, the ink is barely dry and credit unions are already being negatively affected by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* [P.L. 111-203]. Congress must act to stop the Federal Reserve from moving forward with proposed debit interchange regulations. This is an issue of fairness and each stakeholder, including the consumer, deserves to have the debit interchange system studied by Congress before additional action takes place.

With respect to the Consumer Financial Protection Bureau, credit unions remain at a loss as to why they have been placed under a new regulatory regime to begin with. That being said, however, credit unions and their members welcome having an ongoing dialogue with Congress on possible changes as the new agency becomes functional.

Finally, NAFCU urges Congress to enact a series of additional "fixes" to the *Dodd-Frank* legislation to help relieve the new regulatory burdens on credit unions.

I thank you for the opportunity to appear before you today on behalf of NAFCU and would welcome any questions that you may have.

Appendix A

NAFCU comment letter to the Federal Reserve on proposed debit interchange rule [2/22/2011].

NAFCU | National Association of Federal Credit Unions
3138 10th Street North
Arlington, VA 22201 2149

NAFCU | Your Direct Connection to Education, Advocacy & Advancement

February 22, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551

RE: Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the nation's federal credit unions, I am writing to express NAFCU's concerns with the Board of Governors of the Federal Reserve System's ("Board") proposed rule on debit card interchange fees. NAFCU is deeply concerned about the impact the proposed price caps will have on the entire financial services industry, including debit card issuers with less than $10 billion in assets. The proposed rule makes plain that the supposed small issuer exemption is illusory and will do little, if anything, to protect smaller issuers in the long term.

NAFCU strongly opposes the proposed rule and recommends the Board reconsider its determination to implement price caps for debit card interchange fees. Our concerns with the price caps, the fraud adjustment and the network exclusivity and routing provisions are explained in detail below. Additionally, nothing in the proposed rule indicates that the Board met its obligations under the Electronic Fund Transfer Act ("EFTA") to consult with other federal financial regulators, or to consider the impact of Board regulations on financial institutions, consumers and others who use debit cards.[1] Finally, the proposal completely ignores the small issuer exemption for institutions with less than $10 billion in assets.

I. Debit Interchange Fee Caps

NAFCU does not believe the Board has met its statutory obligation to establish reasonable standards for determining whether an interchange fee is "reasonable and proportional" as required by § 1075[2] of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] The Board's two proposed caps would greatly harm credit unions and significantly hamper their ability to provide low-cost alternative financial services. Accordingly, we do not support either of the two proposed alternative price caps.

Should the Board decide to finalize a rule with one of the two proposed alternative price caps for debit interchange, NAFCU would select the higher cap of twelve cents per transaction.

[1] 15 U.S.C. § 1693b(a)(1)-(2) (2010).
[2] Codified as § 920 of the Electronic Funds Transfer Act.
[3] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

While the twelve cent cap is the less harmful of the two alternatives, in the strongest terms possible, we do not believe either the seven cent option or the twelve cent option are appropriate.

A. The two Price Cap Alternatives

The higher twelve cent alternative is preferable for two primary reasons. First, the flat twelve cent cap would be much easier to administer for issuers, the networks and the Board than the more complex alternative permitting an interchange fee between seven and twelve cents based on the issuer's costs. More importantly, the twelve cent fee would better - though still not accurately - reflect some of the actual costs of operating a debit card system.

The twelve cent cap, although it is undesirable and unreasonably low, better reflects the actual costs of debit card issuers. The statute prohibits certain costs from consideration and the Board chose not to consider other costs that were within its discretion to include. Specifically, § 920 directs the Board to consider the incremental costs involved in authorizing, clearing and settling a particular debit transaction, but directs the Board not to consider other costs, "which are not specific to a particular electronic debit transaction...."[4] These two buckets, however, do not represent the entire universe of costs associated with operating a debit card portfolio. The Board, considered and ultimately rejected including other allowable costs that, in its view, would be permitted under § 920(a).[5] Given that the statute prohibits consideration of some costs and the Board chose not to consider other costs that were permissible, the proposed interchange fees are, unquestionably, based on a relatively small percentage of the total costs required to operate a debit card portfolio. Consequently, the higher of the two alternative fees is clearly the more reasonable approach.

B. Neither of the two Proposed Interchange Transaction Fees are Appropriate.

Neither the seven cent fee, nor the 12 cent fee is appropriate, and neither fairly compensates issuers for the costs involved in processing debit card transactions. First, the Board should not have proposed a rule implementing price caps. Second, even if imposing a price cap is a reasonable interpretation of the statute, the Board's proposed fee is unreasonably low. Third, even the higher of the two proposed fees is so low that it raises constitutional issues under the Takings Clause of the Fifth Amendment.

1. The Statute Does Not Require the Board to Implement Price Caps.

Congress did not direct the Board to impose price caps for debit card interchange fees. The interchange amendment only requires the Board "to establish standards for assessing whether the amount of any interchange transaction fee...is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[6] Nowhere does the statute require the Board to impose price caps. Indeed, requiring the Board only to establish standards for assessing

[4] § 920(a)(4)(B).
[5] Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722, 81,734-35 (proposed Dec. 28, 2010) (to be codified at 12 C.F.R. pt. 235).
[6] § 920(a)(3)(A).

interchange fees is distinctly different than directing the Board to impose hard price caps. Imposing hard price caps to meet the statutory requirement of establishing standards is not only unreasonable but also beyond the Board's authority.

The Board's proposal here is inconsistent with previous rules that interpret very similar terms. In 2009, Congress passed the Credit Card Accountability Responsibility and Disclosure Act (the "CARD Act")[7], directing the Board to "establish standards for assessing whether the amount of any" credit card penalty fee "is reasonable and proportional to the omission or violation to which the fee or charge relates."[8] The Board responded by implementing a safe harbor as required by the statute, but also created a flexible standard, authorizing credit card issuers to charge a higher fee based on the costs associated with the violation.[9] The CARD Act and § 920 of the EFTA employ virtually identical wording, yet the Board's CARD Act rule provides flexibility whereas the interchange proposal would affect a strict and unreasonably low cap on the fee in question.

The distinction between what Congress required and what the Board proposed is particularly confusing given that price caps are a tool used only sparingly by the U.S. Government. The Government imposed price caps on a number of goods during World War II, culminating in the Emergency Price Control Act of 1942. That legislation was "in the interest of the national defense and security and necessary to the effective prosecution of the present war,"[10] More recently, price caps were used to combat escalating energy prices. In 2001, the Federal Energy Regulatory Commission (FERC) imposed price caps, throughout several parts of the Western United States. FERC acted in order to minimize power outages that were affecting residents living in California.[11] Further, when imposing price caps, FERC had already determined "that the market structures and rules for wholesale sales of electric energy in California were seriously flawed and that these structures and rules...have caused, and continue to have the potential to cause, unjust and unreasonable rates for short-term energy under certain conditions."[12] Importantly, the statutory scheme provided FERC considerable authority to regulate rates.[13] The two examples above and the proposed debit interchange price caps could not be more disparate.

The Emergency Price Control Act was passed in order to ensure the Government could prosecute the Second World War. The Act also granted the administration wide latitude to stabilize prices, prevent speculation, profiteering, hoarding and manipulation and to protect individuals with limited income.[14] In the much more recent context of the energy shortage,

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[7] Pub. L. No. 11-24, 123 Stat. 1734 (2009).
[8] 15 U.S.C. § 1665d(b).
[9] Truth in Lending, 75 Fed. Reg. 37,526, 37,526-27 (June 29, 2010) (to be codified at 12 C.F.R. pt. 226).
[10] *Yakus v. U.S.*, 321 U.S. 414, 420 (1944) (quoting the purpose of the Act).
[11] *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services*, 95 FERC ¶ 61,115 (2001 (April 26 Order).
[12] *Id.*
[13] 16 U.S.C. § 824d et seq. (the statute (1) requires public utilities to provide regular rate schedules and contracts that may affect the rates; (2) provides FERC specific authority to approve rate changes and temporarily suspend rate changes at its discretion; and (3) authorizes FERC, in examining rates, to review whether utilities are efficiently using resources).
[14] *Yakus v. U.S.*, 321 U.S. at 420 (quoting the purposes of the Act).

FERC acted only after U.S. residents had already experienced power outages, a much more significant concern than merchants being unhappy with the price paid for accepting debit cards. Further, FERC had already determined that the market was not functioning. Finally, the statutory scheme provides FERC clear authority to closely oversee rates. Utilities are required to submit proposed rate increases to FERC. The Commission then has the authority to suspend operation of the proposed rate increases subject to a hearing where the Commission determines whether the higher rates are appropriate.[15]

Debit card interchange fees are not of the same significance as the national defense or access to electricity. The Board has not determined that the market is not functioning, and the statutory scheme provides the Board considerably less authority than FERC possesses in regards to regulating utility rates and prices. Certainly, these two examples are not dispositive of the issue. Nonetheless, national defense and ensuring access to an important public utility in a malfunctioning market are prototypical examples that arguably warrant using a tool as extreme as price caps. It does not follow that capping debit interchange fees is necessary in a market involving multiple networks, thousands of issuers and millions of U.S. consumers. Price caps are a tool seldom used because economists agree that they often do not work and, instead create new, unintended consequences.[16] Had Congress wished the Board to employ this extraordinary measure, it could - and presumably would - have clearly said as much. Given that the statute does not explicitly require price caps and that there are no extenuating circumstances that might warrant employing such a powerful tool, the Board should not implement the proposed debit card interchange fee cap.

2. The Board's Cost Calculation is Unreasonably Low.

Even if it is appropriate for the Board to set hard price caps, the cap should not have been set at a level so low that it fails to cover all of the costs associated with operating a debit card portfolio. First, the Board chose not to consider several legitimate costs associated with issuing debit cards. Then, after discounting several costs from the fee structure, the Board set the rate at a level that fails to compensate issuers even for the small number of costs the Board did include in the fee structure.

The Board, somewhat inexplicably, determined to consider only a very small range of costs in proposing the two potential interchange fees. To be clear, the Board did explain that in determining to include only costs associated with authorization, clearance and settlement, it examined the similarities and differences between debit cards and checks and chose not consider "costs that a payor's bank in a check transaction would not recoup through fees from the payee's bank."[17] However, the Board's rationale for allowable costs taken together with its cost

[15] 16 U.S.C. § 824d(d), (e).
[16] Hugh Rockoff, Price Controls, The Concise Encyclopedia of Economics, *available at* http://www.econlib.org/library/Enc/PriceControls.html (stating, "Despite the frequent use of price controls...economists are generally opposed to them, except perhaps for very brief periods during emergencies. In a survey published in 1992, 76.3 percent of the economists surveyed agreed with the statement: 'A ceiling on rents reduces the quality and quantity of housing available.' A further 16.6 percent agreed with qualifications, and only 6.5 percent disagreed. The results were similar when the economists were asked about general controls.").
[17] 75 Fed. Reg. at 81,735.

measurement, do not lead to a reasonable result. In examining the similarities and differences between checks and debit card transactions, the Board made virtually no mention of the benefits that debit cards provide merchants vis-à-vis checks - such as prompt, guaranteed payment - or the considerable capital invested by the networks and issuers to ensure the debit card system functions properly. The Board failed to include network switch fees, despite the fact that issuers are required to pay a switch fee on each debit transaction.[18] The Board also chose not to include other costs such as customer service costs.[19] Tellingly, the Board acknowledges that its cost measurement does not include fixed costs that are specific to debit card transactions.[20] It simply cannot be that a reasonable interchange fee is one which, by the Board's own estimation, does not include several of the costs *absolutely necessary* to operate a debit card program.

The problem created by the decision not to consider several permissible costs is compounded by the Board's interpretation of what constitutes a "reasonable and proportional" interchange fee. The Board interpreted "reasonable and proportional" to mean "equal to" the allowed costs. This interpretation ignores a bedrock principle of statutory construction; namely that each word matters.[21] Had Congress intended for the Board to set the interchange rate at a level "equal to" the costs, it could have easily used those words. While the phrase "reasonable and proportional" is clearly ambiguous, the Board's interpretation is not a reasonable reading of the term.

The Board's determination of allowable costs and its cost measurement result in allowable costs that are far below the actual per transaction cost. Further, the Board's interpretation of "reasonable and proportional" is itself unreasonable, and ignores fundamental rules of statutory construction. It simply is not reasonable to set the fee at a level that fails to adequately reflect actual costs and then, fails again, to compensate issuers for even the limited number of costs the Board did consider.

It is with the above thoughts in mind that NAFCU recommends that the Board allow recovery through interchange of other costs. Specifically, the following costs should be included by the Board in establishing standards for determining what constitutes a "reasonable and proportional" debit interchange fee.

- Network switch fees;
- Data security controls and procedures;
- Ongoing maintenance, monitoring, review and technical upgrades of card systems;
- Hardware;
- Software;
- Personnel;

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[18] *Id.* at 81,735.
[19] *Id.*
[20] *Id.* at 81,736.
[21] *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) quoting *Duncan v. Walker*, 533 U. S. 167, 174 (2001) ("It is 'a cardinal principle of statutory construction' that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.'").

- Qualifying members for a card through ChexSystems or similar providers;
- Card issuance costs, such as producing, mailing and activating new debit cards;
- Creating a PIN number and mailing separate confirmation of the PIN;
- Bank Identification Number (BIN) management costs;
- Administrative and production activities related to processing transactions, including authorization, settlement and posting to cardholder accounts;
- Error resolution services;
- Insurance premiums;
- Insurance deductibles;
- Fraud and risk management tools; and
- Processing claims, including fraud and non-fraud disputes, chargebacks and copy retrieval requests.

To the extent that the Board determines any of the costs related to fraud should not be included in the fraud adjustment, NAFCU urges the Board to instead include those costs in the base interchange fee.

Including all or some of these costs in the debit card interchange fee will more accurately represent the actual cost incurred by issuers in processing debit card transactions. Further, most if not all of these costs arguably fall within the scope of costs which the Board, in the proposal, indicated would be permissible, but which it ultimately chose not to include.

3. The Proposed Cap is so Low that it risks violating the Takings Clause of the Fifth Amendment.

The Board's proposed price cap raises serious constitutional concerns under the Fifth Amendment's Takings Clause. The Fifth Amendment guarantees that no person will be deprived of property without due process.[22] The U.S. Supreme Court has interpreted the clause to protect private companies against price caps that do not guarantee a fair and reasonable return.[23] By the Board's own estimation the proposed debit card interchange rate of 12 cents fails to cover the allowed costs of twenty percent of covered issuers.[24] Further, the Board also acknowledged that the proposed rate fails to include all costs associated with processing debit card transactions.[25] On the face of the regulation, the more reasonable proposal still (1) fails to consider all of the costs associated with operating a debit card program; and (2) fails, even after ignoring several costs, to fairly compensate twenty percent of issuers for the cost of processing a transaction.

[22] U.S. CONST. amend. V.
[23] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (holding that government imposed rates must be sufficient to provide "enough revenue not only for operating expenses but also for the capital costs of the business.").
[24] 75 Fed. Reg. at 81,737.
[25] *Id.* at 81,734 (stating, "After considering several options for the costs that may be taken into account in setting interchange transaction fees ('allowable costs') the Board" limited such costs "to those associated with authorization, clearing and settlement of a transaction." *Id.* at 81,736. The Board also acknowledged the rate does "*not* consider costs that are common to all debit card transactions and could never be attributed to any *particular* transaction (i.e., fixed costs), even if those costs are specific to debit card transactions as a whole." *Id. at 81,737.*) (emphasis in original).

Meanwhile, the lower of the two proposed rates would fail to cover the allowable costs, much less the actual costs, for a full fifty percent of debit card issuers.

The Board's reasoning is deficient for five different reasons. First, the differences between public utilities and debit card issuers, referenced by the Board, strengthen the argument that issuers are entitled to a fair and reasonable return. Second, the fair and reasonable return rule has been applied in cases that did not involve public utilities. Third, the Board ignores its obligation to avoid creating constitutional issues. Fourth the Board ignores precedent that a company cannot be forced to carry out part of its operation at a loss. Fifth, even absent the four above issues, the ultimate result of the proposal will be increased costs to consumers and thus there will be little, if any, actual benefit.

The Board seemingly dismissed the requirement for a fair and reasonable return, distinguishing that precedent because it applies, according to the Board, only to public utilities.[26] This distinction is all the more unusual, given that the statutory langue in *Hope Natural Gas*, which the Board discusses, requires a "just and reasonable" rate[27] that is very similar to the "reasonable and proportional" fee required by § 920. Nonetheless, the Board states the similarities between § 920 and the public utility cases are limited and that, consequently, the Court's precedent in *Hope Natural Gas* is of little significance in this context. Specifically, the Board distinguished public utilities from debit card issuers because the former are required to provide services while the latter are not, and because debit card issuers presumably have sources, besides interchange fees, which can be used to earn revenue and pay for the costs of operation.[28]

The distinction between public utilities and debit card issuers, however, actually supports the argument for a constitutionally guaranteed fair and reasonable return in this context. Transmitting and selling power is "affected with a public interest" and thus subject to robust federal oversight to protect that interest.[29] Given the importance of ensuring the nation has reliable, affordable access to energy, the government has a much more significant interest in regulating the market and ensuring power can be distributed even if the returns on the investment are extremely small. The debit card system is important, but certainly not as vital as the power grid. Accordingly, there is significantly less rationale for the government imposing price caps that fail to even cover the costs of operating the system. Further, the primary parties in the energy market are the companies that produce and distribute energy and the consumers who use it. By contrast, the primary parties affected by interchange fees are card issuers and the merchants, ranging from simple and small proprietorships to large and complex multinational companies, which pay the interchange fees. Certainly, the merchants that pay for the benefit of accepting debit cards do not require the same sort of protection - in the form of government price caps - as individual citizens that wish to have reliable, affordable access to power. In conclusion, the Board's distinction between public utilities and debit card issuers strengthens the argument that debit card issuers are entitled to a fair and reasonable return on their investment.

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[26] *Id.* at 81,733, n. 44.
[27] 16 U.S.C. 824d(a).
[28] *See* n. 22.
[29] 16 U.S.C. § 824(a).

Next, the Board seems to indicate that the fair and reasonable return test is not applicable here because it has been applied only in the context of public utilities.[30] However, the test has been applied by the courts in several other contexts. Specifically, some version of the rule has been applied to railroads, insurance companies, and landlords.[31] Thus, the distinction made by the Board misses the point entirely. Regardless of whether debit card issuers are public utilities, they are still entitled to a fair and reasonable return. This seems particularly true given the similarities in the statutory language at issue here and in *Hope Natural Gas*.

Next, the Board should reconsider the interchange rate because it raises serious constitutional issues, which should be avoided if possible. This principle was articulated by the Supreme Court, when it ruled that "[w]hen the validity of an act of the Congress is drawn in question, and even if a serious doubt of constitutionality is raised, it is a cardinal principle that this Court will first ascertain whether a construction of the statute is fairly possible by which the question may be avoided."[32] The proposed rate cap does raise serious Constitutional issues as there is significant case law for the proposition that companies are constitutionally entitled to a return on their investment.[33] Further, the Board itself acknowledges that the proposed interchange fee rate does not include all costs associated with operating a debit card program and that the rate is not sufficient to cover costs for twenty percent of issuers, even when considering the relatively small number of "allowed costs."[34] Accordingly, the Board should revise its proposal to either eliminate the proposed price caps altogether or to set the interchange fee at a level that is not so low that it prohibits issuers from earning a return on their investment.

The Board, in stating that issuers may compensate for the decreased interchange revenue by charging more elsewhere ignores Supreme Court precedent to the contrary. In a case involving state rate-setting authority, the Court found that the state of North Dakota could not, "set apart a commodity or a special class of traffic and impose upon it any rate it pleases, provided only that the return for the entire intrastate business is adequate."[35] In much the same way, the Board cannot require debit card issuers to operate a debit card program at a loss simply because it is possible that issuers could make up that lost income in another line of business. Much more recently, the Sixth Circuit held the same, finding, "although the plaintiffs have other unregulated income streams, they are not required to subsidize their regulated services with income from...unregulated services."[36] It is simply not enough to say that debit card issuers may be able to recover their costs through charging other customers or by increasing revenue in other lines of business.

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[30] *See* n. 22.

[31] *B. & O.R. Co. v. United States*, 345 U.S. 146, 150 (1953) (finding "so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates...."); *New Jersey Ass'n of Health Plans v. Farmer*, 777 A.2d 385, 395 (N.J. Super. Ct. 2000) (finding a rate that does not provide a fair and reasonable return would raise serious constitutional issues.) (quoting *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 350 A.2d 1 (1975)); and *Morgan v. City of Chino*, 9 Cal. Rptr. 3d 784, 788-789 (Cal. Ct. App. 2004) (finding price controls may not "deprive investors of a fair return on their investment.").

[32] *Crowell v. Benson*, 285 U.S. 22, 62(1932) (favorably citing six other cases that stand for the same proposition).

[33] *See n. 22.*

[34] 75 Fed. Reg. at 81,737.

[35] *Northern Pacific Ry. Co. v. North Dakota*, 236 U.S. 585, 600 (1915).

[36] *Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 594 (6th Cir. 2001).

Finally, if institutions are forced to offset the losses on their debit card programs elsewhere, the most logical solution is to begin charging customers for checking accounts generally and for using debit cards specifically. Alternatively, issuers may reduce the service and overall support provided to debit card users. Proponents of debit card price caps have argued those increased costs would be offset by lower prices for consumer goods. However, the Government Accounting Office (GAO) reported that officials in Australia, which did cap interchange prices, stated there is no "conclusive evidence" that merchants' savings were passed on to consumers in the form of lower prices.[37] Consequently, the proposed rule is seemingly at odds with the intent of the Electronic Fund Transfer Act, which states its "primary objective" is the provision of individual consumer rights.[38] Instead, this rule will lead to consumers paying fees for a previously free service without any guarantee of a corresponding drop in prices.

In conclusion, the Board should reconsider its decision to implement price caps for debit card interchange fees. Price caps are not required by the statute and the Board's decision to implement price caps will create constitutional issues where none existed previously. If the Board is intent on implementing price caps, however, the fee should include all costs associated with operating debit card programs that are not explicitly prohibited by § 920. NAFCU opposes any price cap for debit card interchange fees, nonetheless, increasing the fee to more accurately reflect the true costs associated with operating a debit card program would, at the least, improve the proposed rule.

II. Fraud Adjustment

NAFCU is also concerned with the proposal as it relates to the fraud adjustment. NAFCU supports the non-prescriptive approach for the fraud adjustment. Moreover, the Board should implement a fraud adjustment when it approves its final rule on interchange fees. NAFCU understands that more research on this issue may be useful; nonetheless, it is imperative that issuers receive the fraud adjustment in tandem with any capped interchange fee.

A non-prescriptive approach is superior to a technology-specific approach. A prescriptive approach would stifle innovation in an area that *must* respond quickly and dynamically to new threats. Some basic anti-fraud technologies change little over time. Other technologies, however, are a result of a never-ending chess match pitting issuers, networks and consumers against increasingly sophisticated criminals. Many of the anti-fraud technologies in place today are a direct response to complex new criminal attempts to commit fraud. A prescriptive approach would discourage issuers, networks and third parties from developing sophisticated new technologies to combat fraud. Issuers obviously have an interest in any cost-effective anti-fraud technology; nonetheless a requirement that the Board formally approve any new technology would certainly factor into an issuer's calculus when determining whether to move forward. Moreover, third party vendors that currently develop anti-fraud programs but

[37] U.S. GOVERNMENT ACCOUNTING OFFICE, *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, But Options for Reducing Fees Pose Challenges* (2009), *available at* http://www.gao.gov/new.items/d1045.pdf.
[38] 15 U.S.C. § 1693(b).

which lack issuers' vested interest in combating fraud may reasonably determine that their resources will be put to better use developing products that do not require government approval. The Board stated that it "would identify the paradigm shifting technology(ies) that would reduce debit card fraud in a cost effective manner" and approve an adjustment for those technologies.[39] However, a prescriptive approach would undoubtedly result in significantly fewer paradigm shifting technologies. Further, the proposal seemingly ignores other technologies that may not have as dramatic an impact but that still successfully combat fraud in a cost-effective manner.

If the Board ultimately chooses a non-prescriptive approach, NAFCU recommends the framework that it implements for examining anti-fraud measures be as flexible as possible for all of the reasons discussed above. If the Board adopts a rigid approach it will have a direct, negative impact on innovation in an area that demands constant change.

The Board should permit issuers to recoup the entire cost of any anti-fraud measures, rather than simply a percentage of the costs. As the Board indicated, issuers bear the majority of the costs associated with fraud losses.[40] However, direct fraud losses are only a small portion of the overall costs associated with combating fraud. First, issuers already spend a considerable amount of money on anti-fraud technology. Issuers pay insurance premiums to minimize out of pocket expenses when fraud occurs. Issuers devote a considerable amount of time and money towards responding to instances of fraud, including employee time dealing with the customer, processing claims, chargebacks and copy retrieval requests, and card and PIN reissuance costs. At least some of these costs appear not to be included in the Board's discussion of the fraud related losses borne by issuers and merchants.[41] These costs, however, are substantial. Moreover, the networks' liberal payment policy benefits merchants who are guaranteed payment in most cases where they follow network rules. Finally, given that the proposed interchange fee cap does not cover all allowable costs, let alone fixed costs, the fraud adjustment is the most logical avenue for ensuring issuers' have the ability to cover their fraud related costs.

The Board indicated it does not plan to implement a fraud adjustment at the same time that it finalizes its interchange fee rule.[42] This planned approach is unnecessary and also contrary to the clear direction of § 920 which instructs the Board to implement standards for assessing the interchange fee and the fraud adjustment within nine months after passage of the Dodd-Frank Act.[43] Accordingly, the Board should adopt a fraud adjustment fee if or when it adopts a final regulation implementing the "reasonable and proportional" requirement.

The Board may implement a fraud adjustment fee with the information it currently has at its disposal. The interchange survey was distributed to all issuers directly affected by the rule as well as networks and merchant acquirers.[44] The information included in the survey was, presumably, sufficient to guide the Board in setting an interchange fee cap. Consequently, it seems unusual that the Board does not have enough information to set the fraud adjustment.

[39] 75 Fed. Reg. at 81,742.
[40] *Id.* at 81,741.
[41] *Id.*
[42] *Id.* at 81,740.
[43] § 920(a)(3)(A), (a)(5)(B).
[44] 75 Fed. Reg. at 81,724.

While NAFCU understands the Board's desire to properly calculate the adjustment, there is nothing in the statute that prevents the Board from implementing an interim fraud adjustment fee that it can increase or decrease upon further study.

More importantly, the Board's decision to implement an interchange fee cap and the fraud adjustment independent of each other is in clear disregard of the statutory mandate, already discussed above, that both rates be finalized by the Board within nine months after passage of the Dodd-Frank Act. Under the familiar *Chevron* analysis, courts defer to agency interpretations of a statute provided (1) the statute is ambiguous or silent to the issue and (2) the agency's interpretation is reasonable.[45] Here, the Board's interpretation would not even satisfy the first prong of *Chevron*. The intent of Congress is not ambiguous. Quite the opposite, Congress could not have been any clearer in its instruction to the Board to set both an interchange fee rate and a fraud adjustment within nine months after passage of the Dodd-Frank Act. The subsection describing the fraud adjustment immediately follows the subsection dealing with the interchange fee itself and is every bit as detailed. Assuming Congress really did intend for the Board to implement price caps based on an admittedly small universe of total costs, it stands to reason that Congress, at the very least, intended for those caps to be implemented hand-in-hand with the fraud adjustment. Indeed, Congress thought the fraud adjustment was so important that it is the sole cost explicitly referenced in the entire amendment.

The Board acknowledges the proposed interchange fee does not consider several costs associated with processing debit card transactions. The Board also acknowledges that even within the smaller universe of "allowed costs" several issuers directly impacted by the rule will be unable to recoup their own costs on each transaction. Given the low interchange fee the Board proposed, the considerable information the Board already has regarding fraud costs, and Congress' clear directive to implement the interchange fee and fraud adjustment simultaneously, the Board should adopt a fraud adjustment fee at the same time that it adopts a final rule on the base interchange fee.

III. Network Exclusivity and Routing Restrictions

NAFCU is equally concerned with the routing and network exclusivity provisions which will affect all debit card issuers regardless of size. NAFCU supports Alternative A, which would require that debit cards have the capability to route transactions over two unaffiliated networks. This option is superior to Alternative B, requiring four unaffiliated networks, because of technical concerns and the cost that would be associated with Alternative B.

Alternative B is currently not technologically feasible. Under this alternative, debit cards must have the capability to process transactions over two unaffiliated signature networks and two unaffiliated personal identification number (PIN) networks. However, debit card transactions currently cannot be processed over multiple signature networks. Further, the Board acknowledged that it may be unfeasible to develop such technology in the "near term."[46] Alternative A is feasible, though still potentially costly. Further, nothing in the statute can be

[45] *Chevron U.S.A. v. NRDC*, 467 U.S. 837, 842–843.
[46] 75 Fed. Reg. at 81,749.

interpreted to require Alternative B. It would be unreasonable for the Board to mandate technology that does not yet exist. This is particularly true when nothing in the statute can be read as requiring such a mandate.

Alternative A will be significantly less costly. Understandably, the cost to the industry is not the Board's primary concern; nonetheless, mandating four unaffiliated networks on each debit card would be extremely costly. The Board itself said,

> "enabling multiple signature debit networks on a debit card could require the replacement or reprogramming of millions of merchant terminals as well as substantial changes to software and hardware for networks, issuers, acquirers, and processors in order to build the necessary systems capability to support multiple signature debit networks for a particular debit card transaction."[47]

While closely related to the feasibility concerns mentioned above, these sorts of wholesale changes to transaction routing will be extremely expensive for all parties involved. The capital costs required by the networks to build these systems will obviously be recouped by higher fees levied on issuers and others that use the system, which brings into question whether there will be any real benefit. Moreover, issuers will have significantly higher reoccurring expenses if they are required to provide debit cards capable of routing transactions over four networks, as opposed to one or two, as is often the case today. Issuers also have legitimate business reasons for limiting transactions to one or two networks, such as simplifying the processing system and consequently minimizing costs. Requiring debit cards to carry four networks will complicate the process and also add new costs. The Board should adopt Alternative A as Alternative B is currently not feasible and by the Board's own estimation would only be feasible at some future date and only at *considerable* expense.

IV. The Board Failed to Meet its Obligations under EFTA.

The Board did not satisfy its responsibilities under EFTA because it failed to consult with other federal financial regulators as required by the Act. Specifically, the EFTA states the Board "shall" consult with other federal financial regulators to ensure the continued evolution of the electronic banking system.[48] However, absolutely nothing in the proposed rule indicates the Board consulted with other agencies. Further, nothing on the Board's website disclosing meetings and communications regarding this rulemaking indicate any consultation with other regulators.[49] It is clear the Board did not carry out its statutory obligation to meet with other regulators regarding this rulemaking.

The Board failed to fully consider the economic impact, costs and benefits to financial institutions, and it also failed to consider the effect of the rule upon competition between small

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[47] *Id.*
[48] 15 U.S.C. § 1693b(a)(1).
[49] The Federal Reserve, Regulatory Reform Communications with the Public, *available at* http://www.federalreserve.gov/newsevents/reform_interchange.htm

and large financial institutions as required by EFTA.[50] There is no indication that the Board conducted any thorough economic analysis of the costs and benefits to financial institutions and consumers, despite the rule's direct and indirect impact on every single debit card issuer in the nation as well as every debit card issuer.

Moreover, the Board refused to consider the likely impact of the rule on smaller institutions and the competitive consequences, as required by the Act. The Board's inattention to smaller institutions is particularly troubling given that both the EFTA and the interchange amendment, through the small issuer carve-out,[51] explicitly single out smaller institutions for protection. The Board refused to consider the likely consequences of the price caps on smaller institutions and failed to meet with smaller issuers on that matter. However, at the December 16 Board meeting, Federal Reserve staff acknowledged that the price caps may ultimately trickle down to all institutions, regardless of whether they qualify for the small issuer exception. The proposed rule fails to account for, much less implement the small issuer carve-out, which Congress clearly included in order to protect smaller issuers from the statute's pricing provisions.

The EFTA clearly requires the Board to consult with other regulators on rules promulgated pursuant to the Act. The EFTA specifically directs the Board to consider the impact of its rules on smaller institutions and the interchange amendment also explicitly directs the Board to take steps to protect smaller issuer from the rule's most onerous provisions. The Board, however, failed to meet any of these duties. The Board should postpone finalizing this rule until after it has carried out its statutory duty to consult other agencies and until such time that it has fully assessed the impact of the rule on small issuers.

V. Small Issuer Exemption

Finally, the Board's determination not to consider, much less implement, the small issuer exemption will create a perverse result where the small issuers that were singled out for protection under the statute will instead suffer the greatest harm. The statute intended for the Board to regulate rates only for issuers with more than $10 billion in assets. The Board's proposed interchange fee rates are, in turn, based on survey results from eighty-nine of the nation's largest debit card issuers.[52] However, as the entire financial services industry predicted, there is an increasing likelihood that the capped rates will ultimately become the industry standard. Consequently, small issuers will likely receive the lower interchange rate, even though that rate is based on results from the nation's largest issuers which, presumably, have a much lower per transaction cost.

Throughout the rulemaking process, the Board refused to consider the costs for small issuers. The Board's issuer survey was sent only to the 131 institutions that had more than $10 billion in assets.[53] No corresponding survey was conducted for issuers with less than $10 billion in assets. It is beyond question that the Board's proposed interchange rates are based solely on

[50] 15 U.S.C. § 1693b(a)(2).
[51] § 920(a)(6).
[52] 75 Fed. Reg. at 81,724-725.
[53] *Id.*

the results it gathered from institutions with more than $10 billion in assets.[54] The Board's determination to ignore the costs of smaller institutions is unreasonable in light of the fact that the Board simultaneously chose not to take steps to implement the small issuer exemption.

As discussed above, § 920 explicitly includes an exemption for small issuers with less than $10 billion in assets.[55] The intent of the exception was to ensure that small issuers would receive the same interchange rate they currently receive even if the Board's rulemaking impacted interchange rates for issuers with more than $10 billion in assets. The rule contains an exemption for small issuers from the lower interchange rates; however, there is no assurance that the exception will actually protect small issuers. That is to say, the card networks that set interchange fee rates are free, under the proposed rule, to set the interchange rate for small issuers at the same level that the Board requires for large issuers, thereby eviscerating the exception. During the debate on the Durbin amendment, NAFCU stated that the small issuer exemption was unworkable and would provide no protection. Consequently, I understand that the Board itself had no real option other than to execute a very flawed and unworkable provision. Nonetheless, that reality is of little solace to the credit unions and other small institutions that will suffer at the hands of a provision intended to protect them.

The Board's decision not to consider small issuers' costs, and the lack of any practical method for enforcing the small issuer exception create a result at clear odds with the intent § 920. On the one hand, small issuers will likely ultimately receive the lower, capped interchange rate. On the other hand, that rate will be twice as difficult for small issuers to manage because the fee is based not on their own costs but on costs of larger, more complex institutions with better economies of scale. Thus, the small issuer exception, which singled out issuers with less than $10 billion for protection will, instead, place small issuers at a significant competitive disadvantage, compared to large issuers. However rational the Board's individual decisions might appear when viewed in isolation; taken together they generate a completely irrational result.

VI. Conclusion

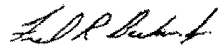
First and foremost, the Board's proposed price caps are unreasonably low, fail to consider all of the costs associated with operating a debit card program and raise serious constitutional concerns. The Board should revise its proposal and eliminate the price caps altogether in favor of a more generalized standard for assessing whether fees are reasonable and proportional. Alternatively, the Board should, at the very least, reconsider the "allowable costs" in order to ensure the interchange fee rates more accurately reflect the actual costs involved in operating a debit card program. Regarding the fraud adjustment, NAFCU supports the non-prescriptive approach as the alternative will undoubtedly stifle innovation in an area that thrives on dynamic and creative responses to an ever-changing threat. NAFCU prefers the Board's proposal to require only two unaffiliated networks on debit cards, though neither of the two options is desirable. As required by the EFTA, the Board should consult with other federal regulators, more thoroughly consider the consequences of this rule on small debit card issuers, and revise

[54] *Id.* at 81,724-726, 81,737-738
[55] § 920(a)(6).

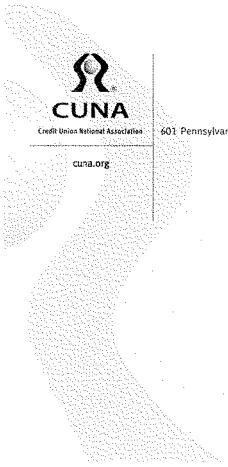
the rule as necessary. Finally, the Board should reconsider the interchange fee as well as its decision to ignore the costs of small issuers when setting the fee. The logical consequence of the Board's rulemaking is a competitive disadvantage for small issuers, a result that Congress specifically sought to avoid.

NAFCU appreciates the opportunity to share our thoughts on the proposal. Should you have any questions or require additional information please call me or Carrie Hunt, NAFCU's General Counsel and Vice President of Regulatory Affairs at (703) 842-2234.

Sincerely,



Fred R. Becker, Jr.
President/CEO



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Testimony of

O. William Cheney

President and CEO

Credit Union National Association

Before the

Subcommittee on Financial Institutions and Consumer Credit

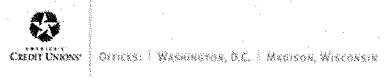
Committee on Financial Services

United States House of Representatives

Hearing on

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

March 2, 2011



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"The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses"
March 2, 2011

Madam Chairman, Ranking Member Maloney, and Members of the Subcommittee, thank you very much for the opportunity to testify at today's hearing and present the views of the credit union movement on the implementation of the Dodd-Frank Act and the regulatory burdens credit unions face. My name is Bill Cheney and I am the President and CEO of the Credit Union National Association (CUNA).[1] Prior to my current role, I served as a credit union CEO for nine years with Xerox Federal Credit Union (today known as Xceed FCU) in El Segundo, California, and as president of the California and Nevada Credit Union Leagues for four years.

Credit unions are the best way for consumers to conduct their financial services. Therefore, relieving credit unions' regulatory burden so that they are able to serve their members in a safe and sound manner is a key objective for CUNA.

As you know, credit unions are not-for-profit financial cooperatives; the only owners of a credit union are its members, who receive the benefit of ownership through reduced fees, lower interest rates on lending products, and higher dividends on savings products. Because of this

[1] CUNA is the nation's largest credit union advocacy organization, representing approximately 90 percent of the 7,600 state and federal credit unions in the United States and their 93 million members.

structure, the cost of a credit union's compliance with unnecessary and unduly burdensome regulations impacts its members directly. Every dollar that a credit union spends complying with an unnecessary or overly burdensome regulation is a dollar that is not used to benefit the credit union's membership.

Credit unions support reasonable safety and soundness rules as well as meaningful consumer protection laws. However, the fact is that credit unions are among the most highly regulated financial institutions in the United States, and their regulatory burdens continue to multiply with little or no apparent regard for the costs of each requirement or, more important, the cumulative impact on the institutions that must comply. These concerns are compounded by the range of upcoming regulations credit unions will face under the Dodd-Frank Act.

Combined with existing regulatory burdens, the increasing regulatory requirements pursuant to the Dodd-Frank Act and other government initiatives are among the major drivers of credit union consolidation. Some have called this a "crisis of creeping complexity" because it is not any one particular regulation, mandatory information collection, or required form which makes it impossible for smaller credit unions to continue to exist. Instead it is the steady accumulation of regulatory requirements over the years which eventually add up until a straw breaks the camel's back. Credit unions are concerned that these creeping regulatory burdens not only take up an increasing share of credit union employee and volunteer time—often necessitating mergers with larger credit unions—but also stifle innovation in credit union financial services.

Approximately 5,500 of America's credit unions today are small institutions with fewer than $50 million in assets. Yet in 1991, there were over 12,000 credit unions under $50 million

in assets[2], or approximately 5,000 more credit unions under $50 million in 1991 than the total number of credit unions which exist today. Many of these smaller credit unions have found it untenable to continue as stand-alone operations because of the employee time required to comply with the many regulatory requirements and dictates that have accumulated over the years.

These creeping regulatory burdens range from interchange regulation, to net worth requirements, to caps on business loans to examination requirements that are constantly changing, to limitations on certain executive compensation, to the elimination of many Regulatory Flexibility Act authorities on which many credit union rely, to new reporting requirements and other government initiatives. And those are only the relatively new regulatory burdens on credit unions!

In addition to the regulatory hurdles that have a negative effect on job growth, there are also statutory constraints that keep credit unions from doing more to help their members promote job creation and economic growth. My testimony will discuss both the statutory and regulatory hurdles credit unions now face as well as two provisions of the Dodd-Frank Act we believe that the committee should insist that the new Consumer Financial Protection Bureau (the Bureau) exercise to the fullest extent possible. This testimony also discusses statutory restrictions contributing to overall regulatory burden as well as examination issues and other regulatory concerns that credit unions have.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

As CUNA said from the time that the Administration first released its proposal to restructure the financial regulatory regime, consumers of financial products, especially

[2] Adjusted for inflation.

consumers of products and services provided by unregulated entities, need greater protections and a consumer financial protection agency could be an effective way to achieve that protection, provided the agency does not impose duplicative or unnecessary regulatory burdens on credit unions. In order for such an agency to work, consumer protection regulation must be consolidated and streamlined; it should not add to the regulatory burden of those who have been regulated and performed well, such as credit unions.

At the time of its enactment, we viewed the Dodd-Frank Act's approach to consumer protection regulation as balanced. We were under no illusions during its legislative consideration that if the Dodd-Frank Act were defeated that the result would mean the end of consumer protection regulation; our view was that whether under the previous structure or under the Dodd-Frank structure, consumer protection regulation was going to continue to exist and continue to be proposed. Now that the Dodd-Frank Act is law, and the Bureau is in the process of being established, it is critically important that Congress support the activities of the Bureau that ensure credit unions – which do not have a history of widespread consumer complaints – will not be adversely impacted by unnecessary and unduly burdensome regulation. It is equally important for Congress to review and consider repeal or significant modification to Section 1075 of the Act related to regulation of debit interchange.

Regulation of Debit Interchange

For credit unions and their members, the most chilling effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act will be the implementation of Section 1075 related to the regulation of interchange fees.[3] Section 1075 and the Federal Reserve Board's proposed

[3] *See* 15 U.S.C. § 1693o-2; Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (Dec. 28, 2010).

regulation are both flawed and will disrupt the debit interchange market that has benefited merchants, card issuers and consumers. Moreover, the impact of this disruption will be proportionately more severe for the credit union Congress sought to protect through a carve-out and the consumers that they serve. In fact, it was the inclusion of this provision that ultimately caused credit unions to oppose the Dodd-Frank Act in its entirety.

As Frank Michael, President and CEO of Allied Credit Union, testified before this Subcommittee on February 17, 2011, Section 1075 adds a new Section 920 to the Electronic Fund Transfer Act (EFTA), which requires the Board to set standards for assessing whether debit interchange transaction fees are "reasonable and proportional" to the issuers' costs associated with a debit card transaction and to issue regulations on debit card transaction routing. When considering the costs incurred by the issuer, Congress directed the Board to distinguish between the incremental costs incurred by the issuer as a result of authorization, clearance, or settlement of a particular electronic debit transaction (which the Board is permitted to consider when issuing its rule) and other costs incurred by the issuer which are not specific to a particular electronic debit transaction but which are essential to the operation of a debit card program. The Board is also permitted to make an adjustment to the interchange transaction fees for fraud prevention costs.

Unfortunately, the Board's interpretation of the statute is that Congress directed the Board to disregard many of the most significant costs associated with operating a debit card program. As a result, the Board has proposed a debit interchange rate that is well below the cost of operating a debit card program. The Board's proposed rule changes the nature of the debit interchange fee from a proportional rate based on the amount of the transaction to a hard per transaction cap that does not distinguish between the type of debit transaction (PIN or Signature)

or take into consideration the risk assumed by the card-issuing credit union or bank for accepting the transaction. To make matters worse, the Board has selectively chosen to exclude clearly permissible incremental costs associated with authorizing clearing and settling a transaction. These costs include, at minimum, network fees, adjustments for fraud prevention costs, and other relevant costs.

At its most basic level, the Board's rule tells financial institutions that seek to meet the debit card demands of their customers that if they want to do this business, they must do so under a set of government-imposed restrictions that require them to do it for less than it costs them to operate the program. Even for not-for-profit credit unions, the idea of the government requiring the operation of a program at a loss is abhorrent; it flies in the face of safety and soundness and certainly is not reasonable and proportional to credit unions' cost of providing debit card programs.

While we urge Congress generally to repeal the Section 1075 or delay its implementation, if that is not possible, we urge Congress to amend Section 1075 to direct the Board to consider all costs incurred in the operation of debit card programs by all issuers, even those which were exempt from the regulation.

This is significant to credit unions, the vast majority of which are exempt from the regulation, because simply being exempt from the language of the regulation does not guarantee that these credit unions will be unaffected by the regulation. We are deeply concerned that the carve-out may be rendered essentially meaningless by the Board's proposed rule for two specific reasons. First, the carve-out relies on the operation of a two-tier debit interchange system; however, it is uncertain whether—and for how long—the various payment networks will be willing and/or able to maintain separate pricing schemes for small and large institutions because

there is no regulatory requirement for them to do so. Second, even if the payment card networks operated a two-tiered system, with the passage of time, market forces and other factors, including the routing and exclusivity provisions which apply to all issuers, will cause convergence of prices between the two tiers. Absent enforcement by the Board of the small issuer exemption intended by Congress, these conditions will render the exemption meaningless.

It is noteworthy that our concern for the impact of Section 1075 and the Board's proposed rule is shared by several Federal financial regulators including the Chairman of the Federal Reserve Board of Governors, who said at a Senate Banking Committee hearing on February 17, 2011:

> "It is possible that because merchants will reject more expensive cards from smaller institutions or because networks will not be willing to differentiate the interchange fee for issuers of different sizes, it is possible that the exemption will not be effective in the marketplace."[4]

Federal Deposit Insurance Corporation Chairman Sheila Bair echoed Chairman Bernanke's concerns at this hearing saying:

> "The likelihood of this hurting community banks and requiring them to increase the fees they charge for accounts is much greater than any tiny benefit retail customers may get."[5]

The Chairman of the National Credit Union Administration (NCUA) has also expressed concern regarding the ineffectiveness of the small issuer exemption and has suggested that the exemption should also cover the network and exclusivity requirements. In a letter to Chairman Bernanke, Chairman Matz said:

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[4] Senate Banking Committee Hearing entitled, "Oversight of Dodd-Frank Implementation: A Progress Report by Regulators at the Half-Year Mark." February 17, 2011.
[5] Ibid.

> "In addition to exempting small issuers from the fee limits, I believe it is important that smaller issuer be exempted from requirements related to network exclusivity and routing restrictions. Such action would be consistent with the exemption from the interchange transaction fee rulemaking, which is intended to shield small institutions from the costs of the Act... The current rule's prohibitions against network exclusivity and merchant routing restrictions could significant increase both the fixed and variable costs for these small institutions, resulting in an inability to remain competitive with large card issuers."[6]

There is little doubt in the minds of credit union executives and Federal financial regulators that the proposed interchange regulation will significantly reduce the amount of debit interchange income credit unions earn, despite the exemption and Congressional pledges to the contrary. The only real question is how much.

We estimate that the reduction of credit union net income would be in the range of 20-30 percent if the Boards proposal were implemented without amendment. But for credit unions, the loss of debit interchange revenue is not just about losing money or receiving less income – it is about the impact that this reduction in revenue will have on credit union members.

Credit unions will not be able to absorb this reduction without passing costs along to their members because their safety and soundness regulator will not permit it. NCUA will expect credit unions to maintain their current net income levels and replace this lost revenue. Credit unions will have to take steps to ensure that they continue to operate in a safe and sound manner.

The implementation of this provision of the Dodd-Frank Act will absolutely hit the pocketbooks of consumers and businesses holding debit cards. As Mr. Michael testified last month, if the exemption for small issuers proved completely ineffective, the Board's proposed 12 cent fixed fee could require credit unions to impose an annual fee in the range of $35-$55 per

[6] Letter from National Credit Union Administration Chairman Debbie Matz to Federal Reserve Board of Governors Chairman Ben Bernanke. February 16, 2011. http://www.ncua.gov/news/press_releases/2011/MA11-0216MatzInterchangeRule.pdf

debit card, a fee in the range of 25-35 cents per transaction, or some combination of the two in order to maintain pre-reform revenue. These would be new fees to credit union members.

Again, these are not solely claims that credit union executives are making. The Federal financial regulators agree. Chairman Bernanke said before the Senate Banking Committee:

> "It is certainly possible that some of those costs would get passed on to consumers in some – in some way, for example, a charge for a debit card or something like that."[7]

Chairman Bair made a similar suggestion:

> "If they are forced down to the 12 cent level, that is going to – to reduce the income that they get for debit cards, so I think they're going to have to make that up somewhere, probably by raising fees that they have on transaction accounts.... That would not be helpful for consumer and that might be an unintended consequence."[8]

The consequences of allowing the Board to proceed to finalize and implement its rule under Section 1075 are potentially devastating for small financial institutions and consumers. That is why credit unions are urging Congress to: Stop. Study. Start over. We implore Congress to intervene to stop the Board's proposed rule from being finalized and implemented. Further study on this issue of the impact of debit interchange on small issuers and consumers is essential. Ultimately, the Board should be directed to issue a rule that includes meaningful enforcement authority for a two-tier system to protect small issuers, and to set standards for assessing interchange rates that take into consideration all of the operational costs associated with offer debit cards to consumers.

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[7] Senate Banking Committee Hearing. February 17, 2011.
[8] Ibid.

Additional Regulatory Burden Associated with the Dodd-Frank Act

The debit interchange price setting regulations are far from the only new regulatory burden on credit unions imposed by the Dodd-Frank Act. Examples of additional new regulatory burdens imposed on credit unions by the Dodd-Frank Act include but not limited to:

- New HMDA reporting requirements under Section 1094;
- Changes to the SAFE Act registry under Section 1100;
- New Fair Credit Reporting Act requirements under Section 1088;
- Changes to the Truth in Lending Act under Section 1100A;
- Numerous new requirements regarding real estate appraisals and mortgage disclosers, including:
  - Appraisal independence requirements under Section 1472;
  - Appraisal management company requirements and automated valuation models under Section 1473;
  - Equal Credit Opportunity Act revisions concerning appraisals under Section 1474; and
  - Revisions to Real Estate Settlement Procedures Act forms under Section 1475.

CUNA urges Congress to be very vigilant in the oversight of the implementation of these provisions. While these new or revised regulations may not change credit unions' business practices—or how they offer financial services to their members—any change in regulation will result in significant compliance costs, especially to institutions which may be too small to hire compliance specialists. The proportional cost of changes in regulation—no matter how well intentioned—is significantly higher on smaller institutions than on the big banks. We hope that Congress and the regulators are mindful of this distinction when implementing these changes.

NCUA's Executive Compensation Proposal

NCUA has recently proposed an interagency rule on executive and director incentive-based compensation—such as bonuses or commissions—as required by the Dodd-Frank Act. There is considerable misunderstanding about the nature and scope of the Dodd-Frank Act provision and the proposal. While most credit unions do not provide the kind of incentives the Act sought to address, nonetheless, credit unions are justifiably concerned about the prospect of new reporting requirements, which add one more regulatory burden on top the myriad reporting requirements already in place. This is especially true because credit union executive compensation is across the board generally much lower than that for executives at similarly-sized banks. Credit unions have another major concern that the proposal would saddle credit unions with more than $10 billion in assets with incentive-based compensation restrictions that only apply to the largest banks, those banks with more than $50 billion in assets.[9]

The Dodd-Frank Act does not require that the restrictions on big banks also apply to credit unions.[10] Credit unions have no systemic record of engaging in the risky compensation structures like those which were problematic in other areas of the financial sector. We are encouraging NCUA to harmonize the asset classes in its proposal with those of the OCC, FDIC, and Federal Reserve Board that give favorable treatment to all but the biggest banks so as to not disadvantage credit unions relative to similarly-sized FDIC-insured institutions.

Dodd-Frank Act Provisions Designed to Reduce Regulatory Burden

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[9] *See* Incentive-based Compensation Arrangements (proposed Feb. 17, 2011) ("The term 'larger covered financial institution' for the Federal banking agencies and the SEC means those covered financial institutions with total consolidated assets of $50 billion or more. For the NCUA, all credit unions with total consolidated assets of $10 billion or more are larger covered financial institutions."), *available at* http://ncua.gov/GenInfo/BoardandAction/DraftBoardActions/2011/Feb17/Item2b11-0217.pdf (last visited Feb. 24, 2011).

[10] *See* 12 U.S.C. § 5641 ("Enhanced compensation structure reporting.").

The Dodd-Frank Act included two provisions (Section 1021(b)(3) and Section 1022(b)(2)(A)(ii)) which are designed to reduce regulatory burden for financial institutions, including credit unions, and we encourage the Committee to exercise considerable oversight over the Bureau's implementation of these provisions.

Section 1021(b)(3) directs the Bureau to ensure that "outdated, unnecessary, and unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens." Section 1022(b)(2)(A)(ii) directs the Bureau in its rulemaking process to consider the impact of proposed rules on credit unions and community banks with less than $10 billion in total assets.

It is widely expected that the Bureau will engage in a comprehensive regulatory review process; quite frankly, credit unions and others expect that at the end of this process the overall regulatory burden will have increased. However, these provisions offer credit unions a modicum of hope that the Bureau will take steps to remove unnecessary, outdated and unduly burdensome regulations from the books and that it will take into consideration the impact of its rules on credit unions. Congressional oversight of how the Bureau executes these provisions is necessary in an effort to minimize burdens for credit unions.

Among the regulations we believe deserve an immediate review by the agency are:

- Regulation Z—Truth in Lending Act;
- Regulation C—Home Mortgage Disclosure Act;
- Regulation DD—Truth in Savings Act;
- Regulation E—Electronic Funds Transfer Act;
- Regulation V—Fair Credit Reporting Act;
- SAFE Act regulations; and
- Regulations under Sections 502 through 509 of the Gramm-Leach-Bliley Act.[11]

[11] 15 U.S.C. §§ 6802-6809.

Our point in seeking review is not to undermine consumer protections, which we ardently support and believe are critical. However, we believe consumers' interests will be even better served if disclosures and other regulatory requirements including those that directly affect consumers are streamlined and more readily understood.

Statutory Restrictions Contributing to Overall Regulatory Burden

Looking beyond the Dodd-Frank Act, there are a number of other statutory restrictions that impose undue regulatory burdens or limit credit unions' ability to serve members.

Credit Union Net Worth Restrictions

If there has been one lesson learned from the recent financial crisis, it is that, for financial institutions, capital is king. Financial regulators in the United States and around the globe have been looking for ways to increase capital requirements for banks and other financial institutions in order to ensure that this country never again experiences failures like those that were caused by the recent economic crisis. It is in everyone's best interests that all financial institutions—including credit unions—have access to the capital-building tools necessary to meet and sustain reasonable capital standards.

Credit unions are the only depository institutions in this country that do not have the legal authority to supplement their capital by issuing capital instruments. This despite the fact that credit unions are the only depository institutions in the United States that must meet specific capital levels set by statute—not only by regulation— or face asset restrictions and other

sanctions that limit growth. The Federal Credit Union Act requires credit unions to have 7% net worth to be considered well-capitalized and 6% net worth to be adequately capitalized.[12]

Over the last two years, as many banks have failed and depositors have sought the safety and stability of credit unions, some credit unions have had to turn away members' deposits or ask members to withdraw funds in order for the credit unions to retain their net worth ratios or increase them. Credit unions exist to serve members, not to turn them away.

We urge Congress to permit the use of supplemental capital instruments to boost credit unions' net worth and permit them to continue to serve their members fully. We ask that the Subcommittee, in conjunction with the Committee on Financial Services, give serious consideration to the need for improvements in the regulation of credit union capital and the ability to supplement capital in a manner that is consistent with safety and soundness.

Member Business Lending Cap

Since they were first established in the United States over one hundred years ago, credit unions have been providing business loans to their members. They want to lend more to their members who own small businesses, but they are restricted in the amount they can lend by a statutory cap imposed in 1998. In the last Congress, when the Administration proposed spending $30 billion of taxpayer money to encourage community banks to lend to small businesses, credit unions encouraged Congress to pass legislation to increase the credit union member business lending cap from its current level, 12.25% of total assets to 27.5% of total assets. The legislation was developed by the Treasury Department and Treasury Secretary Timothy Geithner strongly endorsed it. Also, the National Credit Union Administration Board,

[12] 12 U.S.C. § 1790d; 12 C.F.R. part 702.

the federal regulator for credit unions, supports increased authority and has testified that any risk associated with additional credit union business loans is manageable and that the cap is not needed for safety and soundness reasons.

Bipartisan legislation to increase the member business lending cap (H.R. 3380 and S. 2919) was introduced in both chambers in 111th Congress. Madam Chairman, we appreciate your having cosponsored this legislation. We estimate that if this legislation becomes law, credit unions could lend an additional $10 billion to their small business owning-members within the first year of implementation, helping to create over 100,000 new jobs. This proposal is economic stimulus that does not cost the taxpayers a dime, and would not increase the size of government. It is a commonsense proposal that Congress should swiftly enact.

Recommendations

While we have discussed a number of concerns in this testimony, these just begin to scratch the surface of regulatory hurdles and burdens that prevent credit unions from serving their members even better. As the Dodd-Frank Act is implemented, we encourage Congress to consider the following statutory changes:

- Repeal or significantly reform Section 1075 related to debit interchange regulation so that the intent of Congress that small issuers be exempt from the regulation is realized.
- Provide for regular inflationary adjustments to the various thresholds in the Dodd-Frank Act, including but not limited to the thresholds in Section 1025, 1026 and 1075.
- Require federal financial regulators and the Bureau to report to Congress annually on steps they have taken in the previous year to reduce the regulatory burden on the institutions they supervise.
- Direct the Bureau to conduct a study and present recommendations on statutory and regulatory improvements to reduce regulatory burdens on financial institutions, consistent with the requirement under the Dodd-Frank Act that the

Bureau identify and address unnecessary, outdated and unduly burdensome requirements.

Further, we encourage Congress to play a critical role in helping credit unions do even more to help boost the economy and create jobs by supporting the following recommendations beyond the scope of the Dodd-Frank Act:

- Eliminate or increase the statutory cap on credit union business lending.
- Amend the statutory capital restrictions to allow credit unions to strengthen their net worth with supplemental capital.

Conclusion

Madame Chairman, credit unions appreciate your recognition of the significant costs to our communities and the economy in general associated with the growing regulatory burden faced by credit unions and the prospect of even more regulation under the Dodd-Frank Act. While CUNA supported many of the goals of the Dodd-Frank Act, we are concerned that growing regulatory burdens will divert credit unions from serving their members. We appreciate your review of the implementation of this legislation and it implications for credit unions and their members. And, we look forward to working with you on this issue.

Thank you very much for the opportunity to testify at today's hearing. I am happy to answer any questions that the Members of the Subcommittee may have.

March 2, 2011

Testimony of

Albert C. Kelly, Jr.

On behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions and Consumer Credit

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Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, my name is Albert C. Kelly, Jr., Chairman and Chief Executive Officer, SpiritBank, Bristow, Oklahoma. I am also the chairman-elect of the American Bankers Association. 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. I appreciate the opportunity to present the views of the ABA on the impact of the Dodd-Frank Act on small financial institutions. We think these hearings are extremely important to help set the record straight on how these rules, as well-intentioned as they may have been, have the potential to drive out of business small, traditional banks that had nothing to do with creating the financial crisis or the recession.

The health of the banking industry and the economic strength of the nation's communities are closely interwoven. A bank's presence is a symbol of hope, a vote of confidence in a town's future. When a bank sets down roots, communities thrive. This connection is not new. In fact, most banks have been in their communities for decades and intend to be there for many decades to come.

SpiritBank has survived many economic ups and downs for 95 years. Our long tradition of service is not unique among banks. In fact, there are 2,735 banks – 35 percent of the banking industry – that have been in business for more than a century; 4,937 banks – 64 percent – have served their local communities for more than half a century. These numbers tell a dramatic story about the staying power of banks and their commitment to the communities they serve.

My bank's focus, and those of my fellow bankers throughout the country, is on developing and maintaining long-term relationships with customers, many of which are small businesses. We cannot be successful without such a long-term philosophy and without treating our customers fairly.

Let me give you just a glimpse of SpiritBank's close ties with our community:

- We held $847 million in small business loans within our communities at year-end 2010. Most of these loans were made prior to the regulatory obstruction to which I will testify today. We have not been able to continue to lend at this pace under the new rigors of regulation and capital requirements.
- We funded 25,960 mortgage loans for families in ten states last year, all government guaranteed, none sub-prime, for a total of $3,837,507,773.
- We contributed over $550,000 dollars last year and our 330 employees have logged thousands of hours of service to schools, charitable organizations, and civic and community organizations throughout our area – in a year in which our investors saw no return to them. We far exceeded this amount in years when the economy has been good.
- We started an Entrepreneurial Spirit Award in one of our large communities, launching 20 to 30 companies each year at an annual cost to us of $100,000 each year.

We strongly believe 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. I am deeply concerned that 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. They are the survivors of the problems, yet they are the ones that pay the price for the mess that others created.

Banks are working every day to make credit available. Those efforts, however, are made more difficult by regulatory costs and second-guessing by bank examiners. Combined with hundreds of new regulations expected from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional banks, handicapping their ability to meet the credit needs of their communities.

Managing this tsunami of regulation will be a significant challenge for a bank of any size, but for the median-sized bank with only 37 employees, it is overwhelming. Historically, the cost of

regulatory compliance as a share of operating expenses is two and a half times greater for small banks than for large banks. Moreover, it creates more pressure to hire additional compliance staff, not customer-facing staff. It means more money spent on outside lawyers to manage the risk of compliance errors and greater risk of litigation. All of these expenditures take away from resources that can be directly applied to 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, with a thousand banks or more disappearing from communities all across the nation over the next few years. These are good banks that for decades have been contributing to the economic growth and vitality of their towns, cities, and counties but whose financial condition is being undermined by excessive regulation and government micro-management. Each bank that disappears from the community makes that community poorer.

Congress must be vigilant in overseeing regulatory actions that unnecessarily restrict loans to creditworthy borrowers. Holding oversight hearings like this one, with a particular focus on the implementation of the Dodd-Frank Act, is critical to ensure that community banks are allowed to do what they do best – namely, meet the credit needs of their communities.

In my testimony today, I'd like to focus on three key themes:

- ***New rules substitute Washington bureaucratic judgment for that of local bankers***
  Increasingly, the government has inserted itself in the day-to-day business of banking. The government should not be in the business of micro-managing private industry. Traditional banks tailor products to borrowers' needs in local communities, and prescriptive rules inevitably translate into less access to credit and banking services. The most egregious example is the price-controls on interchange fees resulting from the Federal Reserve's implementation of the Durbin Amendment in the Dodd-Frank Act. Such actions will have significant unintended consequences.

- ***New laws end up punishing community banks that had nothing to do with the crisis***
  Each change in law adds another layer of complextity and cost of doing business. Dodd-Frank rules threaten to drive community banks out of lines of business altogether, particularly mortgage lending and services to municipalities. It has also stimulated an environment of uncertainty and added new risks that will inevitably translate into fewer community financial services.

- ***The consequences for consumers and the economy are severe***
  The Dodd-Frank Act will raise costs, reduce income, and limit potential growth, all of which drives capital away from banking, restricts access to credit for individuals and business, reduces financial resources that create new jobs, and retards growth in the economy.

  I will discuss each of these in detail in the remainder of my testimony.

I. Individual Rules Substitute Washington Bureaucratic Judgment for That of Bankers in Local Communities

Increasingly, the government has inserted itself in the day-to-day business of banking. Micro-managing private industry should not be the role of government. Inevitably it leads to negative unintended consequences.

The most egregious example is the price-controls for interchange fees being promulgated by the Federal Reserve under the Durbin Amendment. The result devastates retail bank profitability, stifles innovation, lowers productivity in our economy and forces a number of individuals out of the protection of the banking system.

The price-controls proposed by the Federal Reserve in the implementing rule will reduce interchange income by as much as 85 percent. Some will say that the so-called "carve-out" from the Federal Reserve's rule under Dodd-Frank for community banks (under $10 billion in assets) will protect community bank earnings. Nothing could be further from the truth. ***Having two different prices for the exact same product is not sustainable.*** The price cap proposed by the Federal Reserve is so severe that it creates enormous economic incentives for retailers to adopt strategies to favor the cards with lower interchange rates. Market share will always flow to the lowest priced product, even if those lower prices are mandated only for some. The result for small banks is either

a loss of market share, loss of revenue that supports free checking and other valuable services, or both.

Revenue from interchange in many cases does not cover the cost of providing debit card services. With the Federal Reserve's proposal, debit cards would be completely unprofitable. In fact, the proposed rule dictates that banks ***must*** lose money on every debit card transaction we process ***unless*** we charge consumers more. It makes no sense to force any provider of any service to offer products below the cost of producing them. I cannot offer financial services if I cannot cover the costs of doing so and provide a reasonable return to my shareholders.

Consumers have embraced debit cards for obvious reasons – they are fast, safe, and accepted around the world. It is consumers who will be severely affected by the government-mandated price control in the Federal Reserve's proposed rule. It will cause new consumer fees, probably including checking account fees, and likely push low-income customers out of the banking system.

Such an important change did not receive the thoughtful and thorough consideration in Congress it deserved. The process, in fact, was deeply flawed. ***It should be revisited and Congress should take immediate action to stop the proposed Federal Reserve interchange rule from being implemented.***

II. The Cumulative Burden of Hundreds of New or Revised Regulations Will Lead to a Massive Consolidation of the Banking Industry

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. The Dodd-Frank Act, in combination with intense regulatory over-reaction, has increased expenses, decreased potential revenue, and limited community bank access to capital. Added to greater uncertainty about new regulatory and legal risks, these pressures directly takes resources away from the true business of banking – making loans in local communities.

The impact of Dodd-Frank on community banks can be broken down into four categories: (1) higher operating costs to comply with scores of new rules; (2) limitations on capital; (3) restraints that may drive community banks out of lines of business; and (4) greater uncertainty and risk. As I will discuss in the next section, all of these will have severe consequences for consumers and communities that banks serve.

1. Dodd-Frank Rules Increases Costs of Doing Business

The Dodd-Frank Act will have an enormous and negative impact on all community banks. Already there are over 1,400 pages of new proposed rules and there will be many thousands more as the 200+ rules under the Act are promulgated. This is on top of the 50 new or expanded regulations affecting banks over the last two years. This flood of new regulations is so large that regulators are urging banks to add new compliance officers to handle it. SpiritBank is larger than many banks in the U.S., and I know how demanding the crush of paperwork is for my staff, along with the fact that our investment dollars this year and next must be spent on compliance with this Act rather than making new loans, products and services available. I cannot imagine the pressure that most community banks face with far fewer employees. The cumulative burden of hundreds of new or revised regulations may be a weight too great for many smaller banks to bear.

Of particular concern is the additional regulatory and compliance burden expected once the Bureau of Consumer Financial Protection (CFPB) becomes fully operational. This new bureaucracy – expected to hire over 1,200 new staff – will certainly impose new obligations on community banks – banks that had nothing to do with the financial crisis and already have a long history of serving consumers fairly in a competitive environment.

One of the claims was that small banks would be exempt from the new CFPB. ***But small banks are <u>not</u> exempt.*** All banks – ***large and small*** – will be required to comply with rules and regulations set by the CFPB, including rules that identify what the CFPB considers to be "unfair, deceptive, or abusive." Moreover, the CFPB can require community banks to submit whatever information it decides it "needs." There are also many other new regulatory burdens flowing from the Dodd-Frank Act empowerment of the CFPB which will add considerable compliance costs to every bank's bottom line.

It is true that although the CFPB will not ***regularly*** examine community banks for compliance with its rules, it can join the prudential regulator by doubling up during any such exam at the CFPB's sole discretion. It is also true that bank regulators will examine for compliance at least as aggressively as the CFPB would do independently. In fact, the FDIC has created a whole new division to implement the rules promulgated by the new CFPB, as well as its own prescriptive supervisory expectations for laws beyond FDIC's rule-making powers. Thus, the new legislation will result in new compliance burdens for community banks and a new regulator looking over their shoulders.

Dodd-Frank also adds compliance burden by unleashing a fragmented enforcement mechanism that empowers Attorneys General to invent their own interpretations of federal standards and bring actions without regard for the exam conclusions of the CFPB or the prudential regulators. This generates increased regulatory uncertainty and litigation risk that will chill innovation and raise barriers to market competition, especially for banks without an army of lawyers to navigate the enforcement minefield.

Where the CFPB should focus its energies is on ***supervision*** and ***examination*** of ***non-bank*** financial providers. Many of the problems that led to the financial crisis began outside the regulated banking industry and creation of the CFPB was largely a result of this enormous gap in the system that ultimately led to problems. ***We urge Congress to ensure that this focus on non-banks is a priority of the CFPB.***

My bank's philosophy – shared by community banks everywhere – has always been to treat our customers right and do whatever we can to make sure that they understand the terms of the loans they are taking on and their obligations to us. We will continue to do this, but now there will be many new hurdles that we will have to jump to serve our customers' most basic needs that will inevitably add cost, time, and hassle for my customers.

The bottom line is the more time bank personnel devote to parsing regulatory requirements, the less time they can devote to the financial and credit needs of bank customers. Adding such a burden on banks that had nothing to do with the financial crisis, constitutes massive overkill. In the end this cumulative burden will only impede fair competition among trusted providers seeking to serve responsible customers.

Much needs to be done to reverse the burdens Dodd-Frank threatens to impose through the CFPB. We recommend the following steps as only a beginning:

- Eliminate the expansive definition of "abusive" practices since appropriate use of existing unfair and deceptive practices authority is more than adequate;
- Prohibit Attorneys General from enforcing federal standards subject to federal supervision, or at least limit such actions to remedy only conduct occurring after the last CFPB or prudential regulator examination; and
- Prevent States and prudential regulators from augmenting or interefering with consumer protections otherwise covered by CFPB rules.

2. The Dodd-Frank Act Makes Access to New Capital Problematic

Capital is the foundation upon which all lending is built. Having sufficient capital is critical to support lending and to aborb 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.

Under Dodd-Frank, all banks that are controlled by holding companies with over $500 million in assets will be prohibited from using trust preferred securities to raise Tier 1 capital at their holding companies going forward. This will eliminate a primary source of capital (particularly for community banks) that often is downstreamed to the bank from its parent holding company. The timing could not have been worse, as banks struggle to replace capital used to absorb losses brought on by the recession. Moreover, this loss of access to 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. As I travel the country, I hear often how regulators are pressing many 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.

Ever-increasing demands for more capital puts a drag on the economy 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.***

3. Dodd-Frank Rules May Drive Community Banks Out of Lines of Business

Congress must be vigilant in its oversight of the efforts to implement the Dodd-Frank Act to ensure that rules are adopted only if they result in a benefit that clearly outweighs the burden. Already we are seeing proposals – such as those implementing the rules regarding interchange, municipal advisors, and swaps transactions – that fail that simple test. Some rules under Dodd-Frank, if done improperly, ***will literally drive banks out of lines of business.*** New rules on registration as municipal advisors and on mortgage lending are two particularly problematic provisions.

New SEC rules on municipal advisors – if done improperly – will drive community banks out of providing basic banking products to local and state 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, like SpiritBank, do not deal in bonds or securities. But community banks do offer public sector customers banking services and we 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 duplicate and costly regulation: community banks like mine may decide not to provide banking services to their local muncipalities, 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 or its implementing regulation should reach through to traditional bank products and services.

New mortgage rules – if done improperly – will drive community banks out of mortgage lending

The housing and mortgage markets have been battered in recent years and are still struggling to recover. Addressing the systemic problems which led to the crisis is critical, but care must be taken to avoid unnecessary actions that do not address systemic issues and which could further destabilize the fragile recovery. Community banks believe strongly that imposing too broad a risk retention requirement – or using risk retention as a means to achieve policy goals beyond improved underwriting – ***is likely to cause lenders to leave the marketplace and result in a constriction of credit to otherwise eligible borrowers***.

Therefore, ABA urges Congress to ensure that the regulations under Dodd-Frank are drafted and implemented in such a way as to avoid such ill effects when risk retention requirements are imposed. For example:

- ***Exemption from risk retention provisions must reflect other legislative and regulatory changes:*** 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. Importantly, Congress recognized 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. Exempting such "qualified residential mortgage" loans is important to ensure the stability and recovery of the mortgage market and also to avoid risk retention and capital requirements not necessary to address systemic issues.

  Risk retention requirements should not be considered in isolation from the many other mandates of Dodd-Frank intended to deter or eliminate these same practices. Even before enactment of Dodd-Frank, there have been dramatic changes to the regulations governing mortgages.[1] Failure to consider the joint impact of these new requirements will result in an over-regulated market that is unable to address the nation's credit needs. Such a course would

[1] For example, changes have been made under the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), and the Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act. In addition, the federal bank agencies have just announced significant changes to appraisal standards.

make it much more difficult for borrowers to obtain credit and inflict another blow on our economy. Importantly, 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.

- **A high down-payment requirement to be a "qualified residential mortgage" is counterproductive and will shackle housings' recovery:** 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 documentation and ability-to-pay requirements, will lead to an unnecessary restriction of credit.

  ABA strongly believes that creating a narrow definition of QRM is an inappropriate method for achieving the desired underwriting reforms intended by Dodd-Frank. Similarly, narrowly defining QRM to achieve goals unrelated to the intended statutory purpose is equally inappropriate.

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.***

There are other related concerns affecting housing that need to be addressed by Congress as well. In particular, Congress needs to make the "Qualified Mortgage" in Title XIV a true safe harbor and ensure that it does not unnecessarily constrict credit. Title XIV of Dodd-Frank sets out new consumer protections for mortgage loans. As defined in Title XIV, a Qualified Mortgage (QM) is one which has specific features and is underwritten in such a way that it is presumed to meet these consumer protection standards. That presumption, however, can be rebutted – subjecting the lender to significant potential liability. The Qualified Mortgage definition (as set in statute and as refined through regulation) also serves as a limitation on the Qualified Residential

Mortgage (QRM) standard discussed above because the QRM cannot be broader than the QM. As the law stands now, the Federal Reserve Board (and eventually the CFPB after the transfer of powers) can unilaterally narrow both the QM and QRM.

To avoid inadvertent and unintended impacts on safety and soundness as well as credit availability, ABA strongly urges Congress to require that any changes which could narrow the eligibility requirements for the QM be undertaken jointly with the regulators responsible for determining eligibility under the QRM.

4. 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. Let me illustrate the regulatory risk and uncertainty with four examples: (1) the unknown burden that will arise from the Bureau of Consumer Financial Protection; (2) the potential law suits that may arise on preemption; (3) the potential risk of future price controls following the precedent set by the Durbin Amendment; and (4) the potential loss of effective methods to hedge risk from rules on use of swap contracts.

The Nature and Extent of Rules from CFPB are Unknown

As discussed above, the CFPB has significant authority to create new rules for consumer lending. What will happen is unknown, but it does create potential litigation risk for actions taken now that may conflict with the ultimate rules devised. The expectation of significant new disclosures will translate into less willingness to lend (and therefore less credit extended overall), greater costs for any loans that are made, and higher costs to borrowers that still have access to credit to cover the added risks undertaken by banks.

Preemption Uncertainty and State Attorneys General Given More Power

One important example of uncertainty and unease created by Dodd-Frank is on 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 standard for federal thrifts has changed, from an "occupation of the field" test to the same "conflicts" test that has applied, and continues to apply, to national banks. This creates uncertainty, will lead to years of litigation, and places banks and savings associations at greater risk of suits over whether a patchwork of state laws apply. All banks will be affected, 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 CFPB. Moreover, in the case of state-chartered institutions, the state AGs may enforce the Dodd-Frank Act even in the absence of implementing regulations. This means that state AGs soon may be in the business of deciding what is an unfair, deceptive, or abusive act or practice for state banks.

Price Control Precedent Poses Future Risks

As discussed above, government involvement in price controls related to interchange fees will create many negative unintended consequences. But the concern about the Durbin Amendment goes far beyond the impact on my bank, my customers, and the economy. It 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.

We 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 and completely dismantle its free-market business model 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.

Banks Face Uncertainty and Higher Risk as Regulators Implement Swaps Rules

It is difficult if not impossible right now for banks to determine how the new swaps regulatory framework mandated by Dodd-Frank will affect the way banks do business. We 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.

Beyond the uncertainty of the current situation, it is critical to ensure that banks have sufficient time to consider the implications that the proposed swaps regulations will have on their ability to manage business risks. Considering the number of new rules that are needed and the way they are interconnected, doing them hastily could cause serious economic harm.

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 affects on lending or competition for U.S. banks.

III. Consequences for Banks, Consumers, and the Economy are Severe

Certainly, I want my bank to be successful, as do all of my fellow bankers throughout the country. Every day, we are facing new challenges that threaten our very existence. But for community banks, it goes beyond just our parochial interests to be successful. We are very much a part of our community. It is why every bank in this country volunteers time and resources to make their communities better. If the relentless pressures on our small banks are not relieved, the loss will be felt far beyond the impact on any bank and its employees. It will mean something significant has been lost in the community once served by that bank.

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.

Thus, 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 means 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. As the FDIC noted: "The conversion of a once-main-office to a branch is sometimes accompanied by reductions in customer services, customer service hours, and managerial authority and decision-making discretion."

SpiritBank will survive these changes. I fear that many other community banks may not. I have spoken to many bankers throughout the country who describe themselves as simply miserable. Some have already sold their banks; others plan to do so once the economic environment improves. The Dodd-Frank Act was intended to stop the problem of too-big-to-fail, yet now we have even bigger institutions; ironically, the result may be that some banks will be too-small-to-survive the onslaught of the Dodd-Frank rules.

Conclusion

An individual regulation may not seem oppressive, but the cumulative impact of all the new rules plus the revisions of existing regulations is oppressive. 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.

It is important to understand that our bank, indeed, any small business, can only bear so much. Most small banks do not have the resources to easily manage the flood of new rules. Higher costs, restrictions on sources of income, limits on new sources of capital, regulatory pressure to limit or reduce lending in certain sectors, all make it harder to meet the needs of our communities. Ultimately, it is the customers and community that suffer along with the fabric of our free market system.

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

On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
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"

March 2, 2011
Washington, D.C.

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.

Testimony of Robert Nielsen

On Behalf of the

National Association of Home Builders

Before the

House Financial Services Subcommittee on Financial Institutions and Consumer Credit

Hearing on

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

March 2, 2011

Chairman Capito, Ranking Member Maloney and members of the Subcommittee on Financial Institutions and Consumer Credit, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on the effect of Dodd-Frank on small financial institutions and small businesses. We appreciate the invitation to appear before the Subcommittee on this important issue. My name is Bob Nielsen and I am the 2011 NAHB Chairman of the Board and a home builder from Reno, Nevada.

NAHB represents over 160,000 member firms involved in home building, remodeling, multifamily construction, property management, housing finance, building product manufacturing and other aspects of residential and light commercial construction. The housing sector is an industry made up of mostly small businesses. Over 85 percent of NAHB's builder members reported building fewer than 25 home per year in both 2008 and 2009. Over 85 percent of them have less than $5 million in annual receipts, and over 95 percent have less than $15 million. In comparison, the U.S. Small Business Administration (SBA) classifies construction businesses as small if they have average annual receipts under $33.5 million.

Thus, the typical home builder easily qualifies as a small business, and these small businesses depend almost entirely upon commercial banks and thrifts for housing production credit. Indeed, small community lenders account for over 90 percent of residential land acquisition, development and residential construction (AD&C) loan originations. With no alternative sources of housing production credit for most firms in the home building industry, NAHB is extremely interested in how the rule-makings required by the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* [1] (Dodd-Frank Act) will impact the ability of small community banks and credit unions to service our industry in the coming months and years. Federal banking regulators are now entering an intense period of rule-making on key components of the Dodd-Frank law. NAHB will be examining and commenting on these critical rule-makings not only for their potential to impact the already struggling housing industry, but also for the additional uncertainty that the sheer weight of new regulation will have on the ability of small builders to obtain much-needed housing production credit. With our industry already paralyzed by overly restrictive actions by federal banking regulators and examiners that have gone well beyond the steps needed to ensure safety and soundness, any additional burdensome and unnecessary regulatory excess will be sure to have a negative impact on small home building companies and thus for the economy as a whole.

NAHB's testimony today will focus on the following areas:

1. The potential impact that ongoing Dodd-Frank rule-making will have on housing finance and the housing industry.

[1] Pub. L. 111-203, July 21, 2010.

2. The current impact of restrictive actions by banking regulators and examiners on the home building industry's access to credit.
3. Policy solutions for improving access to credit for small builders.

Impact of Dodd-Frank on Housing Finance and the Housing Industry

The Dodd-Frank Act is the most sweeping piece of financial reform legislation since the Great Depression, impacting both financial and non-financial firms. The bill calls for more than 240 rulemakings and more than 60 studies. The financial regulatory agencies are now embarking on this intense rulemaking period which has added to the already uncertain economic environment. As noted, NAHB will be examining and commenting on individual rulemakings for the impact on the home building industry and the broader housing finance system.

Of most concern to NAHB at present, are the forthcoming credit risk retention rules required by Section 941 of the Dodd-Frank Act. NAHB is concerned that the rules may result in an unduly narrow definition of the important term "Qualified Residential Mortgage" (QRM) that could forestall the recovery of the housing market by making mortgages unavailable or unnecessarily expensive for many creditworthy borrowers. This could occur, for example, if the rules required homebuyers to make large down payments. The housing market is still weak, with a significant overhang of unsold homes, and an equally large shadow inventory of distressed loans. A move to a larger down payment standard at this juncture would cause renewed stress and uncertainty for borrowers who are seeking or are on the threshold of seeking affordable, sustainable homeownership. We believe careful calibration of the QRM exemption is imperative in light of the enormous potential impact it would have on the cost and availability of mortgage credit at this precarious point in the housing cycle.

Risk retention is intended to align the interests of borrowers, lenders and investors in the long-term performance of loans. This "skin in the game" requirement, however, is not a cost-free policy option. One analyst report[2] suggests that risk retention, when combined with other contemporary accounting and capital changes already in the works, could increase the cost of mortgages funded through securitization by as much as three percentage points. Obviously, an increase in mortgage rates by even a fraction of that amount would price many eligible borrowers out of the housing market.

To address this problem, the Dodd-Frank Act was amended to include an exemption from the risk retention requirements for certain high-quality, lower-risk mortgages. The statute requires the QRM definition to be based on "underwriting and product features that historical loan performance data indicate result in a lower risk of default," and provides guidance on the types of factors to be considered:

[2] JP Morgan Securities, Securitization Outlook, December 11, 2009.

- Documentation of income and assets;
- Debt-to-income ratios and residual income standards;
- Product features that mitigate payment shock;
- Restrictions or prohibitions on non-traditional features like negative amortization, balloon payments, and prepayment penalties; and
- Mortgage insurance or other types of credit enhancement obtained at the time of origination on low down payment loans, to the extent they reduce the risk of default.

This statutory framework is important for two reasons. First, it ensures that the definition is based on objective, empirical data rather than subjective presumptions. Second, it requires a multifactor approach to establishing the parameters of the QRM in order to promote sound underwriting practices without arbitrarily restricting the availability of credit.

We are concerned that the federal banking agencies may be considering a very narrowly defined QRM standard. For example, it has been suggested that the QRM standard include a very high down payment requirement in order to limit QRM eligibility to some arbitrarily small percentage of the market.

Creating an inordinately narrow QRM exemption could cause significant disturbances in the fragile housing market. Today's credit standards are tougher than they have been in decades. As a result, credit availability is extremely tight even for very well qualified borrowers. We have strongly urged the banking regulators to consider the negative ramifications of setting further limits on the availability of credit through a comparatively narrower QRM exemption. If the agencies establish a QRM that is significantly tighter than current credit standards, it would mean that millions of creditworthy borrowers would be deemed, by regulatory action, to be higher risk borrowers. As a result, they would be eligible only for mortgages with higher interest rates and fees and without the protections required by the statutory QRM framework that limit risky loan features.

An overly restrictive QRM definition also would drive numerous current lenders from the residential mortgage market, including thousands of community banks, and enable only a few of the largest lenders to originate and securitize home loans. This sharp dilution of mortgage market competition would have a further adverse impact on mortgage credit cost and availability.

A QRM definition that is too narrow would prohibit many potential first-time homebuyers from buying a home especially if the definition includes an excessively high minimum down payment requirement. Repeat buyers and refinancers also would be adversely impacted if the QRM includes exceedingly high equity requirements. In other words, the important goal of clearing historically high foreclosure inventory – a necessary condition for a stabilized housing market –

will be undermined. We therefore urge the agencies to define the QRM's parameters in a way that facilitates a housing recovery and ensures access to conventional mortgage credit for all buyers and refinancers, including low- and moderate-income households, minority families, and first-time buyers, while preserving high quality, empirically sound underwriting and product standards.

The purpose of the QRM is to create a robust underwriting framework that provides strong incentives for responsible lending and borrowing. Loans meeting these standards will assure investors that the loans backing the securities meet strong standards proven to reduce default experience. The exemption also will keep rates and fees lower on QRMs, which will provide incentives for borrowers to document their income and choose lower risk products. In turn, the market will evolve to establish the appropriate mixture of QRM to non-QRM borrowing.

The majority of industry participants (lenders, home builders, realtors, mortgage insurers) and the sponsors of the QRM language in Dodd-Frank support a broad QRM definition that would encompass the bulk of residential mortgages that meet the lower risk standards of full documentation, reasonable debt-to-income ratios and restrictions on risky loan features. In addition, most believe that loans with lower down payments that have risk mitigating features, most notably mortgage insurance, should be included in the QRM exemption.

A narrower definition would not only deny mortgage credit to many qualified borrowers, impairing the housing market and economic recovery, but would also have a major negative impact on the Federal Housing Administration (FHA), as borrowers who do not meet the QRM criteria would move to FHA in large numbers. This would move significant risk from the private sector to the government.

NAHB recommends the broadest criteria possible should be promoted when defining the QRM exemption, without interfering with the safety and soundness requirements of the Dodd-Frank Act.

Impact of Current Regulations on Home Builder Access to Financing

Community banks are under intense regulatory pressure that has resulted in a severe lack of credit to home builders for land acquisition, development and residential construction (AD&C). Residential AD&C loans are used to purchase land; develop lots; build a project's infrastructure such as streets, curbs, sidewalks, lighting, and sewer and utility connections; and construct homes. Loans extended to builders/developers are short-term obligations lent as progress payments, i.e., portions of the loan commitment are advanced as stages of the construction project are completed. The advances, or draws, are generally made over a six-to-18 month period. While interest payments are made during the development and construction period, the principal on the loan is not repaid to the lender until the home or lot is sold. In addition to the

collateral represented by the project under construction, builders may also secure this financing through personal guarantees and/or offering other assets as collateral.

Portfolio lenders – commercial banks and thrifts – remain the predominant source of residential AD&C financing, accounting for over 90 percent of originations. There are no alternative sources of housing production credit for most firms in the home building industry, the bulk of which are small businesses building 25 or fewer homes a year. A major factor in the housing production credit crisis is overly restrictive actions by federal banking regulators and examiners that have gone well beyond the steps needed to ensure safety and soundness. These excessive regulatory restrictions have been noted by both borrowers and banks. Smaller home building companies are bearing the brunt of the credit retraction.

In this regulatory environment, we continue to hear from NAHB members that it is extremely difficult, if not impossible to obtain new AD&C loans. Builders with outstanding construction and development loans also are experiencing intense pressure as the result of requirements for significant additional equity, denials on loan extensions, and demands for immediate repayment. The credit window seems to have been slammed shut for builders all over the country. This is a major impediment to the housing recovery and an increasing threat to the ability of many home builders to survive the economic downturn.

Current AD&C Financing Conditions

NAHB's member surveys of the availability and cost of AD&C credit find that AD&C credit conditions remain a critical problem for the home building industry with little signs of easing. Our latest survey for the fourth quarter of 2010 found that the number of survey respondents reporting that they have access to credit has hit alarmingly low levels, with condition steadily worsening from the final quarter of 2007 through the middle of last year. With housing conditions almost back to normal in many parts of the country, it is disturbing that very few builders are reporting that loan availability has improved. This is true for both single family and multifamily builders:

- Fifty-four percent of those seeking single family construction loans in the fourth quarter reported that credit availability was about the same as the previous quarter. For the past three years, however, the most frequent response has been that credit availability was worsening. Only eight percent said credit conditions were improving in the fourth quarter.

- Among those seeking multifamily construction credit, 52 percent said credit conditions were about the same as in the third quarter. However, from the last quarter of 2007 through the middle of last year, the vast majority of respondents reported that loan

availability for multifamily construction worsened each quarter. In the fourth quarter, only 12 percent reported signs of improvement.

- Respondents also reported adverse treatment on outstanding AD&C loans. Ninety-two percent of builders who reported tighter terms on outstanding single family construction loans said their loans were performing prior to the lender's decision to tighten, while 94 percent of multifamily construction loans called into question also were in good standing.

Financial Institution Regulatory Obstacles to Home Builder Financing

Of concern to NAHB is that lenders often cite regulatory requirements or examiner pressure that banks shrink their AD&C loan portfolios as the reasons for their actions. While the federal bank regulators maintain that they are not encouraging institutions to stop making loans or to indiscriminately liquidate outstanding loans, reports from NAHB members and their lenders in a number of different geographies suggest that bank examiners in the field are adopting a significantly more aggressive posture.

Commercial Real Estate (CRE) Concentration Guidance

The primary regulatory guidance impacting AD&C loans is the *Interagency Guidance on Concentrations in Commercial Real Estate (CRE) Lending and Sound Risk Management Practices* (CRE Guidance) issued in December 2006, by the Federal Insurance Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC) and the Federal Reserve (Fed) (collectively referred to as "the Agencies")[3].

Though the 2006 Guidance does not define specific CRE concentration limits it specifies the criteria of CRE loans that the Agencies will watch for to indicate "potentially exposed CRE concentration risk" and specifically focuses on land development and construction loans (including 1 to 4 family residential and commercial loans). The guidance includes supervisory screens to identify institutions that are "potentially" exposed to significant CRE concentration risk that would trigger heightened risk management practices. Criteria that the Agencies look for include:

1) Total reported loans for construction, land development and other land loans representing 100 percent or more of the institution's Total Capital; and,

2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction and land development and other land loans, representing

[3] See 71 Fed. Reg. Number 238, pages 74580-74588, Dec. 12, 2006.

more than 300 percent of the institution's Total Capital where the outstanding balance of CRE loans has increased by more than 50 percent during the prior 36 months.

The 2006 Guidance stated that institutions with CRE concentrations above these levels will receive closer supervisory scrutiny and should have risk management systems commensurate with the CRE portfolio's risk characteristics, size and complexity.

While the Agencies maintain that the CRE capital criteria are not hard limits, anecdotal evidence and statements from bankers and builders indicate that the 100 percent of capital lending criteria has become a trigger or hard threshold at which banks either will not or cannot expand their AD&C lending. This is largely due to bank examiner pressure and the belief by some banks of a strict prohibition to lend in excess of this amount.

Financial institution CRE concentrations have a significant impact on the availability of residential AD&C credit since roughly 90 percent of NAHB builder members get their AD&C financing from smaller financial institutions. The highest concentrations of institutions exceeding the criteria are mid-size institutions, those between $100 million and $10 billion in assets. These institutions have the made largest share of loans to home building companies, most of which are small businesses.

The Independent Community Bankers of America (ICBA), which represents smaller banks, has stated in Congressional testimony that regulatory hindrances are impeding the ability of banks to make new CRE loans and to refinance or restructure outstanding loans.[4] ICBA's testimony includes statements that bank field examiners are placing restrictions on banks that go well beyond what is required to protect bank safety and soundness. The result of this examination pressure is that community banks are avoiding making good loans they would have made in the past and are reducing the amount they will lend in the limited cases where they can provide financing.

Collateral Valuations

Appraisers, lenders and examiners have been using liquidation values when assessing collateral on residential AD&C loans on projects that they intend to fund to completion. This practice discourages banks from maintaining funding for residential AD&C loans in good standing and results in inappropriate equity calls that can lead to foreclosure on loans on otherwise viable projects.

[4] See testimony of Stephen G. Andrews, on behalf of Independent Community Bankers of America, hearing before Committees on Financial Service and Small Business, U.S. House of Representatives, February 26, 2010.

In October 2009, the Agencies issued the *Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts* (2009 Policy Statement).[5] The objective of the 2009 Policy Statement is to encourage financial institutions to pursue workouts on troubled CRE loans, a category that includes residential AD&C loans. Their stated intent is to ensure that supervisory policies and actions do not impair the flow of credit to viable borrowers and projects. The statement says that financial institutions that implement prudent CRE workouts will not be subject to criticism for engaging in such efforts and loans should not be subject to adverse classification solely because the value of the underlying collateral has declined.

The 2009 Policy Statement includes specific instructions stating that the appraisal method should be based on the status of the loan and project:

> *"The institution should use the market value conclusion (and not the fair value) that corresponds to the workout plan and the loan commitment. For example, if the institution intends to work with the borrower to get a project to stabilized occupancy, then the institution can consider the "as stabilized" market value in its collateral assessment for credit risk grading after reviewing the reasonableness of the appraisal's assumptions and conclusions. Conversely, if the institution intends to foreclose, then the institution should use the fair value (less costs to sell) of the property in its current "as is" condition in its collateral assessment."*

Although NAHB believes the 2009 Policy Statement was a positive step in encouraging workouts as a preferred course of action and in directing examiners to make balanced assessments of institutions' workout efforts, the criteria specified for prudent loan workouts will allow institutions fairly limited ability to structure workouts for residential AD&C borrowers. Since residential AD&C loans are collateral-dependent with no internal cash flows to service principal and interest, borrowers on these loans will have to demonstrate other sources of loan repayment, provide additional collateral and/or make principal repayments in order to satisfy the criteria for prudent workouts. Many AD&C borrowers are not in a position to meet such requirements.

However, if the collateral value is based on the "as-completed" value of the project, it is less likely that additional equity or other collateral will be required, allowing the borrower to complete the project, rather than facing foreclosure. In the vast majority of cases, lenders would be better off working with their builder/developer borrowers to modify or extend loans, rather than requiring additional equity or shutting off credit.

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[5] Federal Deposit Insurance Corporation, Financial Institution Letter, FIL-61-2009, October 30, 2009.

Equity Calls on Performing Loans

Builders with outstanding construction and development loans are experiencing intense lender pressure, including calls for significant additional equity, denials on loan extensions, and demands for immediate repayment. Even builders who are current on their AD&C loan payments are facing bank demands for additional capital. These equity calls are often triggered by reappraisals of the collateral backing the loan. In many instances, the construction projects are solid projects that simply need to be built out for completion.

AD&C loans are entirely dependent on collateral (the project being financed) for repayment of principal. In other words, sale of the lot or home is required to provide funds to retire the AD&C loan. Most home building companies are small businesses and do not have the capacity to meet significant equity calls. The result is often foreclosure on a loan that had been performing. Such actions can result in a cut-off of loans on other projects a builder is undertaking and can also have severe adverse consequences for other AD&C loans in the bank's portfolio. Foreclosure on such loans is not in the best interest of the lender, builder or the community.

Performing loans that have been extended routinely in the past are now being called. Banks are increasingly refusing to modify AD&C loans or to provide builders more time to complete their projects and pay off these loans. Some lenders are abandoning the construction lending business, without regard to a builder's ongoing projects, and some institutions are auctioning off loans without negotiating with the builder. These actions have increased foreclosures on AD&C projects which in turn have hurt communities by unnecessarily increasing the inventory of unsold or partially completed homes and projects.

Lenders often cite regulatory requirements or pressure from examiners, to reduce AD&C loan exposures as the rationale for the lenders' actions. As noted, the Agencies maintain that they are not encouraging institutions to stop making loans or to indiscriminately liquidate outstanding loans. The federal banking regulators have been reminding financial institutions to adhere to the December 2006 CRE Guidance. In addition, since the economic downturn in 2008, the federal banking regulators have issued several statements encouraging banks to lend to creditworthy borrowers.[6]

While the statements of the banking regulators seem to support a flexible and pragmatic approach to examination of bank AD&C and other lending activities, NAHB has seen no evidence that the problem of extreme regulatory pressures on lenders is abating. We hear daily from builders and bankers who are complaining of excessive actions from bank examiners.

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[6] In addition to the 2009 Policy Statement, other key statements include: *Interagency Statement on Meeting the Needs of Creditworthy Borrowers,* November 2008; *and, Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers,* February 2010.

Furthermore, there are indications that the banking agencies are discussing plans to issue new tougher standards to rein in CRE lending and are considering hard limits on the amount of these holdings on bank ledgers as well as more stringent underwriting standards and increased capital requirements for CRE loans. While NAHB believes that banks should engage in sound, balanced underwriting standards when considering all types of loans, the pendulum has already swung too far on the restrictive side in the current regulatory climate.

At a time when financial institutions need to be engaged in responsible lending practices to spur job creation and economic growth, establishing overly harsh limitations on construction lending will do just the opposite by further stifling the flow of credit for housing production. With the housing market struggling to regain its footing, regulators need to be issuing more flexible guidelines that will encourage banks to maintain funding for residential AD&C loans in good standing that fall below their underlying value. Tightening the screws further could have a devastating impact on the housing market and jeopardize the budding economic recovery.

SBA Regulatory Constraints on Home Builder Credit

The policy initiatives that have been undertaken to address credit problems of small businesses, for the most part, have not addressed the financing disruptions in the home building sector, which is made up largely of small companies. The failure of these efforts to provide any relief to builders seeking financing for housing production stems from the fact that the initiatives generally utilize programs of the Small Business Administration (SBA), which prohibits borrowing for residential development and construction except for limited purposes.

As noted the home building is an industry made up of mostly small businesses that qualify as a small business under SBA's small business definition. Although there have been legislative efforts to utilize the SBA as a source of funding to small business generally they have not worked for builders. SBA has very limited programs for builders. Building under contract for an identified purchaser is eligible for SBA financing. SBA also provides builder financing through a line of credit, under the Builders' CAPLine program (13 CFR 120.391), if the builder can show that financing is available for potential buyers and that a market exists for the project. According to SBA, CAPLines for builders is currently underutilized. Potential issues that NAHB has been made aware of are lenders find it easier to lend directly because of additional SBA process requirements. An example of this is that in addition to the lender approving loan draws SBA must also approve the draws prior to dispersing the funds.

In general, however, SBA has long held the position that the business of home building is speculative. SBA's Standard Operating Procedures defines building homes for future sale as

speculative, and therefore ineligible for SBA's loan programs.[7] Consequently, small home building companies have not seen any real improvement in financing prospects as a result of recent SBA program changes.

A case in point is SBA's America's Recovery Capital (ARC) Program, established in the American Recovery and Reinvestment Act of 2009 (ARRA). The ARC program guarantees interest free, deferred payment loans of up to $35,000 from participating lenders to help existing small businesses meet their current obligations. When the ARC program was rolled out in June 2009, NAHB was hopeful that this program would help many of NAHB's members to stay afloat through these tough economic times. Unfortunately, builders have been informed by bankers and SBA field staff that their businesses are not eligible for this assistance.

More recently, builders have been shut out from the $30 billion Small Business Lending Fund (SBLF) enacted last fall. NAHB weighed-in forcefully during congressional consideration of the SBLF Act to allow construction loans to small builders to be eligible for the SBLF. While the House unanimously supported the builder provision, the Senate version, which was ultimately signed into law on September 27, 2010, did not include builder eligibility.

Economic Impact of the AD&C Credit Crunch

The credit crunch faced by home builders will exacerbate the current housing inventory problem, prolonging the downward spiral in home prices and the housing slump. Clearing out the excess inventory of unsold homes is a key factor toward stabilizing housing markets and prices. While the level of unsold homes varies significantly across markets, builders in depressed areas have slashed home production to levels well below that needed to meet longer-term demand. Lenders in these markets will not resume lending until a supply-demand balance is restored. The credit crunch is also contributing to slowing housing production in areas not impacted by excessive inventories.

The problems in the housing sector have had a significant impact on the nation's economy. The sharp decline in home building from the 2005 peak – a drop of one million units – has translated into 1.4 million lost jobs for construction workers and the loss of $70 billion in wages.

The housing plunge has also affected industries that provide materials and services to home builders. Over 560,000 jobs have been lost in the manufacturing sector due to the housing decline as makers of products such as lumber, concrete, windows, doors, plumbing, flooring and appliances have slashed their workforce in response to slumping demand. This has produced a loss of $25 billion in wages.

[7] See SBA Standard Operating Procedures, SOP 50 10 5(A) at page 110.
http://archive.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105a.pdf

Further, jobs have been lost by lenders, architects, real estate agents, lawyers, support staff and others who provide services to home builders and home buyers. There has been a loss of over 580,000 jobs and $32 billion in wages for these service providers. The total impact of the housing slump has been the loss of over 3 million jobs and $145 billion in wages in all housing-related industries.

The ongoing credit problems for home builders will further inflate these totals. Home builders cannot keep their doors open and provide jobs in their communities if they cannot get credit to build even pre-sold homes. And builders in the middle of viable projects cannot pay subcontractors and other materials and services providers if lenders will not grant routine loan extensions or if banks require payment-in-full before homes can be finished and delivered.

The credit crunch also will cause longer-term economic damage. The development process is lengthy, taking years from the acquisition of land to the completion of homes. With lenders refusing to finance lot development, the pipeline of ready-to-build-on land will drain dry. This will result in a major delay in meeting demand for new homes when consumers return to the marketplace in more significant numbers. In cases where federal permits are also required, expirations of these permits will force builders to start the approval process anew, adding at least several years to the pipeline. The effect will be most severe in markets that have not suffered the boom-bust extremes and would otherwise be poised for more rapid recovery.

NAHB estimates that over the next decade there will be a need for at least 1.7 million additional homes per year. This translates into 5 million jobs and significant economic activity. Without increased AD&C lending, this future demand will not be met, job loss will occur and job creation will suffer.

Policy Solutions for Improving Access to Credit for Small Builders

NAHB has presented banking regulators with specific instances of credit restrictions; provided data showing no difference in credit access across market conditions and requested specific changes to current regulatory guidance. To date, these efforts have not produced any tangible results. With the spigot for housing production loans cut off, and threat that the uncertainty from Dodd-Frank rule-making will further impact the ability of small community lenders to service the credit needs of our industry, it is clear that Congressional action is needed to help open the flow of credit to home builders. Without such action, there can be no housing recovery, which has major implications for our nation's ability to recover from the current economic downturn.

NAHB will soon be presenting a formal legislative blueprint to Congress outlining four key elements critical to help ensure adequate credit availability to home builders. Three of these key elements focus on fixing specific instances of regulatory excess, while the final element aims to address the ability of the Small Business Administration (SBA) to meet the credit needs of small

home builders. In the coming weeks and months, NAHB will be working with Congress to address these critical issues and seek congressional action to address each specific concern.

Allow me to highlight the key elements of NAHB's legislative proposal:

Bank Regulators Need to Follow Their Own Guidelines

Problem: As highlighted earlier, bank regulators should be required to ease or eliminate the 100% of capital bank lending limit for AD&C loans. Bank regulators including the FDIC, OCC and Federal Reserve have not adhered to their own *2006 Interagency Guidance on Concentrations in CRE Lending and Sound Risk Management Practices* which states that regulators should simply *screen* institutions that are potentially exposed to CRE concentration risk because of construction, land development and other land loans representing 100% or more of Total Capital. Rather, based on NAHB member experiences as well as statements from both bankers and builders, it appears that the 100% AD&C capital lending criteria has become a hard threshold or trigger at which banks will not or cannot expand their AD&C lending.

NAHB Legislative Proposal: Our proposal would direct bank regulators to issue regulations to cease implementing the 100% capital lending limit as a "hard" threshold.

Realistic Market Based Appraisals

Problem: Federal banking regulators should be required to issue guidance clarifying that appraisers, lenders and examiners utilize an "as-completed" value, as detailed in the financial regulators *2009 Policy Statement on Prudent Commercial Real Estate Loan Workouts*, when assessing values of loan collateral on residential AD&C projects that have reasonable prospects of reaching completion. Recently, appraisers, lenders and examiners have been using *liquidation values* in assessing collateral on residential AD&C loans on projects they intend to fund to completion. This discourages banks from maintaining funding for residential AD&C loans in good standing and often results in inappropriate equity calls that can lead to unnecessary foreclosures and a further weakness in the housing market.

NAHB Legislative Proposal: Our proposal would require bank regulators to issue regulations clarifying that the 2009 Policy Statement actually requires appraisers, lenders and examiners to utilize an "as completed" value for projects that have reasonable prospects of reaching completion, and that such valuation standards should be applied to all residential AD&C loans in lending institutions portfolios.

Performing Loans Should Not Be Called or Curtailed

Problem: Lenders should be prohibited from curtailing or calling AD&C loans where payments are current. Builders are experiencing increased lender pressure, including calls for additional

equity, denials on loan extensions and demands for immediate repayment. Lenders are often citing regulatory requirements or pressure from bank examiners to reduce AD&C loan exposures as rationale for the lenders' actions.

NAHB Legislative Proposal: Financial institutions should be encouraged to fund viable new projects and to take steps to avoid foreclosure on AD&C loans by accommodating loan modifications and workouts. Regulators should issue more flexible guidelines that will encourage banks to maintain funding for residential AD&C loans in good standing that fall below their underlying value. Our proposal would mandate that bank regulators issue regulations that explicitly direct lenders to stop calling or curtailing AD&C loans in cases where the borrower is making payments in accordance with the original loan documents. In determining collateral values, third-party appraisals utilizing "as-completed" values should be used to determine if the collateral has actually declined in value. If the collateral has declined in value based on "as completed" valuation, but the loans are performing, regulators shall, for a 24 month period, encourage lenders to work with residential construction borrowers by taking actions such as providing workout assistance and loan modifications.

SBA Programs to Assist Small Home Builders

Problem: As noted, the majority of homebuilders are small businesses. In fact, 95 percent of homebuilders have less than $15 million in annual receipts. However, most home builders do not have access to SBA loans because of the SBA's long held belief that the business of building of homes is speculative and therefore ineligible for SBA loan programs.

NAHB Legislative Proposal: Our proposal would enact legislation authorizing a new SBA program to specifically address AD&C financing needs for home building companies that meet the SBA's small business definition. Our proposal would further amend an existing SBA program (CAPlines) to remove impediments to AD&C financing as an eligible activity.

Conclusion

Thank you again for the opportunity to testify on this important issue. NAHB stands ready to work constructively with this Subcommittee, as well as the full House Financial Services Committee, to find prudent and workable solutions to both current and ongoing regulatory constraints that are impacting the ability of the home building industry to fully participate in our nation's economic recovery.

PREPARED STATEMENT OF JOHN M. SCHAIBLE
OF
ATLAS FEDERAL HOLDINGS CORP.

Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee on Financial Institutions and Consumer Credit: My name is John M. Schaible. I am the CEO, Chairman and founder of Atlas Federal Holdings. I commend the Chairman and the Members of the Finance Subcommittee for holding these hearings on the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act") on small business with an emphasis of the financial services industry covered by small institutions. I am a businessman and an entrepreneur.

In my invitation to testify, the Subcommittee has requested I consider the following: (i) an overview of provisions in Dodd-Frank affecting small business; (ii) the effectiveness of the exemption in Dodd-Frank for institutions with less than $10 billion in assets from the Consumer Financial Protection Bureau; (iii) the challenges faced by small institutions as a result of Dodd-Frank; (iv) the interaction of Dodd-Frank and current regulatory requirements and the effect this has on the ability to conduct business; (v) the link between the effects of Dodd-Frank on small institutions and the ability of small businesses to secure loans; and (vi) the effect of the current regulations on small financial institutions and the ability of small business to operate.

I have spent my career building a series of successful, innovative, forward thinking financial services companies. I founded NexTrade, one of the first electronic platforms to compete with the New York Stock Exchange and Nasdaq. NexTrade, which was ultimately acquired by Citigroup, helped democratize the stock market by empowering individual investors to compete on a level playing field with exchanges. I also founded Matchbook*fx*, the first spot foreign currency exchange platform delivered over the internet. Like NexTrade, Matchbook*fx* helped change the way foreign currencies were traded globally. Most recently, I founded Anderen Financial, a Florida state chartered bank and brokerage firm. Today, Anderen remains one of the best capitalized banks in the country.

Through theses firms, I have employed or contracted thousands of Americans and facilitated billions of dollars of economic activity. I have also become expert at building enterprises dedicated to financial services. From this level, I hope my voice will resonate with the members of this committee as I address the implications of Dodd-Frank on small financial services firms and businesses in general.

Dodd-Frank has Resulted in Regulatory Uncertainty that is Undermining the Growth and Job Creation

In 2000 I appeared before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce to discuss Competition in the New Electronic Market. In that testimony I encouraged Congress and the Securities and Exchange Commission ("SEC") to question each component of our current regulatory structure and ask this

question: "Does the additional cost of the regulation outweigh its benefit to the market and the individual investor?" I noted that rules that are beneficial should remain in effect and rules that detract from the market or impede competition should be eliminated. I believe this test is still valid and have viewed Dodd-Frank in this light. However, I have added a corollary to this test, I would add, rules or laws that create uncertainty should be eliminated.

Businesses in America need certainty and Dodd-Frank creates uncertainty. At the core of the legislation there is a philosophy inherently opposed to business development: the concept that regulations should be "flexible". To a businessman, a "flexible" regulation is merely a euphemism for "arbitrary" regulation. Dodd-Frank is massive and unclear piece of legislation that delegates a number of regulatory agencies the drafting of critical rules that should have been discussed in Congress. Dodd-Frank is a jerry-rig, piled on top of a broken and archaic regulatory structure.

In the report of the Commission on the Regulation of U.S. Capital Markets in the 21st Century (the "Capital Markets Commission"), then Treasury Secretary Henry M. Paulson stated:

> Unfortunately, the competitive position of our capital markets is under strain - from increasingly competitive international markets and from the need to modernize our legal and regulatory frameworks. Over the last two decades, markets have truly become global—corporations, accounting firms, investment banking firms, law firms, and now stock exchanges—all have internationalized. ***Yet, the U.S. regulatory structure is deeply rooted in the reforms put in place in the 1930s, a period that was closer in time to the Civil War than it is to today.***[1]

Similarly, in testimony before the Financial Crisis Inquiry Commission, Mr. Paulson called the regulatory system that he confronted as secretary, from 2006 to 2009, "archaic and outmoded."

To make matters worse, Dodd-Frank is specifically focused on financial services, the capital formation engine of the country. The uncertainty created by the Act is potentially toxic to any financial services start-up, in that it affects the ability of small and early stage companies to secure necessary capital. As the unemployment rate hovers near ten percent (10%), any legislation or regulation that impedes the ability of small and early stage companies to secure capital is detrimental to America's economic recovery and the certainty required for economic growth and job creation.

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[1] *See U.S. Capital Markets in the 21st Century: Report and Recommendations*, U.S. Chamber of Commerce, Executive Summary, March 2007 (Emphasis added).

Item A: An Overview of Provisions in Dodd-Frank Affecting Small Business

Dodd-Frank is Toxic to Financial Services and Small Business

Small businesses are critical to the financial well being of the U.S. According to the Small Business Administration ("SBA"), small businesses:

- represent 99.7 percent of all employer firms;
- employ just over half of all private sector employees;
- pay 44 percent of total U.S. private payroll; and
- have generated 64 percent of net new jobs over the past 15 years.

Small businesses in the financial services industry are critically important because they frequently act as the funding source or intermediary to the funding source for small businesses. Within financial services, relatively young start-up ventures can quickly grow to preeminence and become critical to the structure of capital formation. For example, the company that merged with, and arguably saved the New York Stock Exchange, Archipelago, was founded in 1997.[2] Hence, a direct link can be drawn between the impact of Dodd-Frank to the health of all small business.

A proper legislative act should afford all parties subject to the law, clarity with respect to the individual provisions of the law. Unfortunately, most of the provisions of the Act have delegated the burden of crafting rules and regulations to regulatory agencies that are either overburdened or that have little experience whatsoever in balancing the public good against the authority of big government.

Shortly after passage of Dodd-Frank, Davis Polk & Wardwell ("Davis Polk") issued a summary of the legislation. A relevant portion of the summary notes:

> ***The Act marks the greatest legislative change to financial supervision since the 1930's.*** This legislation will affect every financial institution that operates in this country, many that operate from outside this country and will also have a significant effect on commercial companies.... U.S. financial regulators will enter an intense period of rulemaking over the next 16-18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty. ***The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted,*** and even then, many

[2] *See* MarketsWiki - http://www.marketswiki.com/mwiki/Archipelago_Holdings.

> questions are likely to persist that will require consultation with the staffs of the various agencies involved.[3]

Davis Polk counts two hundred forty-three (243) explicit rulemakings that are still required, which they cite as a significant underestimate because that number does not include rules to be issued jointly by several agencies and non-explicit rules deemed necessary by the various Agencies are not included. Further, Davis Polk cites sixty-seven (67) studies that are required to be conducted, largely in advance of the promulgation of these rules.[4]

At the highest level the businesses subject to the Act, the legal community and the regulatory agencies charged with implementing the Act, do not understand the full scope of Dodd-Frank. The full scope and impact of the Act will not be fully understood for some time, possibly years. As such, the uncertainty created by from Dodd-Frank severely impairs investment in new financial services companies.

Many members of Congress have started their own business. Anyone that has been through the process of raising capital for a new enterprise can attest to the difficulty of the process. The fundamental risk that cannot be eliminated is whether the business model for which one is raising capital is correct. Investors expect both the risk and the opportunity in assessing whether or not the company seeking capital is right in their model, however, any additional risk beyond that fundamental one is certain to preclude investment.

A company seeking to raise capital that is unable to clearly articulate to its potential investors the rules that regulate its business activities will never raise capital. No prudent investor, no investor with fiduciary obligations, and no investor in his right mind would invest in a business where the rules are uncertain because the activities that are part of a profit plan can be affected at the sole discretion of government agencies charged with legislative authority. Prudent investors are reluctant to put their money to work in capital investments due to the uncertainty created by Dodd-Frank Nor should it surprise anyone that when Congress should have focused on a comprehensive rewrite of archaic financial services laws, the House and the Senate instead delegated this responsibility to craft rules to several agencies, that financial services firms are troubled by the uncertainty created.

To the extent the financial services industry can evaluate the specific provisions of Dodd-Frank, there are several provisions that are certain to negatively affect small business:

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[3] *See* Davis Polk & Wardwell LLP , Summary of Dodd-Frank Wall Street Reform and Consumer Protection Act. July 21, 2010 (emphasis added).
[4] *Id.*

Title I of the Act Grants the Federal Reserve Unprecedented Powers and Undermines Financial Services Business Viability

The Act establishes a subjective $50 billion threshold for a Bank Holding Company ("BHC") to be subject to the authority of the Federal Reserve System's (the "Fed") enhanced reporting and increasingly stringent prudential standards. In addition to the powers currently possessed by the Fed, the Act grants the Fed expansive new powers, including the authority to subject any Non Bank Financing Company ("NBFC") to Fed authority based on the *perceived* risk the company poses to financial stability.

It would be a mistake for investors and financial services firms to believe the legislative history will serve to protect firms from being subject to the Act. If the Act is interpreted broadly based on in its plain language, the courts may very well find that Congress meant to give the agencies that are covered by the Act, broad authority. No amount of legislative history to the contrary will undermine the authority of the agencies in the absence of plan language in the Act that such powers were meant to be limited.

The legislative history will be little comfort for investors in financial services firms.[5] While the legislative history appears to support the position that the Act was meant to limit the number of companies under supervision of the Federal Reserve, potential investors in financial services companies must consider two distinct scenarios: one, the company in which they consider investing is placed directly under the Fed's supervision or, two, that the company in which the investor is contemplating an investment is likely to become a customer or client (clearing, settlement, custody, leverage, stock loan) of a firm placed under Fed supervision.

An examination of the "anti-evasion" provision of Dodd-Frank demonstrates the unprecedented authority granted to the Fed. If the council determines that a company that is not even a NBFC or $50 Billion BHC, but that is "organized or operates in such a manner to evade" the application of Title I of the Act, and it engages in financial activities, the council can place it under the supervision of the Fed. Consequently, is not merely being a $1 billion (or $1 million for that matter) company sufficient to "evade" the application of the standards? Title I of the Act grants the Fed the power to assert authority over firms whose activities are "not predominantly financial" and to subject them to "tailored" prudential standards. Just to make sure that the Fed has nearly unlimited power, the Act grants the Fed the authority to *examine* any NBFC to see if it poses a *"threat"* to stability. However, Congress failed to define in the Act what constitutes a "threat" to stability. Instead, Congress granted the Fed the authority to define what constitutes a "threat."

Similarly, the unprecedented power of the Fed is enhanced by the authority for the Council to declare an NBFC is an "emergency threat" that is not subject to the hearing

[5] See *FINANCIAL REFORM: 2010 The Final Dodd-Frank Wall Street Reform and Consumer Protection Act A Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,* Gibson Dunn & Cruitcher LLP, July 23, 2010.

procedures set forth in the Act. The Council need only notify the NBFC "within four hours" after the fact.

Title II: The Orderly Liquidation Authority Trumps Legitimate Rights and Gives Unlawful Authority to Regulators

"It is interconnectedness more than anything.... If you fail, what else happens? Who else gets hurt? ... There will be some gray areas. At least in terms of resolution planning I would err on the side of inclusiveness."[6]

The Act also affords the Fed nearly unlimited power to initiate an Orderly Liquidation of a firm. Under Dodd-Frank Orderly Liquidation Authority ("OLA"), the powers extended to the government during an "orderly liquidation" are practically limitless. While the stated intent of Congress was that this authority would seldom, if ever be exercised, the plain language of the Act does not reflect this intent. Under Dodd-Frank, this power can be exercised in at least two distinct scenarios: one, the company into which they consider investing is placed into OLA directly; or, two, the company into which the investor is contemplating an investment is likely to become a customer or client (clearing, settlement, custody, leverage, stock loan) of a firm placed under OLA. Again, it would be a mistake to assume that legislative history of the Act regarding the intention that the exercise of OLA powers was meant to be used in very limited circumstances would be adequate comfort for investors in financial services firms.

BNY Mellon, for example, holds $24.4 trillion in assets under custody and administration. In 2010, through its Pershing clearing subsidiary BNY provided solutions to more than 1,150 institutions, BNY loaned more than $2.5 trillion in stock loan facilities, and acted as the service provider for 44% of the ETFs in the U.S. market.[7] Many start-up broker dealers and fund developers look to Pershing as a preferred provider for clearing and custody services. Investors in such start-ups now face the potential prospect of material service provider being liquidated under the OLA should the Fed determine such liquidation is required.[8] While it may appear at first blush to be inconceivable that a firm as sound as BNY could be subject to the liquidation authority of the Fed, the same could have been said for any number of firms prior to the 2008 financial crisis.

Once a company is subject to the OLA, the firm and its customers' financial activities will be subject to remarkably ambiguous and practically limitless authority. Moreover, the only defense for firms subject to the OLA is to prove in court that the decision to liquidate was "arbitrary and capricious"[9] or that the company is not, in fact, a financial firm.[10] However, proving such action was arbitrary and capricious after

[6] Sheila Bair, FDIC Chairman, Reuters Feb. 17, 2011.
[7] *See* "BNY Mellon at a Glance, Third Quarter 2010" http://www.bnymellon.com/news/factsheet.pdf
[8] *See The New Financial Deal: Understanding Dodd-Frank and its Unintended Consequences.* Video. Professor David Skeel S. Samuel Arsht Professor of Corporate Law University of Pennsylvania Law School.
[9] *Supra* Note 6
[10] *Supra* Note 8

the OLA has been asserted will have little benefit for the firm. In effect the assertion of OLA will be a death penalty for any firm once asserted by the Fed, even if the authority was found by a court to have been improperly asserted.

Once FDIC takes over the company under OLA. The assumption, apparently, is that the FDIC has efficiencies from its experience with resolutions of banks. This is not a logical extension, as the resolution of depository institutions guaranteed by the government makes them the primary creditor in fact. However, this is not the case with respect to the resolution of non-bank entities. Nonetheless, even with securities firms the FDIC still takes over with the Securities Investors Protection Corporation ("SIPC") as trustee. The process is not like a traditional bankruptcy, rather the FDIC can select creditor payments under the "preserve" stability mantra.

The FDIC can repudiate any "burdensome" contract at this point, but still demand performance of contractual obligations *despite termination rights.* Firms contracted to the firm being liquidated cannot do anything to accelerate, terminate, or obtain possession of any property for 90 days unless the FDIC says it is permissible. 90 days or 9 makes no matter to a small financial firm in limbo over the heart of its enterprise, it is a death sentence either way.

The FDIC can effectively freeze qualified financial contracts, such that if they seize a firm, and you are the counter party, you are completely at the whim of the government – unlike the Bankruptcy Code. Further, the fraudulent transfer provision is effectively a two-year claw back against transfers of property that the FDIC does not like because it may "hinder, delay, or defraud the regulators.

Title VI: Enhanced Regulation of Depository Institution Holding Company Creates Serious Liquidity Risks Across a Spectrum of Investments

The Securities Industry and Financial Markets Association ("SIFMA") recently released an in-depth report about the unintended consequences and potential risks of the implementation of the Volcker Rule. In summary, SIFMA noted:

> The risk of unintended consequences for investors and the U.S. economy is significant. Without the liquidity that dealers provide to U.S. capital markets, there could be substantial negative effects, including:
>
> - Higher funding and debt costs for U.S. companies.
> - Reduced ability of households to build wealth through participation in liquid, well-functioning securities markets.
> - Reduced access to credit for small or growing firms with less established credit ratings and histories.
> - Reduced willingness of investors to provide capital to businesses because of greater difficulties in exiting those investments.
> - Higher trading costs and consequently lower returns over time for investors, such as pension and mutual funds.

- Reduced ability for companies to transfer risks to others more willing and able to bear them via derivatives, with a consequent reduction in overall efficiency of the broad economy.

Implementation should also acknowledge the risk that financial activity may migrate to the less regulated "shadow banking" system. Furthermore, the U.S. faces strong competition from overseas capital markets. Given the importance of this activity to the competitiveness, safety, and soundness of the U.S. financial markets and the stated goal of strengthening regulation of the financial system, a rulemaking implementation that pushes these activities outside of the most highly regulated parts of the U.S. financial system would be a particularly undesirable outcome.[11]

Simply banning "proprietary trading" at banks reveals a serious deficiency in understanding of the breadth and the complexity of the issue. The action is similar to the far-reaching consequences of the Shad Johnson accord codified by the Securities Act Amendments of 1982. This myopic approach effectively banned single stock futures trading domestically for twenty years and still effectively precludes the trading of contracts for differences in the U.S., arguably the most important financial product developed since standardized options.[12]

It is incumbent upon Congress to recognize that poorly articulated regulations adopted over the last decade have driven an increasingly important portion of the financial services business out of the United States and to more competitive jurisdictions. In fact, "the rate of growth in the U.S. capital markets since 2001 has been outpaced more than two to one by competing financial centers – notably London, Singapore, and Hong Kong."[13] At this rate, members of the Congress should not be surprised that the U.S. will cease to be the leading global financial center in the next twenty to thirty years and will be replaced by China which will become in our lifetime the largest financial market.

As we have seen over the last ten years, investors will have greater access to a variety of financial products offered by firms in Brazil, Russia, India and China. I am sure that Congress did not intend this future for our children. I am sure that Congress would prefer to see America continue as the preeminent center for economic growth under a climate where investors have the required regulatory certainty that is necessary to fuel economic growth. I am confident that Congress will seek to amend the Act in a manner that will restore the necessary balance between the goal of growth and to ensure the regulators have clearly defined authority that is subject to the necessary limits to promote a fair and balanced regulatory regime. Dodd-Frank as it stands is neither fair nor balanced and looms as a dark cloud on the future of America.

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[11] *The Volcker Rule: Considerations for implementation of proprietary trading regulations,* SIFMA.
[12] According to Tabb Report for LCH Clearnet, notional values of CFDs in 2011 will exceed $1 Trillion. http://www.lchclearnet.com/images/tabb%20report_tcm6-55721.pdf.
[13] *Supra* Note 11.

Title VII: Wall Street Transparency and Accountability Provision Provides Neither Transparency nor Clarity of Accountability for End Users or Product Developers

A great deal of attention had been given to a survey that found the proposed regulations to assess more prescriptive margin requirements to various derivatives would have a significant negative impact on the level of working capital required to operate certain businesses. A requirement to fully collateralize derivative positions would negatively impact job creation, research and development, acquisitions, and business investment and expansion.

An article from Glen Shapiro of Law and Tax News cited "the imposition of a 3% margin requirement on over-the-counter ("OTC") derivatives held by non-financial end-users could cut the capital spending of major United States companies by $5.1 billion to $6.7 billion, and cost 100,000 to 130,000 jobs in the economy."[14] Mr. Schapiro continued:

> The ambiguities in Dodd-Frank and the proposed regulations could cause hundreds of American companies to take their capital and jobs somewhere else," said David Hirschmann, president and CEO of the USCC's Center for Capital Markets Competitiveness. "Beyond the impact this will have on businesses, the higher costs of using derivatives also hurts consumers by increasing price volatility."
>
> "End users of derivatives had nothing to do with the financial crisis. These regulations broadly impact the U.S. business community, imposing a potentially costly, one-size-fits-all approach on a very diverse set of economic participants," said Larry Burton, the BRT's executive director.

Marie Hollein, president of Financial Executives International ("FEI"), added that "FEI members have experienced first-hand the importance of access to OTC derivative markets to companies who need to hedge risk in order to conduct everyday business practices, such as researching and developing new products. The survey results reflect what end-users have been communicating all along - that imposing burdensome margin requirements on American businesses will reduce capital spending and equal job loss."

The Chairman of the House Financial Services Committee, Spencer Bachus, has stated that, while end users of derivatives did not cause the financial crisis, they were among its victims. "Although the Dodd-Frank Act was promoted as being directed at Wall Street, as we are coming to understand more clearly, it is the end users of derivatives who will bear so much of the regulatory brunt of this law. . . ". The Chairman has also stated that the derivatives market has evolved to provide U.S. businesses with the ability to protect themselves against legitimate business risks. Requiring companies that did not cause nor contribute to the financial crisis to be treated like banks would unnecessarily remove capital from the economy. Specifically, he has stated:

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[14] Glen Shapiro, LawAndTax-News.com, New York.

> The implementation of new derivatives rules should not occur in a vacuum, without regard for their impact on all market participants and ultimately the economy. The regulators have not only the authority, but the obligation, to ensure that changes are carried out in an orderly manner that does not disrupt market functioning, . . . If we are not careful, the result will be a patchwork of disparate rules that are both complicated to administer and needlessly increase costs on exactly those Main Street businesses that we are counting on to bring our economy back.[15]

Of fundamental concern to us should be the effect that prescriptive margins, particularly passed to end users, would restrict liquidity in the products. Lower liquidity would result in higher prices and less hedging. It is entirely conceivable that in an effort to reduce risk will actually result in more risk to the economy as a whole. Not only can we reasonably predict less hedging, but more volatile prices in hedge products in general.

To further compound the problems with Title VII, there is general ambiguity caused by the expansive definition of "swaps" that may force various products under the direct regulations of the SEC or the Commodity Futures Trading Commission ("CFTC"), or both. The SEC and the CFTC will regulate issues related to eligible counterparties, information flow, and central clearing. However, unless the SEC and the CFTC regulations mesh perfectly, which has not yet happened since the inception of both Agencies, any transaction involving a swap subject to by both agencies will be extremely costly to create, maintain, transfer or terminate.

According to a memo by Cadwalader Wickersham and Taft, LLP (the "Cadwalader Memo") the "expansive" definition of swap potentially encompasses a variety of products, including: forwards without intent to deliver; commodity options; floating rate loans; certain loan participations; and insurance contracts. The Cadwalader Memo notes, "while Congress likely did not intend the words of the Derivatives Legislation to include all insurance, ***it is not safe to assume how the courts or regulators will determine this issue as to various types of insurance.*** As a practical matter, of course, insurance companies and buyers of insurance will likely have to reach a judgment as to the scope of the definition of the term 'swap' before it is ultimately clarified."[16]

The decision to deem certain products and loans, a "swap" will prove costly for the U.S. economy. Assuming for the sake of argument that loan participation is deemed a security-based swap, the costs and potential liabilities associated with transacting with existing documentation would be major. According to Richards Kibbe & Orbbe LLP, there are at least four noteworthy consequences: first, transactions and activities in a security-based swap are now made subject to the antifraud and anti-manipulation provisions of the federal securities laws, including Section 10(b) of the U.S. Exchange Act and Rule 10b-5 promulgated thereunder, as well as the related new provisions added

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[15] *Id.*

[16] *See Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Cadwalader Wickersham and Taft, LLP, July 20, 2010 (emphasis added).

by Dodd-Frank, including the new Section 9(j) of the U.S. Exchange Act, and the rules to be promulgated by the SEC thereunder.[17]

If a participation is subject to these provisions, counterparties would be prohibited from entering into, elevating, transferring or terminating the participation, or possibly administering the participation at all, while in possession of material non-public information without first disclosing such information to the counterparty or confirming that the counterparty has access to the same information. Since certain loan markets are largely "private" markets, with very little public information about borrowers or their loan agreements, it is difficult to conceive, at this time, how parties could transact in loans based on public information only, except in the rare case where adequate information is publicly available. If parties are compelled to trade participations "on the public side" due to the threat of antifraud liabilities under Dodd-Frank, then this change could impact a borrower's ability to raise capital in the loan market, its disclosure obligations in the capital markets and the liabilities of its loan arrangers in the syndication process.

Second, Dodd-Frank requires certain players in the security-based swap markets to be registered with and regulated by the SEC as security-based swap dealers and major security-based swap participants - without the benefit of a robust exemption for foreign entities as currently exists under Rule 15a-6 under the U.S. Exchange Act for foreign broker-dealers. In addition, Dodd-Frank mandates central clearing and exchange trading in respect of some security-based swaps, and imposes capital, margin, reporting, record keeping, position limits and business conduct requirements in respect of all security-based swaps (depending on the types of market participants). It is entirely unclear how these rules might be applied to certain participations, or whether the rules are even capable of being so applied.

Third, the "sale" of a security-based swap, which includes entering into, terminating, amending or transferring the security-based swap, will be subject to the registration requirements of Section 5 of the U.S. Securities Act, unless both counterparties are "eligible contract participants" as defined in the U.S. Commodity Exchange Act. For purposes of an international participation, this likely means that a party could not enter into, elevate, transfer or terminate certain international participations unless both it and its counterparty were "eligible contract participants." At the very least, grantors of certain international participations will need to ensure that their counterparties are "eligible contract participants" and obtain a contractual representation to that effect.

Fourth, transactions and positions in security-based swaps will be subject to the same regulations applicable to securities under the U.S. Securities Exchange Act, such as margin, capital and books and records requirements applicable to registered broker-dealers. Some of these requirements may overlap or even conflict with the requirements (described above) to be adopted by the SEC by rulemaking prior to the effectiveness of

[17] *Dodd-Frank Crosses the Pond: Unintended Consequences for LMA-Style Loan Participations?* Richards Kibbe & Orbbe LLP Memorandum, November 12, 2010.

Dodd-Frank.[18]

The SEC, on the other hand, released on February 2, 2011 its 464 page proposed rules to provide clarity to Dodd-Frank. Comments on these draft rules are due April 4, 2011.[19] I commend the SEC and the CFTC for working diligently to craft rules that must somehow interact. However, as these rules are meted out, industry participants are left in limbo and capital formation for any nascent swap dealers is utterly frozen.

Moreover, for each specific new rule, industry participants must brace for future unintended consequences and the possible unintended impact on capital formation. As an example, in his comments to the SEC's proposed rules, Patrick Durkin, Managing Director of Barclays notes: "[r]egarding single-name [credit default swaps ("CDS")], one possible adverse outcome is higher funding costs for corporations. As the SEC is aware, a corporate entity's CDS spread is highly correlated to its cost of accessing the capital markets. This is because an important and primary purpose of single-name CDS is to allow banks to hedge credit risk and lower exposure to its banking clients."[20]

Title X: The Consumer Finance Protection Bureau

As described in detail below, the reach of the Consumer Finance Protection Bureau ("CFPB") does not seem limited in any material way for any firm engaged in finance. In addition, as Congress has seen fit to delegate to the regulatory agencies the drafting of future rules, any entrepreneur considering entering the field of finance is left with a high degree of uncertainty with respect to the costs of complying with rules yet to be adopted. In turn, the process of gathering capital to fuel the engine of capital formation itself has been rendered essentially impossible.

The creation of the CFPB is a remarkable delegation of authority by Congress to a poorly defined agency. The unfortunate consequence of this decision, however, is real economic damage. Further, the formation of the CFPB as part of Dodd-Frank, reveals a deep misunderstanding of one of the primary causes of the financial crisis - government intervention. The financial crisis of 2008 – 2009 can be directly linked to the actions of two entities - the Fed and the government sponsored enterprises (the "GSEs").

For nearly a decade the Fed provided too much leverage under an explicit government guarantee and acted as a central point of failure. In addition, the Fed kept interest rates too low for too long fuelling the housing market and the growth of the role of the GSEs. As the role of the GSEs grew to dangerous levels, some members of Congress attempted to rein in the GSEs. However, those efforts were disregarded as Congress sought to promote home ownership. Accordingly, the GSEs fostered a risk to reward ratio for sub prime loans that was unsustainable and incredibly large to an extent only possibly through an implicit government guarantee.

Similarly, the SEC, by virtue of a restrictive approval process that imparted an

[18] *Id.*
[19] http://www.sec.gov/rules/proposed/2011/34-63825.pdf.
[20] *See* http://www.sec.gov/comments/s7-34-10/s73410-56.pdf.

aura of government approval upon the ratings agencies ratings, effectively erased notions of risk and limited the number of rating agencies to an incompetent, non-competitive, and arguably conflicted, self-dealing oligarchy. Actions to "save" the system were poorly timed and culminated with the Government's unprecedented intervention in the financial services industry.[21]

When it is understood that Government played a major role in causing the financial crisis, it will be recognized that the entirety of Dodd-Frank and especially the CFPB is the exact opposite of what we need. I am reminded of that wonderful Saturday Night Live skit with Will Ferrell and Christopher Walken wherein Will is the "cowbell" player from Blue Oyster Cult and Walken, as the sage record producer Bruce Dickinson, demands ever "more cowbell!" when it is exactly what is not needed.

Ironically, the song covered is "Don't Fear the Reaper" and while it is hysterical to watch a furry, bearded Ferrell gyrate in an obscenely tight tan shirt banging a cowbell to the point of destructive distraction, it is decidedly not funny to watch regulation asphyxiate economic growth. The economy has a fever, I do fear the Reaper, and the prescription is not "more cowbell!"

Item B: The effectiveness of the exemption in Dodd-Frank for institutions with less then $10 billion in assets from the Consumer Financial Protection Bureau

The Exemption Will Be Swallowed by the General Rule

The exemption dealing with a $10 Billion threshold can be bifurcated into two categories: (i) the Interchange Fees, and (ii) the general exemption from the Consumer Financial Protection Bureau ("CFPB" or the "Bureau") for institutions with less than $10 billion in assets.

With respect to the Interchange Fees, the American Bankers Association ("ABA") addresses the topic with the following update):

> Two recurring themes emerged (from the Senate Banking Hearing February 17, 2011): Consumers are not guaranteed any benefits and the exemption for small banks will not work.
>
> *Benefits to Consumers Are Not Guaranteed.* Senator Johanns (R-NE) asked Bernanke to confirm that, as a result of the rule, big retailers will surely see the benefit while consumers may not. Bernanke responded, **"There's no guarantee [that consumers will see benefits.]"**
>
> Senator Corker (R-TN) commented to Bernanke, "I know you didn't ask for this... but the price setting at only the transmission cost seems unfair. It also seems we are pushing people into credit cards... this is very perverse and short sighted on our part."

[21] *See, e.g.*, John B Taylor, Stanford University Hoover Institute, *How Government Created the Financial Crisis*, The Wall Street Journal, February 9, 2009.

Bernanke said the statute allows the Federal Reserve to consider only incremental costs when setting the regulation and that "**some of the costs will be passed on to consumer and impact product offerings.**"

Small Banks Will be Impacted by Rule. Senator Tester (D-MT) asked Bernanke if there is a way, in practice, to fully exempt community banks and credit unions from the debit interchange rule. Bernanke responded "**there's no way to guarantee it.**"

When questioned by Chairman Johnson (D-SD) about the exemption for small institutions, Chairman Bernanke said that statute "has an exemption for smaller banks. **We are not certain how effective that exemption will be** because merchants may be able to reject cards from smaller institutions... [the] **exemption may not be effective in the marketplace.**"

Later Bernanke continued, "by statute the smaller institutions will be exempt... **but in practice they may not be exempt**...[the proposed interchange rate] does not cover the full cost [of the service]... **some of those costs could be passed on to consumers**... which means that if the small banks do not have an exemption, **whatever forces are impacting the larger issuers will impact the smaller banks.**"

Tester followed up asking what prohibits a retailer from accepting one card over another. Bernanke responded "at this moment there's nothing stopping them...**merchants might turn down small bank cards** and networks might not find it economical to have a two tiered system."

FDIC Chairwoman Bair said the Fed's proposal will "reduce the income they [banks] get from debit cards and they will have to make it up elsewhere... and could push them [banks and subsequently consumers] into prepaid cards." She also said, "[**i**]**t might not be helpful to consumers** and has unintended consequences and really needs to be fixed."

Tester asked if the proposal should be delayed, at which Bair responded, "**The full policy ramifications might not have been dealt with as thoroughly as it should have been.**"[22]

The exemption is ineffective as costs associated with the interchange may be absorbed by the small financial institution as a result of merchants unwillingness to cover those expenses and consumers having to flee to prepaid cards to avoid the costs associated with the implementation of the rules.

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[22] *See* http://regreformtracker.aba.com/2011/02/bernanke-small-institutions-not-fully.html (emphasis in original).

With respect to the generalized exclusion, any claim that institutions under $10 billion will be outside the CFPB is illusory at best. Dimore & Shohl, LLP notes:

> Although Title X expressly exempts depository institutions and credit unions with total assets of $10 billion or less (the "Community Financial Institutions") from enforcement actions by the Bureau, these Community Financial Institutions, through their prudential regulators, are nonetheless subject to the regulations and rules promulgated by the Bureau. Enforcement of the Bureau's regulations and the consumer financial protection laws is vested in the prudential regulators that already have oversight capacity for these Community Financial Institutions.
>
> Additionally, the Bureau has enforcement authority over service providers that may have relationships with Community Financial Institutions, and the institutions may therefore be required to respond to investigatory demands in relation to investigations of a service provider.[23]

The CFPB will likely reach into smaller institutions and trump the effectiveness of the exemption.

The Act Grants the CFPB Authority over Financial Institutions With Less Than $10 Billion in Assets

Title X of the Act grants the CFPB expansive power over all financial services firms, including those firms with less than $10 billion in assets. Title X of Dodd-Frank also expands the authority to state attorneys general and state and regulators. These changes will place a substantial burden on all financial services firms, particularly small banks and financial services firms that while not subject to supervision and enforcement by the new agency, will be subject to higher scrutiny by state attorneys general and state regulators. Also the Act grants the CFPB the authority to participate in examinations of smaller insured depository institutions with assets under $10 billion and the CFPB may pass rules applicable to such firms.

Similarly, there is an open issue of whether CFTC and SEC registered entities and persons are exempt from the authority of the CFPB. While there is legislative history that supports the position that Title X is not meant to create duplicative supervision of SEC and CFTC regulated entities and persons, the lack of clear language to that effect in Dodd-Frank, could be interpreted by a court as meaning that Congress meant the agency to serve as an additional check on companies regulated by those agencies. We ask Congress to address this oversight in any amendments to the Act that may be passed.

Enforcement Authority. Although the current prudential regulators for Community Financial Institutions retain enforcement authority under the Act, the Bureau will enjoy certain authority over these institutions. The Bureau may require reports from these institutions "as necessary" to support its role of implementing federal consumer financial

[23] http://www.dinslaw.com/dodd_frank_title_x/.

protection laws, to support the Bureau's examination activities, and to assess and detect risks to consumers and financial markets. The Act requires that the Bureau use publicly available information and pre-existing reports provided to federal and state agencies to the largest extent possible. Although the Bureau may not examine Community Financial Institutions on its own, it can send examiners on a "sampling basis" to examinations performed by other prudential regulators and request any reports that result from those examinations from the prudential regulators. If the Bureau takes part in an examination on a sampling basis, the prudential regulator must involve the bureau agent in all aspects of the examination and consider the input of the agent in the scope, conduct and contents of the examination and any reports issued as a result of the examination.

Referrals From the Bureau and Sharing Information Among Regulators. If the Bureau believes that a Community Financial Institution has materially violated a federal consumer financial protection law, it can notify the appropriate prudential regulator in writing and recommend an investigation. The prudential regulator is required by the Act to provide a written response to the Bureau within sixty (60) days of receipt of the Bureau's referral. Additionally, the Act allows for significant sharing of information among prudential regulators and the Bureau. The Bureau is also required to share its reports of examination with state prudential regulators but the Act does not require state prudential regulators to share information with the Bureau.

Subpoena and Civil Investigative Demand Authority. The Act provides authority to the Bureau to issue subpoenas for documents and testimony. The Bureau may also issue civil investigative demands ("CIDs") compelling the production of documents, responses to interrogatories, or testimony of witnesses prior to instituting any legal proceedings. The Act does not limit who the Bureau may issue CIDs to, and because the Bureau has enforcement authority over service providers that may serve Community Financial Institutions, these institutions may find themselves subject to these CIDs in the course of a Bureau investigation. The Bureau is required to describe the nature of the conduct constituting an alleged violation and the provision(s) of law applicable to such violations.[24]

Finally, it is unlikely that any new agency charged with drafting its own rules, will limit its own authority beyond the limitations set forth in the Act. Accordingly, any lack of clarity with respect to the power of the CFPB will be interpreted in a manner that affords the agency the maximum degree of authority. Consequently, potential investors in financial services firms must assume the proposed exclusions are illusory. In consequence, small financial services firms will face a substantial impediment to attracting capital while the full scope of such a powerful new regulatory regime is unknown.

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[24] *Id.*

Item C: The Link Between the Effects of Dodd-Frank on Small Institutions and the Ability of Small Businesses to Secure Loans

The ability of a small financial institution to offer loans is directly related to its capital. Under current capital ratio rules, small banks have an obligation to have Tier 1 regulatory capital equal to at least eight per cent (8%) of its assets. More than 240 U.S. banks have been closed in the period between 2008 and 2010, with more expected to close in the near future. The majority of these banks were closed because they had insufficient capital to operate.

The main reason banks have deficient capital is due to losses against capital resulting from unpaid loans or non performing loans that under current regulatory rules must be written off because of the uncertainty to recover even from pledged collateral. Once a bank enters into a spiral of loan defaults its capital is eroded below levels accepted as "well capitalized" in order to operate the bank in a safe and sound manner.

The ability of small institutions to attract capital has a direct correlation with the investor perception that any investment will have an attractive return of return that is subject to a reasonable degree of risk. It is unclear how anyone invests to recapitalize or capitalize a small financial institution when the risk to capital cannot be measured as a result of the uncertainty of how Dodd-Frank will affect the performance of the financial institution target of a rational investment. It is clear that *uncertainty kills capital attraction or investments in other financial vehicles* In general and as describe above, for small business to secure capital as either equity or debt, providers of capital require certainty. In many cases, because of Dodd-Frank, providers of capital have a fiduciary duty not to invest in the current environment.

Item D: The Interaction of Dodd-Frank and Current Regulatory Requirements and the Effect This has on the Ability to Conduct Business

Capital Creation and Job Creation will Suffer

Business is conducted with the primary objective of generating revenue, creating wealth, and efficiently granting investors a reward for taking monetary (investment) risks. Business is not conducted with the social objective of creating jobs. Job creation is a byproduct and consequence of capital investment, execution of a business plan, and efficient management. If the framework for investing in a business is impaired or removed, investor will be unlikely to invest with the expectation that the object of the investment is the creation of jobs. Rather, a prudent investor will rapidly exit any enterprise that is burdened by unclear regulation. The potential adverse consequences of the Act with respect to the conduct business have even been criticized by some of the regulators to which Dodd-Frank has delegated expansive authority.

SEC Commissioner Kathleen L. Casey has provided the following insightful

comments on "The Regulatory Implementation of Dodd-Frank,"[25] which are summarized as follows:

Severe Reduction in the Size of the Pool of Investors

For primarily smaller corporate issuers, capital formation will be affected by decreasing the pool of eligible accredited investors in small business through private placements under Regulation D, as a result of the removal of the value of an investor's primary residence from the calculation of an investor's net worth. Significantly affecting the ability of small business to raise small amounts of working capital to either grow an existing business or start a new business. Without working capital it will be impossible for any business owner to pay help and therefore the job market will see unemployment raise at levels not seen in the history of this country.

Capital Creation Decimation - IPOs to Suffer Significantly

Going public has historically been viewed as a significant and positive step in the lifecycle of a company. IPOs have been viewed as opportunities for companies to gain access to large pools of capital that will enable the company to grow in directions that may not otherwise have been possible. IPOs have also been viewed as enticing opportunities for investors to share in potentially outsized rewards associated with investing in young, dynamic, growing companies.

To the extent that a result of the new law's requirements and the SEC's rules is that the costs of being a public company are greater than the benefits, some companies that may have sought to expand through a capital infusion may choose not to expand.

Private markets are inherently less liquid than public markets, which can result in a "liquidity discount" in the price paid by investors for their securities. Moreover, because purchasers of privately placed securities do not benefit from liquid markets, retail investors have far fewer opportunities to invest in earlier stage companies with significant growth opportunities, and instead are largely relegated to investing in more mature, lower-growth public companies.

Small Businesses in the U.S. are Placed at Worldwide Disadvantage

In particular, to the degree that Dodd-Frank has overreached and increased the overall burden and cost on our financial markets, our competitiveness may be unduly harmed. Indeed, it remains to be seen whether Dodd-Frank will place the U.S. in a first mover advantage or disadvantage in our regulation of markets, like the OTC derivatives market. How the SEC and CFTC implement these new provisions will be particularly relevant to that outcome.

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[25] *See, e.g.*, Kathleen L. Casey, "The Regulatory Implementation and Implications of Dodd-Frank." Directors' Forum 2011 speech, San Diego, California, January 23, 2011. Available at http://www.sec.gov/news/speech/2011/spch012311klc.htm.

If addressed imprudently, we may end up with a highly prescriptive regulatory regime and no regulatees. Not only will our competitors in Asia and Europe be more than happy to have the business, and the jobs, we will make it more difficult and expensive for American companies that use derivatives to hedge their business, interest rate, credit, and currency risks.

As a result, there is a real risk of overcorrecting for perceived flaws in the financial system, and imposing costs and burdens on the market that may not lead to improvements in the market.

Loss of Jobs in the U.S.

Regulation or limitation of compensation for talent, that otherwise would drive growth to companies smaller than the big corporations, will result in the lack of interest of talented management who will prefer to either remain in big business or become uninterested because of the lack of compensation incentives. The net result will be for management to either remain in big business or rather seek another country where the true value of services can be earned. What is more alarming is the loss of jobs in the U.S. as smaller companies will choose to settle in more friendly countries, resulting in the loss of American jobs, the unintended transfer of talent to Latin America, Asia, and Europe, and the transfer of American wealth to other countries.

Item F: The Effect of the Current Regulations on Small Financial Institutions and the Ability of Small Business to Operate

The U.S. Regulatory Structure Is Not Competitive

On May 20, 1997, the United Kingdom realigned its financial services regulation and created a new regulatory body that would ultimately be named the Financial Services Authority ("FSA"). Shortly thereafter, the United Kingdom centralized the regulation of securities, futures, currencies, commodities, banking and all other significant financial services under this new regulator. In 2000, the Financial Services and Markets Acts were promulgated further consolidating regulatory control into the FSA in addition to requiring principles based enforcement policy. The net result of this consolidation was the creation of a highly effective balance of regulation and business opportunity.

In the United States, the world largest financial services economy, there has been a pronounced lack of evolution in the regulation of the industry. No significant structural changes with respect to the regulation of the financial services industry have occurred to streamline the regulatory regime, and Dodd-Frank is merely more regulation added to an archaic regulatory model. As a consequence of this archaic structure, separate regulators exert authority over the equities, futures, and banking activities. These differences compounded by state and federal levels of enforcement, result in conflicts between U.S. regulators. The addition of the CFPB into the regulatory mix will only exacerbate these problems.

Similarly, the bifurcated regulatory model for products regulated by the CFTC and the SEC, has historically produced compromises of alarming restrictiveness. The Shad-Johnson accord of 1981 (codified in 1982) generated a deleterious compromise by simply banning the trading of single stock futures for decades. Recently, the Commodities Futures Modernization Act lifted that ban, but under intense lobbying from the New York Stock Exchange it merely accommodated a compromise to codify duplicative regulation to allow single stock futures trading under margin rules designed to render the products inferior to actual equities. This increasingly cumbersome and bifurcated regulatory structure is proving inimical to the U.S. capital markets.

Possibly, the most significant and damaging regulatory change in the U.S. since the passage of the 1934 Securities Exchange Act and prior to Dodd-Frank was the enactment of Sarbanes-Oxley ("SOX") in 2002. Passed in the wake of the Enron and World-Com debacles, SOX was designed to enforce stricter accounting and financial controls through greater punitive consequences for corporate misdeeds. Although the intent was noble, SOX is a heavy burden to U.S. corporations and enterprises that are indeed good corporate citizens. The burdens of SOX are particularly pronounced for smaller publicly traded companies.

The U.S. and the UK share common bonds of law and culture. The net result of the rising competitiveness of the UK's market structure, versus the decline of the competitiveness of U.S. market structure, coupled with those natural commonalities, are causing a flight of talent, listings and capital from the U.S. markets to the UK markets. Prior to the introduction of SOX, 24 of the 25 largest IPOs occurred on U.S. markets. Following promulgation of SOX, 24 of the 25 largest IPOs have occurred on exchanges outside the U.S. Since the implementation of SOX, voluntary delistings of companies, foreign and domestic, have increased dramatically.

Conversely, the European Union, a leading competitor with the U.S. financial markets, has taken great strides to unify a largely fragmented financial market by means of the adoption of regulatory regimes like the Markets in Financial Instruments Directive which coordinates the regulation of the financial markets in Europe under a regime of laws adopted by each member of the European Union. Similarly, competitors in other jurisdictions such as Hong Kong and Singapore are making great strides in the development of regulatory regimes that are designed to encourage the capital formation process while protecting the integrity of the capital formation process. Not surprisingly, Hong Kong and Singapore assumed the top two rankings on the Heritage Foundation's 2011 Index of Economic Freedom.[26] Other jurisdictions such as Brazil, Russia, India, China, Panama and Australia are increasingly important as capital continues to seek jurisdictions with a credible regulatory model that also include the requisite degree of certainty.

[26] http://www.heritage.org/index/.

Conclusion

Dodd-Frank is the most important piece of financial services legislation in nearly a century. Unfortunately, the Act lacks the necessary specificity to guide investors and financial services firms that will be subject to the legislation. More importantly, following the financial crisis of 2008 – 2009, Congress missed the opportunity to address the archaic regulatory structure of the U.S. financial services industry. We recognize our regulatory structure is untenable, but rather than correct it, we seek to bandage it by piling nebulous regulation on top of archaic and restrictive regulations.

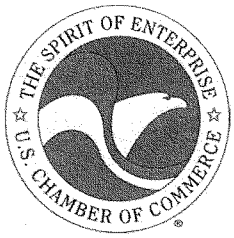
Financial markets have existed for thousands of years and history reveals that imperfections caused by certain aberrations like fraud swiftly correct themselves when left to market forces. Trying to create a system where prevention of financial cataclysms is addressed by massive legislation where rules are undefined and unlimited authority is granted to government agencies to "legislate" over a dynamic ever changing financial landscape is tantamount to directing economic production from a centralized government. The approach of the Dodd-Frank leaves U.S. capital markets at a substantial disadvantage to competitors in Europe, Brazil, Russia, India and China who are developing regulatory models for the next century.

Ambiguous regulatory regimes such as Dodd-Frank, ultimately will fail to satisfy their intended purpose because they chase an increasingly dynamic economic and financial environment where borders are no longer an impediment to capital investments and transactions take place through electronic portals. Free markets are meant to function as a place where winners and losers exchange value. Participants that are unable to compete should be allowed to fail without the intervention of laws attempting to salvage the enterprise or giving the appearance that the government can and will choose winners and losers. Dodd-Frank gives unbridled authority to the agencies to pick winners and losers at their own "discretion."

As this Committee works its way through these various public-policy issues, I would welcome the chance to elaborate on my testimony, and to contribute in the most constructive way possible to this important dialogue.

Respectfully submitted,

John M. Schaible



Statement
of the
U.S. Chamber
of Commerce

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

TO: House Sub-Committee on Financial Institutions & Consumer Credit

DATE: March 2, 2011

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

INTRODUCTION

Chairman Capito, Ranking Member Maloney, and distinguished members of the Committee, my name is Jess Sharp, Executive Director for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. We appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses that the Chamber represents.

The focus of my testimony this afternoon will be on the potential impact of the Dodd-Frank Act's new Consumer Financial Protection Bureau (CFPB) on America's small businesses.

The Chamber firmly supports sound consumer protection regulation that weeds out fraudulent and predatory actors and ensures consumers receive clear and concise disclosures about financial products. We also want to work with the CFPB to ensure that the Bureau takes a targeted approach to regulation and enforcement, taking care to prevent sweeping policies that would impose duplicative regulatory burdens on small businesses and, perhaps even more importantly, that would prevent small businesses from obtaining the credit they need to expand, and create the new jobs that our economy so desperately needs.

The Chamber recognizes that building an agency from the ground up is a tough job. While the Bureau will not be fully constituted until the July 21 designated transfer date, the Bureau and its federal and state partners have an opportunity to begin establishing some clear lines of jurisdiction and coordination that give some structure to the regulatory process to come, and some certainty to the regulated community.

Ultimately, the goal should be to construct a nimble, effective, transparent, and fair new agency that fulfills its consumer protection mandate while ensuring that consumers and small businesses continue to have access to affordable credit from wide range of sources.

CFPB OVERVIEW – HOW ARE SMALL BUSINESSES IMPLICATED?

The CFPB has broad authority to regulate the consumer financial products and services of banks and non-bank financial institutions including, credit cards, mortgages, student loans, and payday loans.

However, the Dodd-Frank Act also gives the CFPB the authority to regulate a number of activities that are common to Main Street businesses well outside the financial services sector (e.g., over-the-counter financing of goods purchased), and in some cases regulate the service providers to those companies.

In addition to casting this very wide net of coverage, the Dodd-Frank Act also gives the CFPB a very broad standard to enforce – the prevention of "unfair, deceptive, or abusive acts or practices" in the consumer financial products market. While unfair and deceptive practices have been proscribed for years with decades of case law to guide compliance and enforcement, the new abusive standard will require immediate interpretation by the Bureau that will likely continue to evolve into the future.

Together, these vague standards give the CFPB tremendous power to interpret its mandate, and give the regulated community, including small businesses very little guidance to follow as we approach the July 21 transfer date. The full universe of covered entities is unknown, and the standards by which those entities will be judged compliant or non-compliant have yet to be written.

THE IMPORTANCE OF SMALL BUSINESSES

It is widely recognized that small businesses play a critical role in the American economy, as job creators and as innovators. According to the Small Business Administration's (SBA) Office of Advocacy:

- There are more than 27 million small businesses in America.
- Small businesses are 99.7% of all businesses.
- Very small firms with fewer than 20 employees annually spend 45% more per employee than larger firms to comply with federal regulations.
- Small businesses employ just over half of all private sector employees, and pay 44% of total U.S. private payroll.
- Small businesses have generated 64% of net new jobs over the past 15 years, and hire 40% of high-tech workers (such as scientists, engineers, and computer programmers). This proportion of small business job creation is even higher in the early stages of an economic recovery.

In addition, while the U.S. commercial banking system remains an incredibly important source of credit and capital to small businesses in the U.S. many small businesses do not have the option of relying on commercial borrowing to capitalize

their operations. Traditional lending requires credit history, collateral, and financial statements that many start-ups or even ongoing small businesses lack.

So large numbers of small businesses turn to the same affordable and accessible consumer financial products to fund and grow their businesses that individuals and families use to extend their buying power. According to research conducted by the SBA's Office of Advocacy 80% of small firms used non-traditional sources such as owners' loans and personal and business credit cards, while 60% used six traditional types of loans, such as credit lines, mortgage loans, and others. In 2009, about 77% of all small businesses used at least one credit card in 2003, and about 47% used personal cards rather than business cards.

OUR CONCERNS ABOUT THE CFPB'S IMPACT ON SMALL BUSINESSES

The CFPB poses two significant threats to small businesses:

First, small businesses may be subject to the CFPB's regulation and other oversight because they engage in one of the 10 broadly described activities laid out in the law, or are a service provider to one of those companies. Virtually all of these businesses are already subject to oversight by the Federal Trade Commission. The Chamber fears that overlap and duplication will be inevitable as the federal agencies sort out lines of jurisdiction and responsibility. In the meantime, even those businesses that are ultimately deemed to be outside the CFPB's authority may see their compliance costs go up in the short term because there is still so much uncertainty about the extent of the CFPB's jurisdiction

Second, CFPB regulation may decrease the availability or increase the costs of the forms of credit small businesses rely on to provide working capital, as described above— home equity loans, credit cards. In this scenario it is even possible that policies that seem to benefit consumers could indirectly harm their small businesses by limiting their access to the credit they need.

I should point out that Congress did put in place some helpful safeguards to mitigate the potential small business impact of the Bureau's activities. The most notable protection is the requirement that the Bureau must follow the process set out under the Small Business Regulatory Enforcement Fairness Act (SBREFA) to solicit input from small businesses as part of every rulemaking.

While this is a very important provision, it will require vigilance on the part of a number of a number of federal agencies—the Bureau, the SBA, and the Office of

Management and Budget—to ensure meaningful compliance. In addition, SBREFA only covers the rulemaking process, while regulatory agencies, like the CFPB, often make policy outside that process through enforcement actions. So small business considerations will not necessarily be taken into account in all of the Bureau's activity.

SUGGESTIONS TO MITIGATE THIS IMPACT

Yesterday, the Chamber and a number of other trade associations sent a letter to Treasury Secretary Geithner, with copies to the Chairmen and Ranking Members of the House Financial Services Committee and Senate Banking Committee, laying out a series of recommendations to guide the Bureau's development. With the Chair's permission, I'd like to walk through a short summary of these recommendations and submit the full letter for the record.

Develop an Effective and Efficient Structure to Facilitate Protection of Consumers and Promotion of Economic Growth

1. The CFPB must organize in such a way as to promote intra-agency coordination and information sharing to avoid the pitfalls that have hobbled other agencies over the years. The Chamber was pleased to see that Elizabeth Warren has established a Chief Operating Officer position. This kind of cross-cutting job should help prevent the "siloing effect" that could inhibit coordination among the CFPB's offices.

Empower Consumers by Rationalizing Disclosure Requirements

2. The CFPB can be most effective by improving and simplifying disclosure in a way that does not limit consumers' choices in the market for financial products. The Federal government requires multiple disclosures to consumers, in the mortgage market, for instance. Too much disclosure or disclosure that is duplicative or even conflicting does not help consumers make choices.

Prevent Duplicative and Inconsistent Regulation of Main Street Businesses

3. After July 21, 2011, the CFPB will have broad new authority, some imported from other agencies, and should move to quickly clarify lines of jurisdiction to prevent sending mixed and overlapping messages. The CFPB should make clear its relationship with the FTC and the State Attorneys General. In addition, the Dodd-Frank Act gives the CFPB the ability to exempt any category of businesses from coverage under the Act. The Bureau should exercise that authority to relieve from regulation under the Act Main Street businesses with a minimal, and tangential, involvement in the activities that trigger the Act's coverage—as well as to clarify the scope of the Act's exemptions.

Preserve Small Business Access to Credit

4. The CFPB must keep in mind at every stage of its rulemaking and compliance processes that many small businesses access credit the same way individuals do. Preserving options in the financial products market is good for our job creators, so the Bureau's decisions should be tailored carefully to prevent broad outcomes that dry up essential sources of capital.

Ensure Coordination with Federal and State Prudential Regulators

5. Regulation of consumer financial products can have an impact on an institution's safety and soundness, so the CFPB must move quickly to establish a high-level consultation process with the prudential regulators.

Defer Rulemaking Until After Confirmation of a Director

6. Until a Director is confirmed, many of the Dodd-Frank Act's consumer financial protection authorities are under the control of the Secretary of the Treasury. While it may be unlikely the Secretary intends to begin making policy before the President nominates and the Senate confirms a CFPB Director, the Chamber believe a statement to this effect would calm concerns in the business community and ensure an orderly rulemaking process.

Before closing I would like to briefly touch on two concerns about the CFPB that are not directly tied the Bureau's small business impact, but have broader implications. First, while we understand that the CFPB's unusual structure as a standalone entity within the Federal Reserve, immune from the budget process, was intended to give the bureau a level of independence, we are concerned that in doing so, Congress has largely written itself out of the oversight process. Second, the Bureau will have a single Senate-confirmed Director, rather than bi-partisan leadership through a multi-member commission or Board similar to the FDIC or the SEC, and it will draw its funding from the Federal Reserve outside the Congressional appropriation process. I believe this combination is unique in government— some agencies have singular leadership, but are subject to the budget process or vice versa, but none that I know of have this double layer of insulation.

This set up leaves Congress with very few opportunities to have meaningful input into the Bureau's policymaking except through amendments to the underlying statute, particularly given the broad authority granted the Bureau to oversee such a massive portion of our economy.

CONCLUSION

Thank you again for the opportunity to testify before the Subcommittee today. The Chamber looks forward to working with Congress and the CFPB to help achieve these objectives. I am happy to answer any questions you may have.

Testimony of
Peter Skillern, Executive Director
Community Reinvestment Association of North Carolina
United States House of Representatives
Financial Institutions and Consumer Credit Subcommittee
Wednesday, March 3, 2011

Thank you Representative Capito and Representative Maloney for the opportunity to speak with you on the impact of the Dodd Frank Act on small financial institutions and small businesses. I am Peter Skillern, Executive Director of the Community Reinvestment Association of North Carolina, a nonprofit community advocacy and development agency.

Small financial institutions are facing long-term trends of consolidation and competition from mega banks and unregulated financial lenders. The Dodd Frank Act will help small financial institutions by providing a more level playing field with mega institutions and non-regulated financial service providers. Small businesses are facing a tougher credit market and slower recovery. The Act makes an extraordinary effort to do no harm to small businesses and to help them through increased transparency in credit and protections. Most importantly, Dodd Frank provides a more stable financial system for small banks and small businesses by mitigating the systemic risks and lending abuses by megabanks and unregulated financial institutions that catalyzed the financial crisis. This legislation stands up for the little guys in the financial market - small banks, small businesses and families.

Small versus Big Banks

Small financial institutions are facing significant challenges in the restructuring of the financial system as their numbers decline while mega institutions grow. As measured by the number of banks under $100 million, the deposit base and mortgage lending, this sector of the financial system is shrinking dramatically. Nationally, the number of banks with under $100 million in assets dropped by 5,410 from 1992 to 2008.[1] In North Carolina, of 146 financial institutions, the bottom 100 hold 10% of deposits, while the top six hold 76%. Nationally, approximately 4,000 small banks made 100 or fewer mortgages in 2007.[2] Yet small banks remain essential components of local financial services, lending and civic engagement. Many areas of the country would not have banking services without small lenders.

By contrast, the consolidation of assets and market share of mega-banks has increased. In 1995, the top 5 banks had 11% deposits share; in 2009 they had nearly 40%.[3] In the last half of 2010, three lenders conducted 50% of mortgage activity.[4] The consolidation of Country Wide and Merrill Lynch into Bank of America, Washington Mutual into JP Morgan Chase, and Wachovia Bank into WellsFargo has further consolidated the financial services sector making institutions that are "too

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[1] It Takes More Than a Village: The Decline of the Community Bank, Celent, http://reports.celent.com/PressReleases/200901293/VillageBank.asp

[2] FFIEC, HMDA Analysis by CRA-NC

[3] It Takes More Than a Village: The Decline of the Community Bank, Celent, http://reports.celent.com/PressReleases/200901293/VillageBank.asp

[4] Mortgage Daily, http://www.mortgagedaily.com/PressRelease021511.asp

big to fail", even bigger. Megabanks' multiple business lines and capital market activities create competitive advantages of scale, efficiencies and leveraged capital, which have contributed to the decline of small banks.

All of these challenges arise prior to the implementation of the Dodd Frank Act. The challenges that small institutions face are not from the Dodd Frank Act, but from long term trends of capital concentrations and consolidation which is furthered by the financial crisis and recession.

The Dodd Frank Act primarily focuses on large financial institutions that operate in the capital markets. Its focus is on reducing systemic risk, creating a means for the resolution of financial giants, prohibiting proprietary trading, regulating derivatives, and reforming the regulatory system itself. These are not primarily the concerns of small institutions other than whether the system is stronger and more stable in which they operate.

Consumer Financial Protection Bureau

The creation of the Consumer Financial Protection Bureau (CFPB) will consolidate and simplify rule writing for all financial institutions for consumer protection laws. The CFPB does not have supervision of banks below $10 billion in assets or 98% of all banks. These banks will continue to be supervised by their prudential regulator. The CFPB will have supervisory oversight for consumer compliance for only 2% or about 114 banks.

Efforts to reduce the CFPB ability to provide oversight of megabanks and non-financial institutions will mean that small banks will again be regulated when others are not, allowing bad practices to drive out good ones. The CFPB creates a more level playing field for regulated small lenders, by ensuring mega-lenders and nonbank lenders are playing by the same rules.

There will be costs related to regulatory reform and there is uncertainty in changes. We agree that the unique needs of small institutions need to be considered as rules are written and implemented. But that is not an argument that rules and reforms are not merited. The CFPB benefits the financial system and small banks.

Risk Retention

The Dodd-Frank Act mandates higher standards for safety and soundness in lending. Given the record number of small bank failures, foreclosures and megabank collapses, we support the emphasis on responsible lending. Risk retention is a reasonable governor on risk, which could expose taxpayers to losses. Yet we urge that the rulemaking does not overly restrict credit or disadvantage small institutions in lending. As an example, rule making to define the Qualified Residential Mortgage (QRM) exemption from the risk retention should be developed so that sound underwriting of low risk, high performing traditional loans should define the QRM. A proposal by WellsFargo to define QRM as loans having 70% loan to value will exempt only 15% of mortgages. The effect will unnecessarily raise

credit costs on 85% of loans. It will limit mortgage lending primarily to large institutions that can afford the 5% risk retention and further disadvantage small banks. The QRM should be concerned with safety and soundness, affordability and inclusion in the lending field. Risk retention should be targeted towards nonconventional risky loans.

Interchange Fees

We are supportive of prepaid cards that provide financial services to the under-banked when the product has low consumer fees, mandated consumer protections and no overdraft or consumer loans attached. The Durbin Amendment provides incentives for these features of the card. We also hope that both small and large institutions can profitably provide the card in serving consumers.

Small Business Impact

Small businesses are faced with a constriction of credit availability. Loans to small businesses in 2009 (volume) were only 44.4 percent of those in 2008. [5] The decline in outstanding balances to small businesses continued in 2010. [6]

The Dodd Frank makes explicit protections to protect small businesses from unintended consequences of regulation. Section 619 prohibitions on proprietary trading do not apply to Small Business Investment Corporations allowing for banks

[5] Community Reinvestment Association of North Carolina, FFIEC CRA Small Business Data.
[6] Small Business Lending in the United States, 2009-2010 Office of Advocacy U.S. Small Business Administration February 2011, pg. 3. http://www.sba.gov/sites/default/files/files/sbl_10study.pdf

to invest in SBICs. Section 1027 excludes merchants, retailers and other sellers of non-financial goods and services. Subtitle C, Section 1031 specifically allows for small business income to be considered in loan underwriting. Subtitle G, Regulatory Improvements Section 1071 data collection is meant to better monitor lending to small business with transparency and without bias. Three different sections 1099, 1424 and 1474 all require studies to ensure that credit costs are not increased for small businesses. The Dodd Frank Act is small business friendly.

Small banks, small businesses and American families will be well served by the Dodd Frank Act and the Consumer Financial Protection Bureau.

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT

HEARING ON:
THE EFFECTS OF THE DODD-FRANK ACT
ON SMALL FINANCIAL INSTITUTIONS

Wednesday, March 2, 2011

WRITTEN TESTIMONY OF CHRIS STINEBERT
PRESIDENT AND CEO
THE AMERICAN FINANCIAL SERVICES ASSOCIATION

HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
THE EFFECTS OF THE DODD-FRANK ACT ON SMALL FINANCIAL INSTITUTIONS

Wednesday, March 2, 2011
WRITTEN TESTIMONY OF CHRIS STINEBERT

My name is Chris Stinebert, and I am the President and CEO of the American Financial Services Association ("AFSA"). AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. The association encourages and maintains ethical business practices and supports financial education for consumers of all ages. AFSA has provided services to its members for over 95 years. AFSA's 375 member companies include consumer and commercial finance companies, vehicle finance companies including the captives, credit card issuers, mortgage lenders, industrial banks, and other financial service firms that lend to consumers and small businesses.

AFSA appreciates the opportunity to provide testimony to the Members of the Subcommittee on how the Dodd-Frank Act is impacting the ability of America's community finance companies to provide access to affordable credit to consumers and small businesses across the country.

Madam Chair, you and the members are familiar with many of AFSA's bigger member companies, which includes many banks, bank subsidies and large captive auto finance companies, but AFSA's roots lie with locally grown family-owned finance companies that have been serving their communities for generations. Our association was started in 1916 by lenders who worked with consumer advocates to establish best practices. Finance companies provide small dollar personal loans to people in their communities:1) the carpenter who needs to repair the transmission on his pickup, 2) the family that needs a new washer and dryer, or 3) the start-up company that needs a little short-term help to land the next client.

Just this week, one of our members received thanks from a small business owner for extending credit to her "when no bank would" after her taxi was involved in a head-on collision with a

drunk driver. "I would never have been able to continue paying my bills during the trying extended time I was waiting for the at-fault's insurance company to reimburse me for my vehicle," her email states. "Your company kept my family from the welfare line, and I am an extremely satisfied and thankful customer."

AFSA member loan products meet the standards of the Center for Financial Services Innovation's definitional benchmarks for high-quality credit. They are marketed transparently. They are affordable, because our members work with customers to determine their ability to repay the loan. They are structured to support repayment, with amortization schedules. And finally, our members report their customers' repayment performance to the credit bureaus so that good payment behavior is rewarded by a higher credit score.

The Defense Department, in its recent policymaking on credit for military members and their dependents, described installment loans as a "beneficial" product and specifically cited the differences between installment loans and payday. Key elements of this helpful structure for consumers include:

- Each loan is individually underwritten for affordability and sensible debt;
- Equal installments of principal and interest support repayment over, on average, 9 to 12 months and no balloon payment;
- Lending and customer service are provided by real people in local brick and mortar offices;
- Customers are constantly monitored in their capability to repay, and performance is reported to credit bureaus.

The FDIC recently reported in its small dollar loan pilot program that loans up to $2500 were too costly for the depositories to achieve much acceptance of future participation – except, perhaps, in cases where government taxpayer subsidies could be applied, and/or a savings account was mandatory or additional bank products could be sold.

Finance companies are not afraid of being regulated, but they don't want to be regulated like depositories because they simply are not banks. Unlike banks, when a finance company makes a

loan, the deposits of consumers are not at risk, and the government and its taxpayers do not insure its capital. The only entity harmed by poor underwriting and defaults is the finance company because it's their money that they are lending, not yours and mine. Banks and credit unions often call for a "level playing field" for supervision and examinations. However, finance companies operate under an entirely different structure.

Prior to enactment of the Dodd-Frank Act, federal financial services regulation was dominated by oversight of depositories, banks, thrifts or credit unions. The natural byproduct of this experienced-based familiarity among regulators and those they regulated has been firm understanding of the federal banking model.

For decades, non-bank finance companies have worked effectively with state regulators in complying with both state and federal consumer protection laws. These nonbank financial companies have been successful in providing needed credit and other financial products and services in the communities in which they operate in part because of the oversight of state regulators who have a familiarity with local and regional situations and issues faced by lenders. This knowledge, along with their geographic proximity to a given lender and financial market, means that state regulators are often the first to identify emerging issues, practices or products that may need further investigation or may pose additional risk to the financial industry. AFSA's finance companies are concerned that this wealth of knowledge will be lost on federal regulators and their emphasis on bank-centric experience.

Non-bank finance companies want to make sure that they're not regulated to the point that it is no longer sustainable to make small dollar loans. The Center for Financial Services Innovation said it best: "Because of the high-touch aspects of this model, installment loans are costly to provide. The primary cost drivers of the installment lending model arise from the operation of physical stores and from underwriting expenses…" U.S. Small Business Administration studies show that the expense for small firms to comply with federal rules is 45 percent greater than for their larger business competitors. And almost 90 percent of our country's 26 million small businesses use some form of credit.

As part of the Dodd-Frank Act, the CFPB is required to comply with the Small Business Regulatory Enforcement Fairness Act (SBREFA) panel process. The SBREFA panel is tasked with studying the potential ramifications of the CFPB's proposed rules on small businesses. The panel involves industry representatives from small institutions that would be affected by a given proposal to get a better understanding of the real world impacts and compliance costs, as well as possible workable alternatives. We believe that this committee should be very clear with the CFPB that it expects it to include a full complement of small institutions represented on these panels to review the rulemaking process.

Consumers and the economy need to expand traditional installment credit, not look for ways to curtail it. At a CFPB conference last week, Michael Heller from Argus Information and Advisory Services stated that consumer credit availability has gone down by 30% for credit cardholders since 2008. The FDIC has validated the urgency of these loans being made widely available in its studies and reports. Respected consumer advocate groups, like the World Bank's Consultative Group to Assist the Poor and the Center for Financial Services Innovation, both have recently proclaimed the importance of small dollar personal and business credit. Jennifer Tescher of CFSI stated in the American Banker, "Demand for small amounts of credit is high. We need to increase access to responsible, scalable, and ultimately profitable forms of credit for households that need and can benefit from it."

Just last month, a Member of Congress asked a group of our members about compliance costs. One company that has been in business for more than 40 years replied that when he took over the business 20 years ago, his costs were minimal but now he has two full-time employees dedicated to nothing but compliance. For a small institution, this often means the difference between a profit and a loss.

While the Obama administration is currently working to implement the Dodd-Frank Act and create a new CFPB, AFSA members, particularly our smaller ones, are struggling to meet the cost of complying with the mortgage licensing requirements under the SAFE Act. According to industry estimates, it costs an average of $661 to train and license every loan originator in each state, whether that officer underwrites 500 or 5 loans a year, as opposed to the $30 it costs a bank

to register one loan originator in all states. While the training and licensing of mortgage loan originators is certainly merited and beyond debate, the cost of regulatory compliance must remain a primary consideration in a fragile economy.

Just as power hates a vacuum, capital despises uncertainty. If investors are unsure about how the finance company model will be impacted, they don't hesitate. They move their money to where the future is more certain. Liquidity is equally important in today's tightened credit market. To maintain liquidity, it is imperative that policymakers and regulators avoid imposing new mandates and policies for consumer credit that would create uncertainty for investors.

For example, the CFPB recently went live with a consumer complaint database as required under the Dodd-Frank Act. Let's review the process. In January, CFPB published the framework of the proposed database in the Federal Register with a 30-day comment period ending on February 9. Coincidentally, this was the same day that they went live with the database. The overlapping deadline meant the database went live before the comments could even be reviewed or considered. Additionally, the Dodd-Frank Act states that the CFPB can share the data with other federal regulators, but the proposal states that they intend to share the data with a host of other parties. Moreover, there is no evidentiary standard for complaints or any process for dealing with frivolous claims. Processes like this create greater uncertainty as opposed to instilling confidence in small institutions.

Again, AFSA appreciates the opportunity to testify before the Subcommittee on the impact of the Dodd-Frank Act on small financial institutions, and I'd be happy to take any questions from Members of the Subcommittee.

Ron Phipps
ABR, CRS, GRI, GREEN, e-PRO, SFR
2011 President

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Chief Executive Officer

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March 1, 2011

The Honorable Shelley Moore Capito
Chair, House Financial Services Subcommittee on Financial Institutions and Consumer Credit
2443 Rayburn House Office Building
Washington, DC 20515

Dear Chairwoman Capito:

As the Subcommittee considers the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the National Association of REALTORS® (NAR) urges you to take into consideration a very important issue to real estate agents, brokers, their affiliates, and their partners in real estate transactions.

The predatory lending provisions in Dodd-Frank have unintended consequences for real estate brokers, their affiliates, agents, and consumers. The provisions attempt to protect homeowners by prohibiting mortgage lenders and loan originators from receiving hidden payments when they steer homeowners into high-cost loans and will create strong underwriting standards to ensure borrowers have the ability to repay their loans. Ability to repay standards have been viewed favorably and recommended by NAR since NAR's subprime working group completed its work in 2005 and its recommendations were adopted by the association. However, one element of the legislation has unintended consequences for firms with legitimate affiliated business arrangements under the Real Estate Settlement Procedures Act.

The predatory lending provisions include a safe harbor for mortgages that are well underwritten and in particular where "fees and points" are 3% or less than the mortgage amount. The problem arises with the definition of fees and points. Normally, one would associate fees and points with actual charges made by the lender in originating the mortgage. That is how they are generally defined for large lenders and other loan providers not likely to have affiliates involved in the transaction. However, the definition of fees and points in the "ability to repay" safe harbor in Title XIV discriminates against real estate brokerage firms and their affiliates by including in the calculation of fees and points, charges for title insurance and escrow as denoted in the Truth in Lending Act regulations. The House bill included language that would have addressed this problem but it was removed during the conference for unclear reasons.

The effect of the removal of the language is that real estate and other firms with affiliated businesses such as title insurance (the vast majority of which are small businesses) would likely not be able to handle the whole or major elements of the transaction and still have the benefit of the safe harbor from predatory lending scrutiny. It is particularly discriminatory because the charges for title services are regulated heavily by the states, meaning they would not differ greatly whether the firm was affiliated or not. Likewise, escrow is largely made up of property taxes and homeowners insurance, also outside of the control of the lender. Neither charge inures to the benefit of the lender whether one is affiliated with other transaction participants or not.

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

Ascribing these charges to the affiliated lender is clearly unfair and may in fact lead to greater costs for consumers or at the very least, increased consumer dissatisfaction and decreased consumer choice. Studies show that consumers see a significant benefit to having their real estate agent and broker at the lead in the transaction and using their affiliated businesses for key services such as mortgage and title insurance. In a recent (Dec. 2010) Harris Interactive study buyers said that using affiliates saves them money (78%), makes the home buying process more manageable and efficient (75%), prevent things from falling through the cracks (73%), and is more convenient (73%) than using separate services.

For these reasons, the Congress, in making adjustments or technical corrections to Dodd-Frank or through another appropriate legislative vehicle, should reinstitute the affiliate fix found in the House legislation and re-level the playing field for affiliated lenders and their industry partners and keep the door open for greater consumer choice in the lending industry.

Sincerely,

Ron Phipps, ABR, CRS, GRI, GREEN, e-PRO, SFR
2011 President, National Association of REALTORS®

Cc: Members, House Financial Services Subcommittee on Financial Institutions and Consumer Credit

March 2, 2011

The Honorable Shelley Moore Capito
Chairwoman
Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Carolyn Maloney
Ranking Member
Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Representatives Capito and Maloney,

As the trade association representing private equity firms that invest in domestic small businesses we thank you for holding this subcommittee hearing on "The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses."

Small businesses access capital from a range of sources including private equity funds. There are over a thousand private equity funds that primarily invest in domestic small business. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is creating significant unintended consequences for these small private equity funds that invest in small businesses. New mandates requiring managers of small business funds to register with the Securities and Exchange Commission (SEC) are adding hundreds of thousands of dollars in costs without adding any additional public value. Fund managers should be focusing on backing job-creating entrepreneurs, not focusing on regulations that were meant for large, systemically risky institutions.

The SEC recently proposed a rule to govern the registration and reporting of private fund investment advisers under Dodd-Frank. The proposal sets forth that fund managers who have never before been required to register must fully register with the SEC and implement compliance programs by July 2011. While this burden is de minimis for the multibillion-dollar funds who supported creating this barrier to entry, the cost is substantial for small business investment funds. This registration system will be most harmful to those managing funds that use any amount of debt or have aggregate assets under management of up to $600 million – generally the size of funds that primarily invest in small businesses. There is no evidence that these small investment funds have ever posed any systemic risk.

Congress attempted to minimize the impact on small business investors by exempting the following types of investment advisers from new SEC registration requirements:

- Advisers who advise licensed Small Business Investment Company (SBIC) funds
- Advisers who advise venture capital funds (the SEC has proposed that the definition of venture capital fund for this purpose will be very restrictive [equity only], and one that would bar most small business investment funds from qualifying. Congress intentionally did not define "Venture" to ensure that job creators would not be damaged)
- Advisers to private funds with an aggregate of less than $150 million in assets under management

Despite these exclusions, there is still substantial confusion about the SEC's implementation, particularly who will be forced to register. The SEC has not yet provided adequate clarity. We are not trying to create loopholes through which large institutions could game the system, but it appears that the SEC is pursuing a regulatory path that is erring on the side of greater regulatory burdens and is not assessing their impact on small business investing. Time is running out for small funds to determine whether or not they must spend time and resources on registration.

For example, if an otherwise exempt Small Business Investment Company manager investing $150 million has another small fund of $25 million dollars, does the manager have to register? The SBIC is exempt and the $25 million dollar fund would be exempt, but together they add up to $175 million and might be forced to register. The SEC's releases have not provided adequate guidance.

Congress wanted to ensure funds investing in job creating small businesses were not encumbered with registration by creating an exemption for Venture investing. The SEC has proposed a definition for venture that would exclude most small business investing funds and would exclude any fund that used debt instruments, including venture debt funds. The proposed definition of venture fund does not help funds of funds investing in venture, SBIC, and other small business funds.

If a manager runs a $75 million venture fund, a $75 million Small Business Investment Company, and a basic small business private equity fund, the venture fund and the SBIC would normally be exempt, but together they might be required to register. The SEC has not provided adequate guidance or time to review or adjust to any forthcoming guidance.

Adding regulatory hurdles for these funds will ultimately harm the small businesses that rely on such private capital to grow their businesses and create U.S. jobs.

<u>We suggest the following improvements:</u>

- The SEC should postpone the implementation of registration for funds primarily investing in small businesses and funds of funds investing in these funds. This would allow costs of compliance to be reduced and would allow the SEC to study the impact on small business funds and those that supply them capital. Further, a delay would give the SEC an opportunity to better understand how to manage thousands of new registrants.
- The SEC should avoid burdening job creators by allowing an alternative venture capital fund definition that would define a venture fund as one that invests at least 75% of its capital in domestic small businesses, regardless of the instrument used.

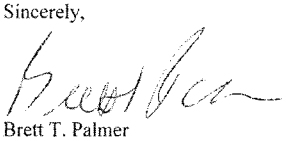
- The SEC should exempt capital from the private fund $150 million registration threshold that is otherwise exempted from registration, such as Small Business Investment Company capital and venture capital. This exemption should include those entities providing capital to these funds.

- Congress should raise the registration threshold above $150 million to capture all funds that primarily invest in small businesses.

- If funds must be forced to register, the SEC should create a "Registration light" system with a lower cost of compliance for smaller funds.

Thank you for taking the time to consider our recommendations which we believe are important to ensuring the continued ability of private equity to provide capital to small businesses.

Sincerely,



Brett T. Palmer
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Statement for the Record
By
Retail Industry Leaders Association

Financial Services Subcommittee on Financial Institutions & Consumer Credit
Hearing on
"The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses"

March 2, 2011

Chairwoman Capito, Ranking Member Maloney, and Members of the Subcommittee:

On behalf of the Retail Industry Leaders Association (RILA), we respectfully submit the following statement for the record with respect to the Subcommittee's hearing titled "The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses." Our comments are specifically focused on the importance of Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which provides critically needed reforms to the system for setting interchange fees with respect to debit card transactions in this country.

By way of background, RILA is the trade association of the world's leading and most innovative retail companies. RILA promotes consumer choice and economic freedom through public policy and industry operational excellence. Its members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs and operate more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

Section 920 of the Electronic Fund Transfer Act ("EFTA"), added by Section 1075 of the Dodd-Frank Act, requires that the Board prescribe regulations to ensure that debit card swipe fees are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction" for the purpose of "authorization, clearance, or settlement of a particular electronic debit transaction . . . ." On December 28, 2010, the Federal Reserve Board ("Board") published a Notice of Proposed Rulemaking, *Debit Card Interchange Fees and Routing*, in the *Federal Register* ("NPRM"), which sets out proposed rules for implementing new Section 920.[1]

As an executive committee member of the Merchants Payments Coalition ("MPC"), RILA has helped to develop the substantial materials that the MPC has submitted to the Board with respect to the NPRM including a submission at the pre-rulemaking stage,[2] a submission on January 20, 2011, concerning the Board's request for comments on the fraud-prevention adjustment

[1] 75 Fed. Reg. 81,722 (proposed December 16, 2010).
[2] MPC, Pre-NPRM submission to Director Louise L. Roseman (Nov. 2, 2010), available at: http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf.

permitted under Section 920(a)(5),[3] and a detailed submission on February 22, 2011, providing views and recommendations regarding the range of issues set out in the NPRM.[4] RILA endorses each of the MPC submissions in their entirety, in particular the most recent comprehensive comment letter. RILA members have provided substantial expertise and input into the MPC's submissions, reflecting the wide support from both RILA members and the broad merchant community.

RILA offers the following comments to the Subcommittee in order to stress the underlying need for Section 920 and the NPRM to address, at least in part, the fact that the market in which interchange fees are set for debit and credit cards is fundamentally broken and to stress that the structure of Section 920 can accomplish the objective of restoring some needed competition with respect to debit interchange fees if implemented consistently through the NPRM.

Interchange Fees are Set in a Broken Market

To place the importance of Section 920 and the NPRM in context, it is essential to keep in mind how we came to this point, with interchange fees in the United States today among the highest in the world. In a functioning market, efficiencies are gained as volume increases and technology advancements are made. Competition among parties further ensures that these improvements are translated into lower costs and/or enhanced services. Yet, as discussed in detail in the MPC pre-rulemaking submission and the attached report on debit interchange fees prepared for RILA by James C. Miller III, Ph.D. ("Miller Report"),[5] in the case of interchange fees, the United States has seen just the opposite. As volume and technology have lowered the costs of operating the system, the card networks have dramatically increased interchange rates on merchants year after year. At the same time, merchants are forced to accept debit cards widely due to the overwhelming market dominance of Visa and MasterCard, which collectively controlled 84 percent of the market in 2009.[6]

Networks will claim that vigorous competition exists in the interchange marketplace, yet this competition is only in order to take market share away from network competitors by offering card issuers more generous interchange rates, to the detriment of the businesses, universities, charities, and even local, state and federal governments, all of which accept debit and credit card cards for payment. While governments and utilities generally have the ability to surcharge debit and credit card users to recoup some of these losses,[7] merchants must pass along these costs to consumers in the form of higher prices, or they must absorb them, which generally results in reduced services to consumers.

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[3] MPC, Fraud-adjustment submission to Director Louise L. Roseman (Jan. 20, 2011), available at: http://www.federalreserve.gov/SECRS/2011/February/20110203/R-1404/R-1404_012011_61804_561400767649_1.pdf.

[4] MPC, NPRM submission to the Board (Feb. 22, 2011), not yet available on the Board's website.

[5] James C. Miller III, "Addressing the Debit-Card Industry's Market Failure," (Feb. 2011) – copy attached.

[6] Miller report at ¶ 4.

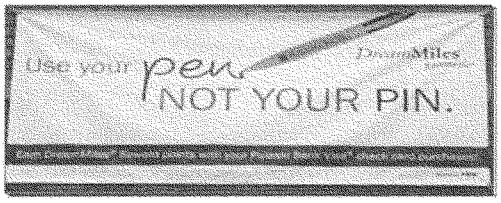
[7] For example, the Internal Revenue Service charges a "convenience fee" up to several percentage points depending on whether a credit or debit card is used for such tax payments. *See* Internal Revenue Service, "Pay Taxes by Credit or Debit Card," available at: http://www.irs.gov/efile/article/0,,id=101316,00.html.

This drive by the networks to increase interchange rates to the benefit of card issuers means that the only competition that exists among the networks is competition to raise interchange fees, unlike the fierce competition that exists in the retail industry to lower prices and offer better services to consumers day in and day out. The fact remains that banks compete every day on a host of products and services, including interest rates, terms of demand deposit accounts, etc., but this is not the case with interchange rates. Instead, every issuing bank agrees to the exact same pricing schedule for exactly the same product, thereby precluding any downward pressure on interchange prices.

Steering Toward Less Secure, More Expensive Transactions

For years card issuers have steered customers to less secure, more expensive payment alternatives. With respect to debit cards, most issuers only offer rewards points for signature debit transactions, while some offer double points for signature debit transactions but no rewards for transactions made using a Personal Identification Number ("PIN") debit transaction. Such efforts to steer consumers away from PIN debit transactions is particularly perverse since PIN debit is far more secure than signature debit. In fact, one RILA member reports that the incidence of fraud on signature debit transactions in its stores is 1 in 9,000 transactions, while the incidence of fraud on PIN debit transactions in its stores is 1 in 11,000,000 transactions. Even card issuers acknowledge the inherent beneficial security aspects of using a PIN, as they require customers using their own automatic teller machines ("ATM") to key in a PIN number rather than using a signature to authenticate a transaction.

Other banks are far more aggressive in their marketing of less secure, more expensive signature debit transactions to their customers versus the use of PIN debit transactions. For example, Pulaski Bank, a community bank headquartered in St. Louis, Missouri, at one point in 2009 ran a marketing campaign promoting its DreamMiles® Rewards card, hanging a banner outside of one of its branches that read "Use your pen NOT YOUR PIN" (emphasis original), as reflected in the picture below.[8]



Similarly, CP Federal Credit Union of Jackson, Mississippi, encourages its customers to "Use your PEN not your PIN!" (emphasis original).[9] The credit union, which reported assets of just over $300 million in 2010, qualifying it for the small issuer exemption, tells customers to "Choose CREDIT over debit!" (emphasis original) and claims that selecting the credit option

[8] Photograph of Pulaski Bank branch signage, Bentonville, Arkansas (Apr. 27, 2009).

[9] CP Federal Credit Union, ATM and Debit Cards general information (accessed on Feb. 22, 2011), available at: http://www.cpfederal.com/ASP/Products/product_4_6.asp.

when prompted is "safer, easier and NOW! even more beneficial" (emphasis original) because the cardholder is only offered rewards points when making a signature debit purchase.

Other banks employ "surcharges" that are far more direct in their messaging to consumers: sign for your debit card transactions or else you will be charged extra for the more secure PIN transaction. Chevy Chase Bank, which was acquired in 2008 by Capital One Bank of McLean, Virginia, surcharges consumers an additional $0.50 for transactions made on a debit card when a PIN is entered, yet the transaction is free if the consumer signs for the purchase.[10] Capital One Bank continues to impose these surcharges for accountholders who were previously Chevy Chase Bank customers.

Finally, the networks themselves steer customers towards less secure technology through promotions. For example, in recent years Visa has run promotions on everything from the Olympics, to the Super Bowl and the World Cup, in which consumers may qualify to win tickets for life to one of the various sporting events by using their debit cards for purchases. Upon closer examination of the fine print, however, only signature debit transactions qualify for the promotions, while PIN debit transactions do not.

We bring these examples to the Subcommittee's attention only to show how card networks and card issuers employ a multitude of tools to steer customers toward less secure, more expensive signature debit payments, all in an effort to drive the collection of higher interchange fees. These fees are paid on every purchase with a debit card by the merchant – and ultimately by consumers overall through higher prices, whether the purchase is made by cash, check or plastic. When combined with the fact that Visa and MasterCard have already rolled out, or are in the process of introducing, more secure chip-and-PIN technology in the European Union, Australia, Canada and even Mexico, American merchants are paying among the highest interchange rates in the world while using inferior 1960's magnetic stripe technology that increases the fraud costs and chargebacks that merchants, again, must pay.

New Section 920 Provides Limited, but Essential, Interchange Reforms

Against the backdrop of a broken market for setting interchange fees and its perverse incentives to maintain a more fraud-prone market, the reforms adopted by Congress in the Dodd-Frank Act are critically needed and narrowly tailored to help restore a semblance of competition with respect to debit card interchange fees. As the Miller Report concludes:

> In the case of interchange fees – and debit interchange fees in particular – the case for regulatory intervention is strong. This is truly a case of market failure: networks with monopoly power over merchants are setting prices for merchants' access to their networks on behalf of their (frequently overlapping) card-issuing members, utilizing agreements in which every bank participating in those card networks agrees to charge merchants exactly the same interchange fees, regardless of who issued the card. Thus, regulatory intervention is warranted to

[10] *See* Chevy Chase Bank Schedule of Fees for Personal Accounts (2009).

> provide the catalyst to return this market to the competitive norm and thus increase the market's overall efficiency.
>
> The pricing solution chosen by section 920(a) and the Board's proposed interchange fee standard approximates the pricing outcome that would obtain in a fully competitive market – that is, prices based on costs, not demand.[11]

We applaud the extensive work that the Board and its staff have already done to develop the regulations required by Congress in new Section 920 of the EFTA. While we again commend to the Subcommittee the MPC's detailed views and recommendations regarding the alternatives and other issues set out in the NPRM, we stress the following key points from the MPC submission:

- With respect to the regulation of interchange fees, Alternative 1 is preferable, but the safe harbor and cap should be much closer to the average per-transaction costs of authorization, clearance, and settlement ("ACS"), which issuers themselves report to be no greater than 4 cents and First Annapolis Consulting reports to be 0.33 cents for PIN debit transactions (and 1.36 cents for signature transactions).

- With respect to the prohibitions on network exclusivity, Alternative B should be fully implemented by April 2012. As a transitional measure, Alternative A should be adopted within three months after the Board issues final rules and network fees charged to merchants should be capped at current levels until Alternative B is fully implemented.

- With respect to merchant routing, the proposal set forth in the NPRM that prohibits networks or issuers from directly or indirectly inhibiting merchants from routing their transactions should be adopted.

- With respect to preventing circumvention and evasion, the MPC has proposed an amended version of the net compensation proposal, which would include a general anti-circumvention provision and close remaining loopholes.

- With respect to the adjustment for fraud prevention costs, the MPC has proposed standards drawn from and marrying the best aspects of both approaches discussed in the NPRM to balance the interests of issuers and merchants and motivate the implementation of potentially paradigm-shifting fraud prevention technologies without prescribing a particular technology.

<u>The Small Issuer Exemption Will Work</u>

An additional issue that bears particular mention, especially given today's Subcommittee hearing, is the exemption in the statue that allows banks and credit unions with assets under $10 billion to continue to collect the same debit card interchange fees that they receive today, notwithstanding the new interchange reforms. Section 920(a)(6) of the EFTA states that "this subsection shall not apply to any issuer that, together with affiliates, has assets of less than

[11] Miller Report at ¶¶ 22-23.

$10,000,000,000, and the Board shall exempt such issuers from regulations prescribed under paragraph (3)(A)." We believe that Congress was abundantly clear in this language that the limitations on interchange fees do not apply to small issuers.

Claims by credit unions and banks that such a small issuer exemption would not work fail to take into consideration the perverse incentives of the debit and credit card issuance market, in which banks and credit unions make decisions about whether to issue their cards under the Visa or MasterCard network based on which company offers them the highest level of interchange fees. Once Section 920 is implemented, exempted issuers will continue to make issuing decisions based on which network offers the highest interchange. Neither Visa nor MasterCard has any more incentive to lower debit card interchange rates for exempted financial institutions as a result of Section 920 than either had in the preceding years. For example, if post-implementation Visa were hypothetically to lower its rates for exempted institutions, these institutions would logically migrate to MasterCard because it would still offer higher rates to attract additional business (and the same would hold true if MasterCard, for example, were to lower its rate). Nothing in the Board's NPRM would fundamentally change this incentive structure for the exempted banks and credit unions. In fact, this structure is likely the reason for Visa's announcement earlier this year that it would institute a two-tier rate system for covered and exempted institutions once the final rules are implemented.[12] And, with history as a guide, we anticipate that MasterCard will announce a similar arrangement in the near future.

We believe that the concerns of exempted banks and credit unions with assets under $10 billion are due either to misinformation, or worse, to scare tactics employed by the card networks to keep exempted institutions lobbying in opposition to the NRPM. These tactics were exposed in a recent *American Banker* article in which Eric Grover, a payments consultant, was quoted as saying that higher interchange for small banks and credit unions "makes total sense" and that the only reason that networks did not put to rest unjustified concerns about why a two-tiered system would work was that it "was simply intended to scare credit unions and small banks to keep them lobbying" against the overall interchange reforms.[13]

In addition to inaccurate claims that the networks will discriminate against small banks and credit unions, some have asserted that merchants would also refuse to accept a Visa or MasterCard issued by a small bank or credit unions. That claim completely overlooks the so-called Honor-all-Cards rule imposed by the networks, which prevents merchants from discriminating by issuer, large or small.[14] In other words, if a merchant accepts Visa cards, it must accept cards issued by a single branch community bank with assets under $10 billion and also any debit cards issued by Bank of America, regardless of the issuer of the debit card.

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[12] First Data has also announced a similar two-tier pricing structure for its Star PIN-debit network. *See* Kate Fitzgerald, "Two-Tier Debit Interchange Rate Plan OK With First Data," *ISO & Agent Weekly* (Feb. 10, 2011), available at: http://www.paymentssource.com/news/first-data-debit-interchange-3005055-1.html.

[13] Sean Sposito, "Visa Plans Two-Tiered Interchange Rates After Fed Rules," *American Banker* (Jan. 10, 2011).

[14] The Honor-all-Cards rule is one of many network rules to which merchants are subject. If a merchant agrees to accept Visa or MasterCard, it must abide by these rules or face the substantial fines upwards of $5,000 a day. *See* Section 5.8.1 of MasterCard's operating rules at p. 114 at http://www.mastercard.com/us/merchant/index.html; and Visa's operating rules at pp. 406-407 at http://usa.visa.com/merchants/operations/op_regulations.html.

Benefits to Consumers

RILA would like to address head-on the claims by opponents that interchange fee reforms will only lead to increasing costs for consumers. If these claims held any validity, then when interchange fees tripled over the past decade, bank fees would have fallen by a corresponding amount. Instead, bank fees, too, have exploded during the same time period. The retail industry is fiercely competitive, with annual profit margins ranging between 1 percent and 3 percent. With such a competitive marketplace, retailers have no choice but to pass along cost savings to consumers. Retailers, after all, are in the business of selling goods, and in the fiercely competitive retail market, as the price of retail goods falls, consumers are drawn to the lowest prices and best service available. Accordingly, retailers will return savings to consumers by lowering prices, reinvesting in new and current employees, opening new stores, and offering additional services to consumers.

Over the past few months, banks have also used scare tactics on consumers and opinion leaders, blaming the interchange reforms in Section 920 of the EFTA for the death of free checking. Such predictions are ungrounded. For example, TCF Bank of Wayzata, Minnesota, announced shortly after enactment of the statute that as a covered financial institution, it would have to eliminate the "free checking" services it offers its customers, and replace it with various service fees to recoup revenue. However, only one month after proclaiming the death of free checking, TCF Bank announced that it was reinstating free checking because consumers demanded it.[15] Other banks are more upfront about the illusion of free checking, with Bank of America spokeswoman Anne Pace saying that "Customers never had free checking accounts."[16] According to Pace, "They always paid for it in other ways, sometimes with penalty fees." And, for the small issuing banks, any impact on free checking is particularly specious since, as noted above, the statute expressly excludes small issuers for the limitations on interchange fees imposed by Section 920.

Any Delay of Final Rules and Implementation is Unnecessary

RILA applauds the thorough and comprehensive work that the Board has been done in the development of the NPRM, including the surveys of card issuers, networks and merchant acquirers, on which RILA provided separate comments. Based on the extensive work done to date, we see no reason why the Board should not issue final regulations by April 21, 2011, in accordance with the statutorily mandated timeline to take effect on July 21, 2011.

In fact, we do not believe there is any rational reason for delaying the issuance of the final rules or for slowing down the implementation of the statute. Opponents of the reforms have made clear their desire to use delay of the final rules as a way to thwart and unravel interchange reforms embodied in Section 920. RILA urges Congress to reject appeals for any delay in the issuance of the final rules. Doing so would not be in the public interest and would only allow the card networks and their issuing banks to perpetuate the broken market with respect to

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[15] *See* Chris Serres, "TCF is Putting an End to Totally Free Checking," *Minneapolis Star Tribune* (Jan. 21, 2011), available at: http://www.startribune.com/business/82255367.html.

[16] Pallivi Gogoi, "Say Goodbye to Traditional Free Checking," Associated Press (Oct. 19, 2010), available at: http://finance.yahoo.com/news/Say-goodbye-to-traditional-apf-1888087707.html.

interchange fees while continuing to collect exorbitant interchange fees on debit card transactions that bear no relationship to the costs of processing the transaction.

Conclusion

RILA appreciates the opportunity to submit its views to the Subcommittee on the importance of Section 920 and its implementation by the Board rulemakings. The interchange reforms enacted in Section 920 are critically needed and will help restore a degree of competition to this broken market to the benefit of consumers and merchants, small and large, across the nation. RILA and the broader merchant community urge the Subcommittee to let the Federal Reserve rulemaking process play out, and we will vigorously oppose any attempts to delay, amendment or repeal of these essential reforms.

Attachment

Addressing the Debit-Card Industry's Market Failure

James C. Miller III

Prepared for the Retail Industry Leaders Association

February 2011

REPORT OF JAMES C. MILLER III

A. Background and Expertise

1. I have been asked by the Retail Industry Leaders Association to offer my opinion regarding the Federal Reserve Board's ("Board's") proposed rules implementing the "Durbin Amendment" to the Dodd-Frank Wall Street Reform and Consumer Protection Act -- adding section 920 to the Electronic Fund Transfer Act ("EFTA Act") -- from the perspective of their appropriateness as a regulatory intervention in the market for electronic payments. In particular, I have focused on the appropriate policy response to collusive or otherwise parallel conduct by the major firms in an industry where there is asymmetry between the competitiveness of buyers and sellers.

2. As set out more fully in my *curriculum vitae* (Exhibit 1), this assessment is based on my extensive academic and governmental experience in the field of government regulation (and deregulation). After a career in university teaching and research, I served in the Reagan Administration as the first Administrator of the Office of Information and Regulatory Affairs at the Office of Management and Budget (1981), as Chairman of the Federal Trade Commission (1981-1985), and as Director of OMB and Member of the President's Cabinet (1985-1988). Presently, I serve on the boards of several mutual funds and corporations, such as Clean Energy Fuels Corp., as well as the Board of Governors of the U.S. Postal Service. I hold a Ph. D. in economics from the University of Virginia and am the author or co-author of over 100 articles in professional journals and nine books, including *Economic Regulation of Domestic Air Transport: Theory and*

Policy (Brookings Institution, 1974), *Reforming Regulation* (American Enterprise Institute, 1980), *The Economist as Reformer: Revamping the FTC, 1981-1985* (American Enterprise Institute, 1989), and *Monopoly Politics* (Hoover Institution, 1999).

B. The Debit Card Industry

The existence of market power

3. The major card networks have monopoly power over merchants. In today's marketplace, merchants have no rational choice but to accept debit cards when presented by their customers, since the use of debit cards is so large and growing. Of the over $7 trillion in consumer expenditures for goods and services in 2009, approximately $1.6 trillion was transacted with debit and prepaid cards (for comparison, $1.8 trillion was transacted with credit cards and $1.6 trillion with cash.)[17] Because of their dominance of the card market, Visa and MasterCard control the costs merchants pay to accept debit cards as a means of payment.

4. There are several reasons for this conclusion. First is the history of development of the two major networks. Both Visa and MasterCard were organized by large banks and controlled by them. As they grew, it became increasingly worthwhile for major banks to issue both networks' cards to their customers. And since the banks controlled both systems -- their representatives sat on the boards of both -- it was only natural that the two card networks would establish schedules of services and prices that are nearly identical. By 2009, Visa accounted for 61 percent of all debit-card transactions, MasterCard for 23

[17] *Nilson Report,* Issue 962 (December, 2010), pp. 1 and 10-11.

percent, and a handful of regional networks for the rest.[18] Merchants have little choice but to accept cards from at least one of these two giant networks, and for survival reasons they usually sign with both. Accordingly, the market for debit card transactions -- vigorously competing merchants on the one side and monopolistic card networks on the other -- is quite asymmetric.

5. It is my understanding that over time the two card networks have charged consistent and increasingly higher interchange fees to merchants, all of whom are captive and have no countervailing pressure available to apply. In short, while banks have faced competition in many lines of their businesses, they have had no difficulty in monopolizing the market for card acceptance.

6. Moreover, I understand that debit cards were initially provided by regional networks using PIN authentication and the processing infrastructure of ATM-networks. These networks charged either zero (at-par) interchange fees or paid interchange fees *to* merchants to compensate them for their investment in PIN pads. After 1990, Visa and MasterCard began to promote their "signature" debit cards, processed over their credit-card networks. Signature debit interchange fees were set at the much-higher rates paid for credit-card interchange. I also understand that, around 1990, Visa purchased Interlink, which was among the leading PIN debit networks in the United States, and began to increase its interchange fees. As Visa continued to drive up Interlink interchange rates, the competing PIN debit networks raised their rates to maintain levels of issuance under the pricing umbrella created by Visa. The result has been a convergence

[18] *Nilson Report*, Issue 961 (December, 2010). p. 10.

of PIN and signature debit rates. Thus, the level of interchange fees charged for Visa's and MasterCard's PIN products, and those of the regional PIN networks, followed an upwards path, despite little evidence of increasing costs in making such transactions.

7. Monopoly power is also evidenced by the prices established by the card networks. The pricing schedules of Visa and MasterCard show a pattern of what economists call "third degree price discrimination" -- which can take place only if there is monopoly power.[19] While the cost of a transaction hardly varies by type of merchant or size of a sale, the interchange fee does. Grocery stores, for example, typically pay a low base fee, whereas restaurants and airlines pay much higher interchange fees.[20] And the fee increases with the amount of the sale. It is easy to see that the card networks are establishing relatively low fees for merchants with relatively high (price-) elasticities of demand for payment cards, and higher fees for those with less elastic demands. The same is true with respect to size of sale: the larger the sale, the less elastic the demand. Again, in a truly competitive market, sellers are not able to divide the market and charge different prices to different consumers unrelated to differences in costs.

8. That this form of discriminatory (monopolistic) pricing is the norm was spelled out recently in Congressional testimony by Visa's General Counsel: "Products and services in this economy should be *fairly priced based on the value provided*, not some limited concept of cost, and certainly not on some

[19] See, for example, D. Salvatore, Microeconomics: Theory and Applications (2003), p. 334.

[20] See, for example, Visa USA Interchange Reimbursement Fees (October 16, 2010), p. 2; and (Visa) Interlink Interchange Reimbursement Fees (October 16, 2010), p. 2.

artificially selected portion of those costs."[21] Again, in a competitive market, prices are related to costs, not to the benefits derived.

9. While debit-card networks establish very high, monopolistic fees for merchants, the issuing banks compete strongly for new card holders – which, of course, leads to more debit-card purchases and more interchange fee revenue. This competition for new card holders (or retention of current card holders) takes a peculiar form, however. The various issuing banks (in alliance with, and incentivized by, the card networks' schedule of charges) offer cards with extensive benefits. "Points" are the ubiquitous benefit -- a sort of currency that can be traded for travel, goods, and even redemptions in cash. I also understand that special favoritism in the form exclusive offers on goods is also common.

10. The very existence of this extensive non-price competition is itself an indication that the debit-card market is not fully competitive. If the banks and the card networks were not charging the merchants monopolistic rates, and instead were charging them truly competitive rates, the extent of such non-price competition for cardholders would be much less. That is, such supra-competitive margins, built into the current interchange fee schedules, lead to marketing efforts that tend to "compete away" those very margins.

The setting of monopolistic interchange fees

11. The cards networks' rules and procedures make clear that each card system is the contractual "hub" through which their interchange fees are set --

[21] Prepared Statement of Joshua R. Floum before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services (February 17, 2011), p. 6; emphasis added.

nominally in the best interests of all participants in the payment system, but actually on behalf of their card issuers.

12. Indeed, Visa's General Counsel has advised the Board that interchange fees should *not* reflect the costs of any particular card issuer, because the networks set fees for all of their issuers. "We believe that this approach [implementing the rate model at the network level] is the most practical and efficient for a number of reasons, including *the fact that the payment card networks currently set the interchange rates for debit transactions over those networks. . . .*[and that]. . . *issuers do not in practice set interchange fees; rather, these fees are set by networks* and issuers accept transactions from different networks."[22]

13. In turn, once interchange fees are set, under the Visa and MasterCard rules – which are binding contracts between each network and its issuers and acquirers—the networks' members use those rates in their payment card transactions.[23]

14. Finally, the networks' "honor all cards" rules bind merchants to this result. Once a merchant decides to accept Visa or MasterCard debit cards, for example, it must accept all debit cards of that type bearing the network's logo. There is no need for each bank to negotiate with individual merchants to accept its debit

[22] See letter from Joshua R. Floum to Louise Roseman, Director, Division of Reserve Bank Operations and Payment Systems, Federal Reserve Board (November 8, 2010), pp. 13 and 17; emphasis added.

[23] See, for example, Visa International Operating Regulations (Public Version, April 1, 2010), pp. 57 and 961-62; Visa, Inc. SEC Form 10-K (November 19, 2010), p. 13; and MasterCard Rules, Section 9.4 (October 29, 2010). The rules technically permit issuers and acquiring banks to enter into bilateral interchange arrangements, but as noted in paragraph 12, such bilateral arrangements have not occurred in practice.

cards. Thus, networks' current rules enable each debit-card-issuing bank to take advantage of the network's monopoly power to obtain excessive interchange fees.

15. Deposit accounts are not offered in isolation, but as a means of generating funds that enable banks to make loans -- which, in turn, provide interest revenue. For example, in the case of checks, the customer's bank absorbs *all* the cost of the transaction (except for fees that may be charged by the merchant's bank for depositing a check). Banks have traditionally done so precisely because demand deposits enable the bank to make loans, on which the bank earns interest, and because the relationship opens opportunities for the bank to provide other (remunerative) services to the customer.

C. EFTA Act, Section 920

16. I have reviewed Section 920 of the EFTA Act, the Board's proposed rulemaking implementing that section,[24] and major submissions to the Board pursuant to that proceeding. Section 920(a) requires the Board to establish standards governing debit-card interchange fees. The statute defines those fees as "any fee established, charged, or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction."

17. The scope of price intervention required by the statute is narrow: it does not address prices charged by an acquiring bank for its role in processing the merchant's debit-card transactions, nor does it restrict the fees that a card

[24] Federal Reserve Board, *Notice of Proposed Rulemaking*, 75 *Federal Register* (December, 28, 2010), pp. 88722 *et seq.*

network may charge acquiring and issuing banks for its role in processing such transactions (except to prevent evasion of the interchange fee standards). As I will discuss below, this limitation on the Board's regulatory power is appropriate, as such additional constraints are not needed to accomplish the objective of making the card market more competitive. By its terms, the statute does not address independent action by a debit-card issuer to charge transactions fees directly to merchants (possibly through the merchant's acquiring bank) when one of the issuer's cardholders purchases goods or services from the merchant, leaving such transactions to the ordinary forces of competition. This competition could take many forms and would be based on rivalry among individual card issuers (without reliance on networks or honor-all-cards rules) to gain acceptance of that card as a payment mechanism at individual merchants. There would be no need for regulation to limit fees that might be charged as a result of interaction between individual merchants and individual issuers, as long as those fees are transparent and are subject to the discipline of market competition. Thus, in such a competitive environment, there would be no need for regulators to specify what costs such fees might or might not recover.

18. In contrast, section 920(a) addresses fees collected by debit-card issuers when those fees are charged by or through a network, thus enabling an issuer to utilize the network's market power. In this regard, while subsection 920(b)(2) gives merchants the right to provide discounts and other incentives for differing forms of payment -- cash, checks, debit cards, or credit cards -- it is my understanding that the "honor-all-cards" requirements of Visa and MasterCard,

for example, will continue to require non-discriminatory acceptance of cards from every issuer of the relevant type of card offered by the card network.

19. Section 920(a) simply ensures that when debit-card issuers rely on card networks' market position to obtain compensation from merchants as a result of card acceptance, the level of those fees are not set at a supracompetitive level but are "reasonable and proportional" to the card issuers' incremental costs for authorization, clearance, and settlement of those transactions.

20. Importantly, Section 920(b)(1) sets in motion potential longer-term structural reform by (a) ensuring that card issuers offer multiple networks for the routing of debit-card transactions for each type of card authorization method, and (b) giving each merchant the ability to direct and/or prioritize the choice of network to be used in a debit-card transaction. To the extent that these provisions are implemented in an effective and timely manner, networks may, arguably for the first time, compete on price for merchants' business.

D. An Appropriate Response to Market Failure

21. Throughout my career I have been a consistent skeptic about the ability of government intervention to improve the functioning of the marketplace. But sometimes a free market does not – or for any number of reasons cannot – correct a divergence from the competitive norm. The persistence of such divergences over time, uncorrected by unencumbered economic forces, is among the few scenarios in which I believe there is reason for government to examine and possibly correct the underlying cause.

22. In the case of interchange fees -- and debit interchange fees in particular -- the case for regulatory intervention is strong. This is truly a case of market failure: networks with monopoly power over merchants are setting prices for merchants' access to their networks on behalf of their (frequently overlapping) card-issuing members, utilizing agreements in which every bank participating in those card networks agrees to charge merchants exactly the same interchange fees, regardless of who issued the card. Thus, regulatory intervention is warranted to provide the catalyst to return this market to the competitive norm and thus increase the market's overall efficiency.

23. The pricing solution chosen by section 920(a) and the Board's proposed interchange fee standard approximates the pricing outcome that would obtain in a fully competitive market – that is, prices based on costs, not demand. Further, the relevant costs identified in the statute and incorporated by the Board in its notice are those costs that I understand are directly incurred in processing each transaction: the costs of authorization, clearance, and settlement.[25]

24. Most significantly, section 920(a) requires regulation only of debit-card interchange fees established by payment card networks. Issuers are free to charge fees for card acceptance negotiated directly with merchants as long as the imposition of these fees is not characterized by market failure, including network honor-all-cards rules. Thus, the proposed regulations appear to be

[25] See Federal Reserve Board *Notice, ibid.*, pp. 88722 and 88735. I realize that the Board is undertaking a separate rulemaking regarding an adjustment for issuer-specific fraud prevention costs using the statutory considerations for such an adjustment, but that is beyond the scope of my report.

consistent with both the limited mandate of section 920 and the policy prescriptions embodied in that provision.

25. It is also notable that the regulatory scope of Section 920 is narrow. It does not regulate any fees that a debit issuer imposes individually and directly (rather than through a network) on merchants or other parties. There should be no market failure associated with such issuer-specific fees as long as they are subject to the discipline of market competition. It is appropriate, therefore, that Section 920 was drafted to leave such fees unregulated under those conditions.

26. Finally, the rules proposed by the Board to implement subsection 920(b)(1) to provide multiple network options on a card and to mandate merchant selection of network routings, promise a longer-term marketplace solution. If implemented to require at least two network choices for each PIN and signature method of authorization, there should be a meaningful increase in competition among issuers. By choosing the lower-cost option, merchants could force issuers and card networks to reduce their interchange and network fees -- perhaps making the regulation of fees no longer necessary, once competition were firmly in place.

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EXHIBIT 1

James C. Miller III

Curriculum Vitae
January 2011

Education and Professional Activities

Degrees: Ph.D. (Economics), University of Virginia, 1969

B.B.A. (Economics), University of Georgia, 1964

Current Positions: Senior Advisor, Husch Blackwell Sanders, LLC, since June, 2006

Senior Fellow (by courtesy), Hoover Institution (Stanford University), since December 1988

Distinguished Fellow, Center for Study of Public Choice, George Mason University, since October 1988

Member, Board of Governors, U.S. Postal Service, since April 2003 (elected chairman 2005, 2006, and 2007))

Member, Board of Directors, Washington Mutual Investors Fund, since October 1992 (Member of Advisory Board, November 1989 – October 1992)

Member, Board Directors, The Tax Exempt Fund of Maryland, since April 2000

Member, Board of Directors, The Tax Exempt Fund of Virginia, since April 2000

Member, Board of Directors, The J.P. Morgan Value Opportunities Fund, since December 2001

Member, Board of Directors, Clean Energy Fuels, Corp., since May 2006

Member, Board of Directors, Americans for Prosperity, since February 2004

Member, Board of Directors-Emeritus (previously Co-Chairman or Counselor), The Tax Foundation, since October 1989

Chairman of the Executive Committee, International Tax and Investment Center, since September 2009

Previous Positions: 2010

Member, Board of Directors -Emeritus (previously Member of Board), Progress & Freedom Foundation, April 1994 – March

Chairman of an Independent Commission to address the fiscal challenges of Cayman Island Government; established by Cayman Islands Government; October 2009 – February 2010

Chairman (or Chairman Emeritus), The CapAnalysis Group (of Howrey, L.L.P.), April 2002 – January 2006

Chairman (or Chiarman Emeritus), The CapAnalysis Group)of Howrey, L.L.P.), April 2002 – January 2006

Member, Board of Directors, Independence Air (formerly Atlantic Coast Airlines d.b.a. "United Express" and "Delta Connection"), March 1995 – January 2006

Member, Board of Visitors, George Mason University, June 1998 – June 2002

Distinguished Fellow, Mercatus Center, George Mason University, August 1997 – April 2003

Director, LECG – Economics-Finance, November 2002 – April 2003

Senior Advisor, Hagler Bailly, January 2000 – November 2002.

Member, Board of Directors and/or Counselor), Citizens for a Sound Economy, January 1989 – April 2003

Member, Board of Directors, The Tax Foundation, October 1989 – April 2003

Member, Board of Visitors, U.S. Air Force Academy, November 1988 – November 1990.

Director, U.S. Office of Management and Budget, Member of President's Cabinet, and Member of National Security Council, October 1985 – October 1988

Vice Chairman, Administrative Conference of the United States, December 1987 – October 1988 (Member of Council, November 1981 – December 1987)

Chairman, U.S. Federal Trade Commission, September 1981 – October 1985

Administrator, Office of Information and Regulatory Affairs, U.S. Office of Management and Budget; and Executive Director, Presidential Task Force on Regulatory Relief, January 1981 – September 1981

Resident Scholar, Center for the Study of Government Regulation, The American Enterprise Institute for Public Policy Research, January 1977 – January 1988; Co-Director of the Center, March 1977 – January 1981; Member, Board of Editors, Regulation, July 1977 – January 1981; and Member, Board of Editorial Advisors, The AEI Economist, September 1977 – January 1981

Consultant, National Science Foundation, July 1977 – January 1981

Lecturer (in Economics), George Washington University, September 1971 – May 1972, September 1975 – May 1976, and September 1978 – December 1980

Assistant Director (for Government Operations and Research), U.S. Council on Wage and Price Stability, October 1975 – January 1977

Adjunct Scholar, The American Enterprise Institute for Public Policy Research, May 1975 – January 1977

Senior Staff Economist, U.S. Council of Economic Advisers, July 1974 – October 1975

Associate Professor of Economics, Texas A&M University, August 1972 – May 1974

Consultant, U.S. Department of Transportation, March 1972 – July 1974

Consultant, National Bureau of Standards, January 1974 – June 1974

Research Associate, The American Enterprise Institute for Public Policy Research, May 1972 – July 1972

Associate Staff, The Brookings Institution, August 1972 – May 1974

Senior Staff Economist, U.S. Department of Transportation, December 1969 – February 1972

Assistant Professor of Economics, Georgia State University, September 1968 – December 1969

Affiliations: American Economic Association

Public Choice Society

Southern Economic Association (Vice President, 1990 – 1991; Member of Executive Committee, 1980 – 1982)

Selected Publications and Presentations

Books: Monopoly Politics (Stanford: Hoover Institution Press, 1999)

Fix the U.S. Budget!: Urgings of an "Abominable No-Man" (Stanford: Hoover Institution Press, 1994)

The Economist as Reformer: Revamping the FTC, 1981-1985 (Washington: American Enterprise Institute, 1989)

The Federal Trade Commission: The Political Economy of Regulation (co-editor and contributor, with Robert J. Mackay and Bruce Yandle; Stanford: Hoover Institution Press, 1987)

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Articles:

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Presentations before Regulatory Agencies:

Co-authorship of and responsibility for approximately 60 Council on Wage and Price Stability filings and/or testimony before U.S. Government agencies, including the U.S. Departments of Agriculture, Commerce, Health, Education and Welfare, Housing and Urban Development, Interior, and Transportation; the Civil Aeronautics Board, the Coast Guard, the Consumer Product Safety Commission, the Environmental Protection Agency, the Federal Aviation Administration, the Federal Deposit Insurance Corporation, the Federal Energy Administration, the Federal Power Commission, the Federal Reserve Board, the Federal Trade Commission, the Food and Drug Administration, the International Trade Commission, the Interstate Commerce Commission, the National Highway Traffic Safety Commission, the Occupational Safety and Health Administration, the Postal Rate Commission, and the Securities and Exchange Commission (October 1975 January 1977)

Other testimony before the Department of Energy, the Civil Aeronautics Board, the Interstate Commerce Commission, the

Postal Rate Commission, the National Commission for the Review of Antitrust Laws and Procedures, and the California and Pennsylvania public utilities commissions (1970-1979)

Presentations before Committees of the U.S. House of Representatives:	U.S. House of Representatives Committee on Appropriations; U.S. House of Representatives Committee on the Budget; U.S. House of Representatives Committee on the Judiciary; U.S. House of Representatives Committee on Public Works and Transportation; U.S. House of Representatives Republican Study Committee; U.S. House of Representatives Rules Committee; U.S. House of Representatives Subcommittee on Administrative Law & Governmental Relations, Committee on the Judiciary; U.S. House of Representatives Subcommittee on Aviation, Committee on Public Works and Transportation; U.S. House of Representatives Subcommittee on Commerce, Consumer and Monetary Affairs, Committee on Government Operations; U.S. House of Representatives Subcommittee on Commerce, Justice, State, the Judiciary and Related Agencies, Committee on Appropriations; U.S. House of Representatives Subcommittee on Commerce, Transportation and Tourism, Committee on Energy & Commerce; U.S. House of Representatives Subcommittee on Consumer Protection and Finance, Committee on Oversight and Investigations; U.S. House of Representatives Subcommittee on Economic Stabilization, Committee on Banking, Finance and Urban Affairs; U.S. House of Representatives Subcommittee on Legislation and National Security, Committee on Government Operations; U.S. House of Representatives Subcommittee on Monopolies & Commercial Law, Committee on Judiciary; U.S. House of Representatives Subcommittee on Oversight and Investigations, Committee on Energy and Commerce; U.S. House of Representatives Subcommittee on Science, Research and Technology, Committee on Science and Technology; U.S. House of Representatives Subcommittee on Small Business Problems, Committee on Small Business; U.S. House of Representatives Subcommittee on Transportation and Commerce, Committee on Interstate and Foreign Commerce; and U.S. House of Representatives Subcommittee on Treasury, Postal Service and General Government Appropriations
Presentations before Committees of the	U.S. Senate Committee on Appropriations; U.S. Senate Committee on the Budget; U.S. Senate Committee on Commerce, Science, and Transportation; U.S. Senate Subcommittee on the Constitution, Committee on the Judiciary; U.S. Senate Committee

U.S. Senate:	on Governmental Affairs; U.S. Senate Committee on the Judiciary; U.S. Senate Committee on Small Business; U.S. Senate Subcommittee on Administrative Practice and Procedure, Committee on the Judiciary; U.S. Senate Subcommittee on Antitrust and Monopoly, Committee on the Judiciary; U.S. Senate Subcommittee on Alcoholism and Drug Abuse, Committee on Labor and Human Resources; U.S. Senate Subcommittee on Aviation, Committee on Commerce, Science and Transportation; U.S. Senate Subcommittee on Commerce, Justice, State and Judiciary, Committee on Appropriations; U.S. Senate Subcommittee on Consumer, Committee on Commerce, Science and Transportation; U.S. Senate Subcommittee on Federal Expenditures, Research and Rules, Committee on Government Affairs; U.S. Senate Subcommittee on Intergovernmental Relations, Committee on Governmental Affairs; U.S. Senate Subcommittee on Productivity and Competition, Committee on Small Business; U.S. Senate Subcommittee on Regulatory Reform, Committee on the Judiciary; U.S. Senate Subcommittee on Treasury, Postal Service, and General Government Appropriations; and U.S. Senate Special Committee on Aging
Presentations before Joint Congressional Committees:	U.S. Joint Economic Comm. Subcommittee on Economic Goals and Intergovernmental Policy, U.S. Joint Economic Committee; Subcommittee on Trade, Productivity and Economic Growth, U.S. Joint Economic Committee; Congressional Grace Caucus; and Motor Carrier Ratemaking Study Commission
Expert Reports:	Various

Panel 1: Any Witness

I have heard from all sides affected by the proposed interchange rules, most notably consumers in my district who are angered because they are the ones that will directly feel the impact from the reduced interchange rate, which is unfair, since the justification for doing interchange is to "protect" consumers.

- I would like to know what the operational, as well as capital impact the proposed Federal Reserve regulations on interchange will have on both the individual institutions, and for the associations, your member companies.

A: At Gerber FCU, we have developed our strategic direction around providing outstanding service through needed products. Our pricing for any one product is not independent of pricing for others. For example, we encourage our members to open checking accounts (share drafts) and debit cards linked to those accounts. We do this because the income generated by debit interchange fees allows us to offer free checking, free bill pay services, free electronic statements, reimbursed ATM fees for using foreign machines, etc. The loss of $210K annually from the proposed Fed rule on debit interchange cannot be absorbed by our current bottom line as we budget to maximize the return to member by keeping our bottom line as close to zero (without losing money) as we can. Our examiners and regulators at the NCUA are not going to look favorably if we let that loss stand without taking any mitigating actions to offset it. These actions could include higher fees charged for other products and services; reduction in costs through limitations on products, lower payroll, fewer hours open, etc.; lower rates on deposits/higher rates on loans to increase net interest margin - neither of which makes any sense in our current economy where we are trying to encourage loans and have the lowest rates paid to depositors in decades.

Our capital position a few years ago was 12%. Currently, it is 10.7% due to losses from higher provision expense (loans going bad) and assessments from the NCUA for corporate stabilization and share insurance as well as some deposit growth. Credit unions, being member owned, have only been able to raise capital through retained earnings.

Our regulator, the NCUA, will not accept a raid on our allowance for loan loss account to make up for the lost revenue from the government-fixed price on debit interchange. Therefore, we would have to go against our own strategic direction, our Board's wishes, and a long history of responsible credit union management and take more from our members to satisfy the government's desire to intrude in our operations to the benefit of merchants. Our members, who are our owners, are also consumers in every way, shape and form. These are not Wall Street types who have benefited from prior years' practices.

These are hard-working folks who just want a fair shake in their everyday living. The Durbin Amendment does not provide that - it almost guarantees a bigger bite out of consumers' pockets all for the benefit of big retailers as it has no provision guarantee any benefits of the new interchange price cap are passed on to consumers.

Many other credit unions are in similar situations as mine. Recent NAFCU surveys of membership, found that nearly 65% of credit unions are considering eliminating free checking to help mitigate lost revenue from the debit interchange rule, and 67% are considering imposing annual or monthly fees on debit cardholders. Implementation of this rule could also lead to lower dividends and higher costs of credit, as 52% of credit unions may consider reducing rates on deposit accounts and 25% will consider increasing rates on loans. Furthermore, it may lead to job losses, as nearly 19% of credit unions will consider reducing staff at their credit unions and nearly 21% will consider closing existing branches or postponing plans to open new ones if the capped rate becomes the default rate for all issuers, which looks to be likely, for, as the Subcommittee is aware, Federal Reserve Chairman Ben Bernanke expressed the very real possibility that the small issuer exemption "will not be effective in the marketplace" in testimony to Congress. Chairman Bernanke pointed to two factors to support this assessment – first, that merchants will reject more expensive cards from smaller institutions, and second, that networks will not be willing to differentiate the interchange fee for issuers of different sizes.

Responding to Questions from Mrs. McCarthy of New York:

Panel 1: Any Witness

I have heard from all sides affected by the proposed interchange rules, most notable consumers in my district who are angered because they are the ones that will directly feel the impact of the reduced interchange rates, which is unfair, since the justification for doing interchange is to "protect" consumers.

- I would like to know what the operational, as well as capital impact the proposed Federal Reserve regulations on interchange will have on both the individual institutions, and for the associations, your member companies.

Mr. Cheney: The proposed interchange regulation will significantly reduce the amount of debit interchange income credit unions earn, despite the exemption and Congressional pledges to the contrary. The only real question is how much.

At one extreme, through some combination of an ineffective dual pricing system or merchant steering in favor of large issuer cards, credit unions' interchange fees could converge on the rate set for very large institutions, or 7 to 12 cents per transaction. In that case, even at the higher 12 cent level, based on 2010 estimated volumes, credit unions would find their net income reduced by $1.6 billion. That would represent approximately 17 basis points (bp) of average assets and would amount to a third of credit unions' recent net income of around 50 bp.

Even if net income recovers to pre-recession levels, the lost interchange income would represent about a fifth of total net income. Absent any alternate price or fee increases by credit unions, such a reduction in income would lower capital at debit card issuing credit unions by 10% after six years. For those credit unions currently under regulatory Prompt Corrective Action (PCA) restrictions due to low capitalization levels, or close to PCA thresholds, such a reduction of net income would seriously impair their ability to restore capital, since earnings retention is the only source of credit union capital.[1]

Even if we conservatively estimate that after the passage of a few years the effect of the debit interchange regulation is only half the reduction to be experienced by larger institutions, the effect would still be substantial. At 2010 volumes, net income would fall by about $800 million or 9 bp. As a proportion of total net income, the loss would be almost 20% at current net income rates, and almost 10% if and when net income reaches pre-recession levels.

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[1]By law – not regulation, as is the case for other insured depositories – credit unions must maintain a 7% net worth (or leverage) ratio in order to be considered "well capitalized." The law also specifies that only retained earnings constitute net worth for credit unions. If credit unions fall below the 6% adequately capitalized threshold, a variety of sanctions apply. (See Section 216 of the Federal Credit Union Act.)

However, that is not where the story ends, certainly not for credit unions. The harmful effects of this law and regulation will not just be the loss of revenue to financial institutions, but the inevitable result will be its adverse impact on consumers.

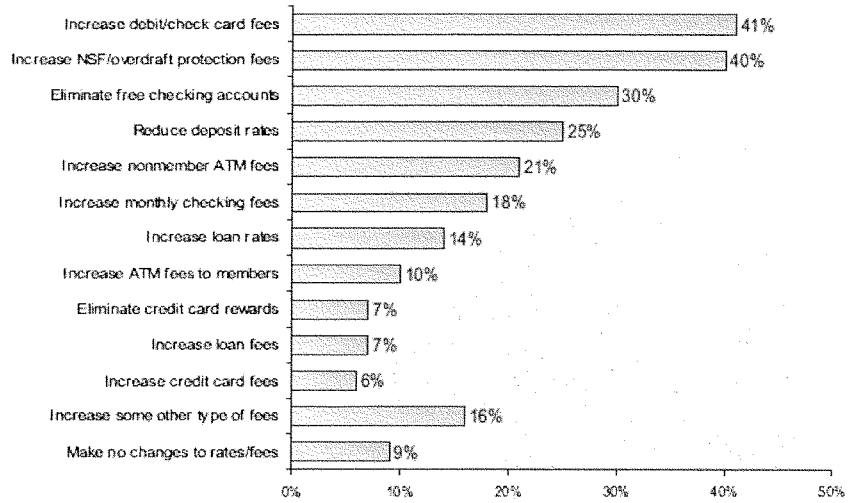
If credit unions experience the significant reduction in debit interchange revenue that is expected as a result of this rule, the National Credit Union Administration (NCUA), which oversees the National Credit Union Share Insurance Fund, will nonetheless expect credit unions to maintain current net income levels and replace the lost revenue. This means that credit unions will have to take steps to cover their losses to ensure that they continue to operate in a safe and sound manner.

Unlike the big banks, which can recover lost revenue by reducing shareholder profits, credit unions have but one choice -- to pass the costs on to our members. Credit union members will lose as a result of these rules when credit unions are forced to reduce dividends, recover fees from members for debit related or other services, or refrain from offering checking account services if they do not already do so. The choices facing the boards of directors and management of credit unions are relatively straightforward and carry a consistent theme: charge more to consumers for services or reduce the services offered to consumers. Either way it is a bad deal for consumers.

According to CUNA's 2010-2011 Fee Survey, 91% of credit unions offering debit cards anticipate making some sort of change to their rates, fees, and/or services as a result of the negative impact of the regulation. The most common changes credit unions anticipate making will be to introduce or increase debit card fees and to increase nonsufficient funds (NSF)/overdraft protection fees. About 40% of credit unions cite these potential changes as shown in the following graphic. Beyond this, 25% to 30% of credit unions say they might eliminate free checking accounts and/or lower deposit rates as a result of the regulation.[2]

[2]Credit Union National Association. "Credit Union Fees Survey For Strategic Planning 2010-2011." Washington DC: 2010. 4-4.

Changes Credit Unions Would Make Due to Negative Impact of Check Card Interchange Legislation



Note: Limited to credit unions that offer the account/service.

If the exemption for small issuers proved completely ineffective, the Board's proposed 12 cent fixed fee could require credit unions to impose an annual fee in the range of $35-$55 per debit card, a fee in the range of 25 – 35 cents per transaction, or some combination of the two in order to maintain pre-reform revenue. These would be new fees to our members.

Panel 1: Mr. Cheney

I have heard routinely from small businesses access to credit is difficult, and that inhibits expansion and job growth.

As your testimony states, there is a cap on the member business loans credit unions can make. If they cap was raised, to the requested 27.5%, do you have an estimate of how many more loans your credit unions members would be able to make?

Mr. Cheney: If the statutory credit union member business lending cap were increased to 27.5%, credit unions could lend an additional $13 billion in the first year after implementation, helping small businesses create over 140,000 new jobs.[3] This could be done at no cost to taxpayers.

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[3] We make the following assumptions in calculating this estimate.

1. Grandfathered credit unions (i.e., those exempt from the MBL cap and have outstanding business loans above the 12.25% cap) do not increase lending;
2. Non-MBL lending credit unions lend in amount equal to 1% of assets on average under the new authority;
3. All other MBL CUs lend in amount equal to their current use rate;
4. Estimates produced using assumptions 1-3 are further adjusted as follows:
   * CUs with net worth/assets <=6% are assumed to have no MBL growth
   * CUs with net worth/assets between 6% and 7% remain at the current 12.25% cap.
   * CUs with MBL/assets >= 10% are limited to a 30% increase in MBLs in the 1st year.
5. First year increases: baseline estimate = 50% of new use rate; adjusted/conservative estimate = 40% of new use rate.
6. Employment increase is based on Council of Economic Advisors 5/09 ARRA job creation estimates ($92,000 in spending creates 1 job)

Response on behalf of Kell Kelly.

The proposed debit card interchange price cap will affect the operations and capital structure of financial institutions.

Capital

The interchange fee cap will reduce bank revenue by 75-80% and will reduce overall industry revenue by over $14 billion. This will require every individual bank to face difficult choices in an attempt to increase revenues or to cut costs to offset the decrease in revenue. Banks must choose from raising checking account, debit card, and other fees, or, closing branches; laying employees; and/or limiting other services that other customers have come to expect. Regardless of the efforts to harness alternative revenue sources or to reduce expenses, banks expect to see revenues drop.

The reduction in revenue will reduce bank capital and the amount of funds available for lending. Ironically, the debit card price caps will make it harder for banks to approve loans to businesses because there will be less money available to lend.

Operations

The proposed interchange routing requirements will affect bank operations. The proposed rule poses two alternatives for consideration

Alternative A. The first alternative would require a debit card to have at least two unaffiliated payment card networks available for processing a debit card transaction. Under this alternative, an issuer could comply, for example, by having one payment card network available for signature transactions and one unaffiliated network available for PIN transactions initiated at a point of sale. This option would require many issuers to add to their debit card a new unaffiliated PIN network to process PIN transactions. Such a transition will be costly and time-consuming because the issuer will be required to add a new relationship with new contract terms related to settlements and dispute resolutions and other points of contact. Card issuers will be required to maintain separate but parallel systems for the processing transactions received from two separate networks. The issuer will also lose any preferred pricing benefit it may have had when its contract was exclusive with one network. Many debit card issuers will incur significant costs associated with complying with Alternative A. Nevertheless, this option avoids the disruption resulting from a requirement that issuers have two signature networks enabled on each card as Alternative B would require as discussed below.

Alternative B. The second alternative would require a debit card to have at least two unaffiliated payment card networks available for processing debit card transactions for each method of authorization available to the card holder. In other words, the card would have to be enabled for two signature networks and two PIN networks. The Board notes that 6.7 million merchant locations in the United States accept signature transactions and only 1.5 million were able to

accept PIN transactions. A requirement that debit card transactions be processed through two unaffiliated signature networks would expand the choice of those merchants. These merchants would benefit from Alternative A by enabling their devices to accept PIN transactions.

If implemented, Alternative B would be extremely disruptive and cause a massive reorganization of the debit card system at the expense of the proposed rule's intended beneficiaries, merchants, as well as issuers. As noted earlier, the current infrastructure does not support two signature networks. Adding a second signature network would require extensive and complex technical changes involving software and hardware updates at the card networks and reprogramming costs for merchant point of sale devices. The process of adding a second signature process would require several years, and the costs would far outweigh any benefit to the consumers or merchants. In addition, requiring at least two unaffiliated networks for each type of authorization would multiply contract negotiation and management costs. It would also increase costs associated with ongoing transactions with multiple, and ultimately duplicative settlement processes and dispute resolution schemes among the many issues that would now have to be managed against multiple sets of rules and contracts. The problems associated with multiple PIN networks outlined in the prior section will be multiplied if more than one unaffiliated network is required to be placed on each card.

April 4, 2011

The Hon. Carolyn McCarthy
2346 Rayburn House Office Building
Washington, DC 20515

Re: Questions for Financial Institutions Subcommittee Hearing: "The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses"

Dear Congresswoman McCarthy:

Thank you for the opportunity to comment further on the Federal Reserve Board's (FRB) proposed interchange rules. This letter is a response to your March 22 question asking to know more about what the operational, as well as capital impact, the proposed FRB regulations on interchange will have on American Financial Services (AFSA) member companies.

The sheer amount of lost revenue is likely to result in a number of additional charges to, and reduced services for, consumers. For example, financial institutions could charge for various debit card-related products and services that are now offered free of charge, such as free debit cards and free debit card transactions. Card issuers could also begin to discourage the use of debit cards for certain transactions which carry greater fraud and operational risk. Additionally, there could be a reduction or termination of various products and services associated with debit card programs.

Asking financial institutions to significantly lower their revenue during a period of financial uncertainty, especially when regulators are urging issuers to increase their capital bases, seems counterproductive. Financial institutions will need to look to various forms of cost savings, including the possibility of layoffs in an industry that already has seen recent and severe declines in its workforce. They will be discouraged from investing in the improvement, maintenance, and security of the debit card interchange payments system because those issuers are unlikely to recoup the costs of such investments, let alone make any return on capital. This will undoubtedly have an effect on safety and soundness.

Please feel free to contact me with any questions at 202-296-5544 or cstinebert@afsamail.org.

Sincerely,

Chris Stinebert
President & CEO
American Financial Services Association