Independent Community Bankers of America

Testimony of

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On behalf of the
**Independent Community Bankers of America**

Before the

Congress of the United States
House of Representatives
Committee on Financial Services

Hearing on

"Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on Economy and Credit Availability"

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Chairman Frank, Ranking Member Bachus, Members of the Committee. My name is Cynthia Blankenship, and I am the Chief Operating Officer and Vice Chairman of Bank of the West in Irving, TX, and the Chairman of the Independent Community Bankers of America (ICBA). Bank of the West is a state-chartered bank with $250 million in assets and is part of a two-bank holding company. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on "Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Issues: Impact on Economy and Credit Availability."

**Summary**

*Troubled Asset Relief Program*

ICBA commends the efforts of the Congress, Treasury, the Federal Reserve and the FDIC to address the current economic crisis. This is a formidable task.

However, ICBA has significant concerns with the pace of implementation of the Troubled Asset Relief Program's Capital Purchase Program (CPP). The term sheet released by the Treasury several weeks ago for large publicly traded banks will just not work for the many privately held banks, thinly traded banks, Subchapter S banks and mutual institutions because of statutory constraints and organizational structures peculiar to each of these types of institutions. ICBA and others have provided Treasury concrete suggestions to overcome the obstacles for these smaller banks. We believe we have had a constructive dialogue with Treasury about these issues, and that Treasury is working in good faith to produce term sheets that will work for each of these types of institutions.

ICBA members are growing increasingly concerned, however, that only $60 billion is left uncommitted from the $250 billion Capital Purchase Program and still more than 6,000 financial institutions cannot qualify for the CPP under the initial public term sheet. There are more than 8,000 community banks nationwide, and they are well-positioned to extend lending to their communities using capital from the Capital Purchase Program. Including these banks in the Capital Purchase Program will stimulate additional lending in local communities throughout the country.

Banks nationwide interested in expanding lending through the Capital Purchase Program are rightly concerned about a provision in the CPP agreement that will allow the government to retroactively change any of the contract terms of the established Securities Purchase Agreement should there be a change to a federal statute. ICBA suggests this provision be modified to say that only future changes to federal law that apply to all financial institutions, not those changes directed solely at institutions participating in the CPP program, could be incorporated retroactively into the agreement. This would ameliorate the concern of community banks that significant terms of the agreement could be retroactively changed.

*FDIC Temporary Liquidity Guarantee Program*

ICBA applauds the FDIC's actions to unlock the credit markets through its Temporary Liquidity Guarantee Program (TLGP). The Transaction Account Guarantee part of the TLGP, which provides unlimited deposit insurance in non-interest bearing transaction accounts, will enhance depositor confidence in community banks. It will also free up bank capital that is now used to purchase securities in connection with secured repurchase agreements for the benefit of large depositors. ICBA supports expanding the Program to fully insure all transaction accounts (interest and non-interest bearing) through December 31, 2009. Expanding coverage to include all transaction accounts would level the playing field for community banks and other institutions NOT too big to fail by eliminating the incentive for customers to move funds to too-big-to-fail institutions or mutual fund money market accounts. Many community banks have few demand deposit accounts over $250,000, but transaction accounts with high balances are typically NOW accounts for small businesses, non-profits, and governmental entities.

The Debt Guarantee Program for senior unsecured debt, however, as currently constituted, provides few benefits for community banks. In contrast to larger institutions community banks, by and large, do not issue much in the way of senior unsecured debt, other than some federal funds purchased. The current pricing for the Debt Guarantee Program (an across the board 75 basis point fee) makes it unattractive for federal funds purchased transactions. Overnight federal funds transactions pose little risk of default and, at current prices for federal funds, the 75 basis point guarantee fee exceeds the interest rate on the instruments. We have suggested the FDIC adopt risk-based pricing for the guarantee, so the guarantee will be more attractive for overnight transactions, and consider allowing banks to separately opt-out of the guarantee for overnight federal funds.

Under the law under which the TLGP was established, holding companies cannot be assessed any special fee that may be required to make up any final deficit in the TLGP, but all banks and thrifts will be subject to such a special assessment. The inability to levy a special assessment against bank holding companies, particularly those with substantial non-bank subsidiaries, creates an inequity in the TLGP. If bank holding companies with substantial non-bank subsidiaries remain in the program, some mechanism should be devised to insure that these holding companies pay their fair share of any net costs of the TLGP.

*Foreclosure Mitigation*

Community banks played no role in causing the current problems because they did not engage in the subprime lending practices at the heart of the crisis. As a result, community banks are not experiencing unusual levels of mortgage defaults. When community banks do encounter a default, they recognize that foreclosure is the least attractive alternative. It is bad for the borrower, the institution and other homeowners in the borrower's community. Community banks work with homeowners to restructure mortgages, when that is a viable option, including through loan modifications under the Hope 4 Homeowners Program and other avenues.

Community banks are truly invested in long-term relationships with their customers and their communities. When community banks service mortgages, they have a strong interest in maintaining those relationships, and not just guarding the interests of investors. Community banks' involvement in finding solutions for consumers extends beyond their own customers. They have frequently offered refinancing to troubled borrowers with loans from other institutions.

**Community Bankers Strongly Supported the EESA**

The ICBA and its 5,000 community banks were strong supporters and advocates of the Emergency Economic Stabilization Act of 2008, which created the Troubled Asset Relief Program (TARP). Although the community banking industry avoided the subprime mortgages and lending practices that are at the center of the current economic and credit crisis, the effects of the crisis have had an impact on community banks and their Main Street customers. We were very pleased Congress included provisions in the legislation addressing key concerns of community banks, and we appreciate the support of Chairman Frank, Subcommittee Chairman Kanjorski, and others on the Committee for including these Main Street bank provisions.

The EESA addresses several key community bank priorities. The legislation provides a temporary increase in deposit insurance limits from $100,000 to $250,000 through December 31, 2009. The increase in FDIC insurance provides the dual benefits of providing additional liquidity to banks for lending as well as providing additional reassurance to depositors with account balances above the $100,000 limit.

The EESA allows community banks to take capital losses against ordinary income for Fannie Mae and Freddie Mac preferred share losses. In many cases, regulatory examiners and outside accounting firms encouraged community banks to purchase GSE preferred stock as a good, safe asset for diversification. While the government's conservatorship of the government sponsored enterprises (GSEs) may have been necessary to restore calm to financial markets, it did, in effect, wipe out the interests of not only the holders of the GSE common stock, but also the holders of preferred stock, including many community banks**.** Allowing community banks to take these losses as deductions against ordinary income softened the impact of the GSE conservatorship and provided some compensation for the government's actions. The EESA also permits the Treasury to use TARP funds to provide financial assistance to community banks that suffered the most serious impact to capital (Section 103 (6)) This provision is separate from the Treasury's Capital Purchase Program. ICBA urges Treasury to use this option to mitigate the damage to the most seriously affected banks owning Fannie and Freddie preferred stock.

The EESA requires that the SEC to conduct a study of mark-to market accounting standards and their impact on financial institutions and the quality of financial information available to investors. ICBA has told the SEC that full mark-to-market, or fair value, accounting is inappropriate for community bank financial statements. We have also said that current standards have exacerbated the current financial crisis as financial instruments are priced not at "fair value," but at forced liquidation values, despite current guidance. Accounting measures should more closely reflect the way financial instruments generate earnings and cash flows.

Community banks are particularly pleased the EESA prohibits the Treasury from establishing future guarantee programs for money market mutual funds. Community banks have paid billions of dollars for federal deposit insurance. The four basis point fee paid by the mutual fund industry is not comparable to banks' current assessment fees (five to seven basis points for the least risky banks) nor to proposed FDIC assessment rates for 2009 (12 to 14 basis points in the first quarter, 10 to 14 basis points thereafter). It would be inequitable to establish another guarantee fund for the money market mutual funds through regulatory actions. We are also pleased the EESA allowed the Federal Reserve to pay interest on so-called bank "sterile reserves" beginning Oct. 1, 2008, three years earlier than previously permitted.

ICBA is particularly appreciative that the EESA ensures community banks will have equal access to the TARP (Section 103 (5)). This language is significant as the focus of Treasury's efforts have centered on the TARP Capital Purchase Program.

**EESA's TARP Intended for All Banks**

The ICBA greatly appreciates the Committee's attention to ensure the Emergency Economic Stabilization Act and, specifically, the TARP's Capital Purchase Program (CPP) are widely available to all interested banks. ICBA has discussed with Treasury many community banking concerns and proposed specific recommendations to facilitate private bank access to the TARP and CPP as intended by Congress.

However, ICBA members are growing increasingly concerned that only $60 billion is left uncommitted from the $250 billion Capital Purchase Program and still more than 6,000 financial institutions cannot qualify for the CPP under the initial public term sheet. Half of the CPP's $250 billion was quickly given to just nine of nation's largest banks.

Notably, an additional $40 billion has been granted to insurer American International Group from the general TARP funds.

Large companies such as credit card company American Express have rapidly converted to a bank holding company so they too may access the TARP funds. This follows the rapid conversion of the gigantic investment firms such as Goldman Sachs and Morgan Stanley into bank holding companies after being battered in the markets. All the while, thousands of traditional community banks stand ready, willing and interested in TARP CPP access to help boost lending, but to date without a term sheet for private banks, they have been largely shut out.

Community banks did not cause the current financial crisis. Nevertheless, many community banks are now suffering the consequences of frozen credit markets and finding it difficult to raise capital in the current marketplace. Community banks, interested in the CPP, therefore deserve prompt access to the TARP capital.

More than 6,000 financial institutions still cannot qualify to participate in the CPP because they are thinly-traded banks, Subchapter S banks, private banks, and mutual institutions that cannot meet the terms of the Treasury's initial public term sheet. If Treasury makes these thousands of community banks eligible, they would be able to boost lending in their local communities.

**Community Banks Positioned to Lend on Main Street**

Some 48 percent of small businesses get their financing from banks with $1 billion and under in assets. By only granting a few dozen of the nation's largest banks the CPP funds, more than half of small businesses may not see any change in their available credit. ICBA believes to get more dollars flowing to Main Street and to boost economic activity as Congress intended, a greater number of interested community banks must be part of the CPP.

We appreciate the Treasury allowing us the opportunity to directly spell out the unique structure of our nation's 6,000-plus private banks and to suggest a means to include private banks, lightly-traded banks, 2,505 Subchapter S banks, and more than 600 mutuals in a term sheet that will work for their structure.

We hope Treasury will release new terms for the CPP program soon so smaller banks can participate. Also we urge that an appropriate application deadline be given to these banks to allow sufficient time for understanding and qualifying for CPP funds and to secure the needed shareholder and board approvals.

**Strong Community Bank Interest in CPP**

Notably, there is very strong interest in the CPP capital from community banks. ICBA surveyed its membership which showed some 20 percent of community banks want to access CPP capital and another 30 percent are interested and want to review the detailed terms for their access. The vast majority of community banks entered this economic slowdown in solid shape and did not stumble on exotic lending and toxic investments. So interested community banks may be better positioned to use the CPP funds to bolster lending rather than solely replace capital due to massive losses seen by the giant investment banks.

Capital access is not solely a problem for the nation's giant banks. According to the ICBA survey, of the community banks interested in accessing CPP funds, some 57% noted they do not have easy access to new capital. Some 31% said capital is not available at any cost. About one-third of banks said they would consider shrinking their balance sheet to increase their capital position -- meaning less lending in their communities unless CPP funds would be available to supplement needed capital.

**Key Concerns on Private Bank CPP Access**

ICBA believes it is entirely feasible to craft workable terms for thinly-traded banks, private banks, Subchapter S banks, and mutuals so they can access CPP funds under similar economic terms as the large publicly traded banks. ICBA has made detailed recommendations to Treasury to incorporate private banks into the CPP.

The major needed modifications for these banks center on obstacles presented in a few areas. They include the inability to issue preferred stock (Subchapter S banks and mutuals) or easily discover a market price for common stock warrants (private banks, non-SEC registered banks, thinly-traded banks and S corporation banks). This can be overcome by offering a private term sheet to banks that are not traded on one of the three major stock exchanges and by substituting a perpetual junior subordinated debt instrument in place of the preferred stock. The junior subordinated debt would pay Treasury the same rate of return as it will receive on the larger banks' preferred shares. Instead of common stock warrants, these smaller institutions would issue Treasury book value-priced "phantom stock" and pay a redemption fee based on income growth. This mechanism could substitute for the upside "equity kicker" Treasury is seeking from the common stock warrants.

**Dividend Policy Deserves Appropriate Attention**

Tax liability on Subchapter S banks' earnings pass directly to the shareholders who must pay taxes on this income, whether or not it is actually distributed to the shareholders. Therefore S corporation banks must pay out substantial dividends in order for individual shareholders to pay the banks' taxes. The potential over-restriction on dividend payments for Subchapter S banks participating in the CPP can be addressed by allowing dividends to grow in sync with bank income and tax rates to cover the increase in flow-through income and tax liability. ICBA urges Treasury to address this issue and other issues affecting the more than 2,500 Subchapter S banks and thrifts through a term sheet for Subchapter S institutions.

ICBA also believes preference should be given in the CPP program for banks that suffered substantial Fannie Mae and Freddie Mac preferred stock losses and hits to their capital due to the GSEs into conservatorship.

These ICBA-recommended terms would allow community banks to participate in the TARP CPP and help boost lending to families and small businesses. Every dollar in new capital a community banks can raise it will facilitate an additional seven to ten dollars of community lending . The cost of this CPP capital is not inexpensive for community banks, at some 7.5% tax effective rate in the first five years, plus further warrant-related costs. So the community banks that use this capital will put it to good use by doing what they do best – lend on Main Street.

**Concern on Changing the CPP Terms Retroactively**

ICBA is also concerned with a provision in recently released documents to be signed by Treasury and CPP program participants. Specifically, Section 5.3 of the Securities Purchase Agreement states that the Treasury Department can:

*"unilaterally amend any provision of this Agreement to the extent required to comply with any changes after the Signing Date in applicable federal statutes."*

Banks are rightly concerned this new provision will allow the government to retroactively change any of the contract terms of the established Securities Purchase Agreement should there be a change to a federal statute.

Notably, the Supreme Court's decision in the 1996 case of *United States v. Winstar* established the principle that the government cannot retroactively change the original terms of an agreement it has entered without being subject to damages for breach of contract. In *Winstar*, the federal regulators encouraged a group of investors to take over an ailing thrift under a supervisory merger agreement that allowed the resulting institution to count goodwill as part of its regulatory capital. Thereafter, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was passed which prohibited thrifts from counting supervisory goodwill and capital credits in computing the required reserves. In essence, the government retroactively changed the terms of the agreement.

Although the court in the *Winstar* case held against the government, it left open the issue of whether future agreements could include provisions that allow the government to unilaterally and retroactively change the terms of an agreement. To participate in the CPP, banks must be able to rely on the agreement and have certainty the contracts and terms they agree to will not change retroactively. Without this certainty, changes made unilaterally and retroactively by Treasury could substantially change the economics of the arrangement, making it difficult for bankers to responsibly decide whether to participate in the CPP program.

ICBA therefore requests the Treasury modify Section 5.3 to clarify that only future changes to federal law that apply to all financial institutions and that are not directed solely at institutions that participate in the CPP program could be subject to retroactive changes to the Securities Purchase Agreement. This would ameliorate the concern of community banks that the agreement could be changed retroactively.

**FDIC's Temporary Liquidity Guarantee Program**

On October 14, 2008, the FDIC announced the establishment of a Temporary Liquidity Guarantee Program (TLGP) as part of coordinated government efforts to unlock credit markets, particularly inter-bank credit markets, which had ceased to function properly. The disruptions in credit markets have significantly impaired the ability of creditworthy companies to issue commercial paper and longer term debt.

The TLGP consist of two parts. The Debt Guarantee Program would provide an FDIC guarantee of all senior unsecured debt issued on or after October 14, 2008 through June 30, 2009 by an eligible entity. An "eligible entity" includes a domestic bank, thrift, bank holding company and most thrift holding companies. The guarantee expires on the earlier of the maturity date of the underlying debt or three years. The FDIC will assess a fee equal to 75 basis points of the guaranteed amount, on an annualized basis. The amount of senior unsecured debt that can be guaranteed under the program is an amount equal to 125% of the amount of senior unsecured debt the institution had outstanding on September 30, 2008. The FDIC will allow banks with little or no senior unsecured debt as of September 30th to request an increase in the amount of debt that is eligible for the FDIC guarantee.

The second part of the TLGP is the Transaction Account Guarantee Program, which provides 100% guarantee for all amounts in non-interest bearing transaction accounts. The FDIC will assess a ten basis point fee (on an annualized basis) only on amounts in transaction accounts above $250,000. The expanded guarantee lasts through December 31, 2009.

Eligible entities have until December 5, 2008, to opt out of either program or both programs. Once an institution opts out of a program, the guarantee terminates. The FDIC issued interim regulations and provided the public an opportunity to file comments by November 14, 2008.

ICBA applauds the FDIC's actions to unlock the credit markets. The Transaction Account Guarantee Program will enhance depositor confidence in community banks and free up bank capital used to purchase securities in connection with secured repurchase agreements for the benefit of large depositors. The Debt Guarantee Program, however, as currently constituted, provides few benefits for community banks. These institutions generally, in contrast to larger institutions, do not issue much in the way of senior unsecured debt, other than some federal funds purchased. The current pricing for the Debt Guarantee Program makes it unattractive for federal funds purchased transactions. The ICBA has provided the FDIC detailed suggestions on how to improve the proposal through our comment letter, including a requirement that all-too-big-too-fail banks participate in the program to help prevent a deficit in the program; a 10-50 basis point range for a risk-based assessment for the Debt Guarantee Program fee, instead of an across the board 75 basis point fee; a guarantee cap formula that includes secured liabilities as well as unsecured senior debt; modification to the Transaction Account Guarantee Program to include all NOW accounts as NOW accounts above $250,000 typically belong to small businesses, governmental entities and charities.

We would like to bring to the Committee's attention one issue that may take congressional action to address. The FDIC used its systemic risk authority to establish the program. The net costs of any activity undertaken pursuant to the systemic risk authority must eventually be borne by all FDIC-insured banks and thrifts through an assessment based on the institutions' assets minus equity. The statute does not expressly authorize the FDIC to assess bank and thrift affiliates, including holding company parents. The Debt Guarantee Program has been extended to holding companies because much of the bank debt that is issued is done at the holding company level. However, should a special assessment be needed to make up for any deficit in the TLGP, the FDIC cannot levy an assessment against the non-bank assets of a holding company.

We have suggested the FDIC exclude from the program holding companies with significant non-bank subsidiaries if it cannot develop a method for assessing holding companies to pay their fair share of program losses, as it would be grossly unfair for community banks and other insured depository institutions to be left with the tab, through a special assessment on FDIC-insured institutions only. It would also be appropriate for Congress to amend the systemic risk statute to authorize the FDIC to assess the consolidated assets of all affiliated companies of a bank or thrift.

**Foreclosure Mitigation**

As noted, community banks played no role in causing the current crisis because, by and large, they did not engage in unwise subprime lending practices. As a result, community banks are not experiencing unusual levels of mortgage defaults. And, ICBA members are still making mortgage loans. Community bank mortgage originations have remained steady over the first nine months of this year. Based on mortgage origination data we collect through ICBA Mortgage Corporation, we estimate community banks have originated approximately 300,000 mortgage loans for an aggregate principal amount of approximately $47 billion for the first nine months of this year.

But we agree that minimizing foreclosures is an important part of the effort to stabilize the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes.

In preparation for this hearing, we have asked Taylor, Bean and Whitaker (TB&W), a national wholesale mortgage lender and servicer that services mortgages on behalf of many of our members, about their foreclosure mitigation efforts. TB&W works with a representative cross section of our membership. As a result, the servicing practices of TB&W fairly reflect the mortgage practices of community banks. We also have information from some ICBA members who retain servicing.

TB&W and community banks that service their own mortgages monitor payment activity for changes that might signal a borrower could have difficulty paying the mortgage. If that occurs, it is the practice of these servicers to contact the borrower quickly to avoid potential problems. It is not their practice to rush to foreclosure, which has significant negative consequences for both borrowers and lenders.

A number of ICBA members prepared to use the Hope 4 Homeowners Program by sending staff to training and applying to become approved FHA lenders. TB&W is a leading FHA approved lender. ICBA has partnered with TB&W to provide ICBA members easier access to all FHA programs, including the HOPE 4 Homeowners Program. Community banks and TB&W will continue to work with individual borrowers to find the best solution to keep borrowers in their homes, including loan modifications under the Hope for Homeowners Program or under any new government programs that would support mortgage modifications.

Community banks are truly invested in long-term relationships with their customers and their communities. When community banks service mortgages, they have a strong interest in maintaining those relationships, and not just guarding the interests of investors. Community banks' involvement in finding solutions for consumers extends beyond their own customers as community banks have offered refinancing to troubled borrowers with loans from other institutions as well.

Thank you for this opportunity to testify, I would be happy to answer any questions.