Community Bankers Association of Illinois

Summary of 2013 Federal Policy Priorities

The Community Bankers Association of Illinois supports fair competition for financial services, the clear separation of banking and commerce, and the dual banking system; and opposes the concentration of economic and financial resources as evidenced by mega banks deemed too-big-to-fail. Based on these principles CBAI proposes the following 2013 Federal Policy Priorities to help community banks better serve their customers and communities.

- **Downsize Too-Big-To-Fail Banks and Financial Firms to Protect Our Financial System, Economy and American Taxpayers from Future Bailouts**
- **Support Community Bank Regulatory Relief as Contained in the Independent Community Bankers of America's (ICBA) *Plan for Prosperity***
- **Support Tiered Regulations and Supervision for Community Banks**
- **Support Community Bank Exemptions From the Basel III Capital and Risk-Weight Requirements**
- **Oppose Expanded Powers for Tax-Exempt Credit Unions**
- **Oppose Expansion of the Farm Credit System (FCS)**
- **Support Mortgage Lending Reform**
- **Support Housing Finance (GSE Secondary Market) Reform**
- **Stop Aggressive Bank Regulatory Examinations**
- **Support Positive Tax, Accounting, and Auditing Changes**
- **Positively Influence the Continuing Implementation of the Dodd-Frank Wall Street Reform Act by Extending the Gains Made by Community Banks and Mitigating the Negative Effects**
- **Maintain the Federal Home Loan Bank System**
- **Permanently Close the Industrial Loan Company Loophole**
- **Fairly Compensate Fannie Mae and Freddie Mac Preferred Shareholders**
- **Oppose Excessive Intervention in Monetary Policy**

Community Bankers Association of Illinois

Detailed 2013 Federal Policy Priorities

Downsize Too-Big-To-Fail Banks and Financial Firms to Protect Our Financial System, Economy, and American Taxpayers from Future Bailouts

CBAI urges Congress and banking regulators to continue reforming our financial system and significantly reduce the probability and severity of a future financial crisis. The taxpayer bailout of big banks and financial firms must never happen again!

An unfortunate result of the financial crisis is that the largest banks have grown larger and remain candidates for bailouts. Today, the 10 largest banks (.2% of the nation's banks) control 77% of all bank assets compared to just 55% in 2002. The nation's 6,500 community banks represent only 12% of all bank assets.

The mega banks, not community banks, caused the mortgage meltdown and the financial crisis, and our nation and profession must be protected from a repeat of the massive financial destruction they caused. These mega banks have demonstrated that they cannot be effectively managed, supervised, disciplined, or resolved, and must be downsized.

Bipartisan support for resolving too-big-to-fail is growing among distinguished thought-leaders within financial services and Congress. This chorus has been fueled by not only the taxpayer-funded bailouts of the mega banks but also by their numerous misdeeds including: massive screw-ups in mortgage servicing, illegal robo-signing and foreclosing on veterans, mortgage securities fraud, anti-money laundering lapses related to terrorist financing and drug trafficking, manipulation of LIBOR rates, massive trading losses, and multi-million dollar executive pay scandals.

Fed Chairman Ben Bernanke acknowledged that three years after the passage of the Dodd-Frank Wall Street Reform Act, Washington still hasn't resolved the too-big-to-fail problem. Bernanke stated recently that TBTF remains a major issue, "I never meant to imply that the problem was solved and gone. It's still here ... I think we will have to do additional steps … it's just not something that we can forget about."

In recent testimony before the Senate Judiciary Committee, **U.S. Attorney General Eric Holder** admitted that the fundamental American constitutional right of "Equal Justice Under the Law" is not applicable when it comes to the largest banks, and the U.S. apparently has a two-tiered system of justice. He stated, “I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute – if we do bring a criminal charge – it will have a negative impact on the national economy, perhaps even the world economy.” Yet, regulators and the DoJ have aggressively pursued actions against community banks, their directors, and officers with board resolutions, MOUs, C&Ds, consent orders, monetary penalties, barring individuals from banking, and criminal prosecution.

Senator Sherrod Brown (D-OH) joined with **Senator David Vitter (R-LA)** to introduce the **T**erminating **B**ailouts for **T**axpayers **F**airness Act of 2013 (S. 798). This legislation will help eliminate the threats posed by too-big-to-fail financial institutions with capital guidelines appropriately scaled to the size, scope and risks of the institutions, and offers much-needed regulatory relief to community banks that will allow them to better serve consumers and small businesses. On the floor of the United States Senate, Senator Brown said, "Wall Street has been allowed to run wild for years. We simply cannot wait any longer for regulators to act. These institutions are too big to manage. They are too big to regulate. And they are surely too big to fail."

CBAI congratulates **Illinois Senator Richard Durbin** for taking a leadership position by co-sponsoring the Terminating Bailouts for Taxpayer Fairness Act.

Senators Bob Corker (R-TN) and Mark Warner (D-VA) questioned whether the top executives of the world’s biggest banks were above the law. “Like many of our colleagues, we believe that criminal behavior at any institution ought to be prosecuted.” they wrote. “If the Administration believes that the orderly liquidation process is insufficient in some respect, then the Administration and Congress should address the necessary changes right away to ensure that no institution is ‘too big to jail’.”

CBAI applauds the proposal of **Federal Reserve Bank of Dallas President Richard Fisher** to restructure the mega banks into multiple business line entities with only the commercial banking operations maintaining deposit insurance and access to the Fed’s Discount Window.

FDIC Vice Chairman Thomas Hoenig also proposes restricting banks to the core activities of making loans and taking deposits, and prohibiting them from engaging in market making, brokerage and proprietary trading. In addition, banking organizations would be prohibited from holding “complicated” securities such as multilayer structured securities (CDOs) because of the difficulty in determining and monitoring credit quality.

Opponents of downsizing the mega banks are their paid cheerleaders, including The Financial Services Forum, Financial Services Roundtable, The Clearing House Association, Securities

Industry and Financial Markets Association (SIFMA), and the American Bankers Association (ABA). These organizations jointly challenged an IMF Working Paper which concluded that the six largest banks enjoy an $83 billion subsidy due to their TBTF status.

Yet FDIC data show that the megabanks have both the lowest credit quality and the lowest cost of funds in the banking system, while community banks have the best credit quality and the highest cost of funds. Last year Moody's declared that its credit downgrades of the largest financial firms would have been even greater if they did not enjoy full government backing.

No TBTF bank, its directors, officers, or employees should ever be too-big-to-manage, too-big-to-regulate, too-big-to-fail, too-big-to-prosecute, too-big-to-jail, and should certainly not be too-big-to-change. They need to be downsized, and "Equal Protection Under the Law" must be restored.

<u>Support Community Bank Regulatory Relief as Contained in the Independent Community Bankers of America's (ICBA) *Plan for Prosperity*</u>

CBAI supports the ICBA's *Plan for Prosperity,* a policy platform for the 113th Congress that promotes a regulatory environment in which community banks can thrive and lend more robustly to small businesses and residents, thereby helping their communities grow and thrive.

The *Plan* contains flexible priorities to ease excessive, redundant, and costly regulations while supporting greater regulatory accountability to help community banks dedicate more of their resources to promoting economic growth. The steady increase in regulations over many decades threatens community banks and their communities.

Among the provisions, the *Plan for Prosperity* would accomplish the following.

- Exempt community banks from certain mortgage reforms to support the housing recovery
- Reduce annual privacy notice redundancies to cut paperwork
- Ease municipal advisor registration burdens to help serve local governments
- Create an Assistant Treasury Secretary for Community Banks to strengthen our voice
- Reform the Consumer Financial Protection Bureau to ensure more balanced regulations
- Improve accountability in bank exams with a workable appeals process
- Offer relief from accounting and auditing expenses for publicly traded institutions
- Support mutual banks with new charter and dividend rules
- Require rigorous and quantitative justification of new rules
- Support additional capital for small bank holding companies
- Cut the red tape in small-business lending
- Facilitate capital formation by reforming Subchapter "S" corporation regulations and extending the net-operating-loss carry-back

<u>Support Tiered Regulations and Supervision for Community Banks</u>

The financial crisis clearly demonstrated that the risks taken by Wall Street mega banks are very different from those assumed by community banks, and they should not be treated the same way. The Dodd-Frank Reform Act laid out a plan for applying separate supervision, capital, and liquidity requirements for the mega banks. In the Act and elsewhere, tiered regulations have established a welcomed and necessary beachhead for community banks. Now is the time to broaden that beachhead and ensure that every new banking law, rule, and regulation clearly distinguishes and appropriately regulates community banks.

<u>Support Community Bank Exemptions from the Basel III Capital and Risk-Weight Requirements</u>

CBAI supports capital rules which are appropriate for the community bank business model, do not disadvantage them relative to other financial institutions, are not overly complex, and do not represent a additional regulatory compliance burden.

CBAI was extremely disappointed when regulators last year proposed rules to impose new capital and risk-weight requirements on community banks. These proposed rules are <u>not</u> required under the Basel III capital agreement. Basel III was originally designed to prevent another financial crisis, to apply only to the largest banks that take on greater risk and are highly interconnected on a global scale.

Community banks did not engage in the reckless behavior that caused the financial crisis and subsequent recession. They have lower risk profiles because they operate under a relationship-based business model which is not appropriate for the one-size-fits-all capital standards approach in the Basel III proposed rules. Community banks pose no systemic risk, and these new proposed requirements should not apply to community banks.

CBAI was encouraged when the Federal Reserve, FDIC, and OCC delayed implementing the Basel III rules to consider the unprecedented responses (2,000+ comment letters) submitted by community bankers, banking associations, Members of Congress, and even fellow regulators. CBAI is urging regulators to heed these warnings and incorporate the many thoughtful recommendations from these comment letters into the final rules.

<u>Oppose Expanded Powers for Tax-Exempt Credit Unions</u>

The original credit union model has become outdated as credit unions have long since strayed from their founding purpose of serving individuals of modest means and with a common bond.

Their federal tax-exempt status, in exchange for serving their original mission, is clearly no longer justified. Their tax subsidy should be eliminated and they should all pay their fair share.

Credit unions are seeking to expand their commercial lending powers by increasing the percentage of assets cap on member business lending. If authorized, any growth will likely come at the expense of tax-paying community banks. In addition, credit unions are seeking to raise capital from outside investors, discarding their longstanding reliance on retained earnings. This change would fundamentally alter the exclusive member-focused character of credit unions – a condition for their original tax exemption. Credit unions should not be granted these or any additional powers as long as they remain exempt from taxation.

CBAI also supports applying Community Reinvestment Act (CRA) requirements to credit unions with the same asset size distinction as banks and thrifts.

CBAI supports the right of financial institutions to choose their operating charter and encourages credit unions that want bank-like powers to convert to bank or thrift charters. In addition, CBAI opposes the National Credit Union Association (NCUA) using inappropriate means to prevent credit unions from converting to a bank or thrift charter and opposes their efforts to undermine common bond via credit union mergers and conversions to geographic charters.

Given current budget deficits and the ever-growing federal debt, together with survey results showing that community banks do a better job serving the very customers credit unions were created to serve, now is the time for Congress to end the credit unions' unfair tax subsidy.

Oppose Expansion of the Farm Credit System (FCS)

CBAI opposes the expansionist agenda of the Farm Credit System which would allow FCS lenders to become the equivalent of commercial banks while retaining their Government Sponsored Enterprise (GSE) status. The FCS's funding advantage as a GSE constitutes an unfair competitive advantage over rural community banks.

The FCS should follow its historical mission of serving *bona fide* farmers, ranchers, and young, beginning and small farmers and their farmer-owned cooperatives. If it chooses not to follow this mission, it should be subject to taxation.

CBAI strenuously opposes the Farm Credit Administration's "Rural Community Investments" proposal which would allow FCS institutions to extend non-farm loans to virtually anyone in towns and cities with populations under 50,000, because such financing would be misleadingly characterized as "investments" instead of loans.

FCS should be refocused as a wholesale funding source for community banks serving agriculture and provide a correspondent banking function rather than a direct retail competitor with its unfair GSE tax and funding advantage. FCS institutions should face regulatory safeguards, disclosures and controls equal to community banks and housing GSEs, including CFPB oversight.

Support Mortgage Lending Reform

Imprudent lending caused the mortgage meltdown and the financial crisis. Community banks are common sense lenders that did not participate in abusive and predatory lending practices. Community banks thrive on the strength of their reputations and have every incentive to make fair, reasonable, and common sense loans. They do not need prescriptive regulations to compel them to do the right things.

Proposals to curb these imprudent practices should not impact responsible lenders' loan products designed to meet the diverse needs of community bank customers, including borrowers with special needs and circumstances, first-time homebuyers, borrowers in rural and underserved communities, and low-to-moderate income borrowers.

Regulators should use their authority under Dodd-Frank to exempt community bank mortgage loans, including those mortgage loans held in portfolio, from any unnecessary requirements or restrictions on balloon loans, escrow accounts for taxes and insurance, prepayment penalties, originator compensation, and any other loan terms and conditions.

Regulators should not stringently define "qualified mortgage" (QM) and "qualified residential mortgage" (QRM) which could drive community banks from the residential mortgage market and result in a handful of large banks dominating the market. Too narrow a definition would severely limit credit availability to many borrowers who do not have significant down payments or who have unique circumstances.

Support Housing Finance (GSE Secondary Market) Reform

Community banks and our economy need the continued existence of an impartial secondary market for residential mortgages that is financially strong and reliable. Fannie Mae and Freddie Mac will likely not survive in their current form. However, the financial crisis demonstrated the need for some government tie to the secondary market to ensure the continued flow of credit and market liquidity during economic duress. CBAI supports common sense reform of the housing GSEs that does not disrupt the slowly improving housing market and economic recovery.

In restructuring the secondary housing market, no rule or regulation should be promulgated that would limit full participation by community banks. There must be open and equal access to all lenders, regardless of size or volume, and loan pricing should be on equal terms with the largest mortgage originators. If the housing GSEs were to disappear and be replaced by the mega banks, then community banks would become exposed to predatory pricing and aggressive cross selling tactics.

The reformed housing GSEs must continue to aggregate whole loans, not directly compete at the retail level with community banks, and continue to permit community banks to retain mortgage servicing rights for the loans they sell.

Also, the conflicting requirements of a public mission combined with private ownership were a primary cause of the mortgage meltdown and must be eliminated. The reformed secondary market entities must have a limited mission and focus solely on supporting residential and multifamily housing.

In addition, CBAI objects to the housing GSE's current practice of aggressively compelling community banks to repurchase transferred real estate mortgages for technical violations of underwriting agreements that had no bearing on loan quality at the time of underwriting.

Stop Aggressive Bank Regulatory Examinations

CBAI continues to express concerns to bank regulators and Congress about aggressive bank regulatory examinations. These aggressive safety and soundness examinations negatively impact community banks' ability to serve their communities, lend to small businesses and individuals, and foster economic recovery.

Public regulatory enforcement actions are routinely being issued against community banks. These public documents negatively impact the banks' image in their communities, may affect liquidity, and could threaten the existence of the bank itself. Few public regulatory enforcement actions against the too-big-to-fail banks and financial firms have been taken. This is not right and must change.

Examiners are unjustifiably requiring capital levels higher than the current standards and are inappropriately downgrading loans and forcing write downs. Regulators must take a longer-term view of real estate held as collateral and not demand excessive write-downs and reclassification of loans based on *forced sale* real estate values in still dysfunctional markets.

Restraint is needed from the most senior regulators in Washington down to the front-line examiners on Main Street in determining bank CAMELS ratings, publishing enforcement actions, and in community bank closures.

Support Positive Tax, Accounting, and Auditing Changes

CBAI urges regulators, agencies and Congress to support positive tax, accounting and auditing changes that are focused on community banks and their individual and small business customers, and which support robust economic activity and foster savings and investments.

Tax reform must preserve the pass-through option, including the Subchapter "S" corporation and the ability of business borrowers to deduct interest. The taxation of capital gains and dividends should be held in parity and at a preferential rate. The tax-exempt status of interest paid on municipal bonds for all recipients is critical to municipal finance and should be preserved.

Any changes to the tax laws that disadvantage one form of corporate entity versus another should include a phase in period and an "amnesty" to allow for a penalty-free corporate conversion. "S" corporation banks' ability to raise capital should be enhanced by giving them the ability to issue preferred stock, increasing their shareholder limits and allowing new IRA shareholder investments.

CBAI strongly opposes new bank specific fees or punitive tax levies specifically targeting the financial service sector. When accounting and auditing standards are being considered and developed, provisions should be made to accommodate or exempt smaller companies including community banks and insure that new standards do not place an undue cost or burden on community banks. The cost to community banks should not outweigh the benefit to the financial statement users.

In addition, CBAI supports allowing community banks to amortize CRE losses over 10 years. Currently, banks must recognize these loan losses in the year in which they are taken. This reasonable regulatory forbearance will strengthen the capital positions of many community banks and help them to recover from the financial crisis and Great Recession. While this reasonable forbearance could have saved many of the more than 450 community banks that have failed from 2008-2013, there are about 650 banks on the FDIC's Problem Bank List that could still benefit from loan loss amortization.

The capital standards should recognize the loss-absorbing abilities of the entire amount of the Allowance for Loan and Lease Losses (ALLL). The 1.25% ALLL <u>dis</u>allowance (for regulatory capital purposes) should be eliminated. Currently, banks are not allowed to use ALLL balances in excess of 1.25% of Risk Weighted Assets in their Tier 2 Capital. Elimination of this disallowance would encourage banks to reserve more and would strengthen capital positions for hundreds of Illinois community banks.

<u>Positively Influence the Continuing Implementation of the Dodd-Frank Wall Street Reform Act by Extending the Gains Made by Community Banks and Mitigating the Negative Effects</u>

CBAI is continuing to work with regulators and legislators on the implementation of the Dodd-Frank Act. The mortgage meltdown, financial crisis**,** and ensuing recession were so severe that Congress was determined to respond with reform legislation. During the ensuing debate, community bankers were actively engaged with a seat at the table during all discussion phases. This involvement served our interests well as community banks earned 16 separate victories, carve outs, and exemptions from regulations which would not have been possible by outright opposing reform, which was the posture taken by the American Bankers Association.

Regulators are now three years into the rule-writing process. Of the 398 required rules, roughly one third have not yet been proposed. CBAI's goal is to retain and strengthen the beneficial provisions and oppose and mitigate the provisions deemed detrimental to community banks.

Dodd-Frank did not adequately address certain key issues, and considerable work remains:

Rein in the Mega Financial Firms and Level the Playing Field with Community Banks

CBAI supports subjecting large financial firms to rigorous regulatory scrutiny including higher capital and liquidity requirements. The Financial Stability Oversight Council's (FSOC) definition of systemically risky institutions must be very broad and include as many interconnected nonbank financial firms as possible. The contingency resolution plans required of large banks and financial firms are essential and must be credible and effective so that they provide regulators with tools for forced downsizing and resolution of failed mega institutions.

CBAI supports a significant capital surcharge on mega banks of not less than what was proposed by the Basel Committee – a progressive common equity Tier 1 capital requirement of between 1% and 2.5%, depending on the bank's systemic risk level.

CBAI also supports the provision in Dodd-Frank to shield banks under $10 billion in assets from FDIC insurance premium increases intended to increase the Deposit Insurance Fund (DIF) reserve ratio from 1.15% to 1.35%.

CBAI generally supports the Volcker Rule which prohibits proprietary trading and limited investment in and sponsorship of hedge funds and private equity funds by banking companies. However, the proposed rule is complicated and requires significant disclosures. The rule should not impact community banks, and they should not be required to update or revise their compliance plans.

Ensure the Consumer Financial Protection Bureau (CFPB) Focuses On Large Banks, Financial Firms and "Shadow" Financial Companies

In 2013, Illinois community bankers and CBAI staff met with CFPB Director Richard Cordray in Chicago. This roundtable discussion was a continuation of the productive dialogue between the Bureau and CBAI bankers that began with Professor Elizabeth Warren in February of 2011. The goal was to share our observations and recommendations with the Bureau concerning consumer regulations and the impact of those regulations on community banks and their communities.

The goal of the CFPB should be to hold the mega financial firms up to the existing high standards for compliance with consumer laws, rules, and regulations currently required and attained by community banks. Community banks should <u>not</u> endure any additional consumer regulatory burdens on top of the crushing burdens they already face on a daily basis.

CBAI supports replacing single-Director governance of the CFPB with a five-member commission.

The prudential regulators should participate with the CFPB in the rule-writing process, and the Financial Stability Oversight Council (FSOC) should have the power to veto CFPB rules under a more practical and realistic standard than currently exists.

CBAI supports a broad definition of firms that grant credit being subject to the CFPB rules, examinations, and enforcement. The focus of any enhanced regulation of financial products should be on the unregulated "shadow" financial companies.

We also encourage the CFPB to use its authority to grant community banks broad regulatory relief that enables them to serve the unique needs of their customers and not hinder new product development and innovation. Regulations promulgated by the CFPB must provide community banks with the flexibility to meet the unique needs of their customers and not burden community banks with additional and unnecessary regulatory requirements that could prevent them from serving their communities.

<u>Maintain the Federal Home Loan Bank (FHLB) System</u>

The FHLBs have developed a strong partnership with community banks. FHLBs must remain a stable source of funding and other financial services for community banks. The regional structure, special functions and purposes of the FHLBs must be recognized and maintained.

<u>Permanently Close the Industrial Loan Company Loophole</u>

The Dodd-Frank Act imposed a three-year moratorium on new industrial loan company charters which will expire in 2013. CBAI urges Congress to eliminate the industrial loan company loophole in the Bank Holding Company Act and make supervision of bank holding companies uniform for all types of financial institutions.

<u>Fairly Compensate Fannie Mae and Freddie Mac Preferred Shareholders</u>

CBAI urges the restoration of Fannie Mae and Freddie Mac preferred share value and dividend payments. The abrupt action taken by the Treasury to seize Fannie and Freddie through conservatorship unjustly and needlessly wiped out the value of GSE preferred shares, thus injuring thousands of community banks that purchased these AAA-rated investments at the encouragement of their bank regulators. Community bank GSE preferred shareholders should be made whole to bolster capital and lending and support the economic recovery.

<u>Oppose Excessive Intervention in Monetary Policy</u>

The sustained record-low near-zero interest rates, which have been engineered and implemented by the Federal Reserve System, is disproportionally impacting community banks, senior citizens and discourages savings.

The Federal Reserve reduced and kept interest rates at historic lows during and since the financial crisis. Recently, Fed President Bernanke indicated these low rates will remain depressed through at least 2015. This extremely accommodative monetary policy has placed a significant drag on the earnings of community banks which derive 80% of their revenue from net interest income. Large banks with additional and non-traditional business lines derive a significantly lower percentage of their earnings from their net interest margins.

In the throes of a financial crisis monetary policy can help minimize damage to the economy and assist in a recovery. However, the record-low interest rates over the past three years, and continuing for the next three years, is not temporary intervention but long-term manipulation. There are limits as to what Fed monetary policy can accomplish, particularly when there are significant offsetting negative effects on the nation's community banks, senior citizens, and savers, all of which are critically important to a stable and growing economy.

The longer rate normalization is delayed the longer community banks will experience tight net interest margins, earnings, and negatively impact their ability to serve their customers and communities.

###