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Testimony of David A. Kelly

before the

U.S. Senate Committee on Small Business & Entrepreneurship

Field Hearing Regarding Reducing the Burden of Federal Regulations on Community Banks and Small Businesses

I am here at the request of the Honorable Senator Cory Gardner to provide testimony on the impact of regulations on financial institutions and would like to thank him for the invitation to share my perspective.

My name is David A. Kelly, Chief Risk Officer for FirstBank Holding Company, based in Lakewood, Colorado. Founded in 1963, FirstBank currently has over $14 Billion in assets and over 120 locations and 2,000 employees serving Colorado, Arizona, and California. In my role, I oversee the enterprise risk management practices of the organization, stress testing under the Dodd-Frank Act, and provide senior management oversight to the Compliance and Loan Review functions. Previously, I was President of our Loan Operations and Mortgage Operations and have also served as head Compliance Officer for the company. I also currently serve as Treasurer of the Colorado Bankers Association and am the former Chair of its Dodd-Frank Act Task Force, which reviewed a number of the new regulatory proposals for impact on Colorado banks.

While FirstBank is no longer classified as a small business, I will share some of our information, as I believe it will provide insight into the impact resulting from all of the new regulatory requirements. Given our history, the impact to our organization was likely less than it was for smaller institutions. However, the impact to our organization has been, and continues to be, significant.

FirstBank is a predominantly retail banking organization, with a large consumer customer base. The company has also been predominantly a real estate lender and significant mortgage lender, with both portfolio and secondary market products. Our organization has always assessed a borrower's ability to repay before entering into a mortgage loan transaction. Our underwriting and documentation standards were flexible and risk-based to meet the needs of our diverse customer base, including many small business owners. Between 2009 and 2014, our mortgage portfolio has grown from over 10,000 loans to just over 24,000. During that time period, we had a total of 179 residential foreclosures. Our peak year for foreclosures was 2010, where we had approximately 50 residential foreclosures, which represented 0.4% of our total mortgages. We did not change our underwriting standards as a result of the economic downturn.

Since 2008, there has been a significant amount of new regulations and risk management guidance issued related to banking in general. Many of these rules impact organizations of all sizes. Some have been scaled to provide limited exemptions or streamlined compliance for smaller institutions. However, minor changes in practices can make an institution subject to all of the requirements. In addition, there is anecdotal evidence that guidance intended to be scaled to the size and complexity of an organization has been fully applied, regardless of size or complexity, often through the suggestion of complying as a "best practice." Whether fully complying or not, small institutions have needed to hire resources, internal or external, to understand the rules and ensure compliance.

The following is a listing of some of the primary regulatory changes that have occurred or are currently in the rulemaking process:

Mortgage Disclosure Improvement Act
Electronic Funds Transfer Overdraft Regulation
Mortgage Loan Originator Compensation Rule (Initial and Revised by CFPB)
Real Estate Settlement Procedures Act (RESPA - HUD Revision and New CFPB Revision)
Electronic Funds Transfer Foreign Transactions
Ability to Repay and Qualified Mortgage Rule
Mortgage Servicing Rules
Appraisal Independence, Disclosure, and Practice Rules
Prohibition on Proprietary Trading (Volker Rule)
Revised Risk-Based Capital Rules (BASEL III)
Guidance on Model Risk Management Practices
Third Party Risk Management Oversight
Data Integrity Regulatory Expectations
RESPA/TILA Merger (Effective August 1, 2015)
Home Mortgage Disclosure Act Data Collection and Reporting (CFPB Rule being finalized)

While the cost of complying with any single rule may be manageable, it is the velocity of change and the cumulative impact of all of the rules that have created the need to significantly increase staffing, change and modify systems, and ensure ongoing proper training for all employees involved in the areas being regulated.

Not only has the volume and velocity of change been significant, the level of complexity of the rules has increased significantly as well. This is especially true with the newer consumer protection regulations. The recent revisions to the Mortgage Loan Originator Compensation, Qualified Mortgage, and Mortgage Servicing rules are all very prescriptive, which adds significantly to the burdens for community banking organizations. The complexity, coupled with the significantly increased civil liability for non-compliance, has made a number of smaller organizations reconsider whether to stay in certain lines of business.

As an example of the growth and complexity of rules, I will discuss the implementing Regulation Z to the Truth-in-Lending Act. This law has governed consumer credit disclosures and protections for decades. In 2008, the regulation, commentary, and appendices totaled 248 pages in the Government Printing Office's Code of Federal Regulations publications. Since 2008, modifications related to disclosures, underwriting, appraisals, and servicing has brought the total page count to 988 as of 2014, with the majority of that occurring since the passage of the Dodd-Frank Act in 2010. Its size has almost quadrupled within a six-year period of time and is only reflective of the actual changes in the rule. It does not account for the thousands of pages of associated preamble commentary discussing the determinations and underlying intent contained in the final rules. No institution could effectively review, understand, implement and ensure compliance with such significant changes without significantly increasing resources.

Between 2008 and 2014, we have increased our centralized compliance personnel resources by approximately 200%. Some of the personnel increase is attributed to the normal growth in operations. However, most of it relates to increase in regulatory burden and the associated complexity of ensuring the rules are understood and implemented appropriately.

Smaller institutions have struggled to find and hire experienced compliance personnel. The salaries for compliance personnel have increased significantly for these institutions, as the demand has outpaced the supply of qualified individuals within the institution's market. Alternate resources, such as external counsel and consulting companies, have been hired to assist with compliance understanding and implementation. These often come at increased costs and may only be a short-term solution for some organizations. Often, these resources need to understand the operations of the entity, which increases the time period for an engagement and costs associated with their utilization.

The Ability-to-Repay rule poses special compliance challenges. This is one of the first rules where traditional compliance overlaps with sound underwriting. Failure to underwrite properly exposes the institution to civil liability in the event the loan defaults. Failure to document the transaction in accordance with the rule opens the institution up to civil liability, regardless of whether the underlying underwriting is sound and the borrower has the ability to repay the transaction. In order to properly test for compliance, it requires a special skill set – one that addresses both components. This can be accomplished in a number of ways, but both require additional resources. The company either needs to have the same loan reviewed by multiple parties, or it needs to employ personnel that can do both. Either way, it results in increased personnel expense to the organization.

Our experience is that the Ability-to-Repay rule has also increased costs for small business owners who are seeking consumer real estate credit. Our institution has a large customer base of small business owners. Small business owners who are in the early growing phases of their business find it more difficult now to obtain financing for buying or refinancing a home. The reason is that their financial information must be verified by a third party. For established business, historical tax returns can be used to establish a stable earnings trend. Even though the verified tax information may be considered stale for making a credit decision and not prudent to rely on from a creditor's perspective, it is acceptable from a regulation perspective. For small businesses in early growth phases, historical income may not be sufficient to qualify, but current earnings and trends are sufficient. In these situations, the business owner must hire an accountant to review their current financials to be considered verified by a third party before the lender may rely on the earnings in making a credit decision. Often, otherwise qualified business owners will need to either incur the expense or delay financing until the taxes are actually filed and can meet the regulatory standard for acceptability. This may prevent them from being able to take advantage of current interest rates, which could also become an indirect cost for them.

The regulatory and documentation requirements also are not scaled to the relative size of the transaction. Smaller transactions carry the same amount of regulatory risk as the larger transactions, so compliance is equally important. The costs associated with originating smaller credits have grown significantly as well, and can outweigh the benefits of offering the products. While it is difficult to quantify costs to particular rules, the amount of time spent processing loans prior to origination gives an indication of the increase. Between 2010 and 2014, which is the timeframe when the majority of the regulation changes were implemented, the time spent processing a consumer loan transaction less than $100,000 has increased 67% within our organization. On the mortgage side, the time spent processing a loan increased 44% for mortgages less than $100,000, 35% for mortgages between $100,000 and $250,000, and 47% for transactions over $250,000. As I mentioned at the beginning of my testimony, we have not changed our underwriting practices, except to comply with the new rules. Most of this increase can be attributed to the increased documentation and disclosure requirements that have already taken effect.

In addition to increased compliance personnel and origination costs, there has also been a significant increase in quality control and ongoing compliance monitoring. For mortgage loans sold on the secondary market, an institution must have a quality control review process in place. An institution's files must be reviewed to ensure quality of underwriting, documentation, and compliance with all applicable laws and regulations. In most cases, an institution must hire an independent third party to conduct such reviews. In these situations, the company is also required to "check the checker" by conducting quality reviews of the third party reviews. For the few private secondary market outlets that have developed, the restrictions in the sale contracts make the originator liable for any inaccuracy or failure that may occur during the loan process. Therefore, it is necessary to have a thorough pre-close and immediate post-close review process to ensure 100% compliance. While this illustration involves mortgage lending, all aspects of compliance require some level of quality control review and remediation processes. The increasing regulatory burden requires additional personnel in this area as well, resulting in increased costs to the organization.

Mortgage servicing is another area where there has been a significant increase in costs resulting from regulations. In many respects, the regulations issued went well beyond the laws passed by Congress. This has required a significant expense for infrastructure related to servicing and collection of loans. The required practices are very prescriptive and opens and institution up to civil liability for technical failures to comply. The documentation standards are inflexible and do not allow organizations to implement the rules in a risk based manner without significant liability. This is one area where the regulators sought to exempt smaller servicers from the rules. However, this has still come at a cost. From a competitive perspective, some institutions comply with certain aspects of the rules, because consumers come to expect similar experiences involving non-defaulted loans. This may involve the ability to offer escrow accounts to its customer base. In other situations, small institutions have needed to forego revenue in order to remain exempt from the servicing rules. For example, some institutions have serviced owner-carry notes for its customer base. However, if they accept a fee for doing so, they are no longer eligible for the servicing exemption. Most institutions involved in this activity ceased offering the service or waived collecting fees on existing arrangements in order to avoid full coverage under the rules.

The full impact of regulation cannot be understood without discussing changes in technology and systems. Financial institutions rely on many software platforms and vendors to assist in compliance with the rules and regulations. The reliance on technology has become more important as the complexity and required formatting for disclosures continue to change. Any time a change is necessary, the software platform must be updated. The expense of updating the systems is passed on to the users of those systems. Significant resources are employed by the vendor to ensure that changes are implemented appropriately. This becomes challenging when substantial changes to the rules are made and a relatively short period of time for implementation is mandated. It gets exacerbated when the regulatory agencies need to continue issuing clarifications during the implementation period.

Once the updates are received, the institution needs to engage in quality control testing to ensure that the systems are working as necessary related to the new rules, and to ensure that the updates didn't corrupt the items not impacted by the changes. In recent years, it has become more challenging to receive the system updates with sufficient time to test them prior to the mandatory compliance dates. This is directly attributed to the significant amount of, and complexity of, the changes being implemented. Since liability to the institution begins immediately, the delays create real challenges. It is frequently necessary to dedicate additional resources to conduct the testing in shorter periods of times. However, the institution must insure that these resources understand the compliance requirements. Even with dedicating additional resources, unrelated errors are periodically discovered post implementation, which require another round of updates and testing.

Separate from the specific software application updates, institutions must re-evaluate internal processes and systems with any new regulation or revisions to existing regulations. Modifications must be made to implement necessary changes, capture appropriate data, test for compliance, and remediate any weaknesses identified. While the processes employed by an institution may be risk-based relative to its activities, the underlying steps must be conducted for every regulatory change as part of an appropriate compliance management system.

Finally, financial institutions must engage in some level of independent compliance testing. This is often referred to as a "third line of defense" for an organization and is important from an overall compliance management program perspective. The testing may be conducted by qualified independent internal or external personnel. While it can be risk-based and scaled to the particular organization, the coverage needs to be sufficient to provide the institution with reasonable assurance that its compliance program is effective. As the amount of regulation continues to grow, along with the liability for non-compliance, the institution's program must expand. This leads to additional costs, especially for smaller institutions.

As I mentioned earlier, the cost of implementing any particular rule may be manageable and appear insignificant. It is the cumulative effect of all of the rules that is significantly impacting the costs for financial institutions, especially the smaller ones. These costs must ultimately be passed onto those utilizing the services.

Thank you again for the opportunity to provide this testimony and be a part of the discussion surrounding the impact of regulation on businesses.