Testimony of

Kenneth L. Burgess

On behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions and Consumer Credit

Of the

Financial Services Committee

United States House of Representatives

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March 21, 2017

Chairman Luetkemeyer and Ranking Member Clay, my name is Ken Burgess and I am the Chairman of FirstCapital Bank of Texas in Midland, Texas. I appreciate the opportunity to be here to present the views of the American Bankers Association (ABA) on ending the drought of new bank charters. The ABA is the voice of the nation's $16 trillion banking industry, which is composed of small, mid-size, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $9 trillion in loans.

FirstCapital Bank was chartered in 1998. In less than 20 years, we have grown our assets to just over $1 billion and serve the Midland, Lubbock and Amarillo markets in West Texas as well as a new market in Central Texas near Austin. We are primarily a commercial bank lending to small businesses and we also have a mortgage lending arm.

ABA appreciates the opportunity to testify on the nearly complete lack of new banks being started (de novo banks). New entrants into any industry are a sign of growth potential and economic opportunity. New banks help fill gaps in the provision of banking services, increases competition, and ultimately strengthen the community banking sector. Consumers and businesses have more choices of competitive products and services which translates into greater economic activity and growth in local communities.

The lack of de novo activity is concerning to our industry and sadly reflects the same forces that are driving consolidation—excessive and complex regulations that are not tailored to the risks of specific institutions. This—not the local economic conditions—is often the tipping point that drives small banks to merge with banks typically many times larger and is a barrier to entry for new banks.

Since the Dodd-Frank Act was enacted in 2010, community banks have shown great resilience and have endeavored to provide the financial services critical to the success of their communities.

They are in the business of lending and have worked to provide credit in spite of the onslaught of new regulations. The fact that they continue to lend and strive for profitability in no way suggests that the Dodd-Frank Act—and its 25,000 pages of proposed and final rules—has not had a negative impact on banks' customers and communities. It has had an impact: since Dodd-Frank was enacted ***1,917 banks*** (or 24% of the industry) have disappeared. Contrast that with only ***six*** de novo banks since Dodd-Frank.[1]

Certainly, consolidation would have occurred without Dodd-Frank, but the increased pace of that consolidation since it was enacted has been extraordinary. Since Dodd-Frank, more than 43% of banks under $100 million in assets have disappeared, as has 17% of banks between $100 million and $1 billion (see Table).

Consolidation Accelerates After Dodd-Frank Act

Asset	2004-2010	2010-2016
< $100m	-36.1%	-43.9%
$100m – 1b	4.4%	-17.8%
$1b - 10b	19.4%	11.9%
>$10b	-7.1%	8.6%
All Banks	-14.1%	-24.5%

Source: FDIC
Time periods defined as 1Q04-2Q10 and 3Q10-4Q16

American Bankers Association

The fact is that the thousands of new regulations that have been imposed on community banks are an enormous driver of decisions to sell to a larger bank. The median sized bank in this country has only 44 employees. These are small businesses themselves. There is simply not enough capacity to read and understand what rules apply (especially as rules are modified); implement, train, and test for compliance with those that do; and still have the time and resources to meet with individuals and businesses about their financial needs.

The FDIC has acknowledged the vital importance of community banks and the need for changes to encourage de novo formations. The agency noted that community banks account for 43 percent of small loans (less than $1 million) to businesses and in one out of every five counties in the U.S., the only physical banking offices are those of community banks. Without a banking presence, any economic vitality will quickly disappear.

To help prospective de novos, the FDIC in April 2016 announced welcome supervisory changes, including community outreach, establishing a team of people to guide prospective de novos through every stage of the process, refreshing its answers to key questions, and developing a guide to the deposit insurance application process to increase transparency. In addition, the period

[1] There were 14 insured institutions established after July 31, 2010. The six true de novos are those charters that are "from scratch" and have no predecessor charters. Two of the six de novos began operation in January and have yet to file a Call Report. Excluded are 7 charters established to absorb or liquidate a failed bank and one credit union that converted to a mutual savings bank charter.

of heightened de novo supervision and strict adherence to the bank's original business plan—what some have referred to as the "penalty box"—was shortened from seven years to three years.

Addressing gaps in knowledge and resources is very important, but it doesn't address the underlying issues that create the barriers to entry: capital hurdles, unreasonable regulatory expectations on directors, funding constraints, an inflexible regulatory infrastructure, technology investments, and tax-favored competition from credit unions and the Farm Credit System. The 3-year penalty box, while better, still acts as a deterrent. If it does not make economic sense, no one will start a new bank. Look no further than the lack of new charters for proof of this. Fix the underlying problems and new charters will result.

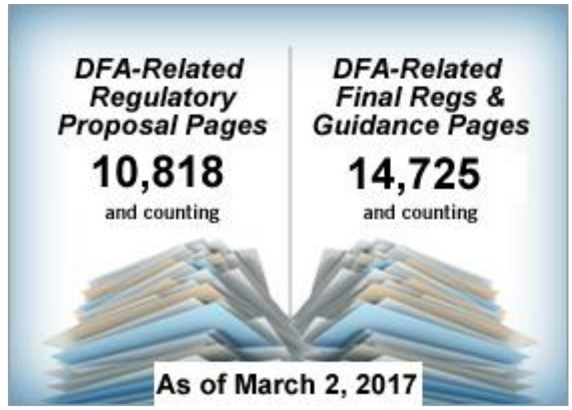
Each and every bank in this country helps fuel the U.S. economy. Each has a direct impact on job creation, economic growth and prosperity. Community banks have always prided themselves on being flexible in order to meet the unique circumstances of each customer. This is why it is imperative that Congress take steps to ensure and enhance the banking industry's capacity to serve their customers, thereby facilitating job creation and economic growth. When a bank disappears everyone in the community is affected.

We thank this subcommittee for its willingness to shed light on these problems and we thank Chairman Henserling and the committee for the work they have undertaken to provide much needed relief. We urge Congress to work together— Senate and House—to pass legislation that will enhance the ability of community banks to serve our customers and help grow our economy.

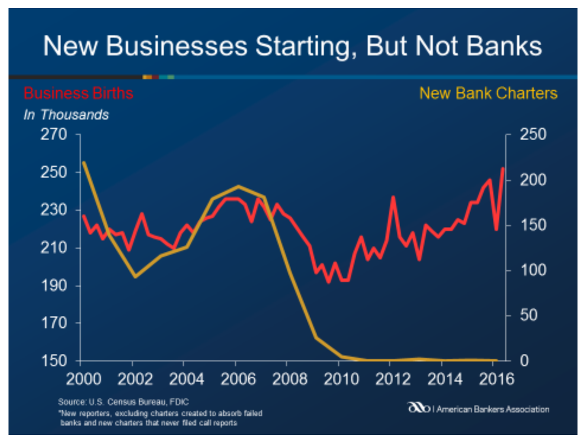
In the remainder of my testimony, I would like to focus on the following key points:

- Lack of de novos has its roots in excessive regulation;
- Constraints on assets, liabilities and capital all conspire to make new charters uneconomical; and
- To assure the broadest possible financial options for our communities, we must think creatively to find solutions that stimulate new bank entrants.

1. Lack of De Novo Banks Has Its Roots in Excessive Regulation



The forces that challenge banks every day are the same as those that make starting a new bank nearly impossible. Certainly, economic conditions have had an impact. The near zero-interest-rate policy is challenging enough for existing banks and it makes starting a new bank that much more difficult. But new banks have been started in all phases of the economic cycle. For example, in the middle of the so-called "S&L Crisis" in 1990 and at the beginning of a severe recession, 191 de novos began operation. Over the next 10 years, 1,500 new banks started! There were opportunities to be found and investors willing to risk their own money to capitalize a new bank.



Contrast that with the latest cycle: it started similarly with 181 new charters in 2007 (the start of the recession) but fell off very quickly over the next two years. Since the Dodd-Frank Act was enacted in 2010, there have only been ***six*** true de novos. Two of those de novos began operation just this January, eight months after the FDIC's announcement of changes. Even more starkly is the contrast between lack of de novo bank formations and the recovery of new business formations across all industries since the recession.

Not only has the regulation been piled on, but more telling is the regulatory approach that a bank should never fail. This is not only an impossible standard, but it is too risk averse and limits new activities and growth. The first chapter in every book on entrepreneurship or economics says that capitalism is built on investors putting ideas and money to work, accepting the very real risk that they will fail in the process.

When my bank was started, we raised $6.5 million to capitalize the bank. This was an amount we felt we could grow into in a reasonable period of time, which would allow us to provide a reasonable return to our shareholders. As we grew, we raised additional capital to keep the bank adequately capitalize, but careful not to overcapitalize. We have raised capital 6 different times since our inception to support our growth. Had we raised it all in the beginning, shareholders would have been unhappy and would not have been willing to invest more when it was needed.

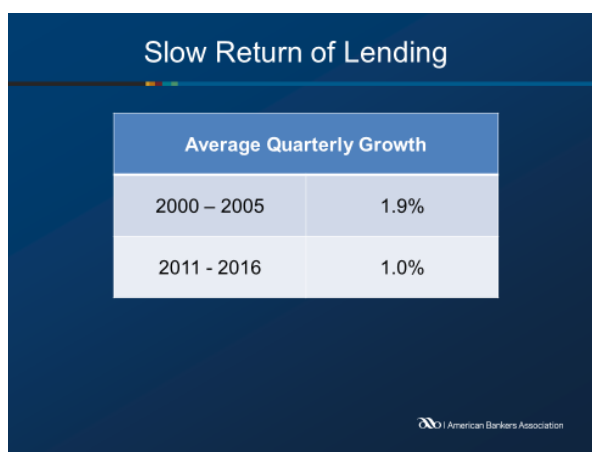
If I was in the position of starting a bank under today's conditions, I would not do so. Even though, with my experience, I could likely raise the funds necessary, I would have to grow the bank so quickly to put the capital to work that it would pose undue risk on our shareholders. Starting a new bank in a small community would be extremely difficult. It would be extremely challenging to raise capital and impossible to grow the bank quickly enough to utilize it. Moreover, I would also be very concerned about running a profitable bank as I would need to hire a highly experienced compliance officer to assure compliance with all the regulations. Good compliance officers now easily make six figures. In many small banks, that is more than the highest paid staff member is paid.

2. **Constraints on Assets, Liabilities and Capital All Conspire to Make New Charters Uneconomical**

On both sides of the balance sheet—assets on one side and liability plus capital on the other—there are constraints that limit the economic potential of any new bank. These are detailed below:

Earning Assets are Under Stress

Some have argued that bank lending continues and therefore, there has been no impact of Dodd-Frank. Banks continue to lend even with the shackles that bind them. However, in the five years since DFA was enacted, the ***pace of lending was half*** of what it was several years before the financial crisis.



Some banks have stopped offering certain products altogether, such as mortgage and other consumer loans. The October 2015 RESPA/TILA integration rules have raised mortgage costs, delayed closings and have limited access to home loans to many potential new buyers. [TRID Survey Results] As a result, consumers now pay more, wait longer, and have incentives not to shop among lenders because of the delays it is likely to create. The result is fewer options for consumers as many community banks abandon mortgage lending altogether due to the added risks and costs that make it uneconomical.

Moreover, in April 2016, 72 percent of community banks reported that the 2014 rules on ability to repay and qualified mortgages have restricted their ability to extend credit, even after over two years of adjustment and adaptation. Mortgage Survey Results

For residential mortgage and home equity lending, new requirements from the Consumer Financial Protection Bureau with help from the other regulators has made this type of lending more risky. The risk comes from an aggressive compliance culture combined with an inflexible definition of qualified mortgages. This means fewer banks will offer these loans, limiting choices and options for consumers.

The last area of profitability for consumer banks is small business lending. This continues to be profitable, but it is now under assault from the tax-free credit unions and Fintech non-bank lenders who make loans without the same obligations and oversight as community banks.

Every earning asset held by community banks is now less profitable than it was in years past. Some of this erosion is caused by regulations, some by the interest rate environment, some by unregulated competitors, and some by untaxed and lightly supervised competitors. For those considering starting a new bank, these stresses combine to limit potential profitability and discourage any investment. Banks compete with all other capital options, and if returns from making good asset decisions are not sufficient to generate a reasonable return, money flows elsewhere.

Funding Constraints Limit Asset Growth

Even when there are good opportunities to lend, funding those loans is the perhaps the biggest hurdle for potential de novos. Banks are funded with deposits. Recent regulations aimed at the largest banks, which take a narrow view of "stable" funding, coupled with the FDIC's aggressive definition of what constitutes a brokered deposit, have steered the industry into insured retail and small business deposits. While these deposits offer low cost funding, this narrow view of stable funding constrains banks, which incur a regulatory cost as compared to other types of funding. The limited array of acceptable funding sources hits de novo banks acutely as it takes time to build the customer relationships necessary to gather these deposits—and de novos can't compete on convenience (with few branch locations) or pay high rates.

There are many other sources of funding available that have proven to be stable and cost effective. For example, as de novo institutions build their deposit base, they may need to look for funding outside of their local market by using the internet-based deposit services or partnering with a third party to help market their products and generate deposits. Unfortunately, all these are considered "brokered" by the FDIC and, as such are unlikely to be approved in the de novo's new business plan. The bottom line is that unlike most new businesses that can work every available option to gain customers and gain market share, new banks are extremely limited in their funding and product options, further detracting from the desirability of a new bank charter.

Capital Thresholds are Too High

As I state before, we started our bank with about $6.5 million. The expectation now in banking circles is that it would take $20-$30 million to start a bank. This is many multiples beyond what ***successful*** banks needed in the past. Can a bank today earn enough to cover the cost of that capital? Great investment options don't exist in today's abnormally low-rate environment. But even with more normal rates and a steeper yield curve, a new bank probably cannot grow fast enough to cover investor expectations. Without adequate yields to investors, capital will flow to better investment alternatives removing capital from the banking industry.

The key point is that investors cannot justify illiquid investments at low yields. If de novos were a good investment that made economic sense, today there would be a lot more new banks started. Besides the enormous regulatory infrastructure that must be covered by capital (with no return, of course), the technology investment required in today's banking world is also large. Moreover, while a strong business plan for the new bank is required, there is strong resistance by the regulators to any change in that plan. Any new business must adjust quickly to the rapidly changing reality of their market, but unlike most new businesses, de novo banks must jump through regulatory hoops to chart a new course. With the 3-year penalty box and strong resistance by the regulators to any change in the business plans of a new bank, it can be nearly impossible to make the necessary adjustments quick enough to be successful. For investors, it raises questions about success and timing of their potential returns.

The pressure to increase capital levels—including requirements of the Basel Capital Standards—increase the hurdle rate for any return to investors. A well-capitalized bank used to operate with 6% leverage capital; now they are being pushed to maintain 9% capital. The simple math is that earnings must increase by 50% to maintain the same return on equity. These high capital requirements mean that new banks are unlikely to make a reasonable return on equity in any reasonable time frame.

So we are back to the beginning. If investors can't see a way to make a reasonable return on investment, they won't invest. No investment means fewer new banks and slower growth for the U. S. economy.

Unreasonable Regulatory Expectations for Directors is Also an Impediment

Typically investors in a de novo institution become the first directors of the newly formed bank. This is because the capital often comes from pooled funding from leaders in the community that see a niche that could be filled by the new bank.

The significant regulatory requirements of directors in banks today—which can impose personal legal liabilities for them—make it difficult for any bank to find a good director and near-impossible for new bank. Directors are now expected to know more than they can, including maturity matching, hedging strategies, derivative accounting, complex asset-liability strategies, and cybersecurity risks and mitigations, to name just a few. They must then tell management how to address each of these. Given the potential liability, the lawyers to these investors most certainly would advise against being a bank director.

3. A Creative Approach is Needed to Encourage New Bank Formations

The changes the FDIC has made are a good beginning, but more can and needs to be done. It's time to think differently to encourage new banks—by requiring less capital, reducing regulatory burden, permitting greater flexibility in business plans, and lifting funding restrictions. Some modest ideas to consider include:

- Create a fast track for new banks.
- Reduce the minimum initial capital level (e.g., to $10 million) and reduce the required capital ratio for the first three years (e.g., to 6%). The goal is enable the new bank to generate earnings and grow quickly enough to become profitable and sustainable.
- Further reduce the "penalty box" and enable changes in the bank's business plan.

- Allow a new bank to fund itself in the least-cost most efficient way without regard to source.
- Define any mortgage loan held by the bank on its own balance sheet as a Qualified Mortgage.
- Address the unfair competition from tax-favored providers such as credit unions and the Farm Credit System.

Simply put, Congress can help by eliminating unnecessary impediments which negatively impacts every community across the United States. This will help stem the tide of community bank consolidation and create an environment conducive to new bank charters. The key to changing the consolidation trend is to stop treating all banks as if they were the largest and most complex institutions. All too often, regulations intended for the largest institutions become the standard that is applied to every bank—Basel III capital requirements being the most egregious. Such an approach only layers on unnecessary requirements that add little to improve safety and soundness, but add much to the cost of providing services—a cost which customers ultimately bear. A better approach to regulation is ***tailored*** bank supervision that is responsive to the charter, business model, and scope of each bank's operations. This would ensure that regulations and the exam process add value for banks of all sizes and types. By facilitating new bank charters, new capital will flow into the entire banking system as it would signal the potential for growth and success.

Conclusion

I grew up in a banking family. My father managed three small banks in three small communities in West Texas. From childhood, I watched the impact that a small town community bank has on its community. They are involved in or behind almost every initiative. They support almost every non-profit and they support the small businesses in those communities like no other bank can. When a small community loses its bank, it quickly begins to die.

The lack of de novos banks is strong evidence that the economics do not add up. Investors have plenty of choices about where to invest, and if the impediments to starting a new bank are too great, they will quickly move money to opportunities with greater promise. The forces that have acted to stop new de novos are the same ones that have led to the dramatic consolidation of the banking industry. Fix the underlying problems and the future will be brighter for both new and existing banks.

Our nation's diverse banking structure is the envy of the world, yet we are letting it slowly dissolve away. Please help us stem this trend before it is too late. We urge Congress to act now and pass legislation to help turn the tide of community bank consolidation, create an economic environment that encourages new bank charters, and protect communities from losing a key partner supporting economic growth.