**TESTIMONY OF**

**J. PAT HICKMAN**

**on behalf of**

**THE INDEPENDENT BANKERS ASSOCIATION OF TEXAS (IBAT)**

**before the**

**SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT**
**COMMITTEE ON FINANCIAL SERVICES**
**UNITED STATES HOUSE OF REPRESENTATIVES**

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Chairman Bachus and members of the Committee, my name is J. Pat Hickman. I appreciate the opportunity to appear before this Committee today on behalf of the Independent Bankers Association of Texas and the roughly 550 community banks across Texas that we represent to share our perspective on this important sector of the financial services industry. In addition to serving as the Chairman of the Independent Bankers Association of Texas, I am Chairman and CEO of the Happy State Bank, a $290 million, locally owned institution with a staff of 130. Happy State Bank now has 11 offices serving 8 communities in the panhandle area of Texas.

IBAT would like to publicly express our appreciation to Chairman Bachus for calling this hearing, as well as Congressman Hensarling for his efforts to provide for a forum to discuss some of the pressing issues facing our industry.

In the fall of 1996, various groups representing small, community based banks began crafting a plan to ensure the continued survival and competitive standing of the community bank. Given the inevitability of Glass Steagall reform/repeal, diminution of the market share of commercial banking in the financial services arena and a highly aggressive credit union industry, it was clear that enhancements to the community bank charter would be necessary to allow for some semblance of competitive equity.

The original proposal contemplated a scenario in which the community banks who were operating in accordance with their charter, and appropriately serving their communities, would be the beneficiaries of favored tax status which would provide some level of parity with the credit unions with whom they compete. Additionally, a framework was provided which would have allowed credit unions to operate and grow without opening the common bond to the extent of making any exclusivity in membership a thing of the past.

In other words, those entities doing the same banking functions for the same clientele would be treated - and taxed - with some level of consistency. With the credit union industry now able to compete directly with community banks on a fully tax-exempt basis, the future viability of community banking is clearly in jeopardy. In a post - H. R. 1151 world, this proposal – or something similar - takes on more significance and urgency.

With the enactment of the "Gramm-Leach-Bliley Act" (GLBA) in the fall of 1999, community banks face additional challenges in their quest to provide competitive products and services to their respective markets. While clearly necessary from a public policy perspective, we believe this law allows more efficient access to new markets for larger financial conglomerates, and will almost certainly accelerate both intra- and inter-industry mergers.

Although credit unions and community banks may compete for customers, it is extremely important that there remain an incentive for both to compete in underserved and marginal communities that the large financial institutions have historically ignored. This becomes more significant with the continued proliferation of merger activities among the financial services giants. With the passage of the far-reaching credit union legislation in the $105^{th}$ Congress, credit unions have been able to grow aggressively and serve virtually anyone. In this environment, these institutions will enjoy the competitive advantages of any large conglomerate financial institution, but will have the added benefit of being both tax-exempt as well as exempt from much of the regulatory burden faced by our institutions.

The entrepreneurial capital and oversight provided by our shareholders is key to prudent credit and pricing decisions, efficient operations, and a long term view of the importance of fostering economic growth and development in the community. The community bank has always played a key role in the overall health and vitality in a multitude of communities across the nation – the extinction of this industry due to legislative mandate would be a significant loss to our economic system.

The Federal Reserve Bank of Dallas, in the January/February 2004 issue of Southwest Economy, published a study entitled “Small Banks’ Competitors Loom Large”. Among the many salient observations in this study is the market share analysis. Small banks (assets less than $1 billion in this study) have declined substantially in number and market share. In 1984, there were over 11,000 of these entities. By mid-2003, that number had declined to about 6000. These small banks controlled 23% of the banking market in 1984, and by 2003 represented some 13% of the market. Large banks (assets greater than $25 billion) increased their portion of the market from 42% in 1984 to 71% in 2003. This represents a dramatic shift toward large banking conglomerates, and as we all are aware, the consolidation and concentration within our industry continues.

The study also found that credit union assets (adjusted for inflation) have more than tripled during the study period from $194 billion to $611 billion, while small bank assets have actually decreased. If adjustments are made to include those small banks that grew into the midsize group ($1 billion to $25 billion), then this portion of the industry has reflected an 80% growth rate. This appears impressive as a stand-alone statistic, but is still dwarfed by the 200% growth in the credit union industry. A similar analysis we commissioned several years ago also reflects a disproportionate and rapid rate of growth in those credit unions in excess of $1 billion in assets.

The Federal Reserve Study also revealed that small banks have lagged far behind both large banks and credit unions in key areas such as asset growth, loan growth and deposit growth. Perhaps most troubling is the fact that the study showed that the profitability of small banks has been lagging far behind their competitors. These key indicators confirm the trend that was first revealed in a Veribanc study that our association commissioned in 1999. Both studies are consistent in their conclusion that in virtually every area of banking activity, small banks are under immediate and serious threat.

Why should this committee be concerned about these trends? The answer is because of the economic consequences if this pattern continues and because you can do something about this. Consider the Fed study also revealed that, despite the incredible asset growth by larger institutions, small banks' share of bank lending to small businesses has slipped only from 40% to 37% in the past ten years. This is particularly remarkable given the fact that small banks control only 13% of the banking system assets.

Let me remind everyone that small businesses account for over 50% of the private sector output and employment, approximately 70% of the net job growth, and they provide the majority of American exports to other countries. The problem is there are fewer small banks to make these loans and a there is a declining percentage of the banking system inclined to make such loans. We don't think we are over-reacting when we state that the continued shrinkage of a viable, vibrant small banking industry threatens this fundamental economic base and the overall health of the domestic economy.

Similar statistics and patterns exist when one examines the relationship between small banks and agriculture. The Fed study confirmed that small banks, as a sector, make 64% of the bank loans made to farming operations. Like small businesses, small banks have unique relationships and understanding of the agricultural lending industry. If we think the family farmer is important, consider that small banks make the overwhelming majority of farm real estate and farm operations loans of $100,000 or less. This component of the U.S. economic base will be similarly impacted by the continued decline of small banks.

Mr. Chairman, we are not fabricating these statistics. We now have two studies that confirm these trends and the losses that small banks are experiencing. Unless we take immediate steps to help us remain relevant and competitive, the small business component of the U.S. economic system is threatened. It is not the marketplace that has negatively impacted our competitiveness, but rather a series of regulatory and statutory requirements promulgated by our Federal government that has created this dilemma.

IBAT has been working on several legislative initiatives at the federal level over the course of several years. One such initiative is "The Community Savings and Investment Act". We appreciate the efforts of the lead sponsors, Congressman Pete Sessions (H.R. 2341) and Senator Kay Bailey Hutchison (S. 2220), along with a significant number of other Members and staff who have supported this initiative. The basis of this initiative is to provide community banks with some level of parity with its tax-exempt competition, recognizing that there is a public need for the benefits our industry provides. Additionally, there are specific tax benefits for those institutions domiciled in and serving bona fide underserved areas, which in our assessment, would create significant economic opportunities and needed stimulus in these areas.

As we met with members of Congress and their staffs, along with other key regulatory and agency personnel, it became clear to us that this initiative should be broadened to recognize the bifurcated banking industry that has evolved, along with the dramatically changing credit union competition. We are in the process of working toward the introduction of legislation that will create a new charter – or at the least recognize and treat community banks differently than the regional, national and global financial services conglomerates. Additionally, if Congress continues to allow the unfettered expansion and growth of community and "sham" common bond credit unions, we believe that substantive changes must be made in the way we as an industry are regulated and taxed.

The "Community Bank Charter" (CBC) concept effectively brings us full circle from where we began in 1996 with the impending passage of H.R. 1151 and what ultimately became GLBA. We believe that the basic components for discussion are as follows:

**Powers**. Community banks provide "core" banking services – lending and deposit functions – as well as retail financial products to their customers. We do not own securities firms or insurance companies, and certainly do not take on the underwriting risk of these products – nor do we wish to. We do not deal in foreign derivatives trading, nor do we have our own proprietary mutual fund products to steer our customers toward. Under a CBC structure, community banks should be prohibited from the <u>underwriting</u> risk of non-core banking activities (securities and insurance products), but should be able to provide similar products and services through third party arrangements or agency ownership.

**Structure**. The CBC should have charter choices – either state or national. Additionally, they should be able to organize as either a C- or S-Corp. As many community banks enjoy widespread ownership among members of their respective communities, they do not qualify for Subchapter S treatment. If an institution qualifies as a CBC, they should also be eligible for Sub S treatment. Also, a bank should be eligible to be a CBC based upon activities and risk profile – not on asset size. While we believe that stock ownership is important for a number of reasons, we believe that a mutual structure should be explored as an option.

**Regulatory Oversight**. Regulators will be directed to establish streamlined examination procedures for these "non-complex" banks. Specific laws and regulations should be amended to provide a more reasonable regulatory environment commensurate with the risk profile of these institutions.

**Deposit Insurance Fund**. Vastly different risk profiles, concentration of assets in a few large institutions, desire for different coverage levels, etc. indicate the need for a serious look at a segregated or separate fund. In a recent speech (PR-30-2004), FDIC Chairman Donald Powell discussed the "bifurcated" industry, and the substantial differences in the activities and risk profiles of community banks and the mega-institutions. We applaud Mr. Powell's bold commentary, and look forward to a serious exploration of this issue.

**Tax Treatment**. Some level of tax parity with the credit union industry is critical to remain competitive over the long term. The present situation is simply not acceptable. In addition to the fairness issue, this will provide additional economic stimulus at the local level. Economic activity and job creation will result from increased lending activity and lower costs. We recognize that while specific industry tax reductions are problematic from a political standpoint, the reality is that such a bold move would be at worst revenue neutral, and would most likely result in substantial economic benefit.

Banks are in the unique position to be a catalyst for the creation of economic activity. Each dollar that is not paid in taxes can be retained as a dollar in the capital, or net worth, of a bank. That dollar can support roughly $12.50 in deposits, of which some 70% can be reinvested back into the community in the form of loans to generate additional economic activity and job creation.

The efficient allocation of capital is a key component of capitalism and economic growth and prosperity. We believe that a migration toward a totally tax exempt banking system in the form of credit unions is disruptive not only for the federal treasury and our industry, but to the economic system on a micro- and macro scale.

We believe that this plan will also encourage more new bank charters, and as importantly, discourage the sale of existing community banks to larger competitors. Additionally, we are hopeful that, moving forward, enactment of this plan will reverse some of the disturbing trends vis-à-vis our large bank and credit union competition.

This is clearly a process, and my comments represent some of the thoughts we have to address some very serious issues impacting our industry. This hearing is an extremely important first step in what we hope will be a serious attempt to address competitive issues, and ensure the long term viability of a community banking industry that has served this nation well for decades.

I want to thank the Chairman and members of this Committee for convening this hearing. On behalf of all of the community bankers across the country, thank you for your consideration of these serious issues that we have placed before you today.