Testimony of

Ellis L. Gutshall
President and Chief Executive Officer
Valley Financial Corporation

before the

Subcommittee on Intellectual Property, Competition and the Internet

of the

Committee on the Judiciary

United States House of Representatives

on

"The Dodd-Frank Act's Effects on Financial Services Competition"

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Chairman Goodlatte, Vice Chairman Quayle, Ranking Member Watt, and members of the Subcommittee, my name is Ellis Gutshall, President and CEO of Valley Financial Corporation and its wholly-owned subsidiary, Valley Bank. My bank is a 17-year old community bank, headquartered in Roanoke, Virginia. The Roanoke Region is the largest metropolitan area in Western Virginia and home to more than 300,000 residents. Our Company has assets of approximately $800million and eight offices serving the Greater Roanoke MSA. I also serve as the 2012 Chairman of the Virginia Association of Community Banks and as a Director of the Virginia Bankers Association Benefits Corporation. Our Bank is a member of the American Bankers Association and the Independent Community Bankers of America, both of which represent banks of all sizes and charters and are the voices of the nation's $13 trillion banking industry and its two million employees.

To begin with a brief background, in 1993, Dominion Bank, a 100-plus year old institution with over $10 Billion in assets headquartered in Roanoke, merged with First Union Corporation. During its heyday, Dominion Bank dominated the banking arena in the Roanoke Valley, controlling roughly one-half of the deposits in the marketplace. With the demise of Roanoke's community bank, the organizers of Valley Bank felt that a region as large and important as the Roanoke Region needed to have a locally owned and locally managed community bank if it were to continue to grow and prosper.Valley Bank opened for business in May of 1995 and in just 17 years, we have grown to the #4 market share in terms of deposits, surpassing even Bank of

America, within the Roanoke MSA. I make this point to demonstrate just how critically important community banking is to communities all across this nation and how community banks such as Valley Bank can effectively compete against the much larger mega-banks. During this 17-year period, our share of the MSA deposit base has grown to nearly 10% while the leader's share, the former Dominion Bank which is now Wells Fargo after the merger with Wachovia, has declined to 27%. For decades, community banks have been the backbone of all the Main Streets across America, and for the Roanoke Region in particular, Valley Bank's presence has provided a strong catalyst to the economic growth, health, and vitality of our community as we have invested over $1 Billion of investment into our community in the form of loans during our 17-year history. It is our vision and mission to continue this role for many, many years to come. Unfortunately, the cumulative impact of years of new regulations is threatening the very existence of community banks.

We all appreciate the importance of regulation that protects the safety and soundness of our institutions and protects the interests of our customers. We know that there will always be regulations that control our business – but the reaction to the financial crisis has layered on regulation after regulation that does nothing to improve safety or soundness and only raises the cost of providing banking services, both credit and depository related, to our customers. New rules, regulations, guidance and pronouncements flood in to our bank almost daily. With Dodd-Frank alone, there are3,894 pages of proposed regulations and 3,633 pages of final regulations (as of April 13) and we're only a quarter of the way through the 400-plus rules that must be promulgated.

While community banks pride themselves on being agile, quick to adapt to changing environments and determined to meet any challenge head on, there is a tipping point beyond which community banks will find it impossible to compete. During the last decade the regulatory burden for community banks has multiplied tenfold, with more than 50 new rules in the two years ***before*** Dodd-Frank.Over the last decade1,500 community banks have disappeared from communities. Each new law or regulation in isolation might be manageable, but wave after wave, one on top of another, will certainly over-run many more community banks.

Without quick and bold action to relieve regulatory burdens we will witness an appalling contraction of the banking industry, at a pace much faster than we've witnessed over the last decade.

Congress must be vigilant in overseeing regulatory actions. Ifleft unchecked excessive regulation will surely negatively affect community banks' ability to effectively compete. Holding oversight hearings like this one is critical to ensure that banks are allowed to do what they do best—namely, meet the financial needs of their communities.

There are three key points I would like to make today.

- The costs to implement new regulations weigh most heavily on community banks making it difficult to compete with the mega-banks, tax-exempt credit unions and nonbank financial firms
- The lost opportunity costs are significant for community banks, their communities and their customers
- Unintended consequences of Dodd-Frank have far-reaching effects on the very ones the legislation was designed to help and protect

I. The Costs to Implement New Regulations are Substantial and Weigh Most Heavily on Community Banks Making it Difficult to Compete with the Mega-Banks, Tax-Exempt Credit Unions and Nonbank Financial Firms

Make no mistake about it, this burden is keenly felt by all banks, however,many small banks do not have the resources to manage all the new regulations and the changes in existing ones. Besides the real, hard dollar costs, there are important opportunity costs related to the products and services that either cannot be offered or will be offered only at higher costs to our customers.

For our bank, in 2011, we estimate that we spent over $500,000 in hard dollar compliance costs. That translates to roughly 7 cents per common share to our shareholders.This includes salaries attributable to compliance, annual bank-wide compliance training, legal and compliance consulting services, compliance software and other IT expenses, printing expenses and privacy mailing costs, and various record-keeping requirements. And there are other costs that we simply cannot capture. We have several dedicated compliance officers just to handle all the legal and paperwork requirements and, in addition, estimate that another one-half of our total staff have some compliance obligations they must fulfill. Historically, the cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks. I fear that gap may widen even more once Dodd-Frank is fully implemented.

Changes in existing regulations and the new regulatory requirements that will flow from Dodd-Frank have necessitated the need for us to add another full-time compliance person. That cost, plus many other ancillary costs of these new changes, will add another $75,000 to the overall cost. Of course, we are only in the early stages of the Dodd-Frank implementation, so we are bracing for additional costs that must somehow be borne. All these extra expenses could have been more productive if they were devoted to providing services to our customers.

As an $800 Million asset bank, we are better able to spread some of the compliance costs than our smaller brethren. In 2006, at a time when we were approaching $500 Million in assets, I made the decision to create an enterprise-wide risk management department that would be responsible for assessing and monitoring risks associated with all of the bank's compliance and non-credit operating units. Looking back now, this was one of the most significant things we could have done as we had fully developed a risk management department and staff prior to Dodd-Frank. I seriously doubt we would be able to do what we are doing now in terms of compliance and training without this enterprise-wide risk management group. However, this group has quickly been stretched to their limits. We will not be able to continue our high level of compliance expertise without additional staffing and training. The rising costs are just not in-house staffing requirements, but also the high costs of attending conferences and seminars, the many subscriptions to legal and accounting services that we feel we have to have just to make sure we do not miss anything, IT software up-grades to monitor our activities and the additional regulatory burden associated with proving we have complied with the new laws. The regulatory agencies want to see independent third-party confirmation, so besides internal audits, banks now have to have outside audits for compliance which is a significant expense for smaller banks. For the median-sized bank in this country with $166 million in assets and 38 employees, the burden is magnified tremendously. For larger banks, Dodd-Frank imposes significant changes that are already driving an entire reevaluation of business lines and models. Together with the new Basel capital and liquidity rules, these added costs likely will total in the hundreds of millions of dollars.

For the industry, a very conservative estimate of all the hard dollar costs would be about $50 billion annually, or about 12 percent of total operating expenses.This expense ratio is only surpassed by the salaries & benefits we pay to our employees.

We at Valley Bank have taken great pride during our 17-year history in the fact that our noninterest expense management has placed us in the top performing quartile of our FDIC peer group. In 2011, our personnel expenses were 22% below the peer average and our total noninterest expenses were 17% below the peer average. At the same time, our employees were managing $5.8 Million in assets per employee compared to $4.6 Million for the peer average, a 26% positive variance and a strong demonstration of the superior productivity of our staff. Our low overhead framework coupled with high productivity ratios have enabled our bank to effectively compete head-to-head with the mega-banks in our market and actually take market share away while also producing the levels of profitability our shareholders demand.However, new regulations just keep being piled on top of older outdated requirements and we are clearly experiencing expense ratios that are increasing much more rapidly than our ability to increase revenues.

II. The Lost Opportunity Costs Are Significant for Community Banks, Their Communities and Their Customers

The direct out-of-pocket expenses are just part of the story when one realizes the significance of the opportunity costs. Instead of teaching staff to reach out to new markets, trainers are bringing the employees up to speed on the latest regulations. Instead of employee time and focus being used to invest our precious capital to support loans to hardworking people and businesses in our communities, it is being spent interacting withconsultants, lawyers, and auditors. Instead of investing our time and efforts to develop new products and solutions to meet the ever-changing demands and needs of our customers, we are spending our time analyzing changes to software to assure compliance with all the new changes. Excessive regulation saps staff and resources that should have gone to meeting the needs of our customers. Even a small reduction in the cost of compliance would free up billions of dollars that could facilitatelending activity and other banking services. The differentiating factors that set community banks apart from the mega-banks are a) that ability to focus our complete attention on our local community and the local customer, and b) to provide local operational support and local decisions. These factors are customer-centric and customer driven. If we are forced to become more internally focused in an attempt to deal with the avalanche of regulations, we will lose the competitive advantage that we have created and that has been so well received by our customer base. Customer service levels will decline and it is the customer who will be disadvantaged by these actions. As I mentioned earlier, Valley Bank's presence has provided a strong catalyst to the economic growth, health, and vitality of our community as we have invested over $1 Billion of investment into our community in the form of loans during our 17-year history. We would like this to be our role for many, many years to come. If banks, especially community banks, find themselves so internally-focused on compliance related activities that they cannot attend to the job of extending credit,any hopes for a sustained economic recovery in this country will fade quite rapidly.

III. Unintended consequences of Dodd-Frank have far-reaching effects on the very ones the legislation was designed to help and protect

Congress must be vigilant in its oversight of the efforts to implement the Dodd-Frank Act to ensure that rules are adopted only if they result in a benefit that clearly outweighs the burden. There is an unintended consequence that is occurring right now in our marketplace and most likely throughout all of America. In an effort to find new and additional revenues to offset the rising costs of new regulations, banks of all sizes are reviewing and analyzing their service charges and fees associated with both loan and deposit products and services. Due to relatively weak loan demand and compressing net interest margins, the traditional spread income most banks, and especially community banks, relied on to support noninterest expense growth is not growing. Therefore, banks are increasing service related fees in an attempt to generate the needed revenues to offset these rising costs. Free checking and "no minimum" balance products are disappearing from the marketplace, and it is not just happening at the mega-banks. Additionally, banks are utilizing their customer profitability systems to a much higher degree to determine which customers are profitable and which ones are not. The result will surely be an effort to improve profitability throughout the spectrum which will result in either increased fees or decreased availabilityof services. In either case, the customer will be paying more or choosing not to use the service at all.

Another unintended consequence we are facing lies in residential mortgage lending. Following the residential mortgage meltdown that essentially obliterated the mortgage broker network, banks once again were viewed as a potential resource for home buyers and homeowners throughout the country. Banks were quite willing to jump in and fill this void and many banks immediately began the process of expanding residential mortgage loan operations. Our bank did exactly that. However, we are finding some rules under Dodd-Frank, if done improperly, ***could literally drive banks out of the mortgage business.*** These new rules on mortgage lending and on mortgage originator compensation are particularly problematic provisions.

One of the changes required in the Dodd-Frank Act is that lenders must show that borrowers meet an "ability to repay" test—***which can be challenged in court for the entire life of the loan***, raising the risk of litigation tremendously. It also imposes broad risk retention requirements on most loans sold into the secondary market. These requirements have the potential to make it much more costly for banks to make loans and could have the unintended consequence of denying quality loans to creditworthy borrowers. Dodd-Frank does provide that banks can show they have met the ability to repay test by making loans that fall into a category known as a Qualified Mortgage or QM. The QM is intended to be a category of loans with certain low risk features made to borrowers shown to be creditworthy and able to meet the payment terms. The Consumer Financial Protection Bureau (CFPB) is tasked with finalizing a rule setting forth exactly what will qualify as a QM, but a number of concerns have arisen with regard to the approach which the CFPB may take. If the QM category is made too narrow by excluding too many loan types or by requiring borrowers to meet too high a standard of creditworthiness, then credit will contract and potential borrowers will be denied credit for which they would otherwise qualify.

How these exceptions are defined will dramatically impact the willingness and ability of banks to make mortgage loans, and of consumers' ability to qualify for credit.

The thought of quality institutions being forced from the mortgage market and of otherwise creditworthy borrowers being denied credit because of overly broad regulations is chilling—especially at a time when our housing economy has been severely battered and is just beginning to show signs of recovery.

There are many other issues raised in Dodd-Frank that will affect the competitiveness of banks and that will also negatively affect customers of banking services. Below, I describe two of those issues.

The municipal advisor proposal would limit services to municipalities by local community banks.

Banks offer public sector customers banking services and are regulated closely by several government agencies. It is generally believed that Dodd-Frank intended to establish a regulatory scheme ***for unregulated persons*** providing advice to municipalities with respect to municipal derivatives, guaranteed investment contracts, investment strategies or the issuance of municipal securities. The Securities and Exchange Commission has proposed a very broad definition of "investment strategies" that would cover traditional bank products and services such as deposit accounts, cash management products and loans to municipalities. This means that community banks would have to register as municipal advisors and be subject to a whole new layer of regulation on bank products for no meaningful public purpose.

Such regulation would be duplicative and costly. Consequently, community banks would not be able to offer services to municipalities at a price that would be competitive. As a result, many banks may decide not to provide banking services to their local municipalities – forcing these local and state entities to look outside of their community for the services they need. This proposal flies in the face of the President's initiative to streamline federal oversight and avoid new regulations that impede innovation, diminish U.S. competitiveness, and restrain job creation and economic expansion.

We urge Congress to oversee this implementation and ensure that the rule addresses unregulated parties and that neither Section 975 of Dodd-Frank nor its implementing regulation reaches through to traditional bank products and services.

The swaps push-out provision would create competitive imbalances between U.S. banks and foreign counterparties.

Section 716 of Dodd-Frank, will prohibit swap dealers from receiving various forms of federal assistance including FDIC insurance and access to the Federal Reserve discount window. This provision will essentially require banks that are swap dealers to "push out" many swaps transactions to a nonbank affiliate. We support repealing the push-out provision because failing to do so would have a negative impact on bank and bank customer risk management practices and create competitive imbalances between U.S. and foreign banks.

Banks currently have the ability to centralize risk management for each customer relationship by conducting a customer's swaps transactions together with that customer's other transactions. In other words, banks can assess the credit risk of the customer and negotiate loan, swap, collateral and other credit terms as part of a complete package. Customers benefit because they can receive more attractive loan terms or a higher credit limit if the bank can net and setoff different exposures from each of the customer's transactions. If the push-out provision is not repealed, bank customers will face higher costs and reduced credit availability.

Many customers also prefer to have a bank as a swap counterparty because it enables customers to centralize their own risk management of loans and other forms of credit. Customers now have "one stop shopping" for all of their credit needs, including swaps that may offset their credit risk. Swap customers may also prefer to have a bank as a counterparty from a credit risk standpoint. If banks have to push out some swaps transactions into a separate affiliate, then customers will not be able to centralize credit risk management with a bank even if it is their preferred swap counterparty.

The push-out provision would also create competitive imbalances between U.S. banks and their foreign counterparties. To date, it does not appear that other countries are considering adopting "push-out" requirements. Therefore, it is likely that foreign banks will still be able to offer integrated credit and risk management products in one entity. Customers who still want "one stop shopping" for their credit needs – including swaps – may choose to move their business to foreign banks. This may not ever affect my community bank in a direct manner, but letting our larger banks lose larger US customers to foreign banks concerns me greatly as I hope it does you.

If banks have to create a separate affiliate to conduct swaps transactions, then the affiliate also will have to be funded separately and meet separate capital requirements. The capital requirements for the affiliate may be entirely different from bank capital requirements if the swap transactions are done through a broker-dealer affiliate. Bank customers would have to sign new credit agreements with the bank and its affiliate. Considering all of these costs and complexities, it is likely that only large financial institutions would be able to create, fund, and capitalize a separate affiliate to conduct swaps activities that need to be “pushed out” of a bank. My own bank uses swaps as part of our commercial lending process, so this is a critical competitive issue for community banks as well as large banks.

Conclusion

The consequences of excessive regulation are real. Costs are rising and will continue to rise. To offset these rising costs, banks must find new and additional revenue sources, most likely from increased service fees, or cut back the services they provide. Both of these actions will adversely affect the customer.With the regulatory overreaction, piles of new laws, and uncertainty about government’s role in the day-to-day business of banking, meeting local community needs is proving difficult at best.

My bank’s philosophy—shared by community banks everywhere—has always been to treat our customers with respect and to strive to provide the best possible financial solutions to create economic growth and wealth creation. We will continue to do this, but with the many new hurdles being placed in our way, our customers’ most basic banking needs will inevitably be more costly, more time consuming to complete and less beneficial to them as the end result.

In my view, there will be three scenarios that will evolve for the community banks of this country. There will be those community banks that will just be unwilling or unable to take on these hurdles and they will move to partner with others in the short term. There will be a second group of community banks that will accept the challenge but eventually fail to produce the return on investment their shareholders demand, and they will ultimately partner up as well. And finally, there will be a much smaller group of banks that are able to successfully navigate the regulatory landscape and be able to also providethe return on investment that just may ensure their independence for the foreseeable future. These scenarios lead us to a banking industry with far fewer competitors than we have today, which may be the largest unintended consequence of all from Dodd-Frank.

Thank you for allowing me to appear before you today.