



Testimony of

**Samuel A. Vallandingham**

President and CEO, The First State Bank  
Barboursville, West Virginia

On behalf of the

**Independent Community Bankers of America**

Before the

U.S. House of Representatives  
Committee on Financial Services  
Subcommittee on Financial Institutions and Consumer Credit

Hearing on

**“Examining Regulatory Relief Proposals for Community  
Financial Institutions, Part II”**

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## Opening

Chairman Capito, Ranking Member Meeks, and members of the Subcommittee, I am Samuel Vallandingham, President and Chief Executive Officer of First State Bank, a \$270 million community bank in Barboursville, West Virginia. I am pleased to be here today on behalf of the Independent Community Bankers of America and the nearly 6,500 community banks we represent. Thank you for convening this hearing titled: “Examining Regulatory Relief Proposals for Community Financial Institutions.”

Community banks play a crucial role in the economic life of rural areas and small communities passed over by larger banks. The credit and other financial services we provide in these communities will help advance and sustain the economic recovery and ensure that it reaches every corner of the country. Community banks are responsible for 60 percent of all small business loans under \$1 million. As the economic recovery strengthens, small businesses will lead the way in job creation with the help of community bank credit. I am proud to note that First State Bank was awarded SBA Lender of the Year in 2001 and SBA Community Bank of the Year in four consecutive years: 2005, 2006, 2007, and 2008.

The role of community banks in advancing and sustaining the recovery is jeopardized by the increasing expense and distraction of regulation drastically out of proportion to any risk we pose. Community banks didn’t cause the recent financial crisis, and we should not bear the weight of new, overreaching regulation intended to address it. I would like to thank this committee for passing a number of important regulatory relief bills this Congress, many of which reflect ICBA’s Plan for Prosperity. We strongly encourage this committee to build on your strong record of regulatory relief by advancing legislation I will discuss today.

I will focus my testimony on three bills before this committee that are of particular interest to community bankers: the “Community Bank Mortgage Servicing Asset Capital Requirements Study Act of 2014” (H.R. 4042); the “End Operation Choke Point Act of 2014” (H.R. 4986); and the discussion draft titled the “Access to Affordable Mortgages Act of 2014.” The common theme of these bills is government overreach whether it’s in the form of arbitrary capital requirements, law enforcement abuse and examination practices designed to deter or discourage banking services to legal and legitimate customers, or rigid and expensive appraisal requirements that unnecessarily escalate the cost of mortgage credit. ICBA supports each of these bills for reasons I will discuss below.

### **The Community Bank Mortgage Servicing Asset Capital Requirements Study Act of 2014 (H.R. 4042)**

ICBA believes it is critical to retain and promote the role of community banks in mortgage servicing and adopt policies that will deter further consolidation of that industry. Community banks, which thrive on their reputation for customer focus and local commitment, promote a competitive mortgage servicing industry and deter future

abuses and avoidable foreclosures such as those that have impeded the housing recovery and led to the national mortgage settlement.

ICBA is seriously concerned about the punitive capital treatment of mortgage servicing assets under Basel III. Combined with prescriptive new servicing standards published by the CFPB, this capital treatment has the potential to drive community banks out of the servicing business, drive further industry consolidation into the largest banks and, increasingly, nonbank servicers which are beyond the reach of the bank regulators. This would result in a bad outcome for consumers and the fragile housing recovery. For this reason, ICBA strongly supports H.R. 4042, introduced by Rep. Blaine Luetkemeyer, which requires the banking regulators to “stop and study” ill conceived rules with the potential to permanently change an industry that plays an outsized role in the economy. With the Basel III MSA provisions scheduled to begin to take effect in less than six months, we urge this committee to take up H.R. 4042 expeditiously.

*Servicing is Key to Relationship Banking and Helps Community Banks Remain Competitive*

Residential mortgage lending has been an important component of First State Bank’s business since its founding and has grown more important over the years. In 2013, we originated over \$200 million in mortgages. In 1982, we first began to sell mortgages into the secondary market in order to access additional funding. Today, we have a \$600 million servicing portfolio consisting of approximately 5700 loans. Most of those loans were sold to Freddie Mac, and a smaller number were sold to Fannie Mae.

Over the years, we have discovered that mortgage lending is a great way to cement long-term relations with customers and win the opportunity to serve their additional banking needs. But in order to sustain customer relations we need to service these loans, whether they are subsequently sold or held in portfolio. We also discovered that customers do care about who services their loans. They value, and even seek out, local servicing. If they have a question, they want to be able to pick up the phone or visit a branch and sit down with a banker in their community. Servicing is key to the marketing of mortgage originations, and together, origination and servicing are integral to our relationship-banking business model.

First State Bank’s experience is typical of community banks. Servicing helps community banks remain competitive in the mortgage origination business. Today, community banks represent approximately 20 percent of the mortgage market, but more importantly, community bank mortgage lending is often concentrated in the rural areas and small towns of this country, which are not effectively served by large banks. For many rural and small town borrowers, a community bank loan is the only mortgage option. Any broad based recovery of the housing market must involve community bank mortgage lending.

Community bank servicing is based on close ties to customers and communities. Because First State Bank's servicing team consists of only eight people, customers always know who is on the other end of a telephone or across the desk. Most importantly, we intervene early to keep mortgages out of default. We know, for example, when an employer closes in our community and how that closure impacts the income of our borrowers. A servicer based thousands of miles away won't have such knowledge. Smaller servicing portfolios and better control of mortgage documents also provide an advantage over the large servicers. For these reasons, community banks have generally been able to identify repayment problems at the first signs of distress.

### *Community Bank Servicing Improves Loan Performance*

This personalized approach to servicing is a natural complement to conservative, commonsense underwriting. We make sure loans are affordable for our customers and they have the ability to repay. Loans are underwritten based on personal knowledge of the borrower and their circumstances – not solely based on statistical modeling done in another part of the country. We don't underwrite option arm loans or other exotic credit products. This combination of quality, personalized underwriting and servicing yields results. Our delinquency rate is just 1.4 percent, a very low rate which is typical of community bank mortgage lenders. Community bank originated and serviced mortgages perform better in all market conditions.

### *Basel III*

Community bank mortgage servicing is under threat from the punitive new capital provisions of Basel III. Basel III provides that the value of mortgage servicing assets (MSAs) that exceed 10 percent of a bank's common equity tier 1 capital must be deducted directly from its regulatory capital.<sup>1</sup> In addition, MSAs that are below the 10 percent threshold must be risk weighted at 250 percent once Basel III is fully phased in. Expressed in terms of capital ratios, MSAs will shrink the numerator (when they exceed the 10 percent threshold) and inflate the denominator, resulting in a lower regulatory capital ratio. My bank would lose over \$1.6 million in common equity tier 1 capital, reducing our tier 1 ratio by 50 basis points. The capital reduction combined with higher risk weighting of MSAs would reduce our risk based capital ratio by 95 basis points. The Basel III MSA provision would have a significant impact on key measures of our regulatory capital adequacy. As if this were not enough, there's a third limitation on MSAs: When MSAs combined with deferred tax assets and investments in the common stock of unconsolidated financial institutions exceed 15 percent of common equity tier 1 capital, the excess must also be directly deducted from regulatory capital. Many banks that do not exceed that 10 percent MSA threshold will be caught by the 15 percent combined threshold. This backup provision shows regulators' unrelenting determination to curtail bank servicing.

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<sup>1</sup> MSAs represent the future value of servicing mortgage loans owned by third parties.

Banks that have strong capital ratios today and that have serviced mortgages for decades without problems, would have starkly lower capital ratios under the new rule, or be forced to raise new capital, a significant challenge for community banks in the current environment. This is a gratuitous and punitive double hit on a community bank servicer's capital ratio, just as Basel III sets out a narrower definition of regulatory capital and higher target ratios. It effectively bans the holding of MSAs above the 10 percent threshold (or the 15 percent combined threshold) as though they were a toxic asset and imposes an exorbitant capital charge on MSAs below the threshold. In addition, the calculations are so complex that many community banks will not realize that they have a capital problem until next year when the provisions begin to take effect.

The Basel III rule is a drastic change from the current rule which allows a bank to hold MSAs up to 100 percent of tier 1 capital (and broader measure of capital) and risk weight MSAs at 100 percent. Any change in policy with such a broad adverse impact should be clearly supported by data and analysis. But regulators have offered no data or empirical analysis whatsoever to suggest that MSAs destabilized banks during the recent financial crisis.

#### *A Rule Based on Flawed Reasoning*

MSAs are intangible assets. When a mortgage prepays either because the home is sold or the owner refinances, the value of that particular servicing agreement ceases. Regulators have used the intangibility of MSAs to justify their concerns. However, MSAs are held in a diverse portfolio, which significantly lowers their risk. In addition, they are counter cyclical. When interest rates rise, creating interest rate risk in loan portfolios, pre-payment risk goes down because fewer people sell their homes or refinance. This makes MSAs more secure and therefore more valuable. Falling interest rates have the opposite effect. For community banks, which cannot afford to hedge with derivatives, MSAs provide a feasible alternative.

#### *Unintended Consequences: Heightened Systemic Risk*

Today, even before the Basel III rule has gone into effect, a high volume of MSAs is shifting from regulated bank servicers to non-bank servicers in the shadow banking system in anticipation of the new capital rules. Non-bank servicers are not subject to prudential standards such as capital, liquidity, or risk management oversight.

The Financial Stability Oversight Council (FSOC) highlighted this trend in its annual report for 2014 and noted the "potential implications for financial stability."<sup>2</sup> The value of MSAs held by banks has dropped by \$758 billion since 2012, while the value of MSAs held by nonbanks has increased by \$806 billion during the same period and now total \$1.7 trillion.<sup>3</sup> Comptroller Thomas Curry carried the implications of this trend further, noting in a recent speech that "the shift of financial assets into the shadow banking

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<sup>2</sup> 2014 Annual Report, Financial Stability Oversight Council. Page 10.

<sup>3</sup> Ibid. Page 54.

system could carry with it the seeds of the next financial crisis if we do not act quickly and effectively.”<sup>4</sup>

Unless the Basel III MSA provisions are repealed or amended, this transfer will only accelerate. The logic of the market dictates that MSAs will be acquired and held by entities that can hold them for the least cost, whether or not this is the best outcome for preserving market stability or for consumers. As noted above, consumers seek out personalized, local servicing because they want to interact with bankers who know their community. Moreover, community bankers are better positioned to anticipate servicing challenges and have a strong incentive to help the borrower work through difficulties. Basel III will push borrower-servicer relationships out of the community and into the shadow banking system.

While ICBA supports better prudential and consumer supervision of the shadow banking system, the best solution is to preserve and strengthen incentives for community banks to retain servicing. Community banks are best qualified to service the loans they originate and have done so without problems for decades.

#### *H.R. 4042 Will Provide Needed Relief*

ICBA is grateful to Rep. Luetkemeyer for introducing H.R. 4042, which would delay the effective date of the Basel III rule with respect to MSAs for nonsystemic banking institutions and require the banking agencies to conduct a joint study of the appropriate capital treatment of MSAs. The study would address many critical questions regarding the impact of the Basel III rule and whether MSAs have ever been associated with the failure or destabilization of an insured depository institution. This information, which is critical for the design of an appropriate rule, does not currently exist. The agencies would report the results of their study to Congress no later than one year from the date of enactment. Any subsequent rule would be subject to a six month delay following the report to Congress. The eventual rule would hopefully be informed by findings of the report.

ICBA strongly supports H.R. 4042 and urges expeditious consideration by this committee.

#### **The End Operation Choke Point Act of 2014 (H.R. 4986)**

ICBA strongly supports H.R. 4986, introduced by Rep. Luetkemeyer, which would help preserve the ability of banks to serve legal and legitimate business customers without undue pressure from law enforcement or examiners.

“Operation Choke Point,” a Justice Department initiative intended to address consumer fraud by “choking off” access to fraudsters’ banking services, is a grave concern to community bankers. Community banks currently dedicate significant energy and resources to monitoring, detection and reporting of fraud and other financial crimes in

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<sup>4</sup> Thomas J. Curry speech before Conference of State Bank Supervisors. May 14, 2014. Page 8.

compliance with the Bank Secrecy Act. Last year alone, depository institutions filed over 600,000 suspicious activity reports to assist federal and local law enforcement in the fight against financial crime.

However, ICBA strongly believes that Operation Choke Point is sweeping in its scope and overly aggressive in its tactics. In the last two years, Choke Point has targeted more than 50 banks and payment processors with subpoenas issued under a very aggressive reading of its authority under FIRREA. Reputation in their communities is the stock-in-trade of community banks. The mere prospect of enforcement action is daunting enough to lead risk adverse community banks to shut off access to their payment systems to all but the most established, low risk businesses.

All legal forms of business should be allowed to operate freely with access to essential banking services, subject to the discretion of banks, and without excessive pressure or intimidation from law enforcement. Law enforcement should focus on law breakers directly, without forcing banks to act as police, and their efforts should be narrowly targeted. ICBA is encouraged that members of Congress on both sides of the aisle have been critical of the aggressive tactics and troubling impact of Operation Choke Point.

At the same time, bank regulators have begun applying unwarranted scrutiny to bank relationships with categories of businesses deemed “high risk” or that supposedly create “reputational risk.” These businesses include internet-based businesses, short term lenders, telemarketers, debt collectors, and other lawful businesses. Regulators have questioned long-standing relationships with businesses that have been properly screened by the bank’s own risk controls. It is beyond the scope of the supervisory process to assess a bank’s reputational risk or to prohibit or discourage community banks from providing these services. Community banks are the best judge of their own reputation risk and have every incentive to safeguard their own reputations through proper screening of customers. We conduct due diligence to assess the level of risk of each customer relationship and ensure that controls are in place to identify and monitor these relationships on an ongoing basis. ICBA is grateful to Chairman Hensarling for his May 22 letter to the bank regulators questioning their use of reputational risk in prudential supervision. We fully endorse the Chairman’s comments in that letter.

*H.R. 4986 Will Rein in Operation Choke Point, Promote Bank-Law Enforcement Cooperation, and Provide a Safe Harbor for Legal Customer Relationships*

ICBA thanks Rep. Luetkemeyer for his leadership in addressing these concerns and specifically for introducing H.R. 4986. This legislation would promote cooperation between banks and law enforcement to enable law enforcement to exercise its responsibility to prosecute illegal wrongdoing directly against the perpetrators of that wrongdoing, instead of taking action that results in cutting off banking services to legal businesses. In addition, H.R. 4986 would rein in DOJ’s abusive use of subpoena authority and create a safe harbor for banks serving businesses that meet specific criteria. ICBA fully supports H.R. 4986 as a response to Operation Choke Point and examiners’ recent assessment of “reputational risk.”

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### **The Access to Affordable Mortgages Act of 2014**

Appraisal standards have changed significantly over the past few years. New standards are often well intentioned, having been designed to prevent abuses by unregulated mortgage brokers that contributed to the collapse of the housing market. However, they have made it nearly impossible for my bank and community banks nationwide to use local appraisers. Using an appraisal management company has become the only practical option for a community bank mortgage lender. This expense, coupled with new appraisal requirements, has increased the cost of an appraisal for our customers by 25 to 50 percent, an experience that is typical of other community banks. Passed on to the borrower, these costs increase the cost of credit. What's more, because the appraisal management companies frequently use appraisers from outside the area, they produce lower quality appraisals.

Under the Dodd-Frank Act, "higher risk mortgages" must have an independent, written appraisal by a certified or licensed appraiser which includes physical inspection of the interior of the home. As defined by the Act, "higher risk mortgages" are non-qualified mortgages under the CFPB's ability-to-repay rule with an APR that exceeds the average prime rate offer by at least 1.5 percent for most mortgages. In today's low rate environment, a 30-year loan with a rate as low as 5.5 percent would meet this definition. Such appraisals typically cost around \$400 depending on the location of the property. On a low dollar loan, which more easily triggers the "higher risk" definition, this is a significant expense. Low dollar loans are common in many parts of the country for purchase or refinance.

ICBA strongly supports Rep. Luetkemeyer's discussion draft, the Access to Affordable Mortgages Act, which would create an exemption from the higher risk mortgage appraisal requirements for loans of \$250,000 or less provided they are held in portfolio by the originator for a period of at least three years. When a lender holds a loan in portfolio, it bears the full risk of default and has every incentive to ensure the collateral is accurately appraised. In house appraisers are not only more cost effective, they have superior knowledge of local markets and provide more accurate property valuations. The discussion draft will increase the flow of mortgage credit for moderate income borrowers and strengthen the housing recovery.

### **Closing**

Thank you again for the opportunity to testify today. We appreciate the role of this committee in putting a check on regulatory overreach and rolling back unwarranted regulation that is reducing credit and promoting industry consolidation. This committee has already passed critical regulatory relief legislation. The bills I've discussed today would build on your previous efforts by addressing critical threats to community banking. We look forward to working with this committee to advance them into law.