EXPLORING THE BALANCE BETWEEN INCREASED CREDIT AVAILABILITY AND PRUDENT LENDING STANDARDS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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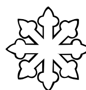

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EXPLORING THE BALANCE BETWEEN INCREASED CREDIT AVAILABILITY AND PRUDENT LENDING STANDARDS

Wednesday, March 25, 2009

U.S. House of Representatives,
Committee on Financial Services,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Gutierrez, Watt, Sherman, Moore of Kansas, Baca, Scott, Green, Cleaver, Ellison, Klein, Wilson, Perlmutter, Foster, Speier, Driehaus, Kosmas, Himes; Bachus, Castle, Manzullo, Jones, Biggert, Neugebauer, Bachmann, Marchant, Posey, Paulsen, and Lance.

The Chairman. The hearing will come to order.

Members of this committee, as well as other Members of Congress, have been urging people in the banking system to increase the volume of loans. We hear from some of our constituents that they are not able to get loans that they think would be very helpful economically. And as obvious as we have said, the economy doesn't recover until the credit system does.

Essentially, we have had a situation in which borrowers have complained about some of the banks. Banks have in turn complained about the regulators and we are here in one room sequentially. I would hope that our friends on the regulatory panel will be able to stay themselves, or through staff, hear what some of the bankers have said. And I assume they have read the testimony.

You know, I don't think there's a matter of ill will. I call it the "mixed message" hearing, because I think it is. We do tell the regulators two things: one, tell people to make loans; and, two, tell people not to make loans. Now, they're not supposed to be the same loans, but there is this tension here. And it's a particularly exacerbated tension now, because I think in normal times, the role of regulators is to make sure that bad loans aren't made or to minimize the likelihood. But, we're not in a normal time now. We're in a time where there is a clear problem making good loans. So it is important that the ongoing important safety and soundness is the role of the regulators, and diminishing the number of imprudent loans coexists with the importance of making sure that loans are made that should be made.

Now, part of the mixed message issue—and that is why Mr. Kroeker is here from the SEC—has to do with the effect of mark-

to-market accounting. We do not want to be post-cyclical, but we also have that potential with regard, for instance, to assessments at the FDIC. Now, some of that is inevitable. If more banks fail, then the assessments go up. But if the assessments go up, some of the banks, small banks, have less ability to lend.

It would be nice if we could simply abolish one or the other of the conflicting objectives. We can't. They are both important. So what we then have to do is to make sure they are done in coordination with each other, and in particular with regard to the question of lending standards, that we avoid the potential of there being compartmentalization, in which some parts of the agencies are urging people to lend, and other parts are urging them not to. We need to make sure that the same people are aware of the importance of both of those.

We had a hearing in general on mark-to-market. It is of particular relevance, obviously, to banks, particularly to banks that are holding securities long-term. We had a special problem brought to our attention regarding mark-to-market with a couple of the Federal Home Loan Bank regents. So we want to be able to address that as well, and as I said, the purpose here is to make sure that we can increase loans in an atmosphere of security and soundness. And, I think, most importantly, demonstrate that those two objectives are not in fact in conflict, but that they go together, that we are capable of a sound banking system that produces an appropriate flow of credit without endangering the safety of the system.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you. I am going to yield to the gentleman from Delaware.

The CHAIRMAN. The gentleman from Delaware is recognized for 1½ minutes.

Mr. CASTLE. Thank you, Mr. Chairman, and thank you for your opening statement, with which I agree. And, I agree that we need to be careful about giving mixed messages, especially to our smaller banks.

I recently heard, in fact it was yesterday, from a bank in my State which has heard firsthand from leaders at the Federal Reserve encouraging them to continue lending, but they indicated in real practice as regulators come around, they are actually being discouraged from doing so for capital reasons, or whatever it may be.

I am particularly interested in helping banks in my State—I am from Delaware—get the word out that they are open for business and able to lend to responsible borrowers. I think a lot of this issue is local. We need to handle it that way. We need to be extremely careful in our efforts here in assisting these institutions on one hand, and then putting restrictions on their ability to conduct their business with the other hand. And I think that applies to some of the things we are doing in Congress as well, I might add.

Ultimately, I believe that this committee, Congress, and the Administration share the goal of doing everything possible to restore economic health, and this cannot be done without our financial institutions. We are all in this together, and I think we need to work on it. I yield back the balance of my time.

The CHAIRMAN. Next, I would take the gentleman from Florida, Mr. Posey, for 1½ minutes.

Mr. POSEY. Thank you very much, Mr. Chairman. And if you don't mind, I would just like to echo a little bit of your comments that you made when you opened. Many borrowers are having their credit severely restricted, not because of any past history they had or failure to repay it, and you know, really obvious apparent or greatly increased risk, we would see to the lender. We are talking about, you know, auto dealers throughout the country.

We are talking about the attractions industry, which is very important in our part of the country. We are talking about people's personal lines of credit, not just business models that rely on these business loans, but personal lines of credit being apparently arbitrarily reduced that are putting people in an unintended lurch. And I understand there is an uncertainty in the market until we get this thing road-mapped out. And there is a way to measure and put accountability into recovery program.

But, I hope in your remarks as you address here today that you will address these issues and what you think needs to be done to loosen that credit up. I have heard the numbers, that sitting on an extra $800 billion, a lot of bail-out money has not been used. It's sitting there, and I can understand that if I was on the sidelines and I was uncertain as to how I might be injured in this policy or by this policy, I might be just a little bit reluctant to be any less liquid than absolutely necessary. But, nonetheless, it's incumbent on us as the chairman mentioned, to do something to loosen that market up, because it exacerbates the problem.

It doesn't help the economy. It doesn't help the problem; and, ultimately, it doesn't help the bankers. I mean, I know you don't make any money if you're not using it to make money. And so that goes for our businesses and our families back home. So I would appreciate it if when you make your presentations, you would each be kind of enough to touch on that so we don't need to ask for written responses from you later.

Thank you.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, I think my major concern is the same as Mr. Castle and others have expressed, and that I have heard from many constituents who are current on their loans but have had their lines of credit cut or their fees increased, or their interest rates.

Today's hearing, I hope, will help us understand why this is happening. Their bankers are on occasion saying that the regulators are encouraging them to pull these loans back. In one instance I have heard of a businessman in Tuscaloosa, Alabama, who had never defaulted on a loan, and had done business with a bank for 30 years. He was not behind on any of his payments, yet he was told that he was going to have to reduce his line of credit by either 10 or 20 percent.

We hear this almost on a weekly basis. These people have not defaulted, and what that does is it causes further disruption, because they have to go out some time and liquidate properties or assets at a loss. And there is actually a growing anger from these same people; and, this is Main Street, that they see our Federal

Government spending billions and hundreds of billions of dollars through the Fed and the Treasury to bail out or intervene on behalf of some of our too-large-to-fail institutions.

And this really, I think, makes a lot of us angry and frustrated, that at the same time as we see our government and our Federal agencies intervening to prop up some of our too-big-to-fail institutions, because we are told there is a systemic threat to our economy—their having bank loans who are current or lines of credit who are current, or even interest rates increased when they are current—and they are not failing. And, let me tell you there is a systemic risk, because that is occurring every day across America in almost every town.

There is also a growing perception, I think much of it justified, that the larger institutions are being favored over the smaller institutions. Chairman Frank and I were some of the first who proposed the capital injections. At the time we did that, we said we wanted it to go to healthy institutions. We wanted the focus to be on rewarding those institutions that had not endangered the economy, were not at risk.

We wanted our healthy institutions to participate, not just failing institutions or institutions that were having extreme liquidity problems. The capital injection program, I think, has been tremendously biased against our smaller institutions. At the same time we are giving money to AIG, or giving money to a large institution because it's having solvency problems, we are telling our smaller institutions that they are not stable enough to receive money.

Now, the large institutions get it because they are failing. The smaller institutions, which are better off and sometimes are being told that they cannot get the money, or small institutions which are not failing are still waiting in line. We started with the largest institutions and we are still moving down. And what I am hearing is that some of that money is still being kept back, because it may be needed on an ad hoc basis to save some large institution. When it seems to me like the regulators are finding reasons to say no to our smaller institutions and our regional banks, I believe it is time for the Federal regulators to turn a lot of their attention to helping our regional or small institutions when 95 percent of the effort is made on a few, too-big-to-fail institutions and also mark-to-market. I am very interested in that.

That doesn't require government funding or government intervention. I hear every day from small, medium-sized, and large banks, and even executives of large insurance companies, the biggest insurance companies in this country, that it is a problem. And I hope the regulators will continue to work with us and the SEC to get FASB to give the relief that all of us have recommended to them.

Thank you.

The CHAIRMAN. Thank you.

And, like you said, they had one particular issue. Several of us were in Massachusetts on Monday on a similar-type hearing. We heard about it a couple of nights ago. It is in Massachusetts, New York, and some other places. We have the mutual savings bank form; and, to date, there is not even a term sheet for them to be able to get funding. And if you have seen this morning's "Wash-

ington Post," Business Section, there is a picture of me showing something to Secretary Geithner. It is a memo saying that it really is important that the term sheet be out from mutual savings banks, and we believe that will be happening soon.

With that, we will proceed now with our panel, and we will begin with a frequent and always welcome witness who has always been very cooperative, and someone who brings her own private banking experience to her current position as a member of the Board of Governors of the Federal Reserve. And I think for fans of "Doonesbury," it's always interesting when we introduce Governor Duke.

[laughter]

STATEMENT OF THE HONORABLE ELIZABETH A. DUKE, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. DUKE. Thank you, Mr. Chairman.

Chairman Frank, Ranking Member Bachus, and members of the committee, I am pleased to be here today to discuss several issues related to the state of the banking system. As you are all well aware, the Federal Reserve is taking significant steps to improve financial market conditions and has worked with the Treasury and other bank and thrift supervisors to address issues at U.S. banking organizations.

We remain attentive to the need for banks to remain in sound financial condition, while at the same time to continue lending prudently to creditworthy borrowers. Indeed, the shutdown of most securitization markets and the evaporation of many types of nonbank credit make it that much important right now for the U.S. banking system to be able to carry out the credit intermediation function.

Recent data confirm severe strains on parts of the U.S. banking system. During 2008, profitability measures at U.S. commercial banks and bank holding companies deteriorated dramatically. Indeed, commercial banks posted a substantial, aggregate loss for the fourth quarter of 2008, the first time this has happened since the late 1980's. This loss in large part reflected write-downs on trading assets, high goodwill impairment charges, and, most significantly, increased loan loss provisions.

With respect to overall credit conditions, past experience has shown that borrowing by households and nonfinancial businesses has tended to slow during economic downturns. However, in the current case, the slow down in private sector debt growth during the past year has been much more pronounced than in previous downturns, not just for high mortgage debt, but also consumer debt and debt of the business sector.

In terms of direct lending by banks, Federal Reserve data show that total bank loans and leases increased modestly in 2008 below the higher pace of growth seen in both 2006 and 2007. Additionally, the Federal Reserve Senior Loan Officer Opinion Survey on Banking Practices has shown that banks have been tightening lending standards over the past 18 months.

The most recent survey data also show the demand for loans for businesses and households continue to weaken on balance. Despite

the numerous changes to the financial landscape during the past half-century, such as the large increase in the flow of credit coming from non-bank sources, banks remain vital financial intermediaries. In addition to direct lending, banks supply credit indirectly by providing back-up liquidity and credit support to other financial institutions and conduits that also intermediate credit flows.

In terms of direct bank lending, much of the increase last year likely reflected households and businesses drawing down existing lines of credit rather than extensions of loans to new customers. Some of these draw-downs by households and businesses were precipitated by the freeze-up of the securitization markets.

The Federal Reserve has responded forcefully to the financial and economic crisis on many fronts. In addition to monetary policy easing, the Federal Reserve has initiated a number of lending programs to revive financial markets and to help banks play their important role as financial intermediaries. Among these initiatives are the purchase of large amounts of agency debt and mortgage-backed securities; plans to purchase long-term Treasury securities; other efforts including the Term Asset-backed Securities Loan Facility known as TALF to facilitate the extension of credit to households and small businesses; and, the Federal Reserve's planned involvement in the Treasury's Public-Private Partnership Investment Program, announced on Monday.

The Federal Reserve has also been active on the supervisory front to bring about improvements in banks' risk-management practices. Liquidity and capital have been given special attention. That said, we do realize that there must be an appropriate balance between our supervisory actions and the promotion of credit availability to assist in the economic recovery. The Federal Reserve has long-standing policies and procedures in place to help maintain such a balance. We have also reiterated this message of balance in recent interagency statements.

We have directed our examiners to be mindful of the procyclical effects of excessive credit tightening and to encourage banks to make economically viable loans, provided that such lending is based on realistic asset valuations and a balanced assessment of borrowers' repayment capacities.

The U.S. banking industry is facing serious challenges. The Federal Reserve, working with other banking agencies, has acted and will continue to act to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy.

The challenge for regulators and other authorities is to support prudent bank intermediation that helps restore the health of the financial system and the economy as a whole. As we have communicated, we want banks to deploy capital and liquidity to make credit available, but in a responsible way that avoids past mistakes and does not create new ones.

Accordingly, we thank the committee for holding this hearing to help clarify the U.S. banking agencies' message that both safety and soundness and credit availability are important in the current environment.

I look forward to your questions.

[The prepared statement of Governor Duke can be found on page 82 of the appendix.]

The CHAIRMAN. Thank you.

Mr. Gruenberg.

STATEMENT OF THE HONORABLE MARTIN J. GRUENBERG, VICE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Mr. GRUENBERG. Thank you, Mr. Chairman.

Thank you for the opportunity to testify on behalf of the FDIC on the balance between increased credit availability and prudent lending standards.

The FDIC is very aware of the challenges faced by financial institutions and their customers during these difficult economic times. Bankers and examiners know that prudent, responsible lending is good business and benefits everyone. Adverse credit conditions brought on by an ailing economy and stressed balance sheets, however, have created a difficult environment for both borrowers and lenders. Resolving the current economic crisis will depend heavily on creditworthy borrowers, both consumer and business, having access to lending.

In response to these challenging circumstances, banks are clearly taking more care in evaluating applications for credit. While this more prudent approach to underwriting is appropriate, it should not mean that creditworthy borrowers are denied loans. As bank supervisors, we have a responsibility to assure our institutions, regularly and clearly, that soundly structured and underwritten loans are encouraged.

While aggregate lending activity for FDIC-insured institutions fell in the fourth quarter of 2008, this decline was driven mostly by the largest banks, which reported a 3.4 percent fall in loan balances. In contrast, lending activity at community banks with assets under $1 billion actually increased by 1.5 percent.

Community banks are playing an important role in the current stressful environment and appear to be benefiting from their reliance on traditional core deposit funding and relationship lending. Some have questioned whether bank supervisors are contributing to adverse credit conditions by overreacting to current problems in the economy and discouraging banks from making good loans.

The FDIC understands the critical role that credit availability plays in the national economy and we balance these considerations with prudential safety and soundness requirements. Over the past year, through guidance, the examination process and other means, we have sought to encourage banks to maintain the availability of credit. We have also trained our examiners on how to properly apply this guidance at the institutions we supervise and how to conduct examinations and communicate their findings to bank management without infringing on bank management's day-to-day decisionmaking and relationships with customers.

The FDIC has taken a number of recent actions specifically designed to address concerns about credit availability. On November 12th of last year, we joined with the other Federal banking agencies in issuing the "Interagency Statement on Meeting the Needs of Creditworthy Borrowers." The statement encourages banks to

continue making loans in their markets, work with borrowers who may be encountering difficulties, and pursue initiatives such as loan modifications to prevent unnecessary foreclosures.

Recently, the FDIC hosted a roundtable discussion with banking industry representatives and Federal and State bank regulators focusing on how they can work together to improve credit availability. One of the important points that came out of the session was the need for ongoing dialogue between these groups as they work toward a solution to the current financial crisis. Toward this end, FDIC Chairman Bair announced last week that the FDIC is creating a new, senior level office to expand community bank outreach, and plans to establish an advisory committee to address the unique concerns of this segment of the banking community.

On January 12th of this year, the FDIC issued a Financial Institution Letter advising insured institutions that they should track the use of their capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these Federal programs improve the stability of the institution and contribute to lending to the community. Internally at the FDIC, we have issued guidance to our examiners for evaluating participating banks' use of funds received through the TARP Capital Purchase Program and the Temporary Liquidity Guarantee Program. Examination guidelines for the new Public/Private Investment Fund will be forthcoming.

Banks should be encouraged to make good loans, work with borrowers who are experiencing difficulties whenever possible, avoid unnecessary foreclosures, and continue to ensure that the credit needs of their communities are fulfilled. In concert with other agencies, the FDIC is employing a range of strategies to ensure that credit continues to flow on sound terms to creditworthy borrowers.

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

[The prepared statement of Vice Chairman Gruenberg can be found on page 97 of the appendix.]

The CHAIRMAN. Next, Mr. Polakoff.

STATEMENT OF SCOTT M. POLAKOFF, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION (OTS)

Mr. POLAKOFF. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee.

Thank you for the opportunity to testify on behalf of OTS on finding the right balance between ensuring safety and soundness of U.S. financial institutions and ensuring that adequate credit is available to creditworthy consumers and businesses.

Available credit and prudent lending are both critical to our Nation and its economic wellbeing. Neither one can be sacrificed at the expense of the other, so striking the proper balance is key. I understand why executives of financial institutions feel they are receiving mixed messages from regulators.

We want our regulated institutions to lend, but we want them to lend in a safe and sound manner.

I would like to make three points about why lending has declined: number one, the need for prudent underwriting. During the

recent housing boom, credit was extended to too many borrowers who lacked the ability to repay their loans. For home mortgages, some consumers received loans based on introductory teaser rates, unfounded expectations that home prices would continue to skyrocket, inflated income figures, or other underwriting practices that were not as prudent as they should have been. Given this recent history, some tightening in credit is expected and needed.

Number two, the need for additional capital and loan loss reserves. Financial institutions are adding to their loan loss reserves and augmenting capital to ensure an acceptable risk profile. These actions strain an institution's ability to lend, but they are necessary due to a deterioration in asset quality and increases in delinquencies and charge-offs for mortgages, credit cards, and other types of lending.

Number three, declines in consumer confidence and demand for loans. Because of the recession, many consumers are reluctant to borrow for homes, cars, or other major purchases. In large part, they are hesitant to spend money on anything beyond daily necessities. Also, rising job losses are making some would-be borrowers unable to qualify for loans.

Steep slides in the stock market have reduced many consumers' ability to make downpayments for home loans and drain consumers' financial strength. Dropping home prices are cutting into home equity. In reaction to their declining financial net worth, many consumers are trying to shore-up their finances by spending less and saving more. Given these forces, the challenges ensuring that the pendulum does not swing too far by restricting credit availability to an unhealthy level, I would like to offer four suggestions for easing the credit crunch:

Number one: Prioritize Federal assistance. Government programs such as TARP could prioritize assistance for institutions that show a willingness to be active lenders. The OTS is already collecting information from thrifts applying for TARP money on how they plan to use the funds. As you know, the OTS makes TARP recommendations to the Treasury Department. The Treasury makes the final decision.

Number two: Explore ways to meet institutions' liquidity needs. Credit availability is key to the lending operations of banks and thrifts. The Federal Government has already taken significant steps to bolster liquidity through programs such as the Capital Purchase Program under TARP, the Commercial Paper Funding Facility, the Temporary Liquidity Guarantee Program, and the Term Asset-backed Securities Loan Facility.

Number three: Use the power of supervisory guidance. For OTS-regulated thrifts, total loan originations and purchases declined about 11 percent from 2007 to 2008. However, several categories of loans, such as consumer and commercial business loans, and nonresidential and multi-family mortgages increased during this period. The OTS and the other Federal banking regulators issued an "Inter-agency Statement on Meeting the Needs of Creditworthy Borrowers" in November 2008. It may be too soon to judge the effectiveness of the statement.

And, number four: Employ countercyclical regulation. Regulators should consider issuing requirements that are countercyclical, such

as lowering loan to value ratios during economic upswings. Conversely, in difficult economic times, when home prices are not appreciating, regulators could permit loan to value ratios to rise, thereby making home loans available.

Also, regulators could require financial institutions to build their capital and loan lost reserve during good economic times, making them better positioned to make resources available for lending when times are tough.

Thank you, Mr. Chairman. I look forward to answering your questions.

[The prepared statement of Mr. Polakoff can be found on page 163 of the appendix.]

The CHAIRMAN. Mr. Long?

STATEMENT OF TIMOTHY W. LONG, SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY, AND CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)

Mr. LONG. Chairman Frank, Ranking Member Bachus and members of the committee, my name is Tim Long. I am the Senior Deputy Comptroller for Bank Supervision Policy at the OCC. I appreciate this opportunity to discuss the OCC's role in ensuring banks remain safe and sound, while at the same time meet the credit needs of their communities and customers.

The last few months have underscored the importance of credit availability and prudent lending to our Nation's economy. Recent actions to provide facilities and programs to help banks strengthen their balance sheets and restore liquidity to various credit segments are important steps in restoring our banking system and we support these initiatives.

Nonetheless, the current economic environment poses significant challenges to banks and their loan customers that we and bankers must address. As a bank examiner for nearly 30 years, I have experienced firsthand the importance of the dynamics between bankers and examiners during periods of market and credit stress. One of the most important lessons I have learned is the need to effectively communicate with bankers about the problems facing their institutions and how we expect them to confront those problems without exacerbating the situation.

Delay or denial about conditions by bankers or regulators is not an effective strategy. It only makes things worse. Against that backdrop, here are some facts that bankers and regulators are facing today: First, asset quality in many bank loan portfolios is deteriorating. Non-performing loan levels are increasing. Borrowers who could afford a loan when the economy is expanding are now having problems repaying their loans. Increased levels of non-performing loans will likely persist for some time before they work through the banking system.

Second, bankers have appropriately become more selective in their underwriting criteria for some types of loans. Where markets are over-lent or borrowers overleveraged, this is both prudent and appropriate.

Third, loan demand and loan growth have slowed. This is normal in a recession. Consumers cut back on spending; businesses cut

back on capital expenditures. What is profoundly different in this cycle has been the complete shut-down of the securitization markets. Restoring these markets is a critical part of stabilizing and revitalizing our financial system. Despite these obstacles, bankers are making loans to creditworthy borrowers. The bankers I talk with are committed to meeting the credit needs of their communities, and they recognize the critical role they play in the wellbeing of our economy.

Simply put, banks have to lend money to make money. The OCC's mission is to ensure that national banks meet these needs in a safe and sound manner. This requires a balance: supervise too lightly, and some banks will make unsafe loans that can ultimately cause them to fail; supervise too strictly, and some banks will become too conservative and not make loans to creditworthy borrowers.

We strive to get this balance right through strong and consistent supervision. In the 1980's, we waited too long to warn the industry about excesses building up in the system which resulted in bankers and regulators slamming on the brakes once the economy turned down. Because of this lesson, we have taken a series of actions starting as early as 2003 to alert bankers to the risks we were seeing and to direct them when needed to take corrective actions.

Today, our message to bankers is straightforward. Make loans that you believe will be repaid, don't make loans that are unlikely to be repaid, and work constructively with borrowers who may be facing difficulties with their obligations, but recognize repayment problems and loans when you see them.

Contrary to some press reports, our examiners are not telling bankers which loans to approve and which to deny. Rather, our message to examiners is this: Take a balanced approach in your supervision. Communicate concerns and expectations clearly and consistently. Provide bankers a reasonable time to document and correct credit risk management weaknesses, but don't hesitate to require corrective action when needed.

It is important to keep in mind that it is normal for our banks to experience an increase in problem loan levels during economic downturns. This should not preclude bankers from working with borrowers to restructure or modify loans so foreclosure is avoidable wherever possible.

When a workout is not feasible, and the bank is unlikely to be repaid, examiners will direct bankers to have adequate reserves and capital to absorb their loan losses. Finally, the reality is that some community banks are so overextended in relation to capital and reserves, the management needs to reduce the bank's exposures and concentrations to ensure the long-term viability of the bank. In all of these cases, our goal is to work constructively with bankers so that they can have the financial strength to meet the credit needs of their communities and borrowers.

Thank you, and I will be happy to answer any questions.

[The prepared statement of Mr. Long can be found on page 132 of the appendix.]

The CHAIRMAN. Next, Mr. Kroeker, thank you for coming back; probably to repeat yourself and answer the same questions, but we appreciate it.

STATEMENT OF JAMES L. KROEKER, ACTING CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. KROEKER. Thank you.

Chairman Frank, Ranking Member Bachus, and members of the committee, I am Jim Kroeker, acting Chief Accountant in the Office of the Chief Accountant, which advises the Commission on accounting and auditing matters.

I am pleased to testify today on behalf of the Commission. There could be no doubt about the urgency of these issues as we work in the public interest to address the global economic crisis. Two weeks ago, I had the privilege of testifying in front of Chairman Kanjorski and Ranking Member Garrett, and other members of this committee's Capital Markets Subcommittee.

Many of the members of the full committee also attended that very constructive and productive meeting herein. A good number of items that are the subject of your invitation today are best addressed by my knowledgeable fellow regulators with me at the table; however, I did wish to highlight a few items in my written testimony. First, the objective of financial reporting and its interaction with banking capital; and, second, to provide an update on the efforts to improve fair value accounting.

As to the first, we reaffirmed in our study to you on mark-to-market accounting that the primary objective of general purpose financial reporting should be and is to provide information that is useful to investors and creditors. Well, this appears to be a fundamental principal. It is also important to reflect on why this has been the wise and longstanding practice and policy of Federal securities laws since their inception 75 years ago.

First, investors generally can and do make decisions on a current basis, necessitating relevant and reliable information about financial values and their prospects. Second, investors generally do not have the ability to otherwise obtain information in a format specific to their own use. Therefore, in evaluating investment decisions, investors are dependent upon financial reporting provided by management.

The securities law provides for this public good through the general purpose financial reporting that has long been considered a benefit to the economy and society. However, once this information is provided, users of this information can then process it as they deem fit for their own specific needs. For example, a credit investor may place less emphasis on short-term volatility than an equity investor needing to make an investment decision in the near future.

Likewise, bank regulators have the similar ability to take GAAP-reported financial information and adjust it for determining how best to establish capital requirements for safety and soundness purposes. And they have done so where it's been deemed appropriate in the past.

For example, unrealized gains and losses on debt securities held as available for sale, which are included in GAAP-based equity, generally do not impact regulatory capital. I give several additional examples in my written testimony.

That being said, our study to you on mark-to-market accounting included recommendations to include but not suspend fair value accounting for financial reporting purposes. Consistent with our own

efforts and what we heard from and what was reinforced by the members of this committee, the FASB has acted diligently to use their expertise as an independent standard setter to respond with two sets of proposed amendments.

The amendments were proposed on March 17th, with a 15-day comment period. They are expected to be finalized in early April and effective for first quarter financial reporting. First quarter reporting would represent a timely response to two of our studies' most significant recommendations, and we are encouraged that the FASB has taken advantage of this opportunity to act.

The first set of amendments would provide additional guidance on the measure of securities in illiquid markets, while the second would revise the accounting for what is referred to as other than temporary security impairments. These proposals are now an important public comment period, and I encourage every one affected to carefully consider them and whether they address the most pressing practice issues, while also maintaining and enhancing information available to investors.

This has been and remains my number one priority. We have been proactively reaching out to investor groups, to the accounting profession, fellow regulators, and to industries most affected by the FASB's proposed amendments. And, of course, we are, as always, in constant contact with the FASB, whom I understand are also engaged in active dialogue with impacted market participants.

Thank you for the opportunity to appear here today, and I would be pleased to respond to any questions.

[The prepared statement of Mr. Kroeker can be found on page 125 of the appendix.]

The CHAIRMAN. I will begin with Mr. Gruenberg.

The assessment question is one, obviously, we are focused on. I hope I can reassure people to some extent. My understanding from the Chair, Ms. Bair, and with the concurrence I know of the Board, is if the Congress provides adequate additional lending authority so that the FDIC will be well-positioned in the case of any unforeseen, potential negatives, that the special assessment could be reduced from the proposed 20 cents. Is that accurate?

Mr. GRUENBERG. Yes, Mr. Chairman.

The CHAIRMAN. Well, do we know what levels we are talking about?

Mr. GRUENBERG. We certainly can reduce them, we think perhaps down to 10 basis points.

The CHAIRMAN. Secondly, then, and that's very reassuring, the other question about the assessments that comes particularly from some of the community banks is whether or not some risk-based factor should be included. Now, obviously, to the extent that we are increasing deposit insurance, which I hope we will do permanently, and I want to say now there has been some suggestion that the Senate wanted to increase the deposit insurance temporarily, I think that it is disruptive for planning. We ought to make it permanent. And I think everyone understands that requires some increase in insurance as you are getting insured for more.

But, to the extent that we are talking about dealing with some of the problems that came from the financial crisis, what is the cur-

rent thinking of the FDIC on some kind of variation of the assessment with the risk factor taken in?

Mr. GRUENBERG. Mr. Chairman, we do currently charge premiums on a risk basis. We are looking for ways, if possible, to respond, particularly to the community bank concerns. In the interim final rule that we issued on the special assessment, we actually asked for public comment on the possibility of imposing assessments based on the assets of the institution rather than the deposits of the institution. That would have a consequence of shifting some of the burden toward the larger institutions. We asked for comment on that.

The CHAIRMAN. Let me go now to Mr. Gruenberg and to Mr. Polakoff and Mr. Long, in particular, and maybe Governor Duke.

We have testimony that is going to come later, and sometimes I think we should reverse the order, but let me quote now from the American Banker's Association representative, Mr. Wilson, on page 5, subhead, "In the face of a weak economy, it is critical that the regulators not make things worse by applying overly conservative standards." And, he says at the bottom of page five, "We continue to hear from bankers around the country—and those particularly in areas where the economy is considerably stressed—that field examiners are being excessively hard on even the strongest banks in the area."

From the community bankers, on page 3 of the testimony of Mr. Menzies, bottom of the page: "Community bankers are saying that the field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional, independent appraisers, and demanding overly aggressive write-downs."

And a letter from a leading minority bank—and I do want to put into the record a letter from the National Banker's Association—but a letter from a minority bank saying, "What bank regulators will not tell the chairman in those hearings is that they have told their examiners all across the country to be tough on banks."

The "be tough" problem started in Washington, was told to the regional staffs, and said, "Marching orders to examiners in the field," and quotes a December article from "The Wall Street Journal," with which some of you may be familiar, by Damian Potter: Headline, "Bank Examiners Are Told To Step Up Sanctions."

Let me ask you to respond, all three. Let's start with Mr. Long, Mr. Polakoff, and Mr. Gruenberg, to the assertion by the representative bankers, and they are hearing, obviously, from their own constituent members that there has been a toughening of the standards on the part of the examiners.

Mr. Long?

Mr. LONG. Congressman, we hear those concerns, too. Over the past several years, beginning in 2003 at the OCC, we began to talk to our banks about a number of excessive risks that we were seeing in the system. The risk has built up. I don't think we have ever gone into an economic downturn with the kind of concentrations in commercial real estate-related credits in the community bank line of business that we have now. And they are in some parts of the country where the asset valuation has grown significantly.

There are some very heavy concentrations, so naturally our examiners are focusing on that during examinations. You have a situation in the economy.

The CHAIRMAN. Mr. Long, are you saying that people may have heard this but it's inaccurate?

Mr. LONG. We haven't ordered our examiners to crack down on banks, but they are obviously more sensitive to problem assets and loan portfolios.

The CHAIRMAN. All right, but Mr. Polakoff, how would you respond to that?

Mr. POLAKOFF. There is an element of truth in those statements. Examiners are human beings. They're going to react to the environment. They are going to react to bank failures. We have met with the National Association of Home Builders. We had that group meet with our regional directors. What we have to do here is improve our communication in this area.

There are mixed messages on a number of different levels, Mr. Chairman.

The CHAIRMAN. Mr. Gruenberg?

Mr. GRUENBERG. Mr. Chairman, we view this as a very serious issue. You mentioned in your opening remarks that you need to try to strike a balance between safety and soundness, and making credit available. And we have spent a lot of time with our examiners from the regional directors on down, trying to make clear the need to really act with sensitivity on this issue, trying to strike this balance and work closely with bankers. It is an ongoing challenge.

The CHAIRMAN. All right. Let me just say, and I have gone over my time, but I assume that you are in regular contact; and, specifically I would hope that there would be, maybe even today, we get a break, some conversation about this. Because these are fairly specific assertions and finding out where they come from, there are a large number of people to control.

Let me just close with this. To some extent, we have been part of the problem, and it is fair to say that public officials, public employees, are worried that maybe if a bad loan went through and they didn't catch it, they would be unduly criticized and more prone to that sometimes.

We want to send a message that as far as the Congress is concerned, we think that while there is always a problem with bad loans, there is a very great problem with not enough good loans right now. And I do want to give people some reassurance, both your agencies and the employees who work for you, that this is not a time when, I think, you have to worry about excessive criticism if a certain number of the loans go bad. There will be more focus on getting good ones to go forward.

Mr. Bachus.

I'm sorry. Mr. Marchant?

Mr. MARCHANT. Thank you, Mr. Chairman. I think one of the big mixed messages that the public is getting is they're picking up the newspaper and they're reading that the Federal Reserve is putting a trillion dollars of liquidity into the system, into the banking system.

And they're hearing that there's TARP money going into each of the banks. They're thinking that because of all this money that's

going into the banks and the TARP money going into the banks, that there surely must be money available at the bank that they can borrow.

I don't think they realize that most of this money is going to the loan loss reserve and to rebuild the capital reserves. And if anything, the TARP money, by paying 5 percent on the TARP money, money that costs 5 percent—5 percent is more than the bank's cost of funds right now.

So their best customers, the customers that your examiners like to see when they come in and crack the books, actually are paying 3 to 3.5 percent on their loans. They are prime plus 1 or 2.

So any TARP money used to make a loan to their absolute best customer will be made at a loan value that is less than the cost of funds.

So obviously the TARP money, while I believe the Congress felt like that is what the money was going to do, to be put in the system to make more liquidity, it hasn't ended up doing that.

And when that public reads that the Fed is putting liquidity into the system, I think the message they think is that there is more money available to borrow. But what the customers in my district are finding out is that they are facing rising interest rates.

A lot of the prime borrowers are going back in to renegotiate a line of credit that they have done for 20 years, and they're finding out that instead of having a prime plus 1 or 2 now, there's a floor being put on the amount of the loan that can go down. And in most instances, that floor is now 5 percent.

They are the best customers of the bank. And the reasons that are being given are: We have this special assessment coming. Our bank is not going to be profitable next year, because of these special assessments.

The other thing that has happened is that there is a definite restriction in the amounts that these lines of credits can grow. So de facto, if a business is doing well and can expand, they're not going to be able to expand their credit line. And most bankers are not expanding credit lines.

And then, of course, you have the customers who are going in and finding that their HELOC loans they're having, they're getting letters in the mail that say that their line has been cut; they're getting letters from the credit card companies that are saying the same things. I know that this hearing is not about that.

And they're getting extra demands on their collateral.

So there are mixed signals that are coming out. I believe sincerely that everyone at this panel today is doing exactly what you feel like is the best thing to do for the system.

The borrower does not understand the interplay of all of these things. And frankly, this Congressman does not understand the interplay many times, and does not understand what the benefit to the system is if the headline is that a trillion dollars has been put into the system by the Fed, but my constituents don't find that to be of any benefit to them whatsoever, when they go to the bank and want to borrow money.

Thank you, Mr. Chairman.

Mrs. MALONEY. [presiding] Thank you. The Chair recognizes herself for 5 minutes, and I welcome all the panelists. I would like to

ask Governor Duke, whom I understand has experience as an online banker in commercial banking, do you believe that the Federal Government could or should have taken different actions in the fall or more recently to ensure that credit would be more available?

I believe all of us are hearing the same story when we go to the caucus meetings, when we talk to our colleagues on both sides of the aisle, that the credit is just not out there; we need to get the liquidity moving.

I'm hearing particularly commercial credit has absolutely dried up; it's very hard to get loans. How effective do you believe that the TALF program and the Public-Private Investment Program will be in opening up credit and allowing financial institutions to lend money?

And also last night, I was reading a report where banks used to provide 60 percent of the credit in our country, and now are providing roughly 20 percent, and it has been picked up by other forms of credit.

Just your comments in general on these questions. Thank you.

Ms. DUKE. Mrs. Maloney, thank you.

As you know, I was a banker and a community banker for nearly 30 years, and so I'm well aware of the tension that exists between bankers and bank examiners, as well as lenders and borrowers.

I think, to your first question, I do believe, I honestly believe that the Federal Government has made every response we can think of to make, in particularly the Federal Reserve, in order to ensure that lending is continuing to take place. And I think if we had not done that, that the circumstances would be substantially worse.

Provision of liquidity to banks is critically important in order that they have the funds to lend. The capital that we put into the banks not only strengthens the banks, but also strengthens them in the minds of others who would provide liquidity. And it's the liquidity that really gets lent forward on to borrowers.

In addition to that, you're right that the banking system percentage of the credit that was extended has dropped. It dropped to about 30-some percent, anyway below 40 percent, although if you add back the securitization that banks did, they were still probably facilitating more than 40 percent of the credit, going into this recent episode.

And so the TALF is really designed to restart securitization markets. And what we have found in our Fed facilities, first with those that were directed at commercial paper, was that by creating a facility to support commercial paper, gradually that market improved.

Now, the first version of the TALF is directed at consumer loans, student loans, and small business loans. And, we had the first issuance of TALF, which is $8 billion. It may not sound like a lot in the context of trillions and trillions of dollars, but that is more than had been done in the last 4 months.

These are difficult times, they're difficult times for bank examiners, they're difficult times for bankers. I think at the end of the day, probably the best thing we can do is everything that we're doing to improve financial conditions.

A lot of the reasons lines get cut is because collateral values have dropped. So if we could put a floor under housing, anything we can

do to support mortgage lending and housing will tend to put a floor on the value of housing, and then that stops the value of the collateral from dropping.

Same thing with commercial real estate, and we're hearing the same things that you hear on commercial real estate. The securitization market for commercial real estate loans has completely shut down. In addition to new commercial real estate, there are also a number of commercial real estate loans that are currently up for renewal. And, we need to provide for the renewal of those. So we are looking at commercial real estate as part of the TALF in the next version.

But again, commercial real estate values are tied to the cash flows of the businesses that operate out of that commercial real estate, and so to the extent that business is down, that retail sales are down, that attendance is down in hospitality areas, that's going to tend to reduce the value of that collateral, and reduce the ability of those owners to borrow and to expand their businesses.

Mrs. MALONEY. Well, thank you. Could you comment briefly? My time is almost up on the first auction of the Public-Private Investment Program. I understand that took place last week. Is that—

Ms. DUKE. It was the first issuance under the term asset—the TALF, the Term Asset-Backed Securities Loan Facility, which we had actually been working on for about 4 months I believe. And this one would cover student loans, credit card loans, small business loans, and auto loans, and $8 billion was issued that was TALF eligible.

Mrs. MALONEY. Okay. Thank you. My time has expired, and the Chair recognizes—

Mr. BACHUS. I am sorry, Madam Chairwoman, we are going go on the order. I will give you the order.

Mrs. MALONEY. Okay.

Mr. BACHUS. Mr. Posey, and then I'll give you the list.

Mrs. MALONEY. Okay. Mr. Posey?

Mr. POSEY. Thank you, Madam Chairwoman.

I hope that we would all agree that the best solution to the crisis would be more private capital into the market. And just to save time, can you shake your head "yes" if you agree?

And so we all agree. Wonderful.

Ms. Duke, are we still approving charters for anybody who wanted to start putting a new institution out there and putting more private capital into the marketplace?

Ms. DUKE. I'm frankly not aware of how many charters the Federal Reserve has approved recently, but we are still approving charters.

Mr. POSEY. Okay. What is the timeline on something like that?

Ms. DUKE. I believe we respond to all applications that come in within 60 days.

Mr. POSEY. Whether up or down?

Ms. DUKE. But, I would like to check that, if I could, and get back to you.

Mr. POSEY. If you would. And the reason I ask that, you know, we parlayed, our Nation did at one time have about 100 percent of the commercial launchers to satellites, to do our communica-

tions. And we parlayed that into about 5 percent of the world's commercial launches.

That was a pretty staggering loss. And we did that basically with the help of, I think, one person, a range safety officer, who was there longer than he should have been, who thought the only safe launch was no launch.

So we overregulated and drove business to other countries and we're suffering for it now.

That was the reason for my question. I mean, I'm familiar with the instance of some business people who are successful bankers in other areas, and they decided that they wanted to open a new branch in a needy area of my district. And they have been approved by the State, but they can't get a yes or no from the Federal Government. And I'm not going to tell you who they are, because I don't want to say I'm pushing them or I'm not. But I'm puzzled by their inability to get a response, a timely response, what I would think would be a timely response from you: Yes or no?

If you're going to do it, do it. I mean, they have done other banks. I don't think there's anything in their background that would be fuzzy. I think they meet the requirements.

I will promise you the people in this community need another bank, and I don't know—I have never really met a banker in my life who wanted to make a bad loan. I know that they have been forced to make some bad loans by some external forces in the past—and I blame, you know, Congress to a large extent for that—but we heard earlier about our community banks.

I think on a scale of a side-by-side comparison to the larger ones, they're in a lot better shape. And I don't think they have gotten any of the relief money or any significant amount of relief money.

I would trust my community banks a whole lot better, just like I trust local government a whole lot better than I do higher government. You know, they're closer to the people, they're more responsive, they're better managed. I mean just—

Anyway, I would appreciate it if you could look into it and find out what the up and down time is, or the yes or no time. Because I think that just like we parlayed the commercial launch business into oblivion, we can do that with the financial market just as well.

And I sure would hate to see us do that.

Ms. DUKE. Congressman, if I could. There are actually two steps to it: There is the charter, which could come through any agency; and then there is also the ability to get insurance through the FDIC.

Mr. POSEY. Yes, I understood it's hung up at the FDIC.

Mr. GRUENBERG. Congressman, let me say, if there's a particular institution that you believe has had difficulty and hasn't gotten a response, please let us know, and we'll look into it.

Mr. POSEY. Well, I don't want to interfere with the—I'm observing it and I'm puzzled by it, and I want to understand it a little bit better. Because it doesn't make a whole lot of sense to me at this point.

Thank you very much for your indulgence, Madam Chairwoman.

Mr. WATT. [presiding] I will recognize myself for 5 minutes. We seem to be playing musical chairs up here, but I think we will provide some continuity.

Let me first thank the Chair in his absence for having this hearing, because it really, this situation has kind of put us in a real practical set of problems here, where we are on the one hand saying, "Extend more credit," and on the other hand, saying, "Be more prudent."

And what it has done for Members of Congress is interesting, and that's where I want to address my question to Mr. Polakoff at the end of the description of the situation that I described, but I want everybody else to try to be helpful to me in knowing how we should be responding.

I have been on this committee more than 18 years now; I am starting my 19th year. I can count on one hand the number of times in the first 17 years that I got calls from constituents, saying, "Would you intervene in a financial lending decision with a bank?"

Hardly a week passes now that I don't get a call from somebody, saying, "My loan was turned down, you all are putting all this money into banks, and would you intervene with the bank and tell them to approve my loan?"

That's the situation that Members of Congress find themselves in at this point.

Two examples quickly. A university that had historically for years and years financed at the end of the year until the next tuition payments came in, had their line of credit pulled and was told in order to renew it, they had to pledge the entire campus, every piece of real estate that they owned, just for a 60-day loan until the next group of students came in and paid their tuition, so they could pay the loan back.

Yesterday, I talked with a gentleman who had a commitment, or a verbal commitment from his S&L—that's why I'm addressing the question to Mr. Polakoff—for a $400,000 loan to do a business which would employ 25 people in my congressional district.

And he said, "Well, you know, maybe I can get away with $200,000." So he takes the $200,000, then he needs to go back and get the other $200,000. In the meantime, they have merged with a First Community Bank, he thinks out of West Virginia, nowhere close to North Carolina, and the line of credit, the money that they told him verbally he could get isn't even available any more.

The problem we have is we can't tell lenders what a commercially prudent loan is, but they're expecting us to, because the Federal Government has put all this money into banks—

And then to make matters worse, they waltz with this guy for 4 or 5 months, so that he can't go and get a loan from anybody else. So by the time they make a final decision, the business opportunity is gone down the pike.

Now the question I have is: Under those circumstances, what are we supposed to do? You are monitoring this as loans on a global level. You say that loan volume is up, especially with community banks.

But this is a problem for all of us, because everybody knows that they have pulled back on the credit.

So, Mr. Polakoff, I have described my problem to you. I don't want to step over the line and start telling lenders when a loan is commercially prudent or not. I don't have that expertise.

But I also have some obligation to try to be helpful to constituents in these situations. It's not like getting a social security check, where I can call up a governmental agent, and say, "What am I supposed to do?"

Mr. POLAKOFF. Mr. Chairman, I don't know if I have a good answer for you on that one. It's a tough situation.

Each institution has a loan policy, and it describes what sort of loans it will make under what terms for what sort of borrowers.

I have yet to meet a banker who wants to turn down a good loan. That's the way they make money.

Mr. WATT. I just described one to you. They said it was a good loan several weeks ago, and then all of a sudden they merged and the new owners say, "Oh, no, no, we're not making this loan."

Mr. POLAKOFF. Each situation is different, sir. I mean it could be that the merged institution has—

Mr. WATT. Does anybody else have any suggestions for me? Mr. Polakoff can't help me. What am I supposed to do in these situations?

[no response]

Who is next on your list? I guess nobody has a suggestion for me?

Ms. DUKE. I will take one stab at it. I have been in that situation, and, so you may not find this very satisfactory, but the one thing we are finding is that those that are increasing their loans are banks that are looking at each individual deal one at a time, and they are finding that they are increasing their business, not because there's a lot more loan demand, but they're doing it because there are banks that are pulling out of specific types of lending. And so they're finding that if they can go in and look at the deal on its merits, there are some banks that are out there making those loans.

Mr. WATT. My time is expired. Well, I'll let Mr. Gruenberg respond. But maybe I should address it to the second panel, that has some bankers on it. Maybe they will be able to help me.

Yes?

Mr. GRUENBERG. Just in regard to what you might say to a constituent, the FDIC does have a call center, where if individuals are having difficulties with their financial institution, and in some sense feel that they have been treated unfairly or haven't been given a fair hearing, they do have the ability to call, and we do try to follow-up on concerns that are raised.

Mr. WATT. I thank you.

Mr. Jones is recognized for 5 minutes.

Mr. JONES. Thank you, Mr. Chairman.

I'm going to be repetitive to many of the questions that you have been asked and many of the statements. But to piggyback on what the chairman just was asking about his situation, Mr. Long, I'm just going to read a subtitle to your comments, and then I'm going to get to your point, and then hopefully maybe a question.

Regulators and examiners are taking a balanced approach, consistent with safe and sound banking practices. Well, I would expect that even in good times, but certainly in tough times, that makes a lot of sense.

About 5 weeks ago, I had the president and a CEO of a bank—and I'm not going to say the name, because I think everybody would have an idea, know who it was—to say the problem is that the regulators, you're being told as Members of Congress, and certainly Mr. Obama, the new President, has said, you know, talk money, we want to get some money out into Main Street, we want to help businesses, we want to get them, you know, sound so that they can expand, or whatever to keep their business running—but this CEO and president said to me, "They're telling us, the regulators, don't move so fast, hold back."

And I think this is what some of the questions and concerns are today.

I realize you have a tremendous responsibility, each and every one of you. But this country right now is suffering on Main Street. There's no two ways about it, it has been said 100 times by other people.

And when I have a CEO and president of a well-known bank—I'm not going to say community, regional, or national—but a well-known bank, come to a Member of Congress, and says, "You're being told, yes we want to free up the credit, but when the regulators come in, they're saying, no, slow down."

So therefore either—Mr. Long, you might have said it, or Mr. Polakoff might have said it—that you need to do a better job. Because I think there is a serious problem.

Yesterday most of us in this Congress, not just the Banking Committee, but most of us had members from home builders associations from our States come to Members of Congress—and I had two or three, they're not even my constituents, they're from Raleigh, North Carolina, which is the capital of North Carolina—telling me that he has been told by his banker—and he said, "I could get my banker to call you, Congressman, and tell you, that he is being told not to make the loans."

Now I'm not going to question your integrity, because you're people of high integrity, but there's something missing in this program right now. And if the truth is that you expect things to get a heck of a lot worse before they get better, then say it.

Let's be honest with these people, because they're coming to us, as Mr. Watt mentioned just a moment ago. The don't understand, they have been good stewards of their businesses, good stewards with the banks, they're paying back on time, and doing everything they were asked to do.

But now they're caught in a situation where many of them will not be here a year from now, if the credit somehow does not get back to Main Street, as the President has said many times.

I don't know if I'm asking you a question or not. I guess I want to comment, because I'm being repetitive, but I can't help it, that's what I'm hearing. And it's more frequent now than it was 4 months ago, and I'm afraid it's going to be even more frequent 6 months out than it is now.

If this is your policy—and I believe it—if this is your policy, can you somehow—at least the bank examiners or the regulators understand that they are supposed to work with these people. And if it's a bad loan, say it's a bad loan.

But I think some of these people who are crying out here in Main Street are pretty good customers who would meet the obligation.

That's my statement. If you can figure a question out of that, and anybody wants to respond to it, that will be fine.

Mr. LONG. I will take a shot at it, Congressman. And they are concerns that we hear too. There are a couple of things. In terms of, do we think it's going to get worse? I would tell you, from the OCC's standpoint, where we are in the cycle, I believe for many community banks, it is going to get worse.

So we are definitely asking our examiners to have good communications with bank management and make sure that they're vigilant, make sure that they have a good handle around the concentrations of credit, the amount of loans that they have to a certain—whether it be industry, developer or whatever.

It may be that being told to slow down could be appropriate, but I would need some more information to address it specifically. It may be that the banker or the regulators feel like that concentration level in total on that balance sheet is getting a little heavy and they need to be a little more selective in terms of the risk.

It may be in terms of their underwriting, given the credit quality of the borrowers and the stress that the borrowers are under, as you know, Congressman, over the last 3, 4, or 5 years underwriting standards got pretty loose. It was pretty easy to extend credit, and it wasn't that difficult to get a loan.

What is happening in the industry right now is a normal occurrence. Bankers tighten up, underwriting standards tighten. Loan demand by good quality borrowers—as I said in my statement, businesses aren't expanding, they don't have capital expenditures—good quality loan demand is harder to come by.

But the examiners and the bankers hopefully are having good robust conversations around risk management issues, concentration issues, underwriting issues, whether it be from an individual loan or from a portfolio loan.

So the comments along those lines could very well be not: Slow down, we don't want you making good loans. It may be: Make sure you have a good handle around the risk profile of your portfolio, because certain concentration levels, no matter how good they get, when you get into an economic downturn, it doesn't take much to tip a bank over.

Mr. WATT. The gentleman's time has expired.

Mr. Sherman is recognized for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman.

You know, we're all looking back nostalgically at this mythical 2007, when all worthy people got the credit they needed to realize their dreams. And we all are asking, why can't we return to that Shangri-La?

I think we have to remember that back in 2007, I was getting plenty of complaints from people who weren't getting the loans they wanted. They didn't ask me to do anything about it, because back in 2007, we had a capitalist economic system.

But also in 2007, the living standards were too loose, even though the banks were in relatively, or thought they were in reactively good shape. Today the banks are in bad shape, and every borrower is in worse shape than they were back in 2007.

The solution, or one of the solutions is to allow banks to make loans even when the good bank examiner, a conservative bank examiner, says you need a 10 or 20 percent reserve against that loan by having the banks have more capital.

I hope that you are pressing your banks to sell more stock, even though at today's depressed prices, they may not want to do it.

I want to address the mark-to-market rule, which I think is depressing bank capital in just a second.

But I also want to mention the credit unions, who aren't represented here. We as a Congress have prohibited almost all credit unions from issuing subordinated debt. That is the way they could have capital, where private investors could give the credit union money, and then if the credit union made a few risky loans and it didn't work out so well, the investors would lose money, instead of the taxpayer or the insurance system.

But we have prohibited issuing that subordinated debt, and I think we should revisit that, maybe not as a permanent change in the way that credit unions are run, but for the life of this economic crisis.

Because for every time somebody has to say no to a businessperson on a loan, hopefully there will be a credit union that's able to say yes, if it's a good loan.

Governor Duke, I would like to ask you a question that's identical to the question I asked Chairman Bernanke yesterday, because I liked his answer and I'm hoping that you give me the same answer.

You may be familiar with Section 13-3 of the Federal Reserve Act. That's the one that says the Federal Reserve can loan money in a time of economic exigency, but only on a fully secured basis.

And your Chairman yesterday said that he figures that means no risk or as little risk as is possible in a financial situation, that was equivalent to triple-A paper, not double-A, not single-A—Triple-A—and that he would stand by that interpretation even if Wall Street came to you a year from now and said, "My God, we need another trillion or the sky is going to fall, and those idiots and populists in Congress won't pass the bill. So you have to step forward, avoid all that democracy stuff, change your interpretation of Section 13-3, and give us the money Congress won't."

Under that kind of pressure, would you give me the same answer as Chairman Bernanke, and say, "13-3 is for triple-A paper?"

Ms. DUKE. Yes, sir, I would.

Mr. SHERMAN. That's a great answer.

Mr. Kroeker, let's talk a little bit about mark-to-market, because my concern is that in the accounting standards that the standards are written to embrace the verifiable and the unassailable, rather than the relevant and the meaningful.

You have probably heard me talk about FASB II, where we assume that all research programs are failures, because that's easier than figuring out which research programs were successful.

Likewise, it's easier to look at computer screen and say that a group of assets is worth 10 cents on the dollar, because that was the last trade, rather than to evaluate what they're likely to yield to maturity, knowing that we're going to have a bad economy at least for a while.

One of the principles of accounting is that two similar institutions are going to face the same standards. But one bank may make a bunch of loans for its own portfolio and not take the steps for them to be sold off into the market.

And so they have a billion dollars of exposure to the widget industry, and you know, 22 different widget companies all in red buildings.

And then another identical bank does a billion dollars worth of loans to the widget companies also in red buildings, 22 of them, and they take the steps to make those loans securitizable. As a matter of fact, they bought this package of loans from somebody across the country.

Why should 2 banks, both of which have a billion dollars of exposure to 22 widget companies, be treated differently, based upon whether it's a securitized group or just a—

Mr. WATT. You have to wrap up your question, so he can answer it.

Mr. SHERMAN. Yes.

Mr. WATT. And your time has expired.

Mr. KROEKER. We have recommended improvements in the mark-to-market accounting rules. And to get to the specific question, does it make sense, I think the FASB's proposal on other than temporary impairment seeks to at least in the income statement do just that, to replicate the losses, the credit losses you would have if these securities were in fact loans. That would be the credit loss and the impairment that you would take through the income statement.

That being said, when loans are packaged up in securities, they often do differ from holding a whole loan; that is, they're tranched up. People take different risk portfolios out of the securitization, they add derivatives or other things to the securitization vehicle.

So it is very difficult once you put the loans together and scramble the egg, if you will, to unscramble that in the accounting.

Mr. WATT. If you need to elaborate on that, could you do it in writing?

Did you get sufficient elaboration? Or not. You all can talk off the record.

The gentleman's time has expired.

Mr. Manzullo is recognized for 5 minutes.

Mr. MANZULLO. Thank you.

I only wish that the first panel had been placed together with the second panel. I would hope that you gentlemen and gentlelady would stick around to listen to the second panel, because there is a huge disconnect that is going on.

Mr. Polakoff, you said you have "yet to meet a banker who turned down a good loan." Well, there are two of them sitting behind you. They're both community bankers. Steve Wilson, LCNB Bank, from Lebanon, Ohio; and Mike Menzies from Easton Bank & Trust Company. And you could take a look at their testimonies. Menzies says, "The current bank regulatory climate is causing many community banks to unnecessarily restrict their lending activities. Left unaddressed, certain field examination practices to propose FDIC special assessment, mark-to-market, will prevent

community banks from realizing their full potential as participants in the rebuilding of our economy."

That's not only as to banks that receive TARP funds, but banks that are doing it on their own dollar. And then also the testimony of Steve Wilson from the LCNB Bank in Lebanon Ohio.

Now, these are the guys on the streets. And they might as well be the bankers that I talk to back home. And you have to listen to them. Because they're under siege from the bank examiners. I mean really under siege.

"Banks hear the message to continue to lend"—this is Mr. Wilson—"to help stimulate the economy. Then they hear messages to pull back, from field examiners that may apply overly conservative standards, from FDIC premium assessment rules that penalize banks that use the Federal Home Loan Bank advances for short-term liquidity."

I mean, you have to listen to them. And you have to, you know, obviously listen to the people who work for you in the field.

And then, Mr. Long, you made the statement that businesses are not expanding. That's not true. I mean, I represent most of northern Illinois, and we have over 2,500 factories, and they have been hit. But you know what? A lot of those factories have some good orders.

And banks are making the statement, they're hearing from the examiners, "Don't loan to manufacturers." That's what your people are telling them. Because, oh, you can't trust the manufacturing climate.

And you know what, you know what's going on with these guys that can't expand? Those jobs are going to China.

I mean, this is—I guess—I'm not giving anybody heck. I mean, I did that yesterday on my birthday, and my blood pressure can't take that much. But what I'm saying is, there is so much disconnect that's going on here.

Mr. Long, have you ever accompanied one of your examiners to the bank? Of course, that would be counterproductive because they would see you there. But did you do any bank examinations yourself? I think you have, haven't you?

Mr. LONG. I have been on this job for 30 years as a bank examiner, for the first 23 of if in the field. Yes—

Mr. MANZULLO. Because I know that you have that experience and I know you're very—

Mr. LONG. And I have gone on exams as recently as less than 12 months ago. Yes, I go on exams.

Mr. MANZULLO. But I mean, there are—I want you to know there are businesses that are expanding. I mean, really not a lot, but it is happening.

Mr. LONG. Congressman, my written statement reflects more of a general sense. During an economic recession—

Mr. MANZULLO. Oh, I believe you 100 percent—yes, sir.

Mr. LONG. —businesses pull back. I don't mean that there aren't businesses that are expanding.

Mr. MANZULLO. Right—

Mr. LONG. And I can tell you that at the OCC, our examiners are not telling our bankers to not lend to manufacturers.

Mr. MANZULLO. They are telling them. That's what my bankers are telling me. You need to get that out to them, because they may be—I mean everybody is acting honestly—I mean everybody—with integrity. There's no dishonesty going on.

There's a lot of disconnect that's going on. Because the examiners, you know, want to make sure they do the best job possible. And under the circumstances, they believe in their heart that they are doing that.

But I'm just saying that this is what we're hearing from the banks and also from the manufacturers.

Mr. LONG. And Congressman, we hear that too, and I think it's a good point, and I think it's a good purpose of this hearing, and of the outreach that we do with the bankers.

I know that there is a fine line of when underwriting standards get too loose and banks are taking on too much risk, and the line of—

Mr. MANZULLO. But we know—

Mr. LONG. Examiners tell bankers—

Mr. MANZULLO. We know, Mr. Long, we know of business after business that has never had a problem with their line of credit, they're being cut off on lines of credit. They're throwing their arms up in the air, and suffering.

But I know you're going to look at it, because I know where your heart is. And it is in the field with those people and the people who want to borrow the money. And I appreciate that.

Thank you.

The CHAIRMAN. The gentleman from California.

Mr. BACA. Thank you very much, Mr. Chairman, and thank you for holding this hearing.

All of us realize that we are at a crisis right now and people are losing their jobs. And you have to understand and put yourself in the place of the people who are losing their jobs. And why are a lot of them losing their jobs? A lot of them have not gotten the kind of loans for the occupations where they are working, whether it is a small business, whether it is even the State of California where I have just talked to the secretary who says, "I'm going to have to borrow 'X' amount of dollars just to exist in our area." You have to put yourself in the place of an individual who is losing their job.

And right now it seems like there is a disconnect or a blaming that goes back. Who is really at fault, is it the regulators or is the bankers? I mean you guys are just throwing it back and forth to one another, but the problem is that the loans aren't going on in the area. We would see the economy changing. And in California, especially in my district where the majority of small businesses aren't getting their loans, and we are looking at automobile dealers and others that can't obtain a loan.

Why is it? You have to put yourselves in the faces of people who have lost their jobs, people who aren't able to provide those kind of jobs for someone else. Put yourselves in that kind of situation and say, how the hell am I going to make sure that people get the kind of funding that will create the kind of job or how do we make the State of California solvent to assure that they don't have to continue to borrow the money? Unless you, both of you guys, the bankers and the regulators, do something.

So whose fault is it? I want you to answer that. And more importantly, how do we fix it now? What is the remedy? What can we do? What can you do to expedite the process and stop this blaming one another? Any one of you want to tackle that?

Mr. POLAKOFF. Congressman, I hope it is not coming across that we are blaming one another.

I think the regulators and the bankers typically have a good, healthy relationship. There is no tension involved with that relationship. We all want the same thing, which is money to be lent.

Mr. BACA. When someone loses their job and they are not getting a loan, that is tension where they are losing revenue, and we are not picking up revenue. That is tension.

Mr. POLAKOFF. I'm not sure I'm understanding the question, but indeed, an examiner would be very uncomfortable, rightfully so, if money was lent to an unemployed individual who didn't have the capacity to repay the debt.

Mr. BACA. Anybody else want to tackle this?

Yes, we are at a crisis. Praise the Lord, we will say a prayer.

Mr. LONG. I don't have a lot to add. It is a natural tendency for banks during downturns, particularly coming out of a period of very loose credit, where they pull back, they protect the balance sheet, they protect liquidity, and they protect capital and they tighten the underwriting standards.

And Scott is absolutely right. I mean the fact that somebody lost a job and they want to get a loan but the don't have the repayment ability, most bankers probably are not going to make that loan.

Mr. BACA. But there are a lot of them who do, even on the minority small businesses or the automobile dealers. I mean, they are the last to get funded, first to get de-funded. It seems like here again, even among minority dealerships who have really helped the economy, are trying to get loans, can't even get loans.

Mr. LONG. I agree. I think the regulators and the bankers are doing a better job this time of communicating with each other and talking with each other, and I think it is important that we continue to do so.

And I think the banks are struggling with this too. I mean, they do want to make good loans, but some of them have gone so far out on the risk curve that they currently have a balance sheet full of loans that are having problems, and they dont have a lot of capacity to—

Mr. BACA. But those loans weren't created here. It was those that were created because we did it with some foreign countries and others and all this money that has gone back there that we can't even recover because all of these bonuses that were there.

I'm sorry.

Ms. DUKE. I just want to point out we are very aware of the problems with loans to small businesses in particular. One of the functions of the Fed facility that just started up last week is that it included floorplan loans for auto dealers in addition to auto loans to consumers. And then we added to it very recently loans for business equipment, and it also includes SBA loans.

In addition, I am reminded from my days as a banker that most small business credit is frankly funded through home equity. A lot of those loans are based on home equity, which again brings me

back to anything that we can do to improve mortgage lending in the housing market will also be helpful to small businesses.

Mr. BACA. I hope we get an answer when, and hopefully we turn this economy around. And we are all working together and I know that we are all trying, but I think they need to say when is it going to happen and how is it going to happen because every day that we don't provide assistance, that means some job is lost somewhere because they are not able to attain the capital to operate.

Thank you. I yield back the balance of my time.

The CHAIRMAN. The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman.

As each of you knows, there has been a lot of discussion about a systemic risk regulator in some form or another, both from the Executive Branch and from within this committee. And I realize that is not something that you necessarily focus on, but you all are regulators, you are all familiar with the various financial institutions which are out there.

I would be interested in your thoughts about a systemic risk regulator. And I'm not asking you to put together how it would be done precisely but as to the effect of it in terms of the decision-making that might have occurred in this case earlier in looking at financial institutions and perhaps any credit type institutions in this country, and what direction perhaps we should be looking. This is still in an infant stage as far as Congress is concerned. So I am interested in your views on the concept of a systemic risk regulator.

Mr. POLAKOFF. Congressman, I will get started if it is acceptable.

We at OTS would support the notion of a systemic risk regulator. We believe that term has three parts: One part of it is the receivership activity associated with that regulator; another part is the ability to provide temporary liquidity assistance; and then the third part is the functional regulation.

The functional regulation can be done in a couple of different ways. It can be done in a prudential examination way, meaning the systemic regulator has the responsibility to actually understand the risk profile of individual institutions. It could be done in a macro way, which means the systemic regulator has the responsibility to assess the horizontal risk across a number of large institutions, or it could be done in a product way, which means a systemic regulator focuses instead on emerging products and what the systemic risk would be associated with those.

So those are some critical issues for Congress to address, but the notion of a systemic regulator makes complete sense to OTS.

Mr. CASTLE. Any other comments?

Ms. DUKE. I think we have talked a lot about systemic risk regulation and, again, I feel like it is important that there is a broad policy agenda. There should be oversight of the system as a whole, not just oversight of the individual components or individual firms. Some parts of it that we think are important are functional supervision and onsolidated supervision, such as we have for bank holding companies, and for companies that may not necessarily be bank holding companies, in addition to systemic risk regulation.

There does need to be a resolution regime for systemically important financial institutions, but I don't know if that necessarily has

to be held by the same entity that has responsibility for systemic risk supervision. We think it is important that systemically important payment systems, as well as firms, be supervised, that there be attention paid to consumer and investor protection, and that some authority have the express responsibility to monitor and address systemic risk wherever it happens.

Places where this might have come to light would be places where individual exposures in firms were identical to individual exposures at other firms, so those two—if the risk of an event happened in one firm, it wouldn't necessarily spill over to all firms. It might also involve looking at particular products, and obviously the mortgage-backed securities and the more complex securities would be an example of that. A third example of a place where this might have come into play would be in credit default swaps.

Mr. CASTLE. I think you said this, Governor Duke, but if we had a systemic risk regulator, should we be looking at things like hedge funds and investment banks and even corporations, insurance companies, other entities beyond the banks which are very involved in the credit markets today?

Ms. DUKE. I'm not certain—I think one of the things about systemic risk is we have to look beyond individual firms. And I think a systemic risk regulator would certainly want to gather information from all participants in the financial markets while they might not necessarily regulate specific firms and specific industries.

Mr. CASTLE. Thank you. Anybody else on that subject?

Let me ask you this question, Governor Duke. I mentioned this earlier in the opening, many hours ago, that I know of a major financial institution in my State that is told go out and extend credit, make loans, or whatever. And yet when they have had the various regulators come in, they have had a much tighter view of it saying, "You have to watch your capital, you have to be careful," whatever, discouraging—in their minds, at least, discouraging loans to a degree.

Is there a communication issue here? Are we hearing something different than is being said when these regulators are sent out on the street?

Ms. DUKE. It is possible that there are some differences between assessments of creditworthiness and factors that have to do with the firm itself. Does the firm itself have enough liquidity to make loans, does it have enough capital to make loans, does the firm have concentrations in areas such as commercial real estate that prevent it from expanding in that area in particular? But a lot of it is communication.

So, in addition to the guidance that we put out there, I can tell you that I personally went back before this hearing and looked at my calendar, and in the last 2 weeks, I have met with our community bank examiners for the system as a whole, with our New York bank examiners, with two community groups, with two banker groups, with a construction industry group, and with the Conference of State Bank Supervisors.

So we are trying to have these conversations and really find out what is happening on the ground and do what we can about it.

Mr. CASTLE. Thank you. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. I thank you for holding the hearing and I thank the witnesses for appearing.

I ask that you provide some ocularity in one specific area, one area. The question is, are creditworthy borrowers being denied loans? Creditworthy. Now you define creditworthy in your minds, but it is creditworthy borrowers that we want to talk about. The empirical evidence as well as the anecdotal evidence seems to connote that they are not getting loans. Not all, but a good many, and possibly too many given the current circumstances.

So let me start by finding or ascertaining whether or not you agree that there are creditworthy borrowers who are not acquiring loans. If you think that creditworthy borrowers are not acquiring loans, would you kindly extend a hand into the air? This will help me to know to whom I should speak. Okay, let's note that we have two persons, Ms. Duke and Mr. Polakoff, who have indicated that creditworthy borrowers are not getting loans.

Let's start with you, Mr. Long. You are a banker. Is it your contention that all creditworthy borrowers are getting loans?

Mr. LONG. Well, I'm not a banker, I'm a bank examiner, Congressman.

Mr. GREEN. Excuse the misstatement.

Mr. LONG. No, that is okay.

I don't know the answer to it. I mean obviously with all the communications we have and in talking to bankers, I have made it a point over the last several months to talk to as many bankers as I can and ask them point blank, "Are you making loans to creditworthy borrowers? Are you making credit available into the industry?" And everybody I talk to is telling me, "Yes, we are."

However, there are some bankers, some banks, that as I said earlier have gone so far out on the risk curve and they are so loaded up on problem assets that they are maybe not able to lend into the market as much—

Mr. GREEN. Is it your opinion that in this circumstance, then, that some creditworthy borrowers may not be getting loans because of the circumstance with the bank?

Mr. LONG. Can I sit here and say that every creditworthy borrower is getting a loan? I obviously can't say that, but I don't—

Mr. GREEN. I don't want to talk about everyone. We are trying to ascertain whether or not we have a significant number such that it is becoming a part of the problem that we are trying to extricate ourselves from.

Let me go on. If we conclude, as some have, that creditworthy borrowers, many are not getting loans—what I would like to do is get to the root of the problem. Is it because of capital requirements or is it because of money that is not available within the bank to lend? The capital requirements, the TARP money that the banks received, generally speaking, was to capitalize the banks. That was not money to lend, generally speaking. Is this a true statement? If you agree that it is a true statement, raise your hand. Alright, everybody has agreed.

Now if that was not money to lend, the money that the bank would lend will come from either money that it gets from overnight circumstances or from various discount windows, true? If so, raise your hand. You are going to have to participate, everyone. Okay,

good, everyone agrees. Or it can come from monies that the banks will have in their loan portfolios, which comes from deposits, true?

So the question is this. Is the problem one of being undercapitalized such that they can't lend money from deposits or from the discount windows, or is one of being capitalized properly, fully capitalized, and not having the money available from deposits? Do you follow my question? If you do not, raise your hand and I will give it to you again.

So if you would, Mr. Polakoff, give your commentary, please.

Mr. POLAKOFF. Congressman, I think each situation is different, but I don't believe it is either a capital restriction nor do I believe that it is a liquidity problem. I think that these are day-to-day decisions that institutions are making as to where they want to be on the risk spectrum given a number of different variables.

Mr. GREEN. Mr. Long.

Mr. LONG. The one thing I would add—and to agree with you in terms of where maybe creditworthy borrowers aren't getting credit—until we get that securitization market opened up, clearly credit is not flowing like it should. That is a huge problem that we have to get fixed.

Mr. GREEN. So Mr. Long, you and I are having a kumbaya moment. We are in agreement with each other, because we agree that there are some creditworthy borrowers, too many probably, who are not getting loans, and we at least have one reason why.

Mr. LONG. I think that there are creditworthy sectors that are not getting access to credit because of the securitization market.

Mr. GREEN. My time has expired. I would dearly like to continue, Mr. Long, but perhaps you and I can talk afterwards.

The CHAIRMAN. I'm going to go to Mr. Neugebauer.

Let me make an announcement. There are votes. We will probably be gone for about 40 minutes. When we return, the members who are now here, who have not questioned this panel, will be allowed to question this panel if they wish. We will then go to the second panel.

So Mr. Neugebauer is going to go, and then we are going to break. Mr. Cleaver, Mr. Perlmutter, Mr. Foster, Ms. Kosmas, and Mr. Himes will be given priority to question this panel, and then we will go on to the next panel. The minority has concurred in that. The gentleman from Texas is recognized for 5 minutes, after which we will break.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

One of the things—and I don't want to spend a lot of time on it because I think the point has been made—we are hearing from a lot of our constituents is that credit terms have changed. I have been a loan officer, been on a loan committee, been a bank director, I have borrowed a lot of money, and one of the things I know—and I'm hearing, I think, things haven't changed is when things are good, everybody runs to loans secured by real estate. When things go bad, everybody runs away from them.

And a number of the loans that I am hearing are getting either renegotiated or are getting more scrutinized or in fact being asked to be paid off for loans having to do with real estate. I think fundamentally sometimes that has to do with maybe regulators pressing that button. I hope that is not the case, because most of the

time when we look at losses that banks take on in real estate, it wasn't because of the real estate necessarily, it was the capacity of the borrowers. But I think sometimes real estate gets tainted as the poisoned pill, particularly when we have a downturn.

But I want to go to the PPIP program. I guess that is what we are calling it, PPIP. We heard yesterday or this week that Mr. Geithner layed out that plan, and it puts FDIC as the 95 percent guarantor of those obligations that are created. Then we also know that the FDIC has issued a special assessment on banks, and it is costing Texas banks nearly a billion dollars, right off the bottom line, right off their capital structure, at a time when we are hearing that banks are cutting back on their lending.

I guess the first question I have is, if the FDIC doesn't have the appropriate reserve funds now, why are we asking them to take on additional responsibility?

Mr. GRUENBERG. Well, Congressman, the program that was announced on Monday is an effort to deal with the troubled assets on the balance sheets of these institutions. Part of the purpose of the program is to take those troubled assets off the balance sheets and put those institutions in a better position to lend. So part of the objective here is to respond to this issue of credit availability.

And that program is still in the process of development, but we are trying to structure it in a way to keep it separate from the Deposit Insurance Fund and have it separately supported by collateralizing those guarantees with the assets that are purchased. Also, fees will be charged for the guarantees, which will be an additional buffer. Furthermore, there will be private equity investment, which would be an additional buffer. So we believe we can structure the program in way to separate it from the Deposit Insurance Fund.

Mr. NEUGEBAUER. But you don't currently have any money in any fund for that purpose, so where are you going to get that money from?

Mr. GRUENBERG. The collateralization of these guarantees will come from the assets that would be purchased. That would be the first line of protection.

Mr. NEUGEBAUER. But you don't have a reserve for that currently?

Mr. GRUENBERG. Well no, once the purchase was made, the assets would be available for collateral.

Mr. NEUGEBAUER. I understand the assets, but in other words, if you are purchasing assets and you are making banks reserve for loan losses and you are saying that you are taking bad assets—those are your words, not mine—off of the books of banks with some potential loss, they may be securitized, but the question—and you said that you weren't going to use any of the funds from the other reserve—so where are you going to get money from this reserve? I mean, if you have losses, how would you pay them?

Mr. GRUENBERG. Well, if there was a default on the loan, we would have the assets placed as collateral. There would be a number of funds established. Each fund would charge fees for the guarantee. They would also have the ability to build up a reserve fund as an additional cushion, and there will be private equity investment in each of these funds as well.

Mr. NEUGEBAUER. I get that. I still don't see where you are going to have any cushion to absorb those losses should those securities—

The second piece of it. It says, I believe, in Treasury Secretary Geithner's plan is that FDIC or the regulating entities will go in, and I guess they will have to sit down with banks and maybe give them permission to participate in this plan. Do you foresee FDIC or any of the regulatory entities encouraging or making banks take certain assets off their books and participating in this program?

Mr. GRUENBERG. I think the program is designed to be voluntary. I think it will be done in conjunction with the primary Federal regulator as well as the institution.

Mr. NEUGEBAUER. I can see my time has expired, Mr. Chairman.

The CHAIRMAN. We will return probably about 12:40.

[recess]

The CHAIRMAN. The committee will reconvene. Mr. Perlmutter is here. I assumed he will be ready to go while we wait for Mr. Kroeker, because that is mark-to-market, which you have already been very explicit about. So, Mr. Perlmutter is recognized for 5 minutes.

Mr. PERLMUTTER. Thanks, Mr. Chairman, and when Mr. Kroeker returns I do have a question or two for him. But he and Mr. Polakoff had a chance to hear me the other day on mark-to-market and I appreciate both of you gentlemen returning. We have had a lot of hearings in this subject, but just, you know, sort of to summarize, we have lost a lot of capital from the securitization market. Chairman Volcker said, you know, it was at a point where it was 70 percent of credit was coming from the capital markets, 30 percent from the banking. We have lost a lot in the capital markets.

I think we determined the other day that we have lost a lot of capital for lending and credit purposes because of mark-to-market, legitimately so or not, you know, there's been a lot of loss and Mr. Long, you have been very honest and I appreciate your testimony today that, you know, from a regulator, from an examiner's point of view, OCC is, you know, concerned about, you know, where we're going in the economy and wanting to make sure that the banks are strong, as strong as they can be.

But, we really have had a dramatic contraction in capital. And it is hitting hard. It is not anecdotes anymore. You heard from Mr. Jones, you have heard from all of us, businesses, home builders, restaurants, car dealers, who have been good borrowers, good business people in the past, are being shut out of credit. They are. Whether you're hearing that from your examiners or not, they are. That is happening.

And so, Governor Duke mentioned the Interagency Statement on Meeting the Needs of Creditworthy Borrowers of November 12th, and there is one sentence in here, I mean, a number of sentences about making sure that credit is extended. I am reading from the third or fourth paragraph, "The agencies have directed supervisory staffs to be mindful of the procyclical affects of excessive tightening of credit and to encourage banking organizations to practice economically viable and appropriate lending activities." So, there are words in there that talk about prudence, but also about encouraging lending. I will start with you, Mr. Long, and then I want to

go to Mr. Kroeker on sort of the mark-to-market situation. Did you guys get that memo?

Mr. LONG. Yes, Congressman, actually, we participated in writing it.

Mr. PERLMUTTER. Okay. So, in Colorado—

The CHAIRMAN. If the gentleman would yield. I do want to note, for historical purposes, that a Member of Congress just asked people if they had gotten the memo and there really was a memo.

Mr. PERLMUTTER. And this really does, back in November, recognize the need to maintain, you know, and extend credit because we have seen, you know, just a loss of demand, a loss of credit, at levels we have never seen before, or at least not for many, many decades. And so, to a degree, we proceed with the prudent lending practices, there still has to be a good look at the borrowers. And my bankers and my borrowers are saying, the examiners are questioning concentration levels.

So, if you're a homebuilder, like Mr. Neugebauer was talking about, and you want a new loan, even though you've been a good customer, you're not going to get it because there's too much concentration in real estate. Too much concentration for auto dealers because that's a distressed industry. Restaurants, commercial facilities, you know, retail outlets, what do you say? And then, an increase of capital from 10 to 10 percent. So, they're giving me specific requirements, or at least suggestions, by the examiner. When an examiner makes a suggestion, you follow it. Am I wrong? Are my guys way off?

Mr. LONG. No, Congressman, they are not way off. But let me put in some context because you raise a number of issues that I want to address.

First of all, in the memo, we periodically get all 1,800 of our examiners on the phone and we walk them through, very specifically, how we want them to treat various loan products, how we want them to treat concentrations, how we want them to treat real estate appraisals, all of that type of thing and what we do is try to use lessons learned from the last time we went through this.

So, we do spend a lot of time with our examiners on the phone, in person, through outreach and through memos to them trying to strike that balance that I talk about in my written testimony. Secondly, the issues that you are hearing from your bankers, they are real issues. These are real issues. We have a number of banks with heavy concentrations of distressed assets and some of those banks are going—

Mr. PERLMUTTER. But I think they're in distressed sectors. They're not, sorry.

The CHAIRMAN. We can be more lax, sir, go ahead.

Mr. PERLMUTTER. As opposed to, I mean, these are performing assets in a distressed sector as determined by you guys. That's what I'm hearing.

Mr. LONG. Well, Congressman, if we have the time, I would like to address one thing, because I hear this a lot. I hear that examiners are looking at current loans and classifying current loans. And I—

Mr. PERLMUTTER. Or not allowing the extension of the line of credit. And with that, I'll shut up, Mr. Chairman.

The CHAIRMAN. Mr. Long, do you want to finish for a bit, go ahead. Mr. Long, do you have any, do you want to conclude, you go ahead.

Mr. LONG. Well, I guess the one thing I would say, I won't take a lot of time. There is a lot to talk around this performing, non-performing issue and, if a loan is performing and it's under reasonable terms, an examiner will not classify that loan. But just because it's current does not mean it's performing and that's a whole long conversation and if you want to talk about that I would—

The CHAIRMAN. Well, I would ask you to elaborate a bit on that. What do you mean, just because it's current, it's not performing?

Mr. LONG. Well, if the loan is performing under reasonable repayment terms, an examiner won't classify that loan. But what I hear from bankers at times is, the loan was current but the examiner classified it. Well, it may have been current, but it's not necessarily performing.

The CHAIRMAN. Well, yes, explain what would make a loan where the payments were being made not performing?

Mr. LONG. We run into this a lot with commercial real estate. It is normal practice in some sectors of commercial real estate lending for the bank to fund an interest carry. And that's simply to bridge the timing differences between the cash outflows and the cash inflows.

So, what we run into in a lot in community banks right now in some parts of the country are these busted residential development loans. And technically, they're current because the bank's paying themselves interest and they're going to be current right up until the day they default and that loan has to be foreclosed.

The CHAIRMAN. Oh. So by current, you mean the bank is paying itself? But not that the borrower is paying it. But if the, I think that's a term of art that I may not have been the only one who missed. But if the banker was, if the borrower was continuing to pay, making the payments, could that still be non-performing?

Mr. LONG. No, it needs to be under reasonable payment terms. I mean, every situation is—

The CHAIRMAN. Well, how about the terms that are in the contract?

Mr. LONG. Every situation is different. If you have a residential development loan, and it is not working and there is a big hole in that project, and the borrower is only able to step up and pay interest and the 2-year loan turns into 12-year loan, that is not acceptable repayment terms.

The CHAIRMAN. Well, but that would, say if it was a 2-year loan, and it would take 12 years, then that wouldn't be, they wouldn't be making the payments. You may be using terms of art that, by "current," I mean the laypeople, myself included, would think that it meant that they were making the payments they were legally obligated to pay. Is that not what you mean by current?

Mr. LONG. Per the contract, if it's interest only, which many of these are, they may be current, but the loan isn't performing. The loan is dead in the water. And many times our examiners will go in and—

The CHAIRMAN. All right, so you're talking, if it's interest only, even if you're making the interest payments, but no principal payments, that would be an example.

Mr. LONG. Right. If it were making principal payments and it was a reasonable, it was a reasonable repayment,—

The CHAIRMAN. But what do you mean, if they're making principal payments and it's a reasonable repayment, is that other than what the contract calls for? How do you, I mean, because I think that's some of what, at least, has been alleged to us is, well, I borrowed the money and I'm paying it back on the schedule I'm supposed to pay it back, but they still, you know, cut me off. What does "reasonable" mean, other than in the terms of the contract?

Mr. LONG. In many of these residential real estate development loans, per the terms of the contract, there are curtailments made as the lots are sold and as the houses are built and sold, and the interest reserve is built in. Technically, some of these loans can be contractually current, but they're not going to pay at renewal. The curtailments will not have taken place. There's a big hole in the project, so in some cases—

The CHAIRMAN. So, even if they are paying back the principal on schedule, they can be declared non-performing.

Mr. POLAKOFF. Mr. Chairman, if I could jump in because I agree with what Tim is saying. If they are paying back principal and interest, it won't be determined to be non-performing, but indeed it could be classified and we could require reserve against it. So, we're probably mixing jargon a little bit.

The CHAIRMAN. Yes, and I think—

Mr. POLAKOFF. It's agreed, it will not be delinquent but it indeed, could be adversely classified.

Mr. LONG. The point I want to make is, because I hear this a lot from legislators and bankers that examiners are classifying loans that are current. Current may not be performing—

The CHAIRMAN. You said that so, but do you not understand how confusing it is, your use of the term "current?" You may be making all the payments you're supposed to make—

Mr. LONG. Congressman, I can be current on my 30-year car loan, but I'm not performing. That is not an acceptable performance.

The CHAIRMAN. What does that mean?

Mr. LONG. That's not acceptable.

The CHAIRMAN. How are you current but not performing?

Mr. LONG. Because the payments aren't at the, performance needs to—

The CHAIRMAN. Are you making the payments that you are contracted to? But what, you have a 30-year car loan, you said? That is a hell of a car. But, so you're paying on your, but you're making all the payments you're supposed to make.

Mr. LONG. Here's my point. You know, performance needs to relate to something—

The CHAIRMAN. No, don't—

Mr. LONG. Performance needs to relate to something. And it's generally the source of repayment.

The CHAIRMAN. And performance does not relate to the terms of the contract is what you're telling me. That when we say perform-

ance, some of us would think, well, you're performing according to the terms of the contract you signed under which you got the money. Then you're saying no, performance has more meaning than that—

Mr. LONG. Yes, it does.

The CHAIRMAN. Meeting the terms of the contract doesn't mean you are performing.

Mr. LONG. Congressman, in many cases, it means more.

The CHAIRMAN. But I think you're using confusing terms and you need to re-work those terms. At least I, maybe I'm alone, but I would have assumed that if I were meeting all the terms of the contract, I was performing under the contract. Now, so there's a real—

Mr. PERLMUTTER. Would the gentleman yield?

The CHAIRMAN. Yes.

Mr. PERLMUTTER. I think what you're saying, because I did some of this work back in my old days, when they classify a loan, it's because at some point they have made the determination as a prudential regulator that it's being paid, but it isn't going to get paid off, or there ultimately is going to be trouble at the end of the loan. And that's a judgment call. And what I'm saying is, go back and read the memo on the judgment calls, please.

The CHAIRMAN. And I would just add, I understand that, but don't call it non-performing. I believe you're confusing what, at least, people meeting the terms of the contract are performing. There may be other reasons for canceling it, but I think rather than saying it's not performing, you ought to say, in some cases, performance isn't enough. And you have to cancel it. I apologize for the extra time and the gentleman from Alabama is now recognized.

Mr. BACHUS. Maybe I can get a little extra time. I have a letter from Jimmy Duncan from Knoxville, one of the Congressmen that I have tremendous respect for and he wrote to all four of the Federal bank regulators. And on December 29th, and his letter was about the same thing we're talking about here. He said that as the president of one bank, with which I have no connection whatsoever said, holding one hand up much higher than the other, I guess he just said, "Look, I swear this is happening. What they are saying at the top is not getting down to the bottom."

In other words, it goes on to say, when the President, the Secretary of the Treasury, and other top officials are trying to unfreeze the credit market and urging banks to make loans, the bank examiners at the local level are making it almost impossible to do so. And here's, I think this is part of the essence of it. And I mean with all respect for all parties. The examiners, almost none of whom have ever been in the banking business and thus do not fully appreciate how difficult it is, are writing up the best, safest loans on the books.

They are doing this even though all payments are current and even on loans people have, oh, loans to people who have more than sufficient income and assets to cover the loan. He goes on to say, and one of the things that I have talked to him about this letter and to numerous members and they say, the bankers don't want to say this publicly because they're actually, they fear, whether it's founded or not, that the examiners will crack down even more.

But, he says, every bank in east Tennessee has told me over the last 3 months or so, that the examiners have just gotten ridiculous. Another banker said, banks cannot make even very good loans now, strictly because the examiners and their "CYA" attitude. I figured out what CYA meant. And he talks about the economy actually is strong in Knoxville, but one of the problems that they're having, and Chamber and other people have said to him, they're pulling lines of credit.

Now, I think today's hearing has been very helpful, because there has been a lot of dialogue and communication. And I am seeing the other perspective. But, what I have tried to say to my colleagues and I issued a statement the week before last, saying to my colleagues that we're all in this together and we have to watch what we say and what we do. Because there's a lot of fear out there, there's a lot of uncertainty, and we ought to all be constructive and really realize that right now there are, just, these are really challenging times.

And even though it may be prudent banking, it may actually, it may appear to be by the rule book but as Governor Duke said, you know, until there's a floor under the housing market, and how do you do that, you know, we're going to continue to have problems. And what people are seeing, they're seeing us pump hundreds of billions of dollars into some of these companies and saying, by the Secretary of Treasury, the Chairman of the Fed, and others, when the economy recovers, these institutions, we're going to give them some breathing room. We're going to give them some time, we're going to give them liquidity where there's none and when the economy comes back, we can get our investment back.

You know, that what these customers are facing right now and some of our banks. I mean, they need time. That's what they need. And that's why mark-to-market is not giving people time to deal with illiquid assets. You know, before, in these downturns, they have had time to work through those and it has taken 4 or 5 years. I had a conversation with the Chairman of the Fed and he said, it is going to take years to work these things out. That's true of a developer. That's true of some of these manufacturers. They're going to need time.

And if you sort of look ahead and particularly if you say, we're feeding into our calculations things are going to get worse, boy they will. Because you call in some of these loans or you increase the terms, you make them pay other than just interest instead of working with the customer, they'll dump a lot of inventory on the market. You'll have more fire sales. Everybody. It's just a downward cycle. And I really want to say to you, if you're sitting there and you have to make a choice between, I would make a choice of trying to give people time to work things out.

You know, we're doing, we're spending trillions of dollars to give people breathing room. We're spending trillions of dollars understanding that if the economy doesn't come back, you know, that money then be gone. But you know, I think we have to all assume that we're going to all go through this together and things are going to get better. If we don't, they won't. And, I don't know.

I really think, and let me say this, my father was a contractor, and there were times when he had to go to the bank to pay his

men. But then, you know, they knew at that bank because this was a guy he'd worked with for years. They knew when times got better, he'd do better. Sometimes he had 20 guys working for him. One time he had 2,000. And he rode through the bad times, but his banker was his friend. And, you know, he needed that banker. And then, in good times, he was a friend of the bank.

And I think we up here, particularly, we're on a fixed income. I mean, I'm going to make the same salary whether the market falls off next month or goes up. You know, we examiners, we that work for the Federal Government, our salary, but you know, that's not the way it is in these downturns for most people. I don't have to worry about my income dropping from $150,000 to $80,000, but you know if I did, and all of a sudden it dropped, for a year or two and somebody started looking at that and said, I'm not sure he can pay this loan, or I'm not sure he can pay that, I'm going to call in this line of credit, I would be in trouble. And, I mean, I think that's what we're facing.

And finally, let me say this, and I usually ask questions, I usually don't talk, but sometimes it's not even prudent lending to, you know, if you go to a developer that has a million dollar line of credit, as one in Birmingham told me last week, he's paying the interest off, and you call in $200,000 of that, and he's going to have to liquidate, or put up for sale one of his two developments, you know, he's going to have to sell that really cheap and that's going to cause a domino effect. And you know, I think that actually worsens your chances.

You might get that $200,000 back, but you may end up losing in the end. And I'm just going to say to you, my time is up. I wish you would communicate to your examiners, that if given a choice between calling in a loan and giving folks time, if you can do it within the regulations. You know, a lot of times, you have discretion. We have discretion up here. We make decisions every day whether to meet with people or whether not to, or whether to have, is use your discretion, number one with the attitude that times are tough out there and number two, I don't assume things are going to get worse. Because they will if you keep restricting credit or calling in these loans.

So, thank you.

The CHAIRMAN. The Congressman from Illinois, Mr. Foster.

Mr. BACHUS. I would like unanimous consent to introduce—

The CHAIRMAN. Without objection.

Mr. BACHUS. —Congressman Jimmy Duncan's statement.

Mr. FOSTER. Yes. One of the most tragic slices of small businesses that, you know, come to my office, and I'm sure everyone else's, are healthy businesses that have good orders and a profitable business and everything else, and yet their credit line is being reduced because of the drop in the real estate value that was used to collateralize, you know, their loan. And I was wondering, are there any of the—any programs out there that could provide collateral support, if you understand what I mean, for businesses in this specific thing? That is, healthy businesses who are just being clobbered by the drop in real estate values.

Mr. POLAKOFF. Congressman, I would offer that—well, first if you accept the notion that it's the bankers who make the decision

what to do with the loans, not the examiners. So the examiners don't decide which loans get funded, which loans don't get funded, which loans get called.

Having said that, though, I would submit that both bankers and examiners should be looking at the cashflow analysis of the underlying loan. The collateral is important, but the collateral really only comes into play if there's a cashflow crisis. So the cashflow of the loan should support whatever the line is.

Mr. FOSTER. And do you believe that is the de facto policy? Because I have certainly heard from people who are being squeezed by their bank that part of the reason give is that, well, look, you know, your factory is not worth anything like what it was worth.

Mr. POLAKOFF. Well, sir, there are over 8,000 banks, so I suspect that there are some bankers who maybe are doing things a little differently than what I just described. And I suspect there may be some examiners who are erring way too much on the aggressive side just to be sure that they don't make any mistakes. But as a general theme, I believe what I said would be accurate.

Mr. FOSTER. Do you think if there was explicit collateral support, that might encourage some slice of lending? Governor?

Ms. DUKE. Congressman, you're right, and particularly a lot of small businesses that use their home equity to finance their businesses are being squeezed by that. I think some of the progress that we have made in talking about loan modifications and talking about refinance that are now allowing, in the GSE loans, refinances to take place, even when the loan to value might be up to 105 percent. I think that could have some help.

On the commercial property side, there is a program under SBA, and I'm not quite sure what the funding necessary is. But SBA does have a program where the bank lends 50 percent of the value and then the SBA loan covers 40 percent and the businessman has 10 percent. That sometimes helps businesses who otherwise wouldn't have largedown payments or equity positions in their buildings.

Mr. FOSTER. Okay. And those SBA programs are limited by the funds allocated to them? Are they limited by recent availability?

Ms. DUKE. I have to say I'm not quite sure I understand that, but I think that's a program that could be very valuable in the current environment.

Mr. FOSTER. Okay. Mr. Polakoff, you mentioned that lowering the loan to value during economic upswings was—could be a crucial part of keeping from getting into this mess ahead of time. And do you imagine doing that by formula or by some political appointee or an independent entity with the wisdom of Greenspan or—who's going to make that decision?

Mr. POLAKOFF. Well, I think the folks sitting up at this table in all likelihood through the FFIEC, which is that interagency body, need to be chatting about, things like that which is countercyclical, that the former Comptroller of the Currency, Gene Ludwig, has given a number of speeches about, countercyclical regulation and the importance of it. And it's something as simple as the LTV. It's something as important as building up the allowance for loan and lease loss in the good times without the outside accountants and auditors suggesting that it's inflated.

So there are a number of issues I think we can touch on.

Mr. FOSTER. Yes. But you could actually imagine that someone like you would be in a position where the economy is going and the bubble is going up, and, you know, half of this committee is asking you, why are you squeezing the bubble when it's bubbling up? It seems to me that if you could establish formulas that at least provided a basis level for what the loan to value ought to be, then—and established a very high political threshold for changing that formula, that you'd have a much better defense against political pressure to, you know, not rain on the parade.

Mr. POLAKOFF. Yes, sir.

Mr. FOSTER. I yield back.

The CHAIRMAN. The panel—oh, the gentlewoman from Florida is here and she is the last member here who has the right from our prior discussions to ask questions. So I will recognize the gentlewoman from Florida.

Ms. KOSMAS. Thank you, Mr. Chairman. Thank you all for being here today. I wanted to chat with you for just a moment about a very specific aspect of lending that I am hearing, and you've heard people sort of nipping around the edges of this all morning, I believe. But I'm dealing with a lot of people in my district, and people coming to me here in Washington who are currently operating their businesses, and it could be anything from, you know, $500,000 to $100 million a year business based on lines of credit that they rely on.

These are commercial loans, which, as you know, generally have what I call a rollover, 3 years, 5 years, 7 years, whenever they become due to be renewed. And they, as you have heard others say, are being denied the opportunity to renew or rollover those loans.

And I have been saying at every turn that I have an opportunity to say it, is that this is what I call, you know, Tier 2 of the economic problems that we're seeing in this country. Tier 1 may be the housing that you talked about, Governor Duke, but Tier 2 being those businesses, and I'm not talking about small businesses less than ten employees that were discussed this morning, but I'm talking about other businesses, whether it's shopping centers, hotels, leisure activities, cruise ships, time share businesses, or any other kind of business, and there are lots of them. I happen to be from Florida, so thus the tourist interest specifically.

But I'm very, very concerned about this particular group of borrowers and their inability to renew their lines of credit that keep them in business, because I think if we think a neighborhood of empty homes is a problem, when we start to see shops and other things literally closing their doors, we're going to understand that we have a whole different problem on our hands. And, obviously, the ability for these businesses to continue to operate helps the employment statistics and helps the housing statistics, and it keeps some things at bay that would be significantly worse should they not be able to get the credit.

So my question I guess to you is, what is it perhaps that you are regulating, or is it the banks and lenders that is putting this pressure on people who have completely performing, compliant loans and lines of credit that are unable to get them renewed or rolled over so that they can keep their businesses going? What do you

think is at the root of that? And then what would you think would be some way that we can mitigate it or resolve it? Would anyone like to respond?

Mr. POLAKOFF. Well, I'll take a stab, and my colleagues will help me. I think, as Tim said earlier, there are a number of institutions that want to diversify their loan portfolio. The two consistent problems within institutions that are distressed is either a concentration of risk or excessive growth. And I think we're finding more and more institutions that need to diversify their portfolio or believe they need to diversify their portfolio to better spread out the risk among various industries, various borrowers.

Many times, it is simply a strategic decision by the board of directors or the executive management of the institution.

Ms. KOSMAS. Thank you. Did anyone else want to respond? I would only say in response to that, I'm wondering whether anybody is looking at the big picture. Because if what you're saying is that individual institutions or banks or lenders are making decisions based on their individual portfolio, that we could have a sort of a stealth crisis going on here that could explode and, as I said, turn into something much worse than what we're currently experiencing if what I'm hearing is as consistent across-the-board as I believe it to be, then how do we resolve it?

Ms. DUKE. I'll take a stab at it if you like. I think Congressman Bachus may have put his finger on the problem. It's not necessarily the most creditworthy borrowers or the healthiest banks. It's when you have banks that have some difficulties of their own, and they can't be as accommodating to long-term customers as they might have been otherwise.

And so we have this whole chain of the government being more patient in working with the banks in order to—or working with the bank regulators so that they can work with the banks, so that they can then work with their customers. And in a lot of these cases, the customers are under stress themselves. Their sales are down and their collateral values are down. And so if at the same time the banks are in weak condition or concerned about criticism from examiners, then they are not as willing as they would have been otherwise to work with those borrowers until they get to better times.

And I think that's the case that we really need to find a way to attack. I think you're exactly right.

Ms. KOSMAS. Again, I guess my question would be, is there anybody looking at the big picture of what the cumulative difficulty of this is, rather than to say each bank has its own problems. And, again, I refer back to the opening comment. I'm talking about completely compliant, performing loans, which have not seen any difficulty at all and the businesses have a business plan that is working, and there's no reason to suspect that they wouldn't continue to function in the same way that they have for as many—in some cases, many, many years.

And the big picture question is one, and then, Mr. Polakoff, if you're going to address that, I was wondering whether your 4th suggestion as a solution which referred to countercyclical regulations might include anything that would allow lenders or banks to perhaps set aside these performing loans and have them counted

in a different way or set aside from the other regulatory restrictions?

Mr. POLAKOFF. Congresswoman, I have a number of thoughts. I think you touched on an interesting point that I had not thought about before, which is assessing in a horizontal way what industries may be finding themselves limited, limited access to capital. That's an interesting point. We hadn't thought about that. There are ways for us to do that, so, I think that's a takeaway for us we should consider.

The countercyclical aspect, one area that we hadn't discussed, is literally the notion of capital. Right now, the regulators tend to look at institutions and have a standard. All institutions should be well capitalized. Is it rational for us to say all institutions should be well capitalized both in the good times and in the bad times, or are there ways for us to say, in the most distressed times, like what we're facing right now, maybe it's okay to be adequately capitalized.

Now the reality is, there are some triggers that are impacted by an adequately capitalized institution. Maybe we need to look at those and make some determinations as to whether they're relevant in today's economic cycle.

The CHAIRMAN. We're running out of time. If I could borrow 15 seconds from the gentlewoman, I would say that's exactly, the last point, where I think mark-to-market comes in. That is, are they inadequately capitalized because of some major failure, or are they inadequately capitalized because of a mark-to-market on some longer-term assets? And I certainly think the capital reaction ought to be different in those cases. That's very much what we have been trying to get at.

I thank this panel.

Mr. BACHUS. Mr. Chairman?

The CHAIRMAN. The gentleman from Alabama first, and then the gentleman from Colorado.

Mr. BACHUS. I have a mark-to-market question, and basically what it is, I'm not one who wants to suspend mark-to-market. I think the revisions are going to be good. But I also think maybe that we could rethink capital requirements or moving to capital requirements that are more countercyclical, that recognize the environment we're in, which is exactly what you have said. But I will submit that for the record for you all to make—

The CHAIRMAN. Yes. And I think on that last point, we have a lot of agreement on that. The gentleman from Colorado is the last—

Mr. PERLMUTTER. For the record, thank you, Mr. Chairman, on the mark-to-market issue, I want to introduce a letter dated March 23, 2009 from former FDIC Chair Isaac, written to you, Mr. Chairman, and the ranking member, on mark-to-market and the changes, and I would like to give a copy to you, Mr. Kroeker, so that you guys can continue to work on this. Thank you.

The CHAIRMAN. And I reiterate, if there are any statutory changes that are needed for you to act in that way, we need to know them. The panel is thanked and excused, and the next panel will come forward. Let's move quickly, please. We will convene the second panel, and I want to begin by—but before we do, let me say

this. And I'm going to call on my colleague, Mr. Wilson, but I have consulted with the ranking member. We have had a very long day.

I think what we most want to hear is what this panel has to say about what you have just heard. So in consultation with the Ranking Member, I'm going to ask everyone to speak for 7 minutes rather than 5 minutes. We probably won't need a lot of questions. We do have a markup at 2:15, but I think we believe it is much more important for us to hear your comments on what we have just had the conversation about than to ask you further questions. So, with that, you'll each have 7 minutes if you want, and then there will be time for a couple of rounds of questions. And with that, I want to recognize my colleague from Ohio, Mr. Wilson, to make an introduction.

Mr. WILSON OF OHIO. Thank you, Mr. Chairman. Thank you for giving me the opportunity to introduce a fellow Ohioan. Steve Wilson is here on behalf of the American Bankers Association. Steve is chairman of the board and chief executive officer at LCNB National Bank in Lebanon, Ohio, and past chairman of the Ohio Bankers League.

He has been very active in the Ohio community, serving as board member of the Federal Reserve Bank of Cleveland, chairman of the Advisory Board for Miami University in Middletown, and current board member and treasurer of the AAA in Cincinnati, a board member of the Harmon Civic Trust, a trustee of Countryside WMCA in Lebanon, and a board member of the Warren County Foundation. He is a member of the Area Progress Council of Warren County, and he serves as the vice chairman of the Warren County Port Authority.

I'm pleased to have an Ohioan here to testify, and I'm proud that he's a banker who is actively investing in our community. In January of 2009, LCNB National Bank approved $11,593,000 of loans to individuals, $6,892,000 in loans to businesses, and $18,353,000 in loans to municipal governments, including Salem Township in my district in southeastern Ohio.

Steve, welcome to our committee and thank you for coming today. We look forward to hearing from you.

The CHAIRMAN. Mr. Wilson, please go ahead for 7 minutes.

STATEMENT OF STEPHEN WILSON, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, LCNB CORPORATION AND LCNB NATIONAL BANK, ON BEHALF OF AMERICAN BANKERS ASSOCIATION (ABA)

Mr. WILSON. Thank you very much. Chairman Frank, Ranking Member Bachus, and members of the committee, as introduced, my name is Steve Wilson. I am chairman and CEO of LCNB National Bank. We have over $650 million in assets and have served our community for 131 years. I appreciate the opportunity to testify on behalf of ABA.

Everyone is frustrated about the current confused situation surrounding the Capital Purchase Program (CPP). We had hoped that by the time we were here today, the mixed messages and disincentives would have disappeared, but in fact they are worse today than they ever have been. If programs to stimulate the economy

are to reach their full potential, the confusion must be clarified and the disincentives corrected

Conflicting messages have characterized the Capital Purchase Program from the beginning. Banks were actively encouraged by Treasury and banking regulators to participate. Indeed, many healthy banks decided to participate even though they were already very well capitalized. And even though they were very nervous at the time, that already the program requirements could change dramatically, and unilaterally, at the will of Treasury or Congress.

My bank, which is well capitalized, applied for and received $13.4 million of CPP in January. I am proud to point out that we were given that opportunity to receive these funds because of our past and current performance in providing loans to those in the communities we serve. We are strong and we are secure. The CPP funds enabled us to respond to our customers when they need credit. In fact, we continue to make loans, sticking to our traditional commitment of making responsible loans that make good economic sense for both the borrower and our bank.

I would also note that we sent Treasury our first dividend check of $67,000 last month. The first dividend payment for all CPP banks totaled $2.4 billion, which shows that CPP is truly an investment by the government in health banks.

Over the last few weeks, banks have received messages that discourage participation in the CPP. But it goes beyond banks that have received the capital injections. The entire industry is unfairly suffering from the perception of weakness perpetuated by government-created mixed messages. Banks hear the message to continue to lend, to help stimulate the economy. But they also hear messages that pull them back from lending, from field examiners that may apply overly conservative standards, requiring severe asset writedowns; from FDIC premium assessment rules that will take $15 billion out of the industry in the second quarter; and from misplaced accounting rules that overstate economic losses.

Any one of these challenges could be handled on its own. But taken collectively, the impact is an absolute nightmare for banks. All of these forces work against lending, which is so critical to our economic recovery. Clarity is so important right now, particularly for CPP participants. The continued speculation of further government involvement continues to unnecessarily erode consumer confidence in the Nation's banking system. I cannot say strongly enough that the investment of private capital will not return until the fear of further government involvement or dilution of private equity investments in the banking system has been significantly abated. Private capital, rather than taxpayer money, is the foundation of our economic system. What the private capital markets are looking for is a steady hand and a predictable government. Wary investors will fear that the government will further change the rules that were in place when banks signed the contracts with the Treasury. That is why it is so critical that the role of government be clearly defined and limited.

I thank you for the opportunity to testify today, and I'll look forward to answering questions. Thank you.

[The prepared statement of Mr. Wilson can be found on page 176 of the appendix.]

Mr. WILSON OF OHIO. [presiding] Sorry, Mr. Ranking Member, sir. Let me repeat that. We will now hear from Brad Hunkler, vice president and controller, Western & Southern Financial Group, on behalf of the Financial Services Roundtable.

STATEMENT OF BRADLEY J. HUNKLER, VICE PRESIDENT AND CONTROLLER, WESTERN & SOUTHERN FINANCIAL GROUP, ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. HUNKLER. Thank you. I would like to express my gratitude to Chairman Frank and Ranking Member Bachus and the committee for the opportunity to be here today and to speak on behalf of the Financial Services Roundtable and Western & Southern Financial Group.

The role of the financial services industry, including nonbanking institutions, needs to be a significant component of your work in expanding credit to consumers and commercial enterprises. The financial services industry invests in all types of consumer loans, including mortgages, credit cards, auto loans, student loans, and many others. The primary investment vehicle for these loans for nonbanking institutions is through securitization.

The amount of consumer lending financed by nonbanking institutions is critically important to maintaining adequate lending capacity for the broader economy. Unfortunately, though, there have been many problems with these assets for the financial services industry as a whole. As such, the industry has been adversely impacted by a lack of regulation, oversight, and clarity of the securitization process. Certainly the economic conditions, such as high unemployment and falling housing prices, have adversely impacted the collateral of these assets, but other noneconomic factors that could have been avoided also have contributed to the losses.

As noted in many media reports, this includes rampant fraud in the mortgage origination and underwriting process, poor underwriting standards that overemphasized rising housing prices and did not adequately consider borrower creditworthiness, monoline insurers whose risk exposures were too highly correlated, inadequate analysis and stress testing from the rating agencies resulted in over-inflated ratings, and a lack of transparency relating to the underwriting collateral—underlying collateral and deal structure which contributed to inefficient price discovery.

In addition to the liquidity—I'm sorry. The issues are—these issues are specific primarily to the nonagency mortgage markets. The industry has also been adversely impacted by lack of transparency and regulatory oversight of the student loan market, where investors who purchased auction rate preferred securities for short-term liquidity needs, are now stuck with illiquid long-term securities with uncertain payment provisions. Some of these issues have been resolved for consumers but not large institutions like insurance companies.

In addition to the liquidity and valuation challenges, mark-to-market accounting has compounded the problems for the financial services industry. Some institutions generally hold whole loans that are not required to be fair valued, while others, including in-

stitutions companies, hold mostly securities which are required to be mark-to-market. These are the areas I ask Congress to focus on going forward so that when economic conditions improve, institutions will return to the securitization markets.

The industry has raised the issue of mark-to-market accounting concerns since the first major application of market value accounting in FASB Statement Number 115. At the time of early deliberations on FAS 115 in the late 1980's, interest rates were at all time highs, primarily Treasury rates. The insurance industry had extraordinary unrealized losses on its investment portfolios, and most, if not all, insurance companies would have reflected negative book values at that time. The industry on the whole question of usefulness or the meaning of reflecting negative book values due to high interest rates having a long-term cashflow-oriented investing strategy allows insurers to manage through periods of interest rate volatility.

Today, excessive speculation in the markets has made market prices potentially deceptive when reflected in the equity of financial statements. Market participants speculate more on assets—can speculate more on assets' ability to increase or decrease in value than on its inherent ability to provide future cashflows. This speculation has led to market bubbles and busts. Adding market values to financial statements in this environment can be misleading. During market bubbles, financial statements can illustrate a false wealth effect. This can lead to excessive risk-taking and overleveraging nonexistent equity. During periods of market declines, the opposite is true. As the market values decline, reported losses in excess of real losses can lead to restricted risk-taking and capital preservation. This can lead to irrational exuberance in bubble periods, irrational fear during the bust. While markets can accommodate, potentially accommodate this type of volatility, the sanctity of the Nation's financial institutions needs to be immune to it.

To address the issue of procyclicality, some would suggest providing a countercyclical regulatory capital model and retaining market values and other procyclical indicators in reported financial statements. I do not believe this represents a sound approach. Reported financial statements that show excessive volatility and potentially negative book values can fuel adverse consumer activity. If regulatory reporting shows strong financial strength through this reporting mechanism, it has the potential to be dismissed, or even worse, it can discredit the regulatory model altogether.

Market prices do, though, provide beneficial information for financial statement users. They provide an objective source of value and can, during normal market cycles, be a proxy for value. Also, market prices are the value that can be exchange of assets or required to be liquidated. In addition, some assets are acquired for purposes of trading and should therefore reflect market prices in the financial statements.

Investors have spoken clearly that fair value accounting does provide meaningful information. But the desire for objective financial data has led to the replacement of principles of prudence and conservatism in accounting with fair value accounting. Therefore, I believe the primary measurement should be cost for cashflow investors. Losses should be recorded when cashflows are impaired, up

to the amount of the impaired cashflows. Then to accommodate the needs of investors and to provide transparent financial information, fair value supplements can be provided to investors that would accompany earnings releases and reported results. These fair values could represent exit values and reflect the impact of liquidating financial instruments if required.

While the FASB may have a more than adequate due process in the exposure and issuance of new standards, the problem is that the preparer concerns have had little weight in the ultimate decision on the issuance of new standards. Investor concerns, primarily the voices of large investor organizations, have driven the FASB agenda in support of fair valuing all financial instruments, and other nonfinancial instruments.

What is interesting, though, is as the FASB has continued to introduce new fair value measurement requirements, equity analysts continue to guide companies to exclude the results of these fair value changes from the core operating earnings they report in their earnings release. What equity analysts are interested in is understanding run- rate earnings and growthin earnings so that they can determine the fair value of the company, as opposed to reflecting the results on the balance sheet.

Congress could potentially play a role in the oversight of the FASB due process, but I think we want to stress the importance of independence in the standard-setting model. We do believe that is critical, but we would welcome some oversight to ensure that preparer concerns are adequately reflected in the due process of FASB. It's a good due process but doesn't always result in all concerns being adequately addressed. I appreciate the opportunity to be here and welcome any questions you have.

[The prepared statement of Mr. Hunkler can be found on page 112 of the appendix.]

Mr. PERLMUTTER. [presiding] We will now hear from Michael S. Menzies, Sr., president and chief executive officer of Easton Bank and Trust Company on behalf of the Independent Community Bankers of America.

Mr. Menzies?

STATEMENT OF R. MICHAEL S. MENZIES, SR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, EASTON BANK AND TRUST COMPANY, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. MENZIES. Thank you, Mr. Chairman. Thank you, Ranking Member Bachus. It is certainly my honor to be here.

As you said, I am president of Easton Bank and Trust from the beautiful Eastern Shore of Maryland. I am especially proud to be the new chairman of the Independent Community Bankers of America.

We are a $170 million bank on the Eastern shore, a community bank, a Subchapter S bank. I am thrilled to represent some 8,000 banks from around this Nation and our 5,000 members in the ICBA to talk about exploring the balance between increased credit availability and prudent lending standards.

Notwithstanding Mr. Long's concern that community banks are overextended, and community banks need to be prepared for a

worse environment, the vast majority of community banks are well capitalized, well managed institutions, actively participating in the economic recovery by lending to small and medium-sized businesses and consumers in their communities.

Community banks represent thousands of communities throughout the Nation and they make relationship-based decisions. We do not make decisions based solely on scoring models or rating agencies, algorithms or computer simulations.

However, the community bank regulatory climate is causing many community banks to unnecessarily restrict lending activities.

For one, there appears to be a disconnect between the banking regulators in Washington who are promoting lending, and we are hearing this, and the field examination staff who require overly aggressive write-down's and reclassifications of viable commercial real estate loans and other assets.

Yes, Mr. Bachus, what they are saying at the top is not reaching the bottom.

Community bankers report that examiners require write-down's or classifications of performing loans due to the value of collateral irrespective of the income or the cash flow or the liquidity of the borrower.

By placing loans on non-accrual, even though the borrower is current on payments, discounting entirely the value of guarantors, substituting the examiner judgment for that of the appraiser, and de-valuing loans merely because it is lying in or close to an area of high foreclosure levels, this all reduces credit available to communities.

What we expect is examiners to be more thorough and careful with their examinations during an economic downturn. Based on what we have heard from our members, we believe that in many cases, examiners have gone too far.

Excessively through exams that result in potentially unnecessary losses of earnings and capital can have an adverse impact on the ability of community banks to lend, since community banks are the prime engine behind small business lending, any contraction of lending further exacerbates the current economic downturn and impedes the flow of loans to creditworthy borrowers.

Community banks are not de-leveraging. We are leveraging up and we need to continue to leverage up.

ICBA does appreciate the recent overtures from banking regulators to improve the examination environment for better communications between banks and regulators, and the education of agency field staffs on the consequences of overly restrictive examination practices on credit availability.

We have several recommendations in our written testimony that would create a regulatory environment that promotes community bank lending. I would like to highlight a few.

Number one, examiners must take a long-term view toward real estate held by banks as collateral on loans and not demand aggressive write-down's and reclassifications of loans because illiquid or dysfunctional markets have forced sales.

Real estate assets are long-term assets, and should not be based upon the short-term business cycle valuations that we are facing today.

Number two, unlike some large money center in regional banks, the hallmark of community bank loan underwriting is a personal relationship with the borrowers we lend to, and character does in fact count in community bank lending.

During this economic crisis, regulators should allow a bank to hold a small basket of character loans from borrowers who have a strong record of meeting contractual obligations and where there are other indicators that support the repayment of that loan.

Loans in the basket would be exempt from strict underwriting standards and could not be criticized by examiners as long as they are performing. The amount of loans that could be held in such a basket might be a percentage of capital.

Three, the examination in the field process should be strengthened to make it easier for bankers to appeal without fear of examination retaliation.

Agency ombudsman determinations should be strengthened and the ombudsman made more independent.

Four, the FDIC should find an alternative, and we are pleased they are seeking an alternative, to the 20 basis points special assessment which would consume much of bank earnings in 2009 and further constrain lending.

The special assessment should include a systematic risk premium and be based on assets. I have never lost based on deposits and liabilities.

Five, OTTI accounting rules are distorting the true value of financial firms and needlessly exacerbating the credit crisis. This does not serve the best interest of investors or the economy.

We appreciate the committee's efforts to resolve this accounting issue. We believe FASB's recent proposal could be a positive step in resolving mark-to-market problems. We will be providing further suggestions and clarifications to the FASB.

If there is time later, I would be happy to comment about this subject to performing loans, I have strong opinions about the meaning of a "performing loan" in today's regulatory world.

Thank you so much for this opportunity.

[The prepared statement of Mr. Menzies can be found on page 151 of the appendix.]

Mr. PERLMUTTER. Thank you for your testimony, Mr. Menzies.

Now, we will turn to Mr. Randall "Truckenbrodt." Is that close?

Mr. TRUCKENBRODT. Close.

Mr. PERLMUTTER. American Equipment Rentals on behalf of the National Federation of Independent Business.

Mr. Truckenbrodt?

STATEMENT OF RANDALL TRUCKENBRODT, AMERICAN EQUIPMENT RENTALS, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. TRUCKENBRODT. Thank you. Mr. Chairman and members of the committee, I want to thank you for allowing me the chance to tell my story.

My name is Randall Truckenbrodt. I am a small businessman and member of the National Federation of Independent Business. I am in the construction equipment rental business in Florida, Illinois, and Indiana.

I and my employees have felt the economic downturn, and I am doing everything I can to stay in business and keep my employees working.

While many policy leaders have talked about improving access to credit for small business, my problem, like most small businesses, has been just trying to keep the doors open and my employees on the payroll.

Unfortunately, my experience with Bank of America has made that prospect more difficult. I started doing business with Bank of America about 7 years ago in Fort Lauderdale, Florida. The relationship started with a small line of credit of $250,000, with a company that was in need of rebuilding. After accomplishing that feat, the lending officer was impressed and wanted to do more deals.

Over the years, we have done quite a few mortgages with Bank of America. In August of 2008, I received a call from an executive at the bank's headquarters stating that I was in their work-out department. The work-out department of a bank is where they work on non-performing or underperforming loans.

I asked why I would be in a work-out department since I had never missed a payment on any loan with Bank of America or any bank for that matter over 32 years that I had been in business.

The executive stated I was in the work-out department because one of my companies, American Equipment Rental in Pompano Beach, Florida, was operating at a loss, to which I replied, "So what."

I reminded him that I had never missed a payment with the bank and have no intention of stopping payments going forward.

We discussed the probability of the company making a profit going forward. I explained that forecasting a profit is difficult to predict in this credit market because it is holding up construction projects and the fact that the real estate market had been overcooked for years in Florida.

I further explained that we were changing some things to help the recovery process and that I have a pretty good track record of fixing our businesses when they come under outside pressures.

After several months, Bank of America advised me that it would be sending me terms for a waiver letter to be issued. I have had 25 to 30 waiver letters issued by banks through the years, and they have always been issued at no charge. Waiver letters protect the bank's rights while allowing a customer to work their way back into compliance.

Since late November, Bank of America sent three proposals explaining their terms for issuing a waiver letter. In the first letter, the Bank of America executive indicated he would charge my company $59,000 in fees and require the company to re-appraise all the mortgaged properties at an estimated cost of $25,000. The bank was proposing to impose all these fees on an not profitable company that it used measuring profits against. I have never heard of anything so ridiculous.

The rest of the conditions of the waiver terms included a statement that I would agree to release all claims against Bank of America. The natural question is, why would I be asked not to sue them if they are doing the things right?

We received 4 of these demand letters over a period of 6 weeks, each one offered to lower the fees in order to get this waiver letter issued.

The third letter indicated it would waive all fees and costs if we would agree to change the maturity of these long-term notes from 2025 to April of 2009. Of course, to sign a statement not to sue them.

The final offer imposed on the last day of this past year a default interest rate of 12.95 percent, 6 points higher than the current rate.

I refused to agree to their terms. One of my concerns was the difficulty in getting these small business loans placed elsewhere, and what it would cost the business to replace them.

These tactics are very troubling especially since they are directed at a small business that has always paid its debts. It bothers me that these tactics might be directed at small business owners all over this country, some of whom might not put up a fight or even understand that they can fight back.

Imagine if a bank were doing this to a homeowner who was granted a mortgage based on a certain income level but then lost his job. Would the bank then demand additional fees even though the homeowner continued paying his mortgage from savings? Would the bank start reappraising the property and charging the homeowner the cost?

In my case, it feels as though Bank of America is doing everything in its power to drive my company towards bankruptcy.

Over the past 6 weeks, the bank has initiated without consent the reappraisal of the properties and they have not communicated any information about these appraisals after numerous requests.

I have never had an appraisal of real estate where a request for more capital was not the basis, such as a refinance.

Finally, I was instructed last week that they intended to raid our accounts for the cost of the appraisals. I will fight these fees in court, if necessary, and have advised Bank of America of that fact.

Bank of America has received billions of dollars in taxpayer bailout money. It was my understanding that the money was supposed to be used to help individuals and businessmen through this rough economy. Instead, they have used it to fund a war against their customers.

I have never asked for or expected help from the government, but I also was not expecting an attack on my business from a bank where all my bank loans are current.

It seems to me that Bank of America is trying to pull cash out of my business to benefit theirs. I wonder if I am the only small business they are doing this to.

If Congress treated Bank of America the way they have treated their customers, they would be out of business, and everything that has been said today applies to me. There is so much more to this story, but I appreciate the opportunity to tell it.

Thank you.

[The prepared statement of Mr. Truckenbrodt can be found on page 172 of the appendix.]

Mr. PERLMUTTER. Thank you, Mr. Truckenbrodt.

Those buzzers mean we have some votes. I think we can get through Mr. Berg, and probably Mr. Wilson, and then hopefully Mr. Manzullo before we take a break.

Mr. Richard S. Berg will be our next witness. He is the president and chief executive officer of Performance Trust Capital Partners, LLC.

Mr. Berg?

STATEMENT OF RICHARD S. BERG, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PERFORMANCE TRUST CAPITAL PARTNERS, LLC

Mr. BERG. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee for inviting me to speak today.

My name is Richard Berg. I am the CEO of Performance Trust Capital Partners. We are a broker-dealer specializing in evaluating the risk rewards of fixed income cash flows, including mortgage backed securities. Our customer base consists of community banks throughout the United States who also lend.

My written testimony obviously is beyond the 5-minute span, so I am going to summarize it in the following points, and really was interested in the discussion on the securitization market that no longer exists, because I will address that in this.

Here is question number one. What is the definition of a "toxic asset?" We are spending trillions, we ought to know what that is.

Number two, what makes an asset toxic?

Number three, what are the automatic ramifications once an asset is considered toxic?

Number four, are there assets called "toxic" that should not be called "toxic?"

Number five, what can be done to de-toxify assets?

One of the keys to understanding the toxic problem can be found in recognizing how the use of letter ratings hard coded into investment policies, regulations, collateral agreements, counterparty agreements, can become an automatic mechanism for labeling assets as "toxic."

For regulated institutions like banks and insurance companies, toxic assets are typically identified by the credit ratings provided by the rating agencies.

As you may know, the rating agencies' scale typically goes from AAA to AA to A to BBB to BB to B, all the way down to the letter D.

Most regulations for financial institutions and insurance companies set BBB as the lowest rung for investment grade. Corporate bonds below investment grade are called "junk." Mortgages and other structured product below investment grade are called "toxic."

Let me give you a simplified example. Consider in 2006 that a lender sold 1,000 loans to good creditworthy borrowers and those loans were then sold in the marketplace, packaged as a normal mortgage backed security. Let us say there was a AAA tranche created off that mortgage backed security.

Three years later in 2009, the housing market deteriorated. The economy deteriorated. More people are delinquent than were originally expected.

Let us suppose for the sake of argument that we know enough loans will go bad so the investor of this AAA security will not receive the full 100 percent but will receive 99 percent of the contractual cash flows.

The impact on the yield of the organization or the institution is minimal, maybe going from 6 percent down to 5.95 percent.

I believe everybody in this room will agree that while this is not perfect, this asset is clearly not toxic, but rather remains a high quality one.

I am not sure that everyone in this room is aware that this security, because it is expected to not receive 100 percent of its contractual cash flow but 99 percent, would be rated CCC.

Stated another way, 100 percent of this asset backed by thousands of individual loans is considered toxic because of a very small percentage of loans that default.

Now that the security is well below investment grade, what are the automatic ramifications hard coded into policies, accounting, collateral agreements, and regulatory standing, like the system?

Your capital goes down. There are few buyers of CCC assets, so market prices go down. You have an increase in troubled assets, you are becoming a troubled bank. OTTI says you have an impairment problem, we are going to mark-to-market.

Counterparty agreements are problematic, you have liquidity problems. You have ineligible collateral. You have more liquidity problems.

What is the result of this? You are not going to have a lot of lending and you have a frozen securitization market.

In essence, this security went from a AAA, high quality, liquid, pledgeable security, to 100 percent highly speculative, very illiquid, non-pledgeable security because of a CCC rating based on an expected 1 percent loss in cash flow.

Although the economic difference between getting 100 percent of cash flows and 99 percent is insignificant, the ramifications to a financial institution is devastating because in most cases, the letter rating is hard coded into all the rules, and below investment grade becomes a cliff event.

For decades, letter ratings made sense because all issuers were single obligor issuers, and the rating tried to describe the probability of default, because default was either zero or 100 percent.

For a multiple obligor backed security, like most of the securities backed by loans, the letter scale makes no sense. We know there will be defaults. The question is how many.

The rating scale for multiple obligor assets should be numerically based, because so many existing policies, agreements, collateral agreements, regulation, accounting, is hard coded into these letter ratings.

Billions if not trillions of multiple obligor securities are now considered toxic because they are simply below investment grade, even though many of them will actually incur minimal loss.

We need to change the letter ratings for multiple obligor securities immediately to a numerically based rating system, to more accurately reflect the structure and the risk of multiple obligor securities.

Thank you in this late moment for allowing me to present my opinions.

[The prepared statement of Mr. Berg can be found on page 63 of the appendix.]

Mr. PERLMUTTER. Thank you, Mr. Berg. We really appreciate your testimony.

Mr. Polakoff, I am glad you are still here to listen to this, and I hope that when you leave today, you will share with Mr. Long, Mr. Kroeker, Governor Duke, and Mr. Gruenberg what you are hearing.

This is what we are hearing all the time. It is with justification that we are concerned about the actions that are being taken on behalf of the regulators, that it is just contracting credit at a tremendous rate. We are pouring money in at the top and it evaporates at the bottom.

Mr. Manzullo, why do we not hear from Mr. Wilson and let him ask his questions. Do you want to take a break now, go vote, and the three of us will ask questions when we come back?

Mr. WILSON OF OHIO. Maybe we can explain to them what we are doing.

Mr. PERLMUTTER. Since I do not often sit in the chair, I will apologize. We are voting now on a couple of matters. We will leave and run over to the Capitol. We have two votes.

We will probably be back here in about half-an-hour. With your indulgence, gentlemen, let us take a recess, and when the votes are over, we will be back here to ask you some questions.

Thank you very much.

[recess]

The CHAIRMAN. I apologize to the witnesses. The hearing is concluded. It was very helpful for us to have this, and I apologize for my oversight that you were kept here unnecessarily during the votes. I apologize.

The hearing is concluded. We are going to start the mark-up. The witnesses are excused.

Again, it is my error and I apologize for it.

[Whereupon, at 2:23 p.m., the hearing was adjourned.]

A P P E N D I X

March 25, 2009

Statement by Rep. Michele Bachmann
House Financial Services Committee Hearing
"Exploring the Balance between Increased Availability and Prudent Lending Standards"

March 25, 2009

Thank you, Mr. Chairman.

Today we will hear from a distinguished panel about the mixed messages that the government has injected into the market since it first went down the road of taxpayer bailouts. On the one hand, lending institutions have been scolded for not adequately increasing access to capital, particularly in light of receiving taxpayer funds under the Troubled Asset Relief Program (TARP). On the other, these same institutions have been criticized for their loose underwriting standards and over-lending to borrowers that should not have had access to certain loans in the first place.

Somewhere in between, there must be some middle ground for institutions to regain their footing and strike the right balance. The bottom line here is that we want institutions to offer healthy extensions of credit to responsible borrowers that can afford to repay their loans. Plain and simple.

If our financial markets are to steady, they need some certainty from the government. We must end our trial-and-error approach to this financial mess and we must put an end to the mixed messages we're sending lenders.

I am in constant contact with local bankers from Minnesota's Sixth District to understand their perspective on today's financial marketplace. The number one thing I've heard is their concern regarding mark-to-market accounting.

They continue to tell me that mark-to-market is hindering their ability to accurately and comprehensively report the true value of their balance sheets. It is hurting them at the capitalization level which in turn stops them from making many loans to creditworthy borrowers. That's why it is so critical that FASB and the SEC respond with some certainty to today's economic woes and make changes to mark-to-market standards.

And, I cannot stress enough the absolute responsibility that this Congress has to develop an exit strategy from the bailout approach. The American people deserve to have an end in sight. They deserve to know that we have an actual plan to make taxpayers whole. And, without an exit strategy, uncertainties in the marketplace will continue to rise. This will only make the situation worse, or prolong the market's current instability.

I hope our Committee will take that responsibility seriously in the coming weeks.

Thank you, Mr. Chairman, and I yield back the balance of my time.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
"EXPLORING THE BALANCE BETWEEN INCREASED CREDIT AVAILABILITY AND PRUDENT LENDING STANDARDS"
MARCH 25, 2009

Mr. Chairman, I want to express my sincere appreciation for you holding this important hearing today.

I want to take this opportunity to commend the FDIC for hosting a roundtable discussion earlier this month focusing on how regulators and financial institutions can work together to improve credit availability. It is my understanding that representatives from the banking industry, including community banks, were invited to share their concerns and insights with the federal bank regulators and representatives from state banking agencies. I was pleased to learn that the attendees, who included representatives of community banks, agreed that open, two-way communication between the regulators and the industry is vital to ensuring that safety and soundness considerations are well balanced.

I also want to commend FDIC Chairman Bair for creating a new senior level office at the FDIC to expand outreach to community banks. It is my understanding that the FDIC also plans to establish an advisory committee to address the unique concerns of this segment of the banking community.

However, I am concerned about the pro-cyclical impact the FDIC Board's February 27, 2009 proposal to levy special assessments on insured depository institutions would have on banks in general, and community banks in particular, especially in this extremely stressful economic environment. I believe that the imposition of a 20 basis points special assessment on June 30, 2009 – due September 30, 2009 – and the FDIC Board's proposal to have the authority to impose up to an additional 10 basis points emergency special assessment at the end of any calendar quarter-- could have the unintended consequence of reducing the capital classification of all community banks, thereby resulting in enforcement actions or possibly eventual failures.

Community banks did not contribute in any meaningful way to the massive economic crisis that we confront. Most can serve a customer base rooted in individual communities and are not too big to manage, too big to fail, nor too big to resolve. Almost all of the community banks are still in place meeting the credit-related needs of their communities, stepping up in many instances to fill markets vacated by their larger competitors.

Community banks have sound underwriting standards, are more than capable of managing their reliance on counterparties, and know their customers' needs and capabilities. Taxing community banks with a special assessment of this magnitude when the banking industry is already under siege would have a negative impact on their lending capacity. Each dollar of special assessments they would pay to the Deposit Insurance Fund would result in a ten dollar reduction in their lending capacity.

If the special assessment were implemented as proposed, it would eliminate approximately $4.5 billion of capital available to community banks, and consequently small businesses, customers, consumers, and communities. If that amount were leveraged, it would result in a loss of $45 billion in capital available to community banks for lending activity throughout the United States. At a time when responsible lending is critical to ameliorating the recession, this sort of reduction in local lending has the potential to extend our economic recovery unnecessarily.

If the special assessment were implemented as proposed, it would eliminate approximately $1 billion of capital available to Texas community banks, and consequently small businesses, customers, and communities in Texas. If that amount were leveraged, it would result in a loss of approximately $10 billion in capital available for lending activity throughout Texas alone. As noted, I believe that this sort of reduction in local lending has the potential to extend our economic recovery unnecessarily.

I acknowledge that it is of the utmost importance that the Deposit Insurance Fund remain funded and be replenished to its designated reserve ratio of 1.15 percent over the next 5 to 7 years as proposed. But the vast majority of community bankers in the United States did not participate in the irresponsible lending that has led to the erosion of the FDIC's Deposit Insurance Fund. Community banks are the lifeblood of the communities they serve. They can help stimulate our economy back to health if allowed to do as they have always done -- looking after the needs of local citizens and communities.

I am aware of the agreement between the FDIC and the Congress that the FDIC will cut in half the 20 basis points special assessment up to 10 basis points provided we increase the FDIC's borrowing authority from the Department of Treasury from $30 billion to $100 billion. Recognizing the importance of ensuring the FDIC has all the authority it needs to protect the Deposit Insurance Fund should its Designated Reserve Ratio fall even more, possibly below zero, the House of Representatives passed legislation that would grant the FDIC an additional $70 billion in borrowing authority. I am also aware that the Senate intends to move legislation that would include language providing the FDIC with emergency borrowing authority at the Department of Treasury up to, but not to exceed, $500 billion with very strong checks and balances.

I support these initiatives.

While these are positive steps in the right direction, I think it necessary for the FDIC Board to consider a full range of alternatives to levying an assessment on community banks that could also help sustain the balance of, and confidence in, the Deposit Insurance Fund.

The alternatives to imposing any special assessment on community banks include, but are not limited to, the following:

- Base assessments on assets with an adjustment for capital rather than total insured deposits;

- Impose a systemic risk premium, which would place a heavier burden on financial institutions that pose the greatest risk to the deposit insurance fund;

- Use a combination of the line of credit and a reduced or postponed special assessment; and/or,

- Allow banks to amortize this new expense over several years.

I appreciate the efforts and resolve of the FDIC Board to ensure that the Deposit Insurance Fund is properly funded and fiscally sound in order to assure consumers that their funds are protected up to the prescribed limits by the United States government. I agree with the FDIC and its Board that it is imperative to maintain consumer confidence in our banking system, and sound deposit insurance is one of the cornerstones of their confidence level.

I remain opposed to any assessment on community banks and believe I have provided the FDIC Board with a number of options to ensure the Deposit Insurance Fund's stability while minimizing the impact on community banks' ability to keep money working in communities throughout the United States.

I hope the Board will take my recommendations into consideration.

I yield back the remainder of my time.

Opening Statement
Congressman Gary C. Peters
March 25, 2009 Financial Services Committee Hearing
Exploring the Balance between Increased Credit Availability
and Prudent Lending Standards

- Thank you Chairman Frank for holding this important hearing. The current financial crisis has had a particularly pronounced effect on my Congressional District, and on the State of Michigan generally. In the last few months I have held meetings and roundtables with businesses large and small that have told me that they are having an extremely difficult time accessing credit.
- We held a hearing last month with the heads of the eight largest TARP recipients, and I asked the witnesses at that hearing point blank whether they had reduced the amount of lending activity in the State of Michigan. The answers I received both at the hearing and afterwards indicated that the largest financial institutions had indeed stopped lending in Michigan due to such factors as the uncertainty in the auto industry and high unemployment.
- What that means is that in my state we are particularly dependent on the community banks to support the kind of business activity that is going to help bring us out of this recession. Like many other members of this Committee, I have been meeting with and talking to community bankers throughout my District in Oakland County and I have heard from many of them about this issue. They want to lend more money, and they have good projects identified, but they are under enormous pressure to preserve capital.
- This pressure is clearly having a negative effect in Michigan, and I'll provide just one example of this. We have a huge foreclosure crisis in Michigan, and Congress has been calling on lenders to perform mortgage modifications to help home owners stay out of trouble. However, when a bank modifies a mortgage to make the payment affordable it is required to treat that loan as a nonperforming asset. This brings about greater regulatory scrutiny, and can be used as an indicator that the bank is a troubled institution.
- In Southeast Michigan real estate values have dropped by 50% or more, and the foreclosure rate is among the highest in the nation. If regulators punish banks that are performing mortgage modifications it will mean even more foreclosures in my Congressional District. I understand the need for ensuring that are banks are adhering to prudent lending standards, but I am deeply concerned that the unintended consequences of these types of actions are not being fully considered.
- Once again, I would like to thank Chairman Frank for holding this important hearing. I look forward to hearing the witnesses address this issue.

Testimony to the U.S. House of Representatives Committee on Financial Services
March 25, 2009

Thank you Chairman Frank, Ranking Member Bachus, and members of the Committee on Financial Services for inviting me to speak to you today. The United States and the world are enduring financial stresses never before seen in terms of their uniqueness and complexity. I applaud Congress for exploring ways to help get credit flowing to jump start the economy.

My name is Richard S. Berg, and I am the CEO of Performance Trust Capital Partners, LLC. I co-founded Performance Trust in 1994 as a broker-dealer specializing in evaluating the risks and rewards of fixed income cash flows, including mortgage-backed securities. Our customer base consists of community-based financial institutions who lend to businesses and individuals throughout the United States. I believe that we have a front row seat to help identify and explain some of the issues facing the financial markets as they relate to mortgage lending and mortgage-backed securities.

Performance Trust did not engineer, create, or underwrite any securitized assets or sell any at origination. In the interest of full disclosure, we have sold private label mortgage-backed securities to our clients The vast majority of purchases were made subsequent to the start of this crisis at discounted to deeply discounted dollar prices. We did not transact in any subprime or affordable ARM products.

We view investing from a long term perspective. Our philosophy of investing is about measuring interest rate risk and reward in different rate scenarios, as well as credit risk and reward in different economic or default scenarios. We typically do not predict any scenario to occur, but rather look for asymmetrical risk reward opportunities. Actual results for the scenario that occurred are then compared to the projected returns.

As a frequent industry speaker as well as market commentator, I have encountered many other executives and market participants who have insights to the extraordinary problems and dislocations in the credit and stock markets. Unfortunately, there is no "silver bullet" to immediately fix our problems. The issues are complex and interrelated, much like a Rubik's cube—just when you think you have one side solved the other sides of the face change. Sometimes the best way to solve a very complicated problem is to begin by asking the question, "What is not working?" If we eliminate things that are not working, we have a better chance of finding things that will work.

As I speak around the United States and on the financial news stations, no phrase evokes more emotion than the phrase "toxic assets." News commentators, accountants, regulators, and even politicians cite toxic assets as a significant reason we are in this mess. For the past

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few months I have asked bankers, accountants, the media, and traders this question: "**What is the definition of a toxic asset**?" This is actually a trillion dollar question. Not surprisingly, there is no clear cut definition of a toxic asset. In fact, the definition depends on whom you are asking. This is very problematic. As Congress and Treasury form plans for removing toxic assets off the books of financial institutions through tax payer assistance in order to get credit flowing again, we need to correctly define toxic assets.

We do acknowledge there are bad assets, credit impaired securities and poorly run banks. However, I am here today to tell you that in some cases, we are incorrectly defining toxic assets. Many assets labeled toxic are not that toxic and in some cases may not be toxic at all. To put it another way, millions of performing mortgage loans are now considered "toxic" because they are placed in the same security as some non-performing loans. If one in ten loans goes bad, the other nine performing loans also get called toxic.

Why is this the case? One of the keys to understanding the toxic problem can be found in recognizing how the use of letter ratings hard coded into investment policies, regulations, and counterparty agreements can become an automatic mechanism for labeling assets as toxic. In the regulated world of financial institutions and insurance companies, there are current policies in place that attempt to identify toxic assets, or at least plant a red flag for an accountant, examiner, regulator, or counterparty when they review the books of one of these institutions. For these institutions, toxic assets are typically identified by the credit ratings provided by an outside Nationally Recognized Statistical Ratings Organization ("NRSRO") such as Moodys, Standard & Poors, or Fitch. As you may recall, the ratings scale typically ranges from AAA, AA, A, BBB, BB, B, CCC, CC, C, down to D (default). Most regulations for financial institutions and insurance companies set BBB as the lowest rung for investment grade. Corporate bonds below investment grade are referred to as junk, where as mortgages and other structured debt below investment grade are often called toxic.

As a simplified example, consider a Private Label Mortgage-Backed Security ("PMBS") issued in 2006 (see also Exhibit 1). Suppose that a lender originated 1,000 first lien mortgage loans in 2006 to credit worthy borrowers, sold these loans in the marketplace, which were then packaged into a mortgage-backed security. Traditionally, a bank or insurance company would be a typical buyer for the safest class (tranche), the AAA security built off these loans.

Three years later, in 2009, given that the housing market and the economy have deteriorated, more than the originally expected amount of borrowers are going into delinquency and are likely headed for default. Suppose for the sake of argument that we *know* that enough loans will go bad so that the investor of this AAA security now will not receive the full 100% of the contractual cash flows, but rather receive 99% of that security's contractual cash flows. The impact on the yield for the bank or insurance company is minimal, perhaps dropping from 6.00% to 5.95%.

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I believe that everyone in this room would agree that while this is not ideal, this asset is clearly not toxic, but rather remains a very high quality one. However, I am not sure that everyone would be aware that once this security is not expected to return 100% of the contractual cash flow, it would now be rated CCC and be considered toxic. Stated another way, the full 100% of this asset backed by a thousand individual loans is considered toxic because a very small percentage of loans default.

Surely, the risk of such a security should not be viewed as exactly the same as a CCC rated corporate bond, say for example, a CCC rated Lehman Brothers senior debenture. This speaks to the definition of what a rating really reflects (see Exhibit 2). When the rating agencies provide a rating on a mortgage-backed security, it is a measure of "default" risk, that is the risk of not receiving 100 cents on the dollar. However, the rating is silent on the magnitude of expected losses. On a security backed by hundreds of loans, a single extra loan going bad can be the tipping point that causes the rating to drop from investment grade to non-investment grade. The incremental economic impact is minimal but rating implications can be significant. Many former AAA senior class PMBS securities are in such a position. Not all are expected to return 99% but even under harsh scenarios, a large majority is expected to return 90% or more.

Because financial institution and insurance company regulations often have hard coded a security's rating into policy language, a CCC rating may trigger cascading negative actions or reactions by accountants, regulators, counterparties and investors. As you may recall in the recent FASB hearing, a CCC security would typically cause a security to become other than temporarily impaired ("OTTI") from an accounting perspective. In this current example, even though the credit loss might only be 1%, the previous mark-to-market requirements for many institutions have contributed to massive write downs.

For a financial institution and insurance company, securities held that are rated below investment grade are often considered substandard and therefore "classified" as such. Institutions with too many classified assets may be viewed as "troubled." In the provided example, should an institution own $10 million of this CCC rated security, the entire $10 million may be classified as substandard. Incidentally, if the institution had exposure to these loans in an unsecuritized form and held them in their loan portfolio, only the portion of the loans that were non-performing would be automatically considered substandard or impaired.

The required capital for below investment grade (typically substandard) assets increases as well. For example, the risk-based capital required for a bank that owns the previous AAA but now CCC rated security is 500% greater. An insurance company has a similar capital "tax" for lower rated assets. Besides the negative effect on capital, asset downgrades affect the liquidity and other counterparty agreements that have hard coded the letter ratings provided by NRSROs into the language.

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The idea of third party credit evaluation began more than one hundred years ago. Regulators, investors, and creditors have used third party opinions of credit quality for many years. For the most part, this third party system has served us well. As we see it, the problem stems from the fact that we are trying to apply a corporate ratings scale to structured products. Long ago the companies supplying an opinion about the credit worthiness of an issuer or "obligor" did so by assigning a letter rating ranging from AAA to D. The letter rating is supposed to indicate the probability of default of the obligor. bbAlthough BBB is the lowest investment grade rating, a B rating is actually the lowest rating assigned to an obligor who is still expected to pay its obligation.

The financial world has become a more complicated place since the inception of the letter ratings scale, and we now have multiple obligor securities like today's structured products (mortgage loans, auto loans, student loans, trust preferred obligations, CLOs, CDOs, etc.). In order to remain consistent and uniform with previous practice and existing regulations, virtually all longer term products (beyond one year), whether they be single obligor or multiple obligor securities utilize the existing letter scale established decades ago. While there are advantages to using the same scale, the disadvantages far outweigh the advantages in this market environment. For instance a CCC rated corporate bond has very different, and in most cases much greater principal at risk than a CCC rated multiple obligor mortgage-backed security. In addition, in the case of single obligor securities, an obligor either makes 100% of the payment or 0%, that is there are no partial defaults. Multiple obligor securities can have partial defaults. Thus, single obligor and multiple obligor securities have very different risks. Unfortunately, because of the reliance on the rating, they are treated much the same for accounting and regulatory purposes.

For multiple obligor securities, a better and more accurate ratings scale would be some type of percentage rating that indicates actual dollars at risk. This makes sense, since the issuer is only a trust that passes through payments received from many hundreds, if not thousands of homeowners. In reality, one *should* expect partial defaults for a multiple obligor security, and in my opinion a simple letter rating does not fit the actual risk analytics or structure.

What is the Rubik's cube effect or systemic effect of ratings downgrades, especially amongst financial institutions and insurance companies? In my opinion, the systemic effect is huge, and significantly contributing to the downward spiral we are now witnessing. Unfortunately, credit ratings are hard coded into many of our current regulations, capital calculations, counterparty agreements, collateral agreements, and investment policies. As an institution creeps closer to mandatory regulatory or policy minimums in these areas, it has less tolerance for any risk taking and will hoard more cash.

How then do we fix this problem so that banks can get back to lending to credit worthy borrowers? The complete solution would be to change the way multiple obligor securities are rated. I would immediately revamp the letter based scale to a numerical based scale for multiple obligor securities. If a security is rated CCC, it is treated as toxic. What if the

rating instead was 99% (expected recovery of 99% of contractual cash flow) rather than a letter rating of CCC? Clearly if a security is rated 99%, then if I purchased it at 100 cents on the dollar I am exposed to some small amount of expected loss (1%). However, if I purchased it at 70 cents on the dollar, I currently have little exposure to loss. Even if a security had a rating of 85% it would be low risk at a purchase price at 70 cents on the dollar. Such a numerically based rating system would moderate the cliff diving effect caused from the current letter rating system of a multiple obligor security that is close to "default" but has only a small proportion of loans that are truly "speculative" or toxic. Policies, regulations, counterparty agreements, and collateral agreements could be set to haircut a security based on the new numerical based system. This numerical based risk assessment and data already exists in the NRSROs' models and evaluation tools

In summary, there are toxic assets, but many assets currently called toxic are not. Use of a single obligor type rating scale for multiple obligor securities is problematic on several fronts, most notably that billions of dollars of current paying loans are now considered toxic by virtue of ratings downgrades. Some of these problems can be minimized with a change in the way certain accounting and regulatory documents are interpreted. We strongly believe that a critical step to restore credit markets is a revamp of the rating system for multiple obligor securities like mortgage-backed securities. Unless a major change is made, it will be very difficult to clean up previously issued securities – those already downgraded, or those feared to be downgraded in the future – without significant government assistance. The current discussion involving loan modifications will certainly cause a whole new round of downgrades and create more toxic assets if this ratings issue for multiple obligor securities is not addressed.

Likewise, going forward market participants will likely permanently avoid any multiple obligor securitized loan product that utilizes a letter grade system for fear of potential future downgrades which taint the entire security rather than the problematic portion. The trillions of assets already or feared downgraded is currently clogging the securitized credit markets. Until we recognize and address the Rubik's cube of how our ratings, accounting and regulatory systems intersect, our attempts to correct our financial system will fall short.

Thank you for allowing me to present our views and ideas to you.

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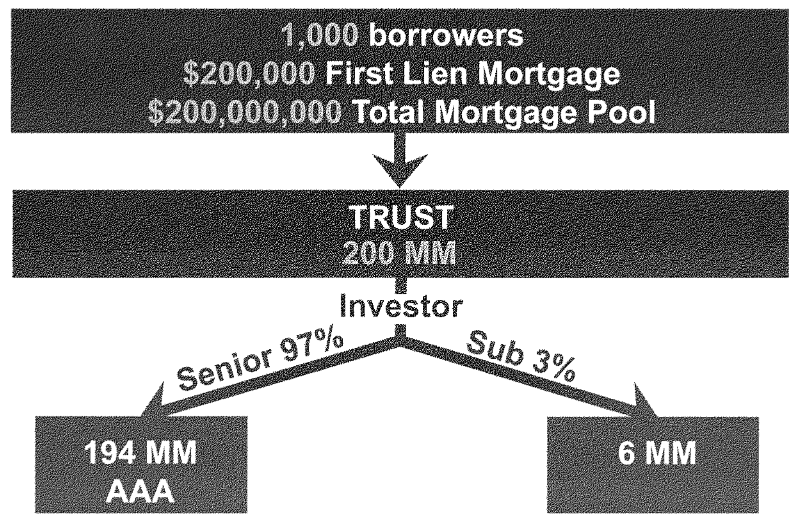
Exhibit 1:

PMBS Example

Simple Example - 2006



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Simple Example – 2009

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Assumptions:

- Over the next 27 years, total of 8% will default
- Each liquidated loan will lose 50% (severity)

Total Pool Loss	=	defaults x severity
	=	8% x 50%
	=	4%
	=	$8,000,000 Pool Loss

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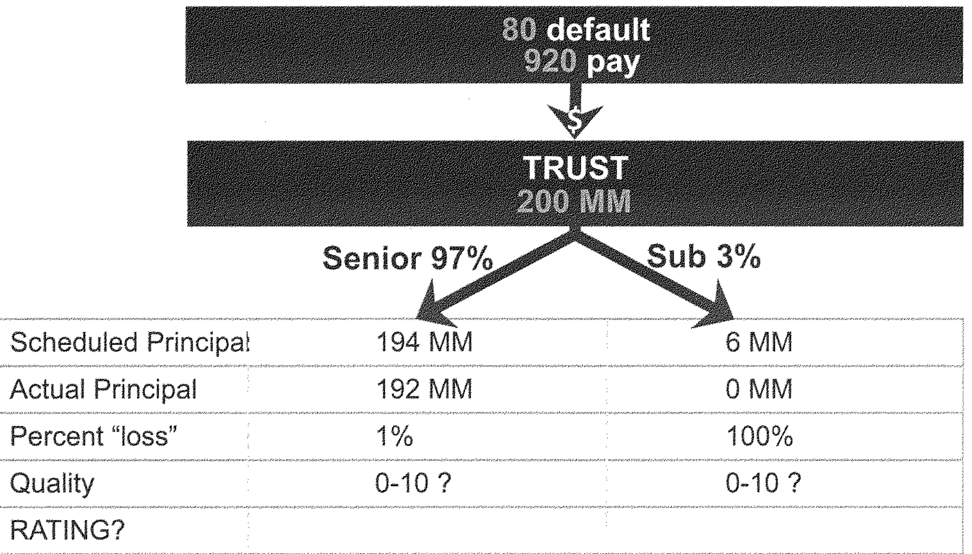
Simple Example – 2009



	Senior 97%	Sub 3%
Scheduled Principal	194 MM	6 MM
Actual Principal	192 MM	0 MM
Percent "loss"	1%	100%
Quality	0-10 ?	0-10 ?
RATING?		

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Ratings

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Rating	Definition
AAA	An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA	An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A	An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
BBB	An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
BB	An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
B	An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.
CCC	An obligation rated 'CCC' is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

Standard & Poor's Rating Definitions

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Ratings Methodology

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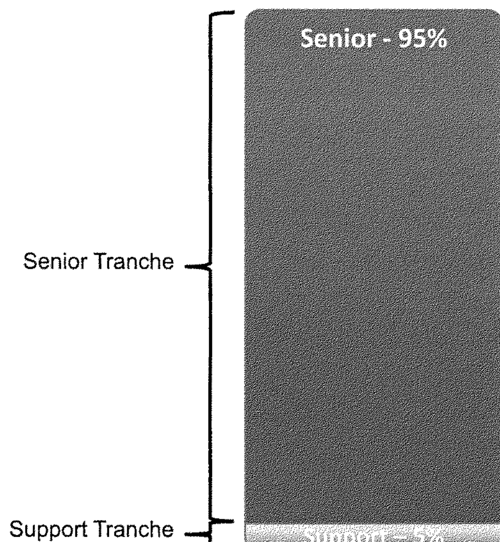
- Senior tranches have credit protection via the support tranches. Supports sit in the first loss position. Senior tranches incur no losses until the supports are gone.
- In this case, a 5% loss in principal would be required to exhaust the support tranche and incur the first $1 of loss to the senior tranche.
- Default * Severity = Loss



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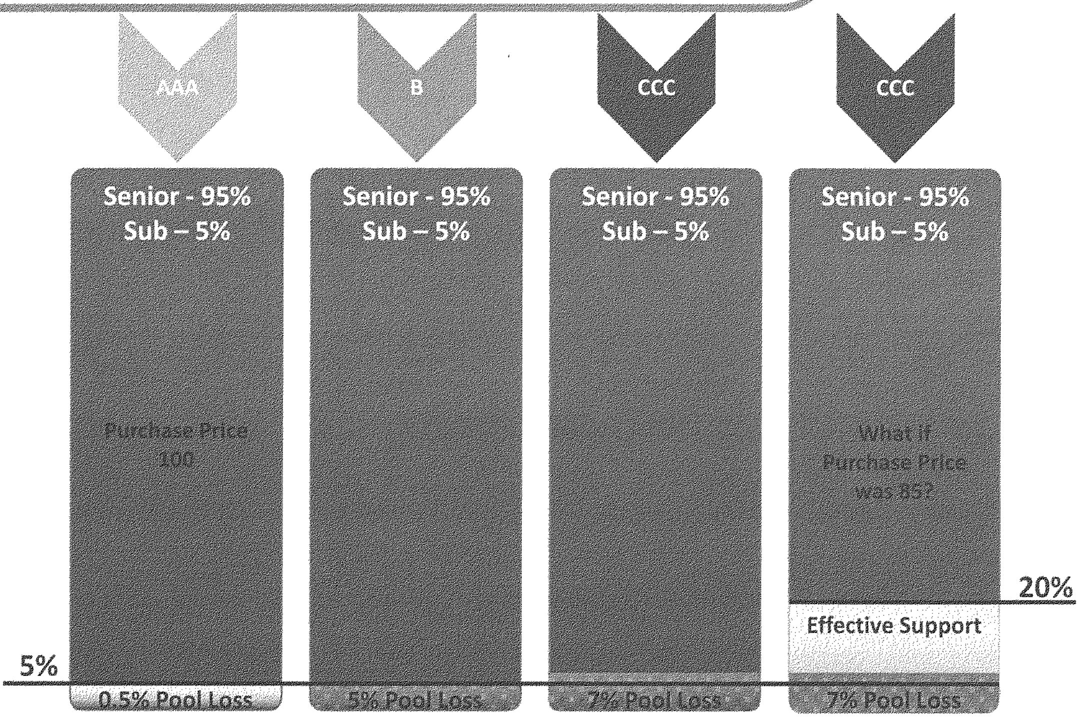

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Single Obligor

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Single Obligor

- Rating is probability of default
- Rating is silent on magnitude of loss
- Default 0% or 100%
- Severities typically large

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Multiple Obligor

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Multiple Obligor Security

- Rating is probability of default
- Rating is silent on magnitude of loss
- Can have "partial" defaults unlike single obligor credits
- Severities are much smaller than single obligor credits (home is collateral)

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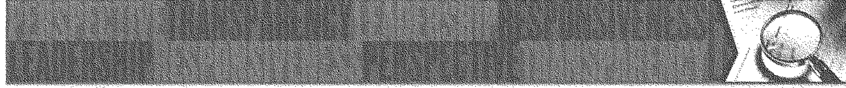
Exhibit 2:

Fitch and S&P Ratings

FitchRatings
KNOW YOUR RISK



Inside the Ratings:

What Credit Ratings Mean

August 2007

Defining Creditworthiness

Credit ratings can apply both to entities and to individual obligations, and can be broadly separated into two types.

1. **Ratings Which Address Relative Likelihood of Default ("First Dollar of Loss")**

   Corporate, bank, insurance and sovereign issuers are typically assigned Issuer Default Ratings (IDRs), which express creditworthiness in terms of relative measures of default likelihood.

   Structured finance ratings are typically assigned to an individual security or tranche in a transaction, and not to an issuer. Ratings in structured finance primarily reflect the relative probability of default of the rated liability[2], and not its loss severity given a default, although loss severity on underlying *assets* is incorporated in the analysis.

2. **Ratings Combining Relative Default Likelihood and Loss Severity**

   Individual securities or obligations of a corporate or sovereign issuer, in contrast, are rated on the long-term scale taking into consideration *both* the relative likelihood of default and the recovery given default of that liability. As a result, individual securities of entities, such as corporations, are assigned ratings higher, lower, or the same as that entity's issuer rating or IDR. The difference between issuer and security rating reflects expectations of the relative recovery prospects for each class of obligation. At the lower end of the ratings scale, Fitch now additionally publishes explicit Recovery Ratings in many cases to complement issuer and issue ratings.

	Corporate & Sovereign Finance	Structured Finance
Issuer	Rating covers Default	-
Issue	Rating covers Default/Loss Severity	Rating covers Default[2]

Foreign and Local Currency Ratings

International credit ratings relate to either foreign currency or local currency commitments and, in both cases, assess the capacity to meet these commitments using a globally applicable scale. As such, both foreign currency and local currency international ratings are internationally comparable assessments.

The local currency international rating measures the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled and hence does not take account of the possibility that it will not be possible to convert local currency into foreign currency, or make transfers between sovereign jurisdictions (transfer and convertibility risk).

Foreign currency ratings additionally consider the profile of the issuer or note *after* taking into account transfer and convertibility risk. This risk is usually communicated for different countries by the Country Ceiling, which 'caps' the ratings of most, though not all, issuers within a given country.

[2] At the distressed level, elements of loss severity may be incorporated in structured finance bond ratings in the 'B' and 'C' categories

The Fundamentals Of Structured Finance Ratings

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Structured finance has become an increasingly important tool in today's financial markets, with issuance levels growing at an extraordinary rate in the past few years both in the U.S. and Europe, as well as in most markets in AsiA-Pacific. Its development has been accompanied by vocal debate from market participants and commentators alike on the manner in which credit rating agencies, including Standard & Poor's Ratings Services, evaluate the creditworthiness of such securities.

Our goal in this article is to demystify some of the complexity that surrounds the structured finance[1] discipline by addressing as directly as possible the primary concerns that have been raised. We think that doing so may also alleviate many of the concerns that have been expressed about the manner in which we arrive at our rating opinions and the process involved.

THE PROCESS OF ASSIGNING STRUCTURED FINANCE AND "TRADITIONAL" CORPORATE OR SOVEREIGN RATINGS

Understanding The Rating Process

The fact that the structured finance rating process involves a degree of interaction and that arrangers may change structures to meet rating agency criteria has led some commentators to muse whether the ratings analyst becomes an advisor. The answer is no. Moreover, any such inference is a fundamental misunderstanding of the role and actions of the rating agencies in structured finance.

When a non-structured finance debt issuer seeks a rating or approaches us to discuss an existing rating, it will engage in a dialogue with our rating analysts. It will seek to explain the way it sees its own strengths and its place in the economic and financial environment in which it operates. The analysts will then take this information away and an analytical committee will reach a conclusion and assign an initial rating, make a rating change, or issue a rating confirmation.

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1 Neither the terms "structured finance" nor "securitization" yet have clear definitions. For the purposes of this paper, both will be used interchangeably.

When we have rated new CDO structures some commentators have occasionally expressed the view that we were entering a totally new field of previously unrated, unexamined structures or credits. Others have expressed the view that a new CDO structure requires us to create an entirely new methodology. Both these views are erroneous, for the reasons given above.

A case in point is the rating of constant proportion debt obligation (CPDO) transactions, where part of our tranche default risk assessment is based on a market value analysis of certain credit derivative indices. Clearly, CPDOs were a new instrument. What was not a new development for us was analyzing market value risk as the basis for a structured finance rating. In fact, market value analysis is a key component of many different structured finance ratings and has been for many years. All RMBS ratings require an analysis of residential property values and their movement over time. Most auto loan ABS transactions require the same for cars, aircraft ABS transactions for aircraft. Over the years we have also rated equity basket CDOs that required analysis of equity market values. A number of transactions have required us to model foreign exchange risks and determine the market value of various currencies. As we have pointed out, even the most complex CDOs are usually variations of well-understood themes; variations on structures that we often have a long experience of rating. CPDOs and the analysis of market value risks is just a case in point.

RATINGS ADDRESS DEFAULT RISK

Meaning Of The Ratings

Another topic of criticism is our use of a single rating scale (see our ratings definitions for Standard & Poor's rating scale, detailed under "***Related Articles***" below) for different types of debt. Some argue that, although structured finance, corporate, and government ratings use the same symbology, a structured finance rating is somehow different from a corporate rating. Sometimes, critics even apply the argument to different asset classes within the structured finance universe: an RMBS rating is claimed to be different from that of a synthetic CDO. The claim is that investors are being misled, as they do not understand the crucial differences between the ratings.

First, it is important to understand the intended meaning of a credit rating. Our ratings are an opinion on the default risk associated with either an issuer or an issue, as of today, based on all the information we have in our possession. Our rating speaks to the likelihood of default, but not the amount that may be recovered in a post-default scenario.

The definitions of each rating category also make clear that we do not attach any quantified estimate of default probability to any rating category. In other words, even though our default and transition studies may indicate that the annual average default rate of 'BBB' structured finance securities between 1987 and 2007 was 0.18%, this does not mean that a 'BBB' rating is a mathematical prediction of a 0.18% default probability. It also follows that we have never claimed that, should a particular set of 'BBB' rated debt suffer a 0.37% default rate, for example, those ratings were somehow wrong or inaccurate. To attach precise expected default rates to any rating category is to imbue the rating process with a degree of scientific accuracy that it could not possibly bear, and which has never been claimed for it.

Let us remember that a rating is only an opinion about the relative likelihood of future events (i.e., default or non-default). Such an opinion may, in the case of Standard & Poor's, be based on an enormous amount of analysis and data, but in the end it remains no more than an opinion. Forward-looking predictions have never been an exact science and rating agencies have never made claims to the contrary.

For release on delivery
10:00 a.m. EDT
March 25, 2009

Statement of

Elizabeth A. Duke

Member

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

March 25, 2009

Chairman Frank, Ranking Member Bachus and members of the Committee, I am pleased to appear today to discuss several issues related to the state of the banking system. First, I will discuss the condition of the banking system, credit conditions, and bank underwriting standards. Then I will describe Federal Reserve activities to enhance liquidity in financial markets and improve conditions in financial markets. Finally, I will discuss the Federal Reserve's efforts to ensure the overall safety and soundness of the banking system as well as promote credit availability.

As you are well aware, the Federal Reserve has taken significant steps to improve financial market conditions, and has worked with the Treasury and other bank and thrift supervisors to address issues at U.S. banking organizations. We remain attentive to the need for banks to remain in sound financial condition while at the same time to continue lending prudently to creditworthy borrowers. Fortunately, many banks continue to lend in this environment, but with the shutdown of most securitization markets and the evaporation of many types of nonbank credit, it is that much more important right now for the U.S. banking system to be able to carry out its credit intermediation function.

Background

The Federal Reserve has supervisory and regulatory authority for bank holding companies, state-chartered banks that are members of the Federal Reserve System (state member banks), and certain other financial institutions and activities. We work with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, foster the stability of the financial system, and provide for fair and equitable treatment of consumers in their financial transactions. The Federal Reserve is not the primary federal supervisor for the majority of commercial bank assets. Rather, it is the consolidated

supervisor of bank holding companies, including financial holding companies, and conducts inspections of those institutions.

The primary purpose of inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the soundness of the company's depository institutions. In fulfilling this role, the Federal Reserve is required to rely to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the company's bank, securities, or insurance subsidiaries. The Federal Reserve is also the primary federal supervisor of state member banks, sharing supervisory responsibilities with state agencies. In this role, Federal Reserve supervisory staff regularly conduct on-site examinations and off-site monitoring to ensure the soundness of supervised state member banks.

The Federal Reserve is involved in both regulation--establishing the rules within which banking organizations must operate--and supervision--ensuring that banking organizations abide by those rules and remain, overall, in safe and sound condition. A key aspect of the supervisory process is evaluating risk-management practices. Because rules and regulations in many cases cannot reasonably prescribe the exact practices each individual bank should use for risk management, supervisors design policies and guidance that expand upon requirements set in rules and regulations and establish expectations for the range of acceptable practices. Supervisors rely extensively on these policies and guidance as they conduct examinations and assign supervisory ratings.

Beginning in the summer of 2007, the U.S. and global economies entered a period of intense financial turmoil that has presented significant challenges for the financial services industry. These challenges intensified in the latter part of 2008 as the global economic

environment weakened further. As a result, parts of the U.S. banking system have come under severe strain, with some banking institutions suffering sizable losses.

State of the Banking System

I would now like to briefly summarize overall conditions at U.S. commercial banks and large banking holding companies (BHCs). For U.S. commercial banks as a group, profitability measures deteriorated dramatically during 2008. Indeed, commercial banks posted a substantial and rare aggregate loss for fourth quarter of 2008, the first time this has happened since the late 1980s. This loss in large part reflected write-downs on trading assets, high goodwill impairment charges, and, most significantly, increased loan-loss provisions taken in response to deteriorating asset quality, higher net charge-offs, and weakening economic conditions. As of year-end 2008, loans delinquent 30 days or more or on nonaccrual status exceeded 4.5 percent of total loans, the highest level since the early 1990s. Moreover, nonaccruing loans--those most likely to result in additional charge-offs--reached almost two-percent of loans, a ratio more than double that of year-end 2007. Despite poor earnings performance, capital ratios held up relatively well, with reported tier 1 and total risk-based capital ratios increasing over the course of the year. The performance of state member banks tracked that of the industry as a whole.

The earnings performance of the 50 largest U.S.-based bank holding companies (BHCs) as a group, which together represent more than three-fourths of all assets at BHCs, deteriorated rapidly during the last two quarters of 2008. In aggregate, these companies reported a fourth quarter net loss of $42.7 billion--versus a $25.5 billion third-quarter loss--due mainly to elevated loan-loss provisions, very large goodwill impairment charges, and a continuation of heavy trading asset write-downs. For the year, these companies generated a $67 billion loss. Nonetheless, regulatory capital ratios actually improved during 2008--supported by substantial

private capital investments in these companies during the first half and by the Troubled Assets Relief Program (TARP) investments by the U.S. Treasury toward the end of the year. As a consequence, these bank holding companies in aggregate continued to maintain capital ratios well in excess of minimum regulatory requirements.

Conditions in Credit Markets

As Chairman Bernanke noted in presenting the Board's most recent monetary policy testimony to Congress in February, the U.S. economy is undergoing a severe contraction. From past experience, we know that borrowing by households and nonfinancial businesses has tended to slow during economic downturns. Since 1953, the inflation-adjusted growth rate of debt owed by households and nonfinancial businesses has fallen, on average, about 2 percentage points at an annual rate in the year following a business cycle peak (as dated by the National Bureau of Economic Research, or NBER). The inflation-adjusted slowdown in debt growth during the past year has been much more pronounced than in previous downturns: Annualized debt growth for households and nonfinancial businesses in the fourth quarter of 2008 (the most up-to-date reading) was, adjusted for inflation, about 7 percentage points slower than it was during the NBER-designated peak in the fourth quarter of 2007.

The slowdown in debt growth has differed by type of borrower. For example, after increasing nearly 6 percent in the fourth quarter of 2007 (unadjusted for inflation), home mortgage debt declined at an annual rate of 1.5 percent in the fourth quarter of last year. The decline in home mortgage debt has been sharper in this period than in any other recession for which we have good data--dating back to the 1950s. Non-mortgage consumer credit also declined in the fourth quarter of last year--at an annual rate of 3.25 percent. The pull-back in consumer credit has also been somewhat sharper than the average experience during the previous

nine NBER recessions. Among businesses, growth in debt for nonfinancial corporations slowed from a 12.5 percent annual rate in the fourth quarter of 2007 to a 1.5 percent annual rate in the fourth quarter of last year. The slowdown in debt growth for this sector is also more substantial than has been experienced in past recessions.

This simple comparison of the current slowdown in credit market flows to those in previous recessions ignores the many important changes to the financial landscape that have occurred during the past half-century. Significant among those changes was the large increase in the flow of credit coming from nonbank sources. For example, holdings of household mortgages by banks, savings institutions, and credit unions decreased from a share of more than 50 percent in 1985 to a share of about 30 percent of the total at the end of 2007. Similarly, banks held about 70 percent of outstanding consumer credit in 1985, but only about 45 percent in 2007. Of course, banks remain vital financial intermediaries, as the current financial crisis demonstrates. The severe turmoil in markets for securitized assets has served to increase banks' importance. And the significance of banks in the provision of credit extends far beyond their direct loans. Banks supply credit indirectly by providing back-up liquidity and credit support to other financial institutions and conduits that also intermediate credit flows.

In 1950, banks' share of financial intermediation was about 50 percent, it fell and then rose to about 48 percent in the mid-1970s, then declined to about 33 percent at the turn of the century. If one adjusts the data to include "credit equivalents" for the off-balance-sheet activities of banks, then the adjusted market share of financial intermediation for banks would remain above 40 percent in recent years.

In terms of direct lending, weekly data that the Federal Reserve Board collects from banks shows that total bank loans and leases increased almost 4 percent during 2008. The

increase in bank lending for the year as a whole was below the roughly 10 percent pace of growth seen in both 2006 and 2007. Much of the increase in bank lending last year likely reflected households and businesses drawing down existing lines of credit rather than extensions of new loans. In addition, the freeze-up of the securitization markets likely contributed to banks' balance sheet growth.

According to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, banks have tightened lending standards sharply over the past 18 months. The January 2009 Survey found that respondents had tightened their lending policies for all major loan categories further in late 2008. Respondents also indicated that demand for loans from both businesses and households continued to weaken, on balance, over the survey period.

With regard to commercial loans in particular, many survey respondents pointed to a less favorable or more uncertain economic outlook as a reason for tightening their lending standards and terms over the previous three months. Most respondents indicated that a worsening of industry-specific problems and their bank's reduced tolerance for risk were also important factors in their decision to tighten lending policies for commercial loans. Among the few respondents that saw an increase in loan demand over the previous three months, all indicated that business borrowing had shifted to their bank from other bank or nonbank sources because the other sources had become less attractive. In addition, more than 30 percent reported that inquiries from potential business borrowers had decreased during the survey period.

For commercial real estate (CRE) lending, 80 percent of domestic banks reported that they had tightened their lending standards over the previous three months, slightly less than the roughly 85 percent that reported doing so in the October survey. Of note, about 30 percent of the respondents indicated that the shutdown of the commercial mortgage backed-securities (CMBS)

securitization market had led to an increase in CRE lending at their bank over the second half of 2008, whereas about 15 percent indicated that the shutdown of the CMBS securitization market had reduced the volume of their CRE lending.

Survey respondents also noted continued tightening for consumer products, including residential real estate lending and revolving home equity lines of credit (HELOCs). Notably, only four of the nearly 80 respondents reported making subprime mortgage loans over the previous three months.

Stepping back, it is now clear that in recent years banking and financial markets experienced a period in which risk was generally under-priced and where credit was too freely available. The realization by many market participants that risks were larger than anticipated has contributed to the decline in prices for financial assets. As a result, some financial institutions--including some banking organizations--have experienced significant losses, leading to the need to raise additional capital or, in some cases, sell or shut down operations. It is apparent that all banking institutions have now been impacted in some way by the adverse conditions of the current environment.

Federal Reserve Actions Since 2007

The Federal Reserve has responded forcefully to the financial and economic crisis and it will continue to do so. In discussing Federal Reserve actions, I will first summarize monetary policy actions and those related to liquidity provision, and then highlight our supervisory actions.

Monetary Policy and Liquidity Provision

In terms of monetary policy, the Federal Reserve has been aggressive. As you know, the Federal Open Market Committee (FOMC) began to ease monetary policy in September 2007, and in December 2008, the Committee set a range of 0 to 25 basis points for the target federal

funds rate. We have also employed additional tools to ease financial conditions, improve the functioning of credit markets, and thereby support economic activity. To improve mortgage market functioning and support housing markets and economic activity more broadly, the Federal Reserve has begun to purchase large amounts of agency debt and mortgage-backed securities, and we recently announced substantial additional purchases of such securities through year-end. In addition, the Federal Reserve announced plans to purchase up to $300 billion of long-term Treasury securities to help improve conditions in private credit markets. Since first announcing such purchases last November, the conforming fixed mortgage rate has fallen more than 1 percentage point.

The Federal Reserve has also established new lending facilities and expanded existing facilities to enhance the flow of credit to businesses and households. In response to heightened stress in bank funding markets, we increased the size of the Term Auction Facility to help ensure that banks could obtain the funds they need to provide credit to their customers, and we expanded our network of swap lines with foreign central banks to ease conditions in interconnected dollar funding markets at home and abroad. Last fall, when money markets tightened considerably following the failure of Lehman Brothers, we established new lending facilities to provide liquidity to money market mutual funds and to support the functioning of the commercial paper market.

The U.S. Treasury, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve have taken a number of actions to strengthen the financial sector and to promote the availability of credit to businesses and households. This included injecting additional capital into banks, increasing FDIC deposit coverage, providing guarantees of selected senior bank obligations and noninterest-bearing deposits, and establishing new liquidity facilities to financial

markets. In addition, the Federal Reserve and the Treasury recently launched the Term Asset-Backed Securities Loan Facility (TALF) to facilitate the extension of credit to households and small businesses and anticipates that the range of eligible collateral for this facility is likely to be expanded to other financial assets. The Federal Reserve expects to assist in the Treasury's Public-Private Partnership Investment Program, announced on Monday, by expanding the range of collateral eligible for the TALF program to include certain legacy securities.

Supervisory Activities and Improvements to Risk-Management Practices

Many of the current problems in the banking and financial system stem from risk-management failures at a number of financial institutions, including some firms under federal supervision. Clearly, these lapses are unacceptable. The Federal Reserve has been involved in a number of exercises to understand, document and help address the risk-management lapses and shortcomings at major financial institutions, including those undertaken by the Senior Supervisors Group, the President's Working Group on Financial Markets, and the multinational Financial Stability Forum. [1]

Based on the results of these and other efforts, the Federal Reserve is taking vigorous steps to improve risk-management practices at regulated institutions. Our actions have covered liquidity risk management, capital planning and capital adequacy, firm-wide risk identification, residential lending, counterparty credit exposures, and commercial real estate lending, among other areas. Liquidity and capital have been given special attention.

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[1] Senior Supervisors Group (2008), "Observations on Risk Management Practices during the Recent Market Turbulence," March 6, www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_finall.pdf; President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments," March 13, www.treas.gov/press/releases/reports/pwgpolicystatemkturmoil_03122008.pdf; Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, www.fsforum.org/publications/FSF_Report_to_G7_11_April.prf.

The crisis has undermined previous conventional wisdom that a company, even in stressed environments, may readily borrow funds if it can offer high-quality collateral. For example, the inability of Bear Stearns to borrow even against U.S. government securities led to its collapse. As a result, we have been working to bring about needed improvements in institutions' liquidity risk-management practices. Along with our U.S. supervisory colleagues, we are closely monitoring the liquidity positions of banking organizations--on a daily basis for the largest and most critical firms--and are discussing key market developments and our supervisory analyses with senior management. We use these analyses and findings from examinations to ensure that liquidity and funding management, as well as contingency funding plans, are sufficiently robust and incorporate various stress scenarios. Looking beyond the present period, we also have underway a broader-ranging examination of liquidity requirements.

Similarly, the Federal Reserve is closely monitoring the capital levels of banking organizations on a regular basis and discussing our evaluation with senior management. As part of our supervisory process, we have been conducting our own analysis of loss scenarios to anticipate the potential future capital needs of institutions. These needs may arise from, among other things, future losses or the potential for off-balance-sheet exposures to return to institutions' balance sheets. Here, too, we have been discussing our analyses with bankers and ensuring that their own internal analyses reflect a broad range of scenarios and capture stress environments that could impair solvency. We have intensified efforts to evaluate institutions' capital planning and to bring about improvements where needed.

Our efforts related to capital planning and capital adequacy are embodied in the interagency supervisory capital assessment process, which began in February. We are conducting assessments of selected banking institutions' capital adequacy, based on certain

macroeconomic scenarios. For this assessment, we are carefully evaluating the forecasts submitted by each financial institution to ensure they are appropriate, consistent with the firm's underlying portfolio performance, and reflective of each entity's particular business activities and risk profile. The capital assessment program will permit supervisors to assess whether institutions' capital buffers over the regulatory capital minimum are appropriate under more severe but plausible scenarios.

To sum up our efforts to improve banks' risk management, we are looking at all areas of risk management--both on an individual and collective basis--to ensure that all institutions have their risk-management practices at satisfactory levels. More generally, where we have not seen appropriate progress, we are aggressively downgrading supervisory ratings and using our enforcement tools.

Maintaining Balance in the Supervisory Process

The Federal Reserve has long-standing policies and procedures in place to promote sound risk identification and management practices at regulated institutions that also support bank lending and the credit intermediation process. In fact, guidance issued as long ago as 1991, during the commercial real estate crisis that began in the late 1980s, specifically instructs examiners to ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers.[2] The 1991 guidance also states that examiners are to "ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance." The 1991 policy statement covers a wide range of specific topics, including:

[2] "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," (November 1991); www.federalreserve.gov/boarddocs/srletters/1991/SR9124.htm.

- the general principles that examiners follow in reviewing commercial real estate loan portfolios
- the indicators of troubled real estate markets, projects, and related indebtedness
- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value
- a discussion of approaches to valuing real estate, especially in troubled markets
- the classification guidelines followed by the agencies, including the treatment of guarantees
- the factors considered in the evaluation of an institution's allowance for loan and lease losses

This emphasis on achieving an appropriate balance between credit availability and safety and soundness continues today. To the extent that institutions have experienced losses, hold less capital, and are operating in a more risk-sensitive environment, supervisors expect banks to employ appropriate risk-management practices to ensure their viability. At the same time, it is important that supervisors remain balanced and not place unreasonable or artificial constraints on lenders that could hamper credit availability.

As part of our effort to help stimulate appropriate bank lending, the Federal Reserve and the other federal banking agencies issued regulatory guidance in November 2008 to encourage banks to meet the needs of creditworthy borrowers.[3] The guidance was issued to encourage bank lending in a manner consistent with safety and soundness--specifically, by taking a balanced approach in assessing borrowers' ability to repay and making realistic assessments of collateral

[3] "Interagency Statement on Meeting the Needs of Credit Worthy Borrowers," (November 2008); www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

valuations. This guidance has been reviewed and discussed with examination staff within the Federal Reserve System.

Earlier, in April 2007, the federal financial institutions regulatory agencies issued a statement encouraging financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans.[4] The statement noted that, "prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term interest of both the financial institution and the borrower." The statement also noted that, "the agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems." It further stated that, "existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties." This guidance has also been reviewed by examiners within the Federal Reserve System.

More generally, we have directed our examiners to be mindful of the procyclical effects of excessive credit tightening and to encourage banks to make economically viable loans, provided such lending is based on realistic asset valuations and a balanced assessment of borrowers' repayment capacities. Across the Federal Reserve System, we have implemented training and outreach to underscore these intentions. We are mindful of the potential for bankers to overshoot in their attempt to rectify lending standards, and want them to understand that it is in their own interest to continue making loans to creditworthy borrowers.

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[4] "Federal Regulators Encourage Institutions to Work with Mortgage Borrowers Who Are Unable to Make Their Payments (April 2007); www.federalreserve.gov/newsevents/press/bcreg/20070417a.htm.

Conclusion

The U.S. banking industry is facing serious challenges. The Federal Reserve, working with the other banking agencies has acted--and will continue to act--to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy. We have aggressively pursued monetary policy actions and provided liquidity to help repair the financial system. In our supervisory efforts, we are mindful of the risk-management deficiencies at banking institutions revealed by the current crisis and are ensuring that institutions develop appropriate corrective actions.

It will take some time for the banking industry to work through this current set of challenges and for the financial markets to recover. During that recovery, the economy will need a strong and stable financial system that can make credit available. The challenge for regulators and other authorities is to support prudential bank intermediation that helps restore the health of the financial system and the economy as a whole. We want banks to deploy capital and liquidity, but in a responsible way that avoids past mistakes and does not create new ones. Bankers should operate prudently in the current challenging environment, but should not let fear drive their decisions. The Federal Reserve will continue to work with other banking agencies and the Congress to promote the concurrent goals of fostering credit availability and a safe and sound banking system.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

MARTIN J. GRUENBERG
VICE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

EXPLORING THE BALANCE BETWEEN INCREASED CREDIT AVAILABILITY AND PRUDENT LENDING STANDARDS

before the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

March 25, 2009

2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the balance between increased credit availability and prudent lending standards.

As federal insurer for all banks and thrifts, and primary federal supervisor for just over 5,000 state chartered banks, the FDIC is very aware of the challenges faced by financial institutions and their customers during these difficult economic times. Among the greatest strengths of our economy is the diverse collection of over 8,000 FDIC-insured depository institutions that operate almost 100,000 offices in every corner of our nation. Bankers and examiners know that prudent, responsible lending is good business and benefits everyone.

Adverse credit conditions brought on by an ailing economy and stressed balance sheets, however, have created a difficult environment for both borrowers and lenders. The deterioration in the economy in recent months has contributed to a decline in both the demand and the supply of credit. Resolving the current economic crisis will depend heavily on creditworthy borrowers, both consumer and business, having access to lending.

In response to these challenging circumstances, banks are clearly taking more care in evaluating applications for credit. While this more prudent approach to underwriting may mean that some borrowers who received credit in past years will have more

difficulty receiving credit going forward, it should not mean that creditworthy borrowers are denied loans. Unfortunately, in such a difficult environment, there is a risk that some lenders will become overly risk averse. As bank supervisors, we have a responsibility to assure our institutions, regularly and clearly, that soundly structured and underwritten loans are encouraged.

In my testimony, I will briefly describe the trends in the availability of credit and the conditions currently creating obstacles to credit availability. I also will describe the bank examination process and address concerns that banks are receiving mixed messages from their supervisors. Finally, I will discuss the efforts the FDIC is making to encourage prudent lending by the institutions we supervise.

Use and Availability of Credit Over the Business Cycle

Following the intensification of financial market turmoil in September 2008, the U.S. economy experienced a marked deterioration in performance from what already was a recession level. During the fourth quarter, real gross domestic product (GDP) declined at an annualized rate of 6.2 percent, the largest decline in any single quarter since 1982. Payrolls have declined by just under 3 million jobs since September, bringing total job losses during the recession to 4.4 million. The unemployment rate rose to 8.1 percent in February 2009, compared to just 4.9 percent when the recession started in December 2007.

This rapid deterioration in business conditions has had important effects on both the demand for, and the supply of, credit. The demand for business credit tends to vary over the business cycle with the level of spending on new capital equipment and inventories. During the fourth quarter of last year, business spending on nonresidential equipment and structures declined at an annualized rate of over 21 percent -- the largest quarterly decline since 1975. Private inventories fell by almost $28 billion during the year (adjusted for inflation), the largest annual decline since the 2001 recession.

Amid this downturn, loan performance has deteriorated and lenders have tightened lending standards. According to Standard and Poor's (S&P), the 12-month default rate on U.S. high-risk loans rose to 4.35 percent in December, up from 0.26 percent a year earlier.[1] Meanwhile, the Federal Reserve *Senior Loan Officer Survey* shows that large lenders have progressively tightened standards on loans to both large and small business borrowers since late 2007.[2]

Surveys of small businesses conducted by the National Federation of Independent Business (NFIB) show that while small business loans have clearly become harder to obtain, deteriorating business conditions appear to represent an even larger problem. In an NFIB survey conducted in January, the percent of respondents who said that loans were "harder" to get in the last three months outnumbered those who said loans were

[1] "U.S. Corporate Default Rate Forecasted to Reach All-Time High of 13.9% in 2009," Standard and Poor's *RatingsDirect*, January 23, 2009.
[2] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, http://www.federalreserve.gov/boarddocs/SnLoanSurvey/

"easier" to get by 13 percentage points, the highest margin since 1981.[3] At the same time, however, the percent of respondents who said that sales were "lower" in the last three months outnumbered those who said sales were "higher" by 31 percentage points, the highest margin in the 35-year history of the survey.

Given that the center of the current crisis has been in residential mortgage lending, the effects on loan demand and the availability of credit have been even more pronounced in the case of U.S. households. Net borrowing by U.S. households exceeded $1 trillion annually in 2004, 2005 and 2006, fell to $849 billion in 2007, and declined to $51 billion in 2008.[4] During the peak borrowing years, some 87 percent of household borrowing was comprised of mortgage debt. As in the case of business credit, the shrinking volume of household credit reflects trends on both the demand side and the supply side of the equation.

A significant contributing factor behind the contraction in the volume of credit in recent months has been the virtual shut-down of the private securitization market. Private-label securitization played an increasingly important role in bank funding through 2007, but declined precipitously in 2008. It was the securitization market that fueled much of the growth in residential and commercial real estate lending in the earlier part of this decade, so the impact of this tightening is felt particularly in these sectors.

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[3] *NFIB Small Business Economic Trends*, February 2009, http://www.nfib.com/object/IO_39981.html
[4] Federal Reserve Board, *Flow of Funds*, Table F.2.

As they face a very difficult economic environment, businesses and households are curtailing their spending, which tends to reduce the volume of credit they wish to obtain in the aggregate. Meanwhile, rising unemployment and falling business profits are reducing the creditworthiness of some business and household borrowers at the same time that lenders are raising credit standards in response to higher loan losses. In a normal economic cycle, these trends will tend to self-correct over time; however, the current environment appears particularly challenging.

Bank Credit Quality and Lending Activity

Fourth quarter financial results demonstrated considerable stress for FDIC-insured institutions. The industry posted an aggregate loss of $32 billion over the quarter, as revenues were outpaced by increased expenses of provisions for loan losses, goodwill writedowns, and trading losses. Asset quality also continued to deteriorate. At year-end, the ratio of noncurrent loans to total loans at insured institutions climbed to 2.93 percent, doubling from just one year earlier.[5] This is the highest noncurrent rate for the industry since fourth quarter 1992, when the noncurrent rate was 2.94 percent. Noncurrent rates rose rapidly during 2008, reflecting the slowing economy and growing inability of some businesses and consumers to make loan payments. Net charge-offs also rose steadily in 2008, climbing to an annualized rate of 1.92 percent in the fourth quarter -- the highest level in the 25 years that institutions have reported quarterly net charge-offs.

[5] Noncurrent loans are loans that are past due 90 days or more or that are in nonaccrual status.

These credit problems are most pronounced in construction and development lending, where the percent of noncurrent loans stood at 8.55 percent as of year end 2008 -- a marked increase from 3.22 percent at year end 2007. Steady declines in performance are also evident in other loan types such as residential mortgages, credit cards and commercial real estate. Because of the rapid slowdown in the economy and the protracted distress in the real estate sector, it seems clear that credit quality will continue to be problematic this year.

The fourth quarter bank and thrift financial reports also show that lending activity has slowed. Year-end 2008 Call and Thrift Reports showed aggregate loan balances of $7.9 trillion, reflecting a decline of 1.4 percent during the fourth quarter and a smaller decline of 0.4 percent from year-end 2007. While many factors -- including loan sales, write-downs, payments, and originations -- can affect loan balances, changes in loan balances can also reflect changes in lending patterns over time. Prior to the third quarter of 2008, the industry had reported an increase in total loans outstanding in 25 consecutive quarters dating back to third quarter 2002.

Fourth-quarter loan growth at FDIC-insured institutions tended to vary according to the size of the institution. Table 1 shows that largest institutions, those with assets over $100 billion, reported a decline of 3.4 percent in loan balances while the smallest, those with assets under $1 billion, showed an increase of 1.5 percent. In fact, the fourth-quarter decline in loans outstanding at FDIC-insured institutions was driven mostly by large declines at some of the biggest banks. More than half of the insured institutions

with assets greater than $100 billion reported a decline in loan balances during the quarter, and the change in loan levels at the three institutions with the greatest decreases represented more than 100 percent of the total industry decline in loans outstanding.

Table 1. Loan Growth by Asset Size Groups, Fourth Quarter 2008
(Dollar amounts in billions)

Asset Size	Number of Institutions	Number Reporting Decline in Loans	Number Reporting Increase in Loans	Aggregate Net Change in Loans ($ Billions)	Percent Change
> $100 Billion	22	13	9	($142.7)	-3.4%
$10 - $100 Bill.	92	43	49	$6.9	0.4%
$1 - $10 Billion	561	179	382	$8.2	0.8%
< $1 Billion	7,630	2,657	4,973	$15.6	1.5%
All Insured Institutions	8,305	2,892	5,413	($112.0)	-1.4%

Source: Call and Thrift Financial Reports

The data also point to some important differences in portfolio structure between small banks and large banks that may account for the relative stability of loan balances at small banks. On average, community banks at the end of fourth quarter 2008 had a higher ratio of core deposits to assets than did banks with assets over $1 billion. Community banks also reported a higher average ratio of loans to assets than larger banks. These differences suggest that, at least in this stressful period, the business model that relies on funding through core deposits and relationship lending, which has been adhered to by many community banks, has proven to be resilient.

The Role of Bank Supervision

The FDIC is committed to ensuring that examiners carry out their responsibilities in an objective and even handed manner. Examiners are expected to closely review and test bank management's assessment of risk, market conditions, policy parameters, and use of any federal financial assistance. The examination process focuses on assessing banks' own risk management process and identifying any weaknesses for consideration and action by bank management.

In the period leading up to the credit market disruption, regulators should have been more aggressive in their supervisory approach to high risk credit practices that contributed to our current economic problems. While the banking supervisors issued a number of warnings to the industry and provided guidance for enhancing risk management, in hindsight, the agencies should have been more vigilant about some institutions' outsized risk exposures and underwriting practices.

Some have suggested that bank supervisors are now contributing to adverse credit conditions by overreacting to current problems in the economy and discouraging banks from making good loans. Borrowers report that banks are reluctant to lend and some are attributing this to the bank examination process. In particular, concerns have been expressed that bank examiners are discouraging banks from making loans in an effort to preserve capital, or that examiners are requiring banks to engage in aggressive exit

strategies with borrowers who are experiencing difficulties in their businesses, particularly those involving real estate.

The FDIC understands the critical role that credit availability plays in the national economy, and we balance those considerations with prudential safety and soundness requirements. Through our formal and on-the-job training process at the FDIC, field examiners are taught how to review banks' policies, lending and investment practices, financial reporting, and management performance. Based on their findings, examiners communicate their observations to superiors and bank management both orally and in writing. The examiners are instructed on how to deliver their observations without infringing on bank management's day-to-day decision-making and relationships with customers.

A number of discussions have taken place with the FDIC's regional management to raise sensitivity to issues of credit availability. FDIC senior management has reiterated that examiners should be encouraging banks to continue making prudent loans and working with customers facing financial difficulties.

Many members of the FDIC's supervisory staff served through the 1980s and 1990s as regulators and have an average tenure of nearly 16 years. Given their seasoning as regulators, our examiners are keenly aware that credit extended by banks is critical to local economies across the country. Most FDIC examiners live in the communities of the banks they examine, and are very familiar with the local markets and economic trends.

We also have heard criticisms that regulators are requiring widespread re-appraisals on performing real estate loans, which then precipitate write-downs or a curtailment of credit commitments based on a downward revision to value. While we encourage banks to review collateral valuations when a borrower's financial condition has materially deteriorated or loan covenants have not been met, periodic credit reviews, including collateral assessments, by bank management are a long-standing credit practice. Bank management has considerable flexibility in making collateral assessments, both for individual loans and portfolio reviews, and we have not revised our supervisory expectations in the current environment. In cases where market values of collateral have significantly deteriorated and the borrower also is seeking a modification of loan terms, we have encouraged banks to work with the borrower during this difficult period. It is our hope that banks can reach mutually-advantageous workout arrangements that take into account the borrower's financial position and the collateral's valuation and result in a re-structured, and stable credit relationship.

In regard to fair value accounting, we are faced with a situation in which an institution confronted with even a single dollar of credit loss on its available for sale and held to maturity securities must write down the security to fair value, which includes not only recognizing the credit loss, but also the liquidity discount. The FDIC has expressed its support for the idea that the Financial Accounting Standards Board (FASB) should consider allowing institutions facing an other-than temporary-impairment (OTTI) loss to recognize the credit loss in earnings but not the liquidity discount. The FASB last week issued a proposal that would move in this direction.

The FDIC understands the tight credit conditions in the market and is contributing to a number of efforts to improve the current situation. Over the past year, we have issued guidance to the institutions we regulate to encourage banks to maintain the availability of credit. Moreover, examination professionals have received specific instruction on properly applying this guidance within the context of FDIC supervised institutions.

On November 12, 2008, we joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* (FDIC FIL-128-2008).[6] This statement reinforces the FDIC's view that the continued origination and refinancing of loans to creditworthy borrowers is essential to the vitality of our domestic economy. The statement encourages banks to continue making loans in their markets, work with borrowers who may be encountering difficulty during this challenging period, and pursue initiatives such as loan modifications to prevent unnecessary foreclosures.

In light of the present challenges facing banks and their customers, the FDIC hosted a roundtable discussion earlier this month focusing on how regulators and financial institutions can work together to improve credit availability. Representatives from the banking industry were invited to share their concerns and insights with the federal bank regulators and representatives from state banking agencies. The attendees agreed that open, two-way communication between the regulators and the industry was vital to ensuring that safety and soundness considerations are well balanced with the

[6] See: http://www.fdic.gov/news/news/press/2008/pr08115.html

critical need of providing credit to businesses and consumers. I believe this was a very productive meeting, and look forward to working with the industry and our colleagues at the other agencies to ensure credit remains available during this challenging period.

One of the important points that came out of the session was the need for ongoing dialog between bankers and their regulators as they work jointly toward a solution to the current financial crisis. Toward this end, Chairman Bair announced last week that the FDIC is creating a new senior level office to expand community bank outreach. In conjunction with this office, the FDIC plans to establish an advisory committee to address the unique concerns of this segment of the banking community.

As part of our ongoing supervisory assessment of banks that participate in federal financial stability programs, the FDIC is taking into account how available capital is deployed to make responsible loans. It is necessary and prudent for banking organizations to track the use of the funds made available through federal programs and provide appropriate information about the use of these funds. On January 12, 2009, the FDIC issued a Financial Institution Letter titled *Monitoring the Use of Funding from Federal Financial Stability and Guarantee Programs* (FDIC FIL-1-2009),[7] advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community. Equally important to this process is providing this information to investors and the public. This Financial

[7] See: http://www.fdic.gov/news/news/financial/2009/fil09001.html

Institution Letter advises insured institutions to include information about their use of the funds in public reports, such as shareholder reports and financial statements.

Internally at the FDIC, we have issued guidance to our bank examiners for evaluating participating banks' use of funds received through the TARP Capital Purchase Program and the Temporary Liquidity Guarantee Program, as well as the associated executive compensation restrictions mandated by the Emergency Economic Stabilization Act. Examination guidelines for the new Public-Private Investment Fund will be forthcoming. During examinations, our supervisory staff will be reviewing banks' efforts in these areas and will make comments as appropriate to bank management. We will review banks' internal metrics on the loan origination activity, as well as more broad data on loan balances in specific loan categories as reported in Call Reports and other published financial data. Our examiners also will be considering these issues when they assign CAMELS composite and component ratings. The FDIC will measure and assess participating institutions' success in deploying TARP capital and other financial support from various federal initiatives to ensure that funds are used in a manner consistent with the intent of Congress, namely to support lending to U.S. businesses and households.

Conclusion

FDIC-insured banks are uniquely equipped to meet the credit needs of their local markets, and have a proven tradition of doing so, through good times and bad. Banks should be encouraged to make good loans, work with borrowers that are experiencing

difficulties during this challenging period whenever possible, avoid unnecessary foreclosures, and continue to ensure that the credit needs of their communities are fulfilled. In concert with other agencies and departments of the federal government, the FDIC continues to employ a range of strategies designed to ensure that credit continues to flow on sound terms to creditworthy borrowers.

Testimony of

Bradley J. Hunkler

Vice President, Controller

Western & Southern Financial Group on behalf of

The Financial Services Roundtable

Before the

House Committee on Financial Services

March 25, 2009

Hearing on

"Exploring the Balance between Credit Availability and Prudent Lending Standards"

I would like to express my gratitude to Chairman Frank and the Committee for the opportunity to be here today and speak on behalf of the financial services industry and Western & Southern Financial Group (W&S). My name is Brad Hunkler. I am a Vice President and Controller with the Western & Southern Financial Group. W&S is a mutual holding company owned by its policyholders and located in Cincinnati, Ohio. W&S sells mostly life insurance products including traditional life insurance and annuity products. Like other life insurance companies, we have been adversely impacted by losses sustained in the investment in securitized loans. As the witness for the Financial Services Roundtable, I intend to divide my testimony into four parts:

1. Overview and background;
2. Securitization concerns;
3. Pro-cyclicality – and its unintended consequences; and
4. The importance of maintaining independent accounting standards.

Overview and Background

The role of the financial services industry, including non-banking institutions needs to be a significant component of your work in expanding credit to consumers and commercial enterprises. The financial services industry invests in all types of consumer loans including mortgages, credit cards, auto loans, student loans, and many others. The primary investment vehicle for these loans is through securitization. The amount of consumer lending financed by our industry is critically important to maintaining adequate lending capacity for the broader economy. For example, of the approximate $11 trillion of residential mortgages

outstanding as of September 2008, banking institutions held approximately $4 trillion as direct loans with the remaining $7 trillion securitized. Of that $7 trillion, banks still held significant investments in securitized loans, but much of those assets were held by non-banking institutions such as insurance companies, pension plans and other institutional investors. Approximately $5 trillion of the $7 trillion were conforming balance mortgages and wrapped through the government sponsored entities. This represents only residential mortgages. Insurance companies also acquire a significant amount of assets securitized by other types of loans as well.

From the insurance perspective, insurance companies acquire these assets due to their high credit ratings and the yield and duration that the securities offer which match the duration of many insurance liabilities. Many insurance companies have ceased to write direct consumer loans and have relied on the securitization markets to provide access to this asset class. As such, the insurance industry has become reliant upon the implicit integrity of the securitization process, including high quality underwriting, rating and structuring of these investments. In addition, many loans are guaranteed by monoline insurers and government sponsored entities – the industry relies on the quality of these credit enhancements as well.

Unfortunately, there were many unknown problems in these areas for the financial services industry as a whole. As such, the industry has been adversely impacted

by a lack of regulation, oversight and clarity of the securitization process. Certainly the economic conditions, such as high unemployment and falling housing prices, have adversely impacted the collateral of these assets, but other non-economic factors, that could have been avoided, also have contributed to the losses. As noted in many media reports, this includes: rampant fraud in the mortgage origination and underwriting process; poor underwriting standards that overemphasized rising housing prices and did not adequately consider borrower creditworthiness; monoline insurers whose risk exposures were too highly correlated; inadequate analysis and stress testing from the rating agencies resulting in over-inflated ratings; and a lack of transparency relating to the underlying collateral and deal structure which contributed to inefficient price discovery. These issues are specific to the non-agency mortgage markets. The industry has also been adversely impacted by a lack of transparency and regulatory oversight of the student loan market where the investors who purchased auction-rate preferred securities for short-term liquidity needs are now stuck with the illiquid, long-term securities with uncertain payment provisions.

In addition to the liquidity and valuation challenges, mark-to-market accounting has compounded the problems for the financial services industry. Some institutions generally hold whole loans that are not required to be fair valued, while others, including insurance companies, hold mostly securities which are required to be marked-to-market. These are the areas that I ask the Committee to

focus on going forward so that when economic conditions improve, institutions will return to the securitization markets.

Securitization Oversight

The industry needs to rely on certain standards for securitized assets. These standards need to be defined and oversight needs to be provided to ensure that standards are strictly enforced. The following points summarize the areas of concern in the markets for securitized assets:

- **Collateral Information:** The mortgage backed securities (MBS) market lacks a standardization of underlying collateral information, both at the time of securitization and in the ongoing monthly performance reporting. The industry would propose that all collateral information, such as loan-to-value ratios, FICO scores, and other collateral and borrower information be provided in detail within a standardized format to allow for more comprehensive and accurate valuation by investors (similar to the CMBS market).
- **Underwriting Standards:** It is has been extensively reported that mortgage brokers have committed significant amounts of fraud, and bank and Wall Street underwriting due diligence failed to pick this up. As such, the industry is looking for strict enforcement of improved underwriting standards and for originators and perhaps servicers to retain some "skin in the game" in the securitized loans.

- **Deal Structure:** Deal structure can vary from deal-to-deal for non-agency MBS. This includes variability in bankruptcy carve-out provisions and other cash flow triggers. This challenges analysis and has contributed to a lack of transparency that has led to reduced trading of existing securities. Standardized deal structures would help immensely.
- **Rating Agencies:** Rating agencies provided ratings that did not adequately reflect the level of risk in the investments. AAA ratings should only be awarded to securities that have an extraordinary low risk of default. This rating was based on recent historical MBS performance and did not discount the possibility of sustained negative home prices nationwide. Some oversight over this industry needs to be considered as investors need a rating process with integrity and accuracy to foster confidence in valuations.
- **Monoline Insurers:** Monoline insurers were permitted to insure highly correlated assets well in excess of their risk tolerance. Rating agencies assumed only idiosyncratic risk – they never considered a systemic risk event.
- **Auction Rate Securities:** Auction rate securities backed by student loans have traded for some time with minimal government oversight. For the market to function, it relied on the liquidity support of the investment banks that were involved in the trading and their willingness to use balance sheet capacity to provide liquidity. While loans are mostly supported by

government guarantees, the investment banks became concerned about holding increasing amounts of assets due to insufficient balance sheet capacity and thus, allowed auctions to fail. This has left many holding securities that were thought to be cash or liquid investments, but are now securities with significantly longer-term maturities at short term interest rates with no source of liquidity. The ability to control this market and the auction process by investment banks needs to be addressed by Congress so that the industry can resume investing with confidence in these types of asset classes.

In addition to the improvements in regulation noted above, Congress also needs to continue to address the issue of existing assets on financial statements. At this point, the best thing regulators can do is to choose a course of action and stick to it. The added uncertainty of government intervention in mortgages, housing and toxic assets has significantly deteriorated the markets on these assets. The announcement made by Treasury on March 23, 2009, for the Public/Private Program for Legacy Assets provides good direction and comprehensive action on these issues. We believe that this represents a positive development in this regard.

Mark-to-Market Accounting Concerns

The industry has raised mark-to-market accounting concerns since the first major application of market value accounting in the Financial Accounting Standards

Board (FASB) Statement No. 115. At the time early deliberations were occurring on FAS 115 in the late 80's, interest rates were at all time highs. The insurance industry had extraordinary unrealized losses on its investment portfolios and most, if not all, insurance companies would have shown negative book value at that time. The industry on the whole questioned the usefulness or the meaning of reflecting negative book values due to high interest rates. Having a long-term, cash flow oriented investing strategy allows insurers to manage through periods of interest rate volatility. For some institutions and even for some assets of insurance entities, reflecting market values in the financial statements makes sense. Generally speaking, equity investments are acquired for the purpose of investing and should be carried at market values at all times. But generally speaking, the industry holds mostly fixed income investments purchased for the purpose of providing future cash flows to support future policyholder claims. For these investments, market value accounting provides less meaningful information and should be limited to disclosure.

Today, excessive speculation in the markets has made market prices potentially deceptive when reflected in the equity of financial institutions. I believe that today's markets move well into the extremes of economic cycles. Market participants speculate more on an asset's ability to increase or decrease in value than on its inherent ability or inability to provide future cash flows. This excessive speculation has led to market bubbles and busts. Adding market values

to financial statements in this environment can be misleading. During market bubbles, financial statements can illustrate a false wealth effect. This can lead to excessive risk-taking and over-levering non-existent equity. During periods of market declines, the opposite is true. As market values decline, reported losses in excess of real losses can lead to restricted risk-taking and capital preservation. This can lead to irrational exuberance in bubble periods and irrational fear during the busts. While markets can accommodate this type of volatility, the sanctity of the Nation's financial institutions needs to be immune to it.

Pro-cyclicality

To address pro-cyclicality, some would suggest providing a counter-cyclical regulatory capital model and retaining market values in reported financial statements. I do not believe this represents a sound approach. Reported financial statements that show excessive volatility and potentially negative book values can fuel adverse consumer activity. If regulatory reporting results show strong financial strength through this reporting mechanism, it has the potential to be dismissed or even worse it can discredit the regulatory capital model altogether. Wearing my insurance hat, I could follow on that this is the case today in the insurance industry. Insurance companies have reported unrealized losses in their GAAP financial statements while properly reflecting statutory capital well in excess of levels normally required to retain existing financial strength ratings. But

during the first quarter of this year, many insurance companies received two or more rating notch downgrades and saw significant declines in their stock prices. Some insurance companies also saw adverse policyholder activity with higher surrenders. This occurred in spite of the fact that regulatory capital remained strong for many of these institutions. With GAAP and regulatory accounting showing different results, conservative investors tend to migrate to the least favorable outcome. Therefore, although regulatory capital may be a more accurate reflection of solvency, it potentially could be disregarded by analysts, investors, and even consumers. This can result in economic hardship for an otherwise healthy financial institution.

Market Prices

Market prices, though, do provide beneficial information for financial statement users. They provide an objective source of value and can be a proxy for value in active, rational markets. Also, market prices are the value that can be exchanged if assets are required to be liquidated. In addition, some assets are acquired for the purpose of trading and should therefore reflect the market prices in the balance sheet. Investors have spoken clearly that fair value accounting provides meaningful information. But the desire for objective financial data has led to the replacement of the principles of prudence and conservatism with fair value accounting. Therefore, I believe that the primary measurement attribute should be

cost for cash flow investors. Losses should be recorded when cash flows are impaired up to the amount of the impaired cash flows. Then to accommodate the needs of investors, a fair value supplement can be provided and made available concurrently with reported results. Fair values would then represent exit values and reflect the impact of liquidating financial instruments if required.

I believe that this approach has merit. It reflects the needs of investors yet does not subject the industry's financial statements to the whims of the markets. It is this approach that the financial services industry has supported since the first broad issuance of a fair value standard with FASB Statement No. 115 in 1993. But this is not the apparent direction of the FASB or the International Accounting Standards Board (IASB). Fair value accounting continues to be incorporated into the financial reporting standards over the objections of many industry groups. The FASB has continued to introduce fair value requirements regardless of whether an active market exists or has ever existed for the asset or liability. This topic was well-vetted in your March 12 mark-to-market subcommittee hearing. I would like to add to that testimony by saying this is not a concern that is being raised for the first time by the industry. Even when benefited by the reporting of fair values, the industry has consistently had concerns regarding the application on fair value reporting.

The FASB has a more than adequate due process in the exposure and issuance of new standards. It is open and transparent, collects data from all sources and it is conducted in a timeframe that accommodates all parties. But the problem is that preparer concerns have held little weight in the ultimate decision on the issuance of new standards. Instead investor concerns – primarily the voices of large investor organizations – have driven the FASB agenda in support of all financial reporting on a fair value basis. What is interesting, though, is that as the FASB has continued to introduce new fair value measurement requirements, equity analysts continue to guide companies to exclude the results of these fair value changes from the core operating earnings that they report in their earnings release. What equity analysts are interested in is understanding run-rate earnings and the growth in earnings so that THEY can determine the fair value of the company based on its operating results and ability to provide future cash flows.

A Thoughtful Congressional Role in Accounting Standard Setting

Congress can play a role in the oversight of the FASB due process. They can oversee it and ensure that all voices are not only collected, but given due consideration in the creation of new standards. What is important though is to retain the ultimate independence of FASB to create standards without political interference. This is a difficult balance and to the extent that any role is created by Congress it will need to be carefully thought through to limit its authority to just the observance of an adequate due process.

Congressional input into the standard setting process should be considered as well. Today, Congress has the authority to speak directly to the FASB as was done at the March 12, 2009, hearing. Moreover, though, Congress can comment on any FASB proposal that was issued through the FASB due process. From time-to-time, individual Representatives have provided comment letters to FASB and, given the extent of taxpayer investment in financial institutions, I would encourage more Congressional input and oversight of the setting of accounting standards. Furthermore, Congress should consider the need for a process to provide feedback to FASB on proposed accounting standards.

Conclusion

In conclusion, I come to you today to provide some background information on the role of the financial services industry in lending within the securitization markets. In your valued oversight role of FASB in the accounting rulemaking process, the Roundtable believes that your focus should include:

1. Securitization concerns;
2. Pro-cyclicality – and its unintended consequences; and
3. The importance of maintaining independent accounting standards.

I thank you for the opportunity to be here today and look forward to your questions.

Testimony Concerning Exploring the Balance Between Increased Credit Availability and Prudent Lending Standards

James L. Kroeker
Acting Chief Accountant
U.S. Securities and Exchange Commission

House Committee on Financial Services

March 25, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee:

I am Jim Kroeker, Acting Chief Accountant in the Office of the Chief Accountant (OCA), which advises the Commission on accounting and auditing matters. I am pleased to testify today on behalf of the Securities and Exchange Commission (Commission).

Your invitation to this hearing included a number of important questions that are appropriately the province of my fellow regulators here today. One area you did inquire about related to fair value accounting. I am happy to provide you with an update on this topic.

Recent Efforts to Improve Fair Value Accounting

Two weeks ago, on March 12, this Committee's Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on the critical topic of fair value accounting, at which I also testified. I believe that the hearing helped to further crystallize and advance the objective sought by market participants for improved guidance on the measurement of fair value and accounting for impairments.

There can be no doubt, and we at the Commission fully understand, the gravity and urgency of these issues as we all work in the public interest to address the global economic crisis. The hearing on March 12 underscored our own efforts for swift consideration and appropriate action, including action to address and, as appropriate, implement the critical recommendations the Commission staff identified in our Congressional study on mark-to-market accounting, which we conducted in consultation with the Department of the Treasury and the Federal Reserve.

Consistent with the sentiments we have clearly heard from many members of this Committee, I believe swift action must be taken to address the accounting for investment impairments and to improve the measurement guidance for illiquid assets for first quarter 2009 reporting. We are therefore pleased that the FASB has acted diligently and responsively to use their expertise as an independent standard-setter and expose amendments to the measurement of securities in inactive markets and the recognition of "other-than-temporary" security impairments. Following the FASB due process procedures, the proposed amendments were deliberated fully at an open public meeting of the full Board, were approved by a majority vote, and are now subject to public comment.

On March 17, the FASB's amendments were made available for a 15-day public comment period ending April 1.

The FASB's proposed amendments seek to directly address two of the recommendations in the Commission staff's December 30, 2008 study on mark-to-market accounting. First, these proposed amendments seek to provide additional guidance on determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurements. Generally, if the market is not active, then a valuation technique other than one that uses the quoted price shall be used. For example, the reporting entity could use an income approach (that is, a present value technique based on estimated cash flows) to estimate fair value based on an orderly transaction between willing market participants. This amended ability to use cash flows to measure securities in inactive markets seeks to address concerns about using distressed, forced or disorderly sales as the basis for estimating fair value.

Second, the FASB's proposed amendments seek to provide a clearer benchmark for when an other-than-temporary impairment exists and needs to be recorded on securities held outside of a company's trading book, and to transparently disclose the amount of the impairment directly associated with probable cash flow declines. These proposed amendments seek to provide greater clarity than exists today about the nature of losses. Under these proposed amendments, the probable losses in cash flow would be recorded in earnings, and the loss attributable to all other factors (e.g., liquidity and changes in interest rates) would be transparently reported as a component of "other comprehensive income" (OCI). To be clear, securities available for sale would continue to be reported at fair value on the balance sheet.

To illustrate how the FASB's proposed amendments would seek to improve the accounting for other-than-temporary impairments, consider their proposed application to a mortgage-backed security (MBS) comprised entirely of a large portfolio of residential mortgage loans. Under the existing guidance for other-than-temporary impairments, if it becomes probable that the MBS investor will suffer even a minor loss of expected cash flow, instead of recording the minor loss in earnings, the loss is based upon the MBS's current fair value. The FASB proposal would seek to provide additional information to the investor by reporting the minor loss of expected cash flow in earnings with other changes in value recognized in equity (i.e., OCI) until a decision to sell the security, and realize the loss, was made. That is, such a model would appear to help bridge the gap between the current fair value and the value expected from holding investment positions until markets return to normal liquidity levels.

We understand that the FASB's current plan is for its proposed amendments to be finalized by the first week of April in time for first quarter 2009 reporting. First quarter 2009 reporting would represent a timely response to our study's recommendations, and we are encouraged that the FASB has taken advantage of this earliest opportunity to act.

These proposed amendments are now in an important exposure period. As Representative Kanjorski aptly described at the March 12 hearing, there are strongly held views on all

sides of these issues. It is critical that all those affected carefully consider the proposed amendments and whether they properly address the most pressing practice issues in the measurement of fair value and assessment of security impairment while also enhancing the information available to investors.

We also are actively taking steps to advance these issues. This has been and remains my number one priority. We have been proactively reaching out to investor groups, the accounting profession, fellow regulators, and representatives from those industries that would be most affected by the FASB's proposed amendments. And of course we are, as we always are, in constant contact with the FASB, and we understand that they have likewise engaged in active dialogue with capital market participants.

As I have testified before, we continue to believe the FASB must be responsive to the needs of capital market participants. While the Commission has broad authority and responsibility to prescribe accounting standards,[1] it has long relied on the FASB as a private sector standard-setter and recognized the importance of the FASB's independence.[2] The FASB, in turn, is obliged to consider, in adopting accounting principles, the need to keep standards current in order to reflect emerging accounting issues and changing business practices.[3]

I am hopeful that the FASB will continue, on a timely basis, to enhance the tools available to assist preparers and auditors when making these difficult judgments. As I testified on March 12, as the principal advisor to the Commission on accounting and auditing issues, I and my office remain ready to assist the Commission in any way it deems necessary.
I am also hopeful that the FASB will continue its efforts to comprehensively reconsider the accounting for all financial instruments, which was also a recommendation in the staff's mark-to-market study. We will be working closely with the FASB in the near future as they continue that undertaking, including closely monitoring their efforts to harmonize the accounting for loans and securities and to choose a measurement objective that meets the needs of investors.

Interaction between Regulatory Capital and U.S. GAAP

As you are aware, the Commission and my office are not responsible for monitoring the availability of credit, nor are we responsible for assessing financial institutions' lending practices. These aspects of regulation are already best addressed by others here today.

However, my office is responsible for establishing and enforcing accounting policy to enhance the transparency and relevancy of financial reporting in fulfilling the Commission's separate and mission of investor protection, market efficiency and capital formation, a mission that is at the heart of our privately financed economy. As part of our fulfillment of this responsibility and mission, we oversee the activities of the FASB. As part of our oversight, we remain cognizant of the primary objective of U.S. GAAP reporting and how that primary objective interacts with the separate objectives of others, including regulatory capital reporting, and we engage in regular and meaningful dialogue, interaction, and consultation with banking regulators.

As we discuss in our December 30 study on mark-to-market accounting, the primary objective of financial reporting is, and should be, to provide information useful to investors and creditors in their decision-making processes. The primary objective of prudential banking oversight has been to foster safety and soundness and financial stability.

When considering these often complementary, yet different, objectives, it is also important to recall two points. First, investors generally can, and do, make decisions on a current basis, necessitating relevant and reliable current information about financial values and prospects on a timely basis. While an individual entity may have a long term horizon, the capital allocation decisions of investors depend on their own individual circumstances.

For example, working Americans are faced with daily decisions about which investment to purchase and hold in an IRA or 401(k). The historical cost of an asset (that is, the price the reporting entity bought the asset years ago) may in many cases provide little relevance to an investor making a current capital allocation decision. Rather, information about the current values and the financial prospects of the reporting entity may be extremely important to the investor when determining which investment to purchase.

The full Commission and I believe that confidence in our markets begins with the quality and transparency of the financial information available to help investors decide whether, when, and where to invest their hard-earned dollars. The goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting provides necessary confidence in the fairness of the markets and plays a fundamental role in contributing to make our markets the most efficient, liquid and resilient in the world.

Second, investors generally may not have the ability to otherwise obtain information in a format specific for their own use. Therefore, in evaluating their investment decisions, investors are dependent on the financial reporting provided by management and as guided by the Commission. However, unlike investors, banking regulators have the ability to prescribe the format of information provided to them, including the ability to adjust U.S. GAAP reporting, or require additional information for purposes of their own analysis and, as I describe further below, have exercised that ability in many cases.

As we noted in our study, regulatory capital requirements for banks in the U.S. currently start with financial information provided in accordance with U.S. GAAP. Section 121 of FDICIA requires that the accounting principles used in the reports and statements filed with banking regulators by insured depository institutions be no less stringent than U.S. GAAP.[4] The banking regulations for preparing balance sheet and income statement reports filed with regulators are consistent with FDICIA.

There are, however, instances in which the prudential banking regulators have determined that adjustments should be made to U.S. GAAP accounting results for regulatory capital purposes, thereby reflecting the important differences between the objectives of U.S.

GAAP reporting and the objectives of regulatory capital requirements. We understand that these adjustments are intended to reflect the solvency and safety and soundness of the financial institutions on an ongoing basis. This can be done, for instance, by seeking to limit volatility that is temporary in nature.

For example, consistent with the safety and soundness objective, losses on assets that are reflected in income and retained earnings in accordance with U.S. GAAP are generally recognized in regulatory capital. However, while equity, as presented under U.S. GAAP, is the starting point for the banking regulators' regulatory capital calculations, the regulatory capital standards and their instructions for calculating regulatory capital include several adjustments from U.S. GAAP-based equity. An example in this area is that unrealized gains and losses for available-for-sale (AFS) debt securities generally do not impact regulatory capital calculations, even though these unrealized gains and losses are reported in U.S. GAAP-based equity (as part of accumulated other comprehensive income). Losses that are realized by a financial institution, either by sale of the debt security or determination that the decline in the fair value of the debt security is other-than-temporary, are reflected in regulatory capital.

In 1995, the Office of Thrift Supervision (OTS), as well as the other banking regulators (collectively, the Agencies), issued a final rule to exclude unrealized gains and losses for available-for-sale debt securities recognized under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) from regulatory capital. In its final rule, the OTS stated:

> After considering all the comments received, the OTS, in consultation with the other Agencies, has decided not to adopt its proposal to include the FAS 115 equity component in computing regulatory capital. ...Based on the comment letters received, the OTS determined that adoption of the proposal could potentially have an inappropriate impact on associations' regulatory capital and result in an inaccurate picture of their capital positions. For example, fluctuations in interest rates could cause temporary changes in regulatory capital levels, which in turn could trigger more permanent regulatory intervention and inappropriately affect industry profitability. ...The OTS considered the comments received regarding FDICIA's requirement that regulatory accounting policy be no less stringent than GAAP. Section 121 of FDICIA requires that policies applicable to reports and statements filed with the Federal banking agencies generally conform to GAAP. The section, however, does not require the calculation of an institution's regulatory capital or the components of regulatory capital to conform to GAAP, and the legislative history of the section indicates that was not necessarily the intent of Congress.[5]

In addition to making adjustments to exclude from regulatory capital certain amounts reported under U.S. GAAP in accumulated OCI, the regulatory calculation of capital also includes adjustments to certain assets that are recognized and included in equity under U.S. GAAP.[6] For example, goodwill[7] is deducted from regulatory capital and the inclusion in regulatory capital of certain servicing rights recognized as assets under U.S.

GAAP is limited. As a result, fair value measurements that adjust the carrying amount of items excluded from regulatory capital, while reducing U.S. GAAP-based equity, may not have an impact on regulatory capital.

In certain circumstances, the regulatory calculation of capital also includes items not reported in equity under U.S. GAAP. In 2005, the Federal Reserve issued a final rule addressing the definition of regulatory capital in which it stated:

> A change in the GAAP accounting for a capital instrument does not necessarily change the regulatory capital treatment of that instrument. Although GAAP informs the definition of regulatory capital, the [Federal Reserve] is not bound to use GAAP accounting concepts in its definition of [T]ier 1 or [T]ier 2 capital because regulatory capital requirements are regulatory constructs designed to ensure the safety and soundness of banking organizations, not accounting designations established to ensure the transparency of financial statements. In this regard, the definition of [T]ier 1 capital since the [Federal Reserve] adopted its risk-based capital rule in 1989 has differed from GAAP equity in a number of ways. The [Federal Reserve] has determined that these differences are consistent with its responsibility for ensuring the soundness of the capital bases of banking organizations under its supervision. These differences are not differences between regulatory reporting and GAAP accounting requirements, but rather are differences only between the definition of equity for purposes of GAAP and the definition of [T]ier 1 capital for purposes of the Board's regulatory capital requirements for banking organizations.[8]

In sum, while financial reporting may serve as a starting point for other users, such as banking regulators, it should continue to be developed by the FASB to primarily satisfy the needs of private sector investors and other users that may not have the ability to otherwise obtain information in a format specific for their own use. As I testified two weeks ago, the full Commission and I continue to believe the FASB is best positioned to promulgate neutral financial reporting standards. As previously described, if they deem necessary, the banking regulators have the ability to adjust financial reporting or require additional information for purposes of their own analysis and have exercised that ability as they deem appropriate.

Conclusion

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. We support the FASB's swift and responsive actions to propose amendments that seek to address the recommendations included in the SEC staff's study. We will continue to solicit input from all parties affected by this issue. My office and I are assisting the Commission, by advising them on the FASB's recent actions. We stand ready to provide support to Commission and the FASB, in any way the Commission deems appropriate, to help ensure that FASB timely consider and address the recommendations for improvements included in our study, and to ensure information available to investors in these economic

conditions is as accurate, timely and useful as possible. This remains my number one priority during these challenging economic times.

Thank you for the opportunity to appear today, and I would be pleased to respond to any questions.

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[1] See, e.g., sections 7, 19(a) and Schedule A, items (25) and (26) of the Securities Act of 1933, 15 U.S.C. 77g, 77s(a), 77aa(25) and (26); sections 3(b), 12(b) and 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(b), 78l(b) and 78m(b); and sections 8, 30(e), 31 and 38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-8, 80a-29(e), 80a-30 and 80a-37(a).

[2] Policy Statement Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003) [68 FR 23333 (May 1, 2003)] ("2003 Policy Statement").

[3] See section 19(b) of the Securities Act of 1933, 15 U.S.C. 77s(b), as amended by the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7201 et seq. Further, in the 2003 Policy Statement, the Commission stated its belief that the FASB "should provide timely guidance to public companies, accounting firms, regulators and others on accounting issues that the Commission considers to be of immediate significance to investors." Further, the Commission stated that: "We expect that the Commission staff will refer issues to the FASB or one of its affiliated organizations when those issues may warrant new, amendments to, or formal interpretations of, accounting standards. We also expect that the FASB will address such issues in a timely manner." Id. (footnotes omitted)

[4] See 12 U.S.C. 1831n.

[5] Regulatory Capital: Common Stockholders' Equity, OTS Release No. 95-151 (August 3, 1995) [60 FR 42025 (August 15, 1995)].

[6] See "Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)," last updated December 2008 as provided on the FFIEC website, for a description of the assets reported under U.S. GAAP that are not eligible to be included in Schedule RC-R – Regulatory Capital. (available at http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_041_200812_i.pdf).

[7] In December, the Agencies jointly issued a final rule allowing goodwill, which must be deducted from Tier 1 capital, to be reduced by the amount of any associated deferred tax liability. See Minimum Capital Ratios; Capital Adequacy Guidelines; Capital Maintenance; Capital; Deduction of Goodwill Net of Associated Deferred Tax Liability, Docket No. OTS-2008-0019 (December 15, 2008) [73 FR 79602 (December 30, 2008)].

[8] Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital, Docket No. R-1193 (March 10, 2005) [70 FR 11827 (March 10, 2005)].

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Testimony of
TIMOTHY W. LONG

SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY AND CHIEF NATIONAL BANK EXAMINER

Before the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

March 25, 2009

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Timothy Long, and I am the Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner for the Office of the Comptroller of the Currency. I appreciate the opportunity to describe the OCC's role in ensuring that banks remain safe and sound, while at the same time meet the credit needs of their communities and customers. This is our core mission, and we recognize it is a balance: supervise too lightly, and some banks will use federally insured deposits to make unsafe loans that can ultimately cause them to fail; supervise too strictly, and some banks will become too conservative and not make loans to creditworthy borrowers. The OCC strives every day to get this balance right through strong, thoughtful and consistent supervision that reflects constant interaction with and feedback from the banks that we supervise.

All of us – supervisors, bankers, and members of this Committee – recognize the important role that credit availability and prudent lending plays in our nation's economy and we all share the goal of ensuring that banks can continue to meet the credit needs of their customers. The actions undertaken over the past few months – providing facilities and programs to help banks strengthen their balance sheets, restoring liquidity to various credit segments, including small business owners, and promoting supportable residential loan modifications – are important steps in restoring our banking system and economy.

The OCC fully supports these initiatives and we believe they will have a positive impact on banks' ability and willingness to lend. We must recognize, however, that banks are operating in an economic environment that continues to pose significant challenges to them and their loan customers. The sharp decline in fourth quarter gross domestic product and increasing unemployment levels are placing strains on borrowers'

ability to service their loan obligations and is contributing to the tighter loan underwriting standards we are seeing at many banks. Notwithstanding these challenges, bankers *are* making loans to credit worthy borrowers. For example, as the Treasury Department has reported, over $800 billion of new loans – in the form of new originations, renewals, and refinancings – have been generated in the four month period from October 2008 through January 2009 by the nine large national banking organizations that have received funds from the Capital Purchase Program. Moreover, every banker I have talked to reiterates that lending is the backbone of their business and that they are committed to meeting the credit needs of their customers through this economic cycle. Our examiners, who are in the banks, also confirm that bankers are continuing to make loans to creditworthy customers.

I understand that some bankers believe they are receiving mixed messages from regulators about the need to make loans to creditworthy customers while at the same time being subject to what some have termed as "overzealous" regulatory examinations. We believe we are striking the right balance in encouraging bankers to make loans to creditworthy borrowers, but always consistent with safe and sound banking practices – and to the extent we're not, we are continually prodding bankers to let us know, both directly to our examiners and indirectly through our Ombudsman. Our message to bankers is straightforward:

- Do make loans that you believe will be repaid;
- Do not make loans that are unlikely to be repaid; and
- Continue to work constructively with troubled borrowers, but recognize repayment problems in loans when you see them, because delay and denial makes things worse.

OCC examiners do not and will not criticize bankers for making loans that are prudently underwritten and appropriately managed. This does not mean that every person or company that wants credit will receive a loan. The simple truth is that, given the economic conditions facing our country today, there are borrowers that simply cannot afford or manage new or existing debt obligations – borrowers and companies that find themselves overleveraged. In these cases, we encourage bankers to work with the borrower, to the extent possible, to restructure or modify the loan so that repossession of collateral or foreclosure is avoided wherever possible.

But for some borrowers, a workout is not feasible and the bank is unlikely to be fully repaid. In these cases our goal is to ensure that the bank has adequate reserves and capital to absorb its loan losses. In this regard, we have and will continue to be forceful in telling bankers that they need to be realistic in their evaluations of a borrower's condition and to take appropriate actions, including charge-offs, when warranted. Likewise, there are some community banks that find themselves overextended in relation to their capital and loan loss reserves. In most cases, these institutions will need to reduce their exposures – sometimes by raising more capital, but often by cutting back on loans – to survive. While this is not always an easy step for management to take, in these circumstances we believe it is both prudent and necessary.

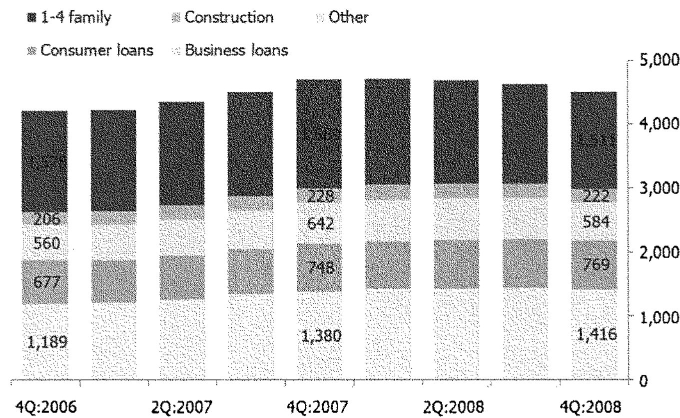
National Banks are Making Loans, but Loan Demand and Some Loan Volumes are Down

Before discussing our supervisory approaches in the current environment, it is useful to begin with some facts about current credit conditions. There have been clear signs of weakness, especially since last summer. As Chart 1 shows, the total dollar volume of loans on the books of national banks declined four percent over the course of 2008, with the deceleration picking up in the fourth quarter. Naturally, some categories

of lending were weaker than others. Examples include 1-4 family residential mortgages and construction lending. But these examples are hardly surprising, given the significant contraction in these sectors during 2008 that sharply curtailed the demand for new loans.[1] Outside of the real estate realm, business loans increased slightly in 2008, as did non-mortgage consumer lending (see Chart 1).[2]

Chart 1

Loans on balance sheets of national banks ($ billions)



Source: Integrated Banking Information System (OCC)
Data are merger-adjusted and include historical information for Washington Mutual

There are also some technical reasons for a portion of the decline that shows up in the data. We have traced a sizable share of the reported reduction in bank loan volume – approximately $56 billion – to accounting adjustments that were made in connection with mergers and acquisitions. The loans moved onto the acquiring bank's books at a lower

[1] During 2008, the value of residential construction put in place fell by 27 percent. Existing home sales fell by 13 percent and new single family home sales declined by 38 percent. The Federal Reserves' Senior Loan Officer Survey reported 14 straight quarters of net decline in demand for home mortgage loans and the Mortgage Bankers Association's weekly mortgage application survey saw a 19 percent drop in new purchase applications for 2008.

[2] Commercial/industrial and commercial mortgage loans increased by 2.6% in 2008. Consumer loans (credit card and installment) rose by 3%. 1-4 family mortgages dropped by 11% and construction by 2.6%.

value and were correctly reported at that lower value which can make it look like lending has fallen, when in fact, there may have been no change at all.[3] While we will not have first quarter data until mid-May, recent data suggests that there has been further contraction in commercial and industrial (C&I) and commercial real estate (CRE) lending, whereas residential mortgage loan balances have increased.

Looking solely at the outstanding volume of loans held by national banks, however, does not give a complete picture of the amount of *new* loan dollars that banks are extending, because it only captures the net change in loan volume. Because some portion of loans amortize or payoff each month and banks appropriately are charging off loans deemed uncollectible, the actual volume of new loans that banks are generating is higher than what is suggested by the level of outstanding balances. As noted in the U.S. Treasury's recent "January Monthly Lending and Intermediation Snapshot" report for the 21 largest Capital Purchase Program recipients, "the nation's largest banks continued to originate, refinance, and renew loans in January 2009 in the face of a worsening economic downturn."[4] The report notes that most institutions had higher originations across consumer lending categories than in December 2008, whereas C&I and CRE lending decreased due to weakening demand. Nonetheless, looking over the fourth month period, from October 2008 through January 2009, these financial institutions on a combined basis reported nearly $960 billion in loan originations, renewals, and refinancings. National banking organizations accounted for more than 80 percent of that total.

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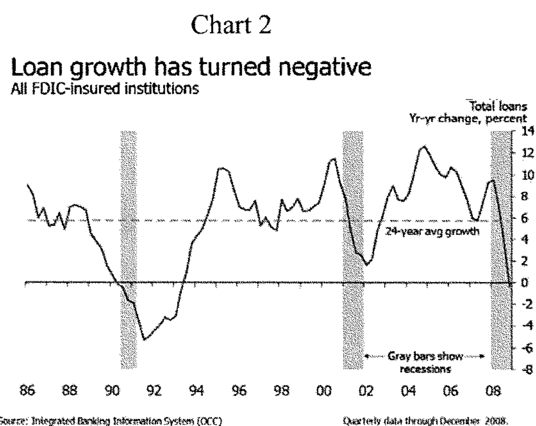
[3] Includes accounting adjustments related to Washington Mutual, but excludes those related to acquired thrift loans at Wachovia/Wells Fargo.
[4] *See* "Treasury Department January Monthly Lending and Intermediation Snapshot" at http://www.treas.gov/press/releases/tg59.htm and "Treasury Department Monthly Lending and Intermediation Snapshot" at http://www.treas.gov/press/releases/reports/tg30-2-122008.pdf.

But a recitation of figures on short-term fluctuations in bank lending makes it possible to lose perspective. While concerns about recent softening should not be minimized, as Chart 2 illustrates, this pattern is consistent with the experience of all insured depository institutions in past recessions.

Chart 2



A number of supply and demand-related factors are having a direct bearing on loan growth:

- Reduction in loan demand, as reductions in consumer spending lead businesses to cut back on inventory and other investments;

- Reductions in the demand for consumer and other credit from borrowers who may have been able to afford or repay a loan when the economy was expanding, but now face constrained income or cash flow and debt service capacity;

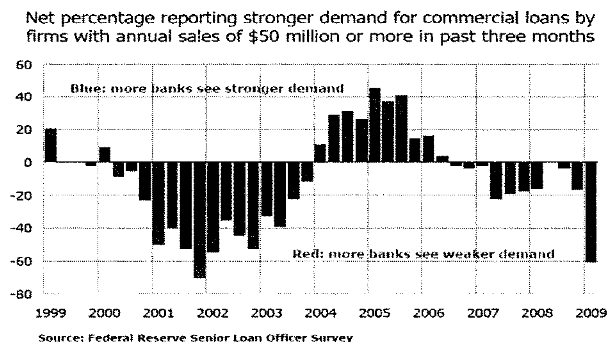
- Self-corrective actions taken by bankers to scale back risk exposures in the face of declining collateral values, and to strengthen underwriting standards and loan terms that had become, in retrospect, too relaxed; and finally,

- The absence of a normally functioning loan securitization market.

This interplay of factors and their effect on lending is consistent with a variety of recent reports and surveys. For example, as shown in Chart 3, data from the Federal

Reserve's quarterly Senior Loan Officer Survey illustrates that as the economy weakened, demand for bank loans waned.

Chart 3



This trend has continued in 2009. The Federal Reserve's January survey results show that nearly 70 percent of bank respondents reported the demand for C&I loans from large and middle market companies was moderately or substantially weaker and 65 percent reported weaker demand from small businesses. Almost 53 percent reported decreases in the number of inquiries from potential borrowers regarding the availability and terms of new credit lines. Reduced customer inventory and receivables financing needs and reduced investment in plant and equipment were factors cited as contributing to the decrease in loan demand. Nearly all respondents reported that the less favorable or more uncertain economic outlook and the worsening industry-specific problems contributed to tightening credit standards and loan terms.[5]

Similarly, the results of a recent National Small Business Poll on Access to Credit conducted by the National Federation of Independent Business indicate that only 8.9

[5] See: "January 2009 Senior Officer Opinion Survey on Bank Lending Practices," Federal Reserve Board, at: http://www.federalreserve.gov/boarddocs/SnLoanSurvey/200902/table1.htm.

percent of respondents cited an inability to obtain credit as their most immediate problem, compared to slowing or lost sales (45 percent) and the unpredictability of business conditions (23 percent).[6] The same study reports that "...sharply falling real estate values accompanied by the onset of what appears to be an abnormally severe recession have become the real small business problems and are the principal causes for the most obvious small business credit consequence, depressed demand."[7]

Because of various anecdotal reports about the shutdown of credit in the commercial real estate market, we recently asked our examiners at a cross section of national banks to describe their observations regarding banks' appetite for, and willingness to extend, this type of credit. Our findings indicate that while national banks are still making income-producing commercial real estate loans to well qualified borrowers, bankers are reducing their appetite for risk. Examiners report that most banks, both large and small, are being more circumspect in their underwriting.

For example, as real estate values continue to decline in many parts of the country, many banks are underwriting to lower loan-to-value ratios, typically in the 70 to 80 percent range, than was previously the case. Others are increasing cash equity requirements or are requiring higher pre-leasing requirements. We believe these more selective underwriting criteria have been prompted by the sharp deterioration of, and continued uncertainty about, the underlying real estate markets, rather than a fear of examiner criticism. Weaknesses in underlying commercial real estate projects, coupled with expectations that there will be further increases in retail and office vacancies, have led to concerns about the adequacy of debt service capacity and the ability of collateral to maintain its value. In addition, because most banks tend to be short-term lenders, some

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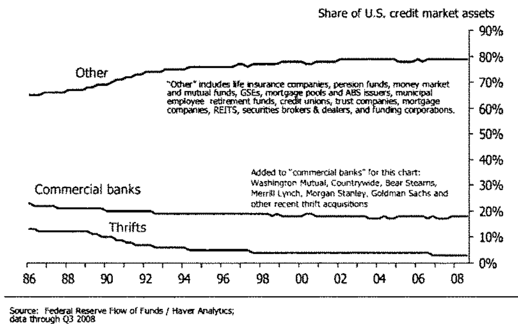
[6] NFIB National Small Business Poll – *Access to Credit*, page 15.
[7] Ibid, page 2.

banks have scaled back their commercial real estate lending due to the lack of more permanent financing for completed properties through the commercial mortgage-backed securities markets.

Another factor that has played a critical role in the reduction of credit availability is the absence of fully functioning and liquid securitization markets. While commercial banks are a key component of credit intermediation, as Chart 4 illustrates the bulk of U.S. credit market debt is held *outside* of the commercial banking system. In 2006, the non-agency securitization markets financed $1.46 trillion in new credit originations. By 2007, these levels had fallen to just under $1.1 trillion before contracting dramatically to $176 billion in 2008.[8] Restoring these markets must continue to be an overarching objective of our collective efforts to stabilize and revitalize our financial system. Banks do not and will not have the capacity to fill this gap.

Chart 4



[8] Non-agency securitizations include credit card, auto, student loan, collateralized debt obligations, subprime residential mortgage-backed securities, equipment, commercial mortgage-backed securities, other. Source: Deutsche Bank.

Regulators and Examiners are Taking a Balanced Approach Consistent with Safe and Sound Banking Practices

The mission of the OCC and our examination force is to ensure that the national banking system remains safe and sound and fully able to support the needs of its consumer and business customers. One of the most difficult jobs we have in carrying out this mission is knowing when and how to modulate our actions – when and how hard to tap on the brakes to rein in excessive risk taking without causing bankers to become so conservative or uncertain about regulatory actions that they unduly restrict credit. We are acutely aware that our actions – both on the policy side at the 50,000 foot level, and on the ground, through our on-site examinations – can and do influence banks' behavior and their appetite for taking risk. We also recognize that in past downturns, many believed that overzealous regulators and examiners exacerbated the contraction in credit.

One of the lessons we learned from the early 1990s was the detrimental effect of waiting too long to warn the industry about excesses building up in the system, resulting in bankers and examiners slamming on the brakes too hard when the economy experienced problems. We also learned that it is critical that our expectations for bankers be clear and consistent; that the "rules of the game" under which banks operate not be changed abruptly, and that changes in regulatory policies are made in an open and transparent manner that provides bankers with reasonable timeframes to make necessary adjustments.

Throughout this credit cycle, we have strived to take a balanced and measured approach in our supervision, alerting banks as early as September 2003 when we started to see signs of increasing risk embedded in their loan portfolios. These alerts were followed by more specific and targeted supervisory guidance and on-site examinations. To ensure that our expectations and guidelines were clear and transparent, we sought

public and industry comment on the guidelines before they were issued and became effective. We also conducted numerous outreach sessions with bankers and bank directors to discuss our concerns and outline our expectations.

More specifically with respect to residential mortgage, home equity, and commercial real estate loans, we started alerting bankers to our concerns as early as 2003 and 2004 in response to the results of various targeted horizontal examinations conducted at a cross-section of banks. While these portfolios were generally still showing favorable performance metrics, we were concerned with declining underwriting practices that were becoming widespread in the industry. These practices included interest only and payment option ARMs, which were often underwritten with limited documentation and no income verification, within residential loan portfolios; extended maturities for revolving home equity lines of credit with little or no amortization of loan balances and acceptance of higher loan-to-value ratios; and increasing concentrations within the commercial real estate portfolios at many community banks. As a result of these findings, we worked closely with the other federal banking agencies to develop and issue additional risk management guidelines for these products.[9]

Similar supervisory concerns led to the 2003 interagency guidance on Credit Card Account Management and Loss Allowance Practices, which addressed a number of inappropriate account management, risk management, and loss allowance practices identified through our examinations. These practices, which often increased credit risk and masked portfolio quality, included the general easing of minimum payment requirements, increased negative amortization, liberal credit line management, and

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[9] See: OCC Bulletin 2005-22, "Credit Risk Management for Home Equity Lending;" OCC Bulletin 2006-41, "Interagency Guidance on Nontraditional Mortgage Product Risks;" OCC Bulletin 2006-46, "Interagency Guidance on CRE Concentration Risk Management;" and OCC Bulletin 2007-26, "Statement on Subprime Lending."

excessive over-limit activity. Although we faced considerable criticism by some that our guidance and actions could have negative repercussions on bank profitability, consumer spending, and the broader economy, we thought it was critical that the continuing decline in required minimum payments be curtailed. We also issued additional guidance to national banks on credit card marketing and account management practices that could involve unfair or deceptive acts or practices, or other violations of laws or regulations.

Our goal in issuing these guidelines has been to ensure that bankers recognize potential problems at an early stage so that they can take steps to mitigate risk, including strengthening systems to identify loans or borrowers whose conditions have or are likely to deteriorate; building and maintaining adequate loan loss reserves; obtaining current appraisals when needed to reflect current market conditions; and working with borrowers to restructure credit terms, if appropriate.

We reinforce our expectations through numerous outreach venues with bankers and discussions with bank management teams through our ongoing supervisory efforts. The Comptroller and I, along with other members of the OCC's senior management team, make frequent speeches and visits to a variety of industry groups to convey our message and to listen to their concerns and issues. These sessions are supplemented by our managers in the field who hold frequent meetings with bankers and bank directors, and by web conferences for bankers led by OCC examiners and risk experts. We also conduct a series of workshops tailored for community bank directors that discuss key risk concepts and regulatory requirements, including a credit risk workshop designed to improve directors' ability to affect and influence credit risk in their banks. For banks where we do not have a continuous on-site presence, examiners conduct quarterly calls and onsite visits with bank management to discuss emerging trends and issues.

Equally important to the outreach we conduct with bankers are the steps we take with examiners, through training, guidance, and periodic nationwide conference calls, to ensure that they understand and apply our policies in a consistent manner. We also have various mechanisms in place to help ensure consistency in our examination findings and any attendant supervisory actions. For example, each report of examination is reviewed and signed off by the applicable deputy comptroller or assistant deputy comptroller before it is finalized. Supervisory enforcement actions are reviewed by district and, for certain cases, headquarter supervisory review committees. Our Large Bank and Midsize/Community Bank lines of business have instituted quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies and procedures. These reviews are augmented by targeted reviews conducted by the OCC's Enterprise Governance unit.

Notwithstanding these efforts, there are going to be occasions where we may not have made the right call, or where there are additional facts and circumstances that a banker believes were not given full consideration. To address these situations, the OCC was the first federal banking agency to establish an Office of the Ombudsman. The independent Ombudsman's office administers the OCC's national bank appeals process that bankers may use to appeal a pending supervisory action or decision. Perhaps more important, the Ombudsman's office provides bankers with an impartial ear to hear complaints and a mechanism to facilitate the resolution of disputes with our supervisory staff. The office also administers the OCC's consumer complaint resolution process.

As we work through this stage of the credit cycle, our message to examiners continues to be this: take a balanced approach; communicate concerns and expectations clearly and consistently; and provide bankers reasonable time to document and correct

credit risk management weaknesses. This does not mean that examiners are giving bankers a "free pass" to ignore or obfuscate their credit problems. If a banker does not or cannot identify and take appropriate action to manage the risks in the bank's credit portfolio, examiners will direct bank management to take corrective action. Our expectations and standards for banks remain the same throughout the cycle. Specifically, bankers should:

- Make loans to borrowers on prudent terms, based on sound analysis of financial and collateral information, with a full assessment of the borrower's ability to repay;
- Have sufficient risk management systems and practices to be able to identify, manage, and control risks;
- Continue to work with borrowers to restructure or modify loans so that foreclosure or repossession of collateral is avoided wherever possible;
- Set aside sufficient reserves and capital to buffer and absorb actual and potential losses; and
- Accurately reflect the condition of their loan portfolios in their financial statements.

At some institutions where bank management has not sufficiently identified or addressed their loan problems, our reviews may result in a bank needing to make additional loan loss provisions; to charge off loans that are deemed loss; or to place loans on nonaccrual where full collection of principal and interest is in doubt. Similarly, some banks may be directed to strengthen their credit underwriting or risk identification and management practices. These efforts may prompt bank management to obtain new appraisals, rework loan terms or covenants, or reduce concentrations to certain borrower or industry segments. While these actions may be prompted by an examiner's directive to improve risk management, let me underscore what examiners will not do. Examiners will not tell bankers to call or renegotiate a loan; dictate loan structures or pricing; or

prescribe limits (beyond regulatory limits) on types or amounts of loans that a bank may make if the bank has adequate capital and systems to support and manage its risks. These are and must be decisions by bank management. It is also important to note that an examiner's directive to classify a loan does not preclude bankers from working with those borrowers to restructure or modify the loan. As stated above, the OCC expects and encourages bankers to continue to work constructively with customers who may be facing difficulties in meeting their loan obligations.

Similarly, I would like to clarify four other misperceptions that we hear from bankers and others about examiners' actions.

- *Examiners are directing banks to classify loans to borrowers who are current and can meet their debt obligation – what has sometimes been referred to as "performing non-performing" loans.* The OCC will not direct banks to classify borrowers who have the demonstrated ability to service their debts under reasonable payment schedules. There are instances, however, where liberal underwriting structures can mask credit weaknesses and obscure the fact that perceived performance by the borrower is really illusory. This can be the case where the initial term of the loan allows a borrower to delay any meaningful principal amortization or uses an introductory low interest rate that will increase over the life of the loan. Or, a more common example in today's environment, bank-funded interest reserves on commercial real estate projects. For these types of loans, the initial contractual payment performance does not reflect the ultimate payment terms that a borrower must meet, and may mask deterioration in the borrower's underlying condition and hence, their ability to continue to perform over the life of the loan. In these cases, examiners will not just accept that the

loan is good quality because it is current. Examiners will also evaluate the borrower's ability to make future payments required by the terms of the loan, or, in the case of certain types of commercial real estate projects, the viability of the underlying project. This forward-looking analysis may sometimes result in classifying a loan that is still current. This is appropriate because, while the borrower may be "current" under their existing liberal contractual obligation, there are demonstrable weaknesses that raise obvious doubts about the borrower's ultimate ability to repay the loan.

- *Examiners are criticizing loans or borrowers simply because the current market value of their collateral has declined.* The OCC does not classify borrowers solely as a result of a decline in collateral value. An evaluation of a credit is based principally on cash flows, whether derived from operations or conversion of assets, not collateral. The collateral value, while often directly tied to the ability to generate cash, is not a sufficient reason by itself for an examiner to classify a loan. For many commercial real estate projects, however, the value of the collateral and the repayment of the loan are both dependent on the cash flows that the underlying project is expected to generate. Because of this linkage in these types of loans, current collateral values can be an important indicator of the project's viability and can signal adverse changes, such as the loss of major tenants that will adversely affect the cash flow that will ultimately be available to service or repay the loan.
- *Examiners are telling bankers to stop making commercial real estate loans.* The OCC does not direct what types of loans a bank can make. We do, however, expect banks to appropriately recognize and manage their risks, including the

risks that can be posed from significant loan concentrations with a borrower, market or industry segment. There are some banks that may need to strategically redirect resources from a particular type of lending. This can be due to a number of factors, including past decisions by management to become too concentrated in a particular product or poor underwriting and risk selection decisions that have led to an excess level of problem loans within a particular product line. In these instances, we expect bank management to take prudent steps to manage their risk appropriately, and in fact, they may need to reduce their concentration levels for various products.

- *If bankers raise issues with an examiner or examination finding, examiners will retaliate.* While this is not a common allegation, it is one so serious that I want to take this opportunity to address it with the Committee. Simply put, this type of behavior is not tolerated at the OCC. Any banker who believes this is an issue should contact me or the OCC's Ombudsman directly to discuss the specific circumstances underlying their concerns.

Conclusion

We are clearly dealing with an unprecedented financial and credit environment that will require the resources and cooperative efforts of both the public and private sectors to resolve. While I believe we are taking positive steps to address these problems, I also fully expect that we will see further deterioration in some banks' loan portfolios in the months ahead as the effects of the economic downturn work through these portfolios. Nonetheless, it is critically important that we not lose sight of several important facts:

- The vast majority of national banks are strong and have the capacity to weather this financial storm;

- The vast majority of borrowers – both consumers and businesses – are performing and meeting their loan obligations; and
- National banks are continuing to meet the legitimate credit needs of their communities.

The OCC is committed to work constructively with bankers as they work through these problems. We will continue to encourage bankers to extend loans to creditworthy borrowers and stress that we expect them to work with borrowers who are facing financial difficulties. And we will continue to ensure that our supervision remains fair and balanced.

Testimony of
R. Michael S. Menzies, Sr.
President and CEO, Easton Bank and Trust Company

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

"Exploring the Balance between Increased Credit Availability and Prudent Lending Standards"

March 25, 2009
Washington, DC

Chairman Frank, Ranking Member Bachus, Members of the Committee, my name is Michael Menzies, and I am the President and CEO of Easton Bank and Trust Company, Easton, MD, and the Chairman of the Independent Community Bankers of America[1]. Easton Bank is a state-chartered community bank with $150 million in assets. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on "Exploring the Balance between Increased Credit Availability and Prudent Lending Standards."

Mr. Chairman, this nation is going through its worst economic crisis in 75 years. The vast majority of our nation's community bankers are well-capitalized, well-managed common sense lenders. Community banks are ready and willing to help in the economic recovery by lending to small businesses and consumers in their communities. However, the current bank regulatory climate is causing many community banks to unnecessarily restrict their lending activities. Left unaddressed, certain field examination practices, the proposed FDIC special assessment and mark-to-market accounting rules will prevent community banks from realizing their full potential as participants in the rebuilding of our economy

The following is a summary of concerns of our members with the current regulatory environment.

- On November 12, 2008, the federal banking agencies issued a statement that they "expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers."
- ICBA commends the banking agencies for issuing the Interagency Statement.
- However, actions of bank field examiners are often unnecessarily putting constraints on community bank lending.
- Community bankers are saying that the field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional independent appraisers and demanding overly

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[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $1 trillion in assets, $800 billion in deposits, and more than $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

aggressive write-downs and reclassifications of viable commercial real estate loans and other assets.

- Bankers also report that examiners are being tougher on banks that have taken, in the view of the examiners, significant amounts of Federal Home Loan Bank advances. Many community banks rely on the Federal Home Loan Bank System to provide liquidity, for asset-liability management purposes and for longer-term funding not available to them through deposits.
- These practices undermine the fundamental goal of the Interagency Statement. In this climate, community bankers may avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital.
- ICBA appreciates recent overtures from banking regulators to foster communications between the banks and regulators on the examination environment, and steps taken by regulators to educate their field staffs on the consequences of overly restrictive examination practices on credit availability.
- The one-time 20 basis point special assessment announced by the FDIC in February will severely reduce earnings for community banks in 2009, dramatically reducing funds available for lending to creditworthy borrowers.

- Current mark-to-market accounting rules have a highly negative impact in trying to get credit flowing. We appreciate the Committee's efforts to address the consequences of mark-to-market accounting.

ICBA has six recommendations, listed at the end of the statement, that would improve the current regulatory environment for community bank lending.

Interagency Statement Encourages Cooperation

The November 12, 2008, Interagency Statement on Meeting the Needs of Creditworthy Borrowers established a national policy for banks to extend credit to creditworthy borrowers as a means to help our nation get back on its economic feet. It stated that, "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers."[2]

The statement also stressed the importance of banks and regulators working together to ensure that these needs are met: "At this critical time, it is imperative that all banking organizations and their regulators work together to ensure that the needs of creditworthy borrowers are met."[3]

[2] Interagency Statement on Meeting the Needs of Creditworthy Borrowers, November 12, 2008
[3] Ibid.

Community Banks Ready to Lend

Let me assure this committee that our nation's community banks are ready, willing and able to meet the credit needs of our communities and to help in the nation's economic recovery. Even in today's economic climate, the vast majority of community banks remain well-capitalized, because they are common sense lenders that did not engage in the risky practices that led to the current economic crisis. Most community banks stuck to the longstanding fundamentals of responsible banking, and are more risk-averse than big Wall Street or regional banks. In spite of the trouble on Wall Street, community banks remain committed to taking deposits and making loans on Main Street, and are anxious to do our part to aid the economic recovery.

Indeed, ICBA commended the banking agencies last fall for issuing the Interagency Statement. We believe it is important for banks and their regulators to work together to ensure that the needs of creditworthy borrowers are met. Given the fact that most community banks are well capitalized and have appropriate dividend, compensation, and loss mitigation policies, we believed – and still do -- that the community banking industry is well prepared to comply with the new guidelines.

However, for the Interagency Statement to have its intended effect regarding lending, the banking agencies must address the current examination environment. Mr. Chairman, we are hearing from community bankers all across the nation that this level of cooperation, at least at the field examiner level, is not being achieved. In fact, we are hearing the opposite. In a recent (if unscientific) survey conducted by ICBA, 61 percent of respondents said that their most recent safety and soundness exam was "significantly tougher" than their last exam.[4] Several bankers commented that they were being treated like they had a portfolio full of sub-prime mortgages, even though they had no sub-prime loans on their books.

Field Examiners Criticize Good Loans

Community bankers are saying that the field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional independent appraisers and demanding overly aggressive write-downs and reclassifications of viable commercial real estate loans and other assets.

While the banking regulators in Washington have been very willing to discuss their safety and soundness examination policies with us and have reassured us

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[4] ICBA "Quick Poll," July 7, 2008

that they are taking measures to ensure their examiners are being reasonable, we continue to hear from our members that their examinations are unreasonably tough.

For example, one banker told us he was forced to write down a real estate loan based solely on absorption rates (lots sold) and not on the current market condition or the ability of the borrower to repay the loan. This had an impact of $100,000 on that bank's earnings.

Other bankers are complaining that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that is unjustified in today's world and could ultimately lead to capital problems at otherwise healthy banks.

Other reports from community bankers cited examiners requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have not been criticized before; and substituting their judgment for that of the appraiser.

In some cases, banks are suddenly finding themselves classified as "adequately capitalized" rather than "well-capitalized" because of these tough examinations. When a bank becomes "adequately capitalized," it must seek a waiver from the FDIC before it can continue to accept brokered deposits. Yet, the FDIC is being very tough on granting brokered deposit waivers causing further liquidity problems for banks.

Examiners Tougher on FHLB Borrowers

Bankers also report that examiners are being tougher on banks that have taken, in the view of the examiners, significant amounts of Federal Home Loan Bank advances. Many community banks rely on the Federal Home Loan Bank System to provide liquidity, for asset-liability management purposes and for longer-term, cost-effective funding not available to them through deposits. This is a solid, reliable source of funding for community banks that own and hold capital in the Federal Home Loan Banks. Bankers report that some examiners do not believe that available lines of credit at Federal Home Loan Banks provide real liquidity. Community banks generally have ample acceptable collateral to pledge against their FHLB advances, and therefore, ready access to FHLB advances.

These practices not only undermine the fundamental goal of the Interagency Statement, they are costing community banks money, leading to a contraction of credit, and forcing many of them to rethink their credit policies. Under this

climate, community bankers may avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital.

Examination Practices Hurt Bottom Line, Impair Banks' Ability to Lend

While we expect examiners to be more thorough and careful with their examinations during an economic downturn, based on what we have heard from our members, we believe that in many cases examiners have gone too far. Unfortunately, excessively tough exams that result in potentially unnecessary loss of earnings and capital can have a dramatic and adverse impact on the ability of community banks to lend, impairing their ability to support economic growth. Since community banks are the prime engine behind small business lending, any contraction of lending would further exacerbate the current economic downturn and impede attempts by policymakers to keep loans flowing to creditworthy borrowers to help foster an economic recovery.

Community Banks Appreciate New Overtures by Banking Regulators

The FDIC recently hosted a roundtable between banks and federal regulators to discuss the lending and examination environment. ICBA was pleased to participate in the roundtable with several of our member banks. The discussions provided community banks an opportunity to explain to agency officials in Washington what the bankers are experiencing during examinations and other contacts with agency field staff. The roundtable was an important step in fostering better communication on these issues.

ICBA also appreciates comments by FDIC Chairman Bair and Federal Reserve Chairman Bernanke at our convention last week. Chairman Bair explained the FDIC has made clear that examiners should not classify performing loans solely because the value of any underlying collateral has declined, particularly when other indicators are healthy. Chairman Bernanke remarked the Federal Reserve System is conducting examiner training and outreach to remind examiners to be mindful of the procyclical effects of excessive credit tightening.

Special Assessment Will Dampen Ability to Lend

Special Assessment

The one-time 20 basis point special assessment announced by the FDIC in February to replenish the Deposit Insurance Fund (DIF) also will make it more difficult for community bankers to fulfill the mandate in the Interagency Statement. This assessment, which could be the first in a series, will seriously cut into the earnings of community banks. ICBA asked its members to estimate

the impact of the special assessment on their earnings. According to the survey, 32% of community banks answering estimated the special assessment will consume 16-25% of their 2009 earnings; 17% of the respondents estimate it will consume 26-40% of earnings.

Reduced earnings could push some community banks into a higher risk category, which could require them to increase capital and loan loss reserves. This would have a dampening effect on their ability to meet the credit needs of their communities. The FDIC has already indicated that the special assessment will cause 12 to 17 institutions to become undercapitalized.

One banker reported that he had planned to increase his auto lending business because other auto lenders in his community were no longer able to meet the demand. But after calculating the cost of the special assessment on his bank, he made the decision that he could no longer afford to expand his auto lending operation. This not only will affect his bank, but will adversely affect consumers, auto dealers, and other businesses in his community.

Community banks are being unfairly penalized with this assessment. We did not participate in the risky practices engaged in by large Wall Street institutions that led to the economic crisis, yet we are being penalized by having to pay this onerous special assessment.

ICBA urges the FDIC to seek alternatives to the special assessment, such as borrowing from Treasury or the industry, or issuing bonds, to temporarily fund the DIF, with the industry repaying the amount borrowed, with interest. The DIF will still be industry-funded if the FDIC uses its borrowing authority, but the industry would be able to spread the cost of funding the DIF over time. In addition, the FDIC should seek to shift the cost of replenishing the DIF to those institutions responsible for the economic crisis and away from community banks.

ICBA supports FDIC borrowing authority amendments found in H.R. 1106, adopted by the House on March 5, 2009, and S. 541, which was introduced in the Senate on the same day. Both bills bill would increase the FDIC's standby line of credit with the Treasury from $30 billion to $100 billion. In addition, S. 541 would also temporarily allow the FDIC to borrow up to $500 billion with the concurrence of the Federal Reserve and the Secretary of the Treasury, in consultation with the President. According to FDIC Chairman Bair, the increased borrowing authority up to $500 billion would allow the FDIC to reduce this special assessment to as much as one-half of the proposed rate.

ICBA appreciates Chairman Bair's commitment to a reduction in the special assessment, if the FDIC is granted borrowing authority up to $500 billion. We appreciate the House's efforts to increase in FDIC borrowing authority, and urge Congress to act quickly to raise the borrowing authority to $500 billion. We also

appreciate the FDIC's decision to devote some fees received in connection with its Temporary Liquidity Guarantee Program to shoring up the DIF now, rather than waiting to transfer that portion of the TLGP fees to the DIF at the end of the TLGP. However, we still believe it is in the best interest of our communities, if the FDIC were to find an alternative to the special assessment in order to keep as much capital in the community banking system for lending.

Assessment Base

ICBA also urges the FDIC to use an asset-oriented assessment base for all deposit insurance assessments, including any special assessment. The change would result in a fairer assessment system than the current one, which assesses all domestic deposits. Bad assets, not deposits, cause bank failures, and all forms of liabilities, not just domestic deposits, fund a bank's assets. The amount of assets that a bank holds is a more accurate gauge of an institution's risk to the FDIC than the amount of a bank's domestic deposits

Under the current system that assesses domestic deposits, community banks pay approximately 30% of FDIC premiums, although they hold about 20% of bank assets. And while community banks fund themselves 85-95 percent with domestic deposits, for banks with more than $10 billion in assets the figure is 52 percent. Thus, while community banks pay assessments on nearly their entire balance sheets, large banks pay on only half.

ICBA believes it would be fairer if the FDIC were to use assets minus tangible equity (to encourage higher levels of tangible equity) as the assessment base instead of domestic deposits. Changing the assessment base does not change the amount of revenue the FDIC will receive. It only changes how the premium assessments are distributed among FDIC institutions. Under the asset-oriented assessment base, community banks would bear their proportionate share, or about 20% of deposit insurance premiums rather than the current 30%.

Disparate Treatment in Enforcement Actions

I also would like to call to the committee's attention the apparent disparate treatment between small banks and too-big-to-fail banks in the area of enforcement actions. Community banks did not engage in the high-risk activities that led to the problems in the mortgage marketplace and the current financial downturn. And community banks are generally well-managed and well-capitalized institutions that practice the fundamentals of responsible banking. Nonetheless, most enforcement actions seem to be aimed at community banks and not the money center and regional banks that caused most of the problems.

It is unfair to continue to ask community bankers to play by the rules, while the too-big-to-fail banks continue to ignore the rules with impunity and no apparent consequence. They were the first in line, and the first to receive, TARP assistance, while community banks are still trying to gain access for all types of community bank charters. But I have yet to hear of an enforcement action against a too-big-to-fail bank, while such actions are commonplace in the community banking industry. This is difficult for many community bankers to understand.

"Mark-to-Market" Rules Are Exacerbating Downturn and Constraining Lending

Impact of Mark-to-Market Accounting

Current mark-to-market accounting rules hinder transparency and distort the true condition of financial institutions holding mortgage-backed securities (in particular private label mortgage-backed securities), asset-backed securities (including consumer loan-backed and student loan-backed securities) and other debt securities. This, in turn, has a highly negative impact in trying to get credit flowing in these important sectors of the capital markets. We appreciate the efforts of Chairman Frank, Chairman Kanjorski and members of the Committee to help resolve the mark-to-market issues. The hearing on March 12th by the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises was a very important step in the resolution of these issues.

At the hearing, ICBA's witness, the President of Brentwood Bank in Pennsylvania provided a real life example of the consequences of the current rule. In the case of Brentwood, the bank had to take approximately $2 million in capital charges as a result of current mark-to-market rules. He explained the $2 million in charges represent lost opportunity cost to finance an additional $20 million in loans based on a 10% equity requirement. The loss has also made the bank a bit more conservative as it looks at new lending opportunities.

Moreover, the current rules have made borrowing from several Federal Home Loan Banks more expensive. Because of artificial write downs in their mortgage backed securities portfolios, these FHLBs have had to suspend dividends and, in some cases, stock redemptions. These actions increase the all-in cost of FHLB advances for community banks. Community banks rely on FHLB advances as a reliable source of funding, in addition to deposits. An increased cost for FHLB advances further constrains community bank earnings and lending.

ICBA's Proposed Solution

The application of mark-to-market in frozen markets is the heart of the problem. When these rules were developed, the current unprecedented situation could not

have been imagined. ICBA proposes an alternative that addresses other than temporary impairment (OTTI).

Congress should ask the SEC and FASB to apply existing accounting rules that apply to loans held in portfolio to asset- backed securities and other debt securities for which the institution has the intent and ability to hold. The determination of whether OTTI exists as well as the magnitude of loss recorded should be based on a rigorous credit analysis appropriate to the characteristics of the securities, taking into account the nature of any credit enhancements. Any OTTI should reflect the true economic loss (i.e., probable credit losses). If economic losses change, such changes would be recognized immediately through earnings. To accommodate the existing GAAP fair value framework and provide transparency as to the recorded amounts, the OTTI loss on held-to-maturity (HTM) debt securities should be separated and reported in two components: (1) through earnings for probable credit losses and (2) through the footnotes to financial statements to disclose the fair (market) value of the securities.

This proposed solution would also work for Available-For-Sale securities that the institution intends to hold until recovery. The OTTI loss should be (1) recognized through earnings for probable credit losses and (2) all other portions of the loss (such as from liquidity discounts) will remain in accumulated other comprehensive income (loss) in stockholders' equity until the security is sold or matures.

New FASB Proposal

At the March 12th hearing, Chairman Kanjorski secured a commitment from the Chairman of FASB to issue additional guidance on these issues by April 2nd. We commend the Chairman and committee members for pressuring FASB to act quickly to address mark-to-market problems so institutions do not face further inappropriate write downs at the end of the first quarter. On March 17th, FASB released two proposed staff positions (FSP) on fair value measurements and OTTI. The proposal does incorporate our recommendation that credit losses be recognized through earnings, while market-related loses are recorded in other comprehensive income in shareholders' equity until the security is sold or matures. . We believe the two proposals are an important step in addressing mark-to-market accounting problems. We are carefully reviewing the proposals and will likely offer suggestions for further clarifications. We and others in the financial services industry will be providing comments to FASB before its final action, now scheduled for April 2, 2009.

We appreciate the Committee's commitment to recall the FASB, SEC and OCC to a hearing, after the Passover-Easter recess, to examine the effectiveness of the proposed changes. We believe that it might be appropriate for the committee to ask the Public Company Accounting Oversight Board (PCAOB) to also testify

at this hearing in order to determine how that agency will guide auditors on these issues in light of the new FASB proposal to ensure consistent application of these accounting guidance changes.

Recommendations for Change

Community banks are ready to meet the objectives stated in the Interagency Statement of lending to creditworthy households and businesses, but they cannot meet those objectives without a change in the current regulatory environment.

ICBA has six recommendations that would improve the current regulatory environment for community bank lending.

1. The agencies should adopt a more flexible and reasonable examination policy, particularly with regard to real estate lending, and provide more transparency in the criteria that the examiners use to evaluate loans in the examination process. There should be more dialogue between bankers and bank examiners to reduce the intimidation factor many bankers may feel.

2. The agencies should insist that examination criteria be applied consistently across the country so as not to discriminate against banks based solely on their geographic location.

3. The appeals process should be strengthened to make it easier for bankers to appeal without fear of examiner retaliation. In addition, the ombudsman determinations should be strengthened and the office made more independent, again to reduce the possibility of retaliation.

4. With respect to commercial real estate loans, examiners should take a longer term view of real estate held by banks as collateral and should not demand aggressive write-downs and reclassifications of loans based on forced sales of real estate that occur during illiquid or dysfunctional markets. The FDIC should be more flexible with regard to granting broker deposit waivers for banks that have unexpectedly been classified as "adequately capitalized."

5. During this economic crisis, some consideration should be given to the basket approach, under which a bank would be permitted to hold a "small basket" of character loans from borrowers who have a strong record of meeting contractual obligations with the bank and where there are other indicators of likely repayment of the loan. Loans in the basket would be exempt from strict underwriting standards and could not be criticized by examiners so long as the loans are performing.

The amount of loans that could be held in such a basket could be a percentage of total capital.

6. Congress should ask the SEC and FASB to apply existing accounting rules that apply to loans held in portfolio to asset-backed securities and other debt securities for which the institution has the intent and ability to hold. To accommodate the existing GAAP fair value framework and provide transparency as to the recorded amounts, the OTTI loss on held-to-maturity (HTM) debt securities should be separated and reported in two components: (1) through earnings for probable credit losses and (2) through the footnotes to financial statements to disclose the fair value of the securities. This proposed solution would also work for Available-For-Sale securities that the institution intends to hold until recovery.

Thank you for this opportunity to testify. I would be happy to answer any questions the committee may have.

Embargoed until
March 25, 2009, at 10:00 a.m.

Statement of

Scott M. Polakoff, Acting Director
Office of Thrift Supervision

concerning

Exploring the Balance between Increased Credit Availability and Prudent Lending Standards

before the

Committee on Financial Services
United States House of Representatives

March 25, 2009

Office of Thrift Supervision
Department of the Treasury

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Exploring the Balance between Increased Credit Availability and Prudent Lending Standards before the Committee on Financial Services United States House of Representatives March 25, 2009

Statement of Scott M. Polakoff, Acting Director Office of Thrift Supervision

I. Introduction

Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. Thank you for the opportunity to testify on behalf of the Office of Thrift Supervision (OTS) on finding the right balance between ensuring the safety and soundness of U.S. financial institutions and ensuring that adequate credit is available to creditworthy American consumers and businesses.

Available credit and prudent lending are both critical to our nation and its economic well-being. Neither one can be sacrificed at the expense of the other, so striking the proper balance is key.

Access to credit is essential to spur economic recovery. Banks and thrifts should never have to turn away a good customer. Yet, as you well know, the trust that is vital to our financial system has been shaken by fear and questions about whether money that is loaned will be repaid. If trust is the lubricant for a well-running financial system, a lack of trust is a gum that prevents the system from operating smoothly.

In a smoothly running system, financial institutions offer an array of loan products, so creditworthy borrowers are able to obtain loans at reasonable rates.

As we assess whether current economic conditions are causing mixed messages to be sent to banks and thrifts, it is important to note that the OTS and the other banking regulators are also receiving mixed signals. When financial institutions fail, regulators are subject to criticism for not having cracked down hard enough and early enough. Yet, regulators are also urged not to tighten the screws too tightly— lest financial institutions become too cautious, hoard their resources and become unreasonably hesitant to lend.

In exploring ways for making the system run smoothly again, I'd like to begin by citing reports that define the scope of the problem, then discuss important facets of the problem before discussing possible solutions. On the subject of solutions, one obvious point is that the ultimate solution is for this nation to find its way past its current economic downturn. Until that happens, credit will remain tight and our financial institutions will continue to face daunting challenges with loan delinquencies, charge-offs and other credit quality issues that threaten their viability.

II. Recent Data on Credit Demand and Availability

The OTS uses a variety of measures to gauge credit availability and lending activity. Our examiners and regional staff members routinely talk to thrift institution managers about what they are experiencing in their market areas with regard to credit demand and credit availability. These issues are discussed by supervision staff members within each OTS region, between regions and in regular meetings between our four Regional Directors and senior agency leaders at our headquarters in Washington.

We also assess the availability of credit by reviewing the detailed financial reports — called Thrift Financial Reports or TFRs — that thrift institutions file quarterly with the OTS. TFRs contain data on originations, purchases and sales for major loan types. From this data, we can detect changes in lending volumes and compare those changes to peer groups. We also compare the lending volumes to outside indicators of credit availability and demand.

For OTS-regulated thrifts, total loan originations and purchases declined about 11 percent from 2007 to 2008. However, several categories of loans — such as consumer and commercial business loans, and nonresidential and multifamily mortgages — increased during the period.

Other recent studies confirm that credit is tight, but not getting increasingly tighter, and that demand for residential mortgages has decreased.

According to a mortgage loan application survey last month (February 20, 2009) by the Mortgage Bankers' Association of America, mortgage purchase applications have declined 30 percent from one year ago. Given the rise in unemployment and general economic conditions, that finding is not surprising.

The Federal Reserve Board (Fed) has issued two releases recently on the availability of credit. In January, the Fed's quarterly opinion survey of senior loan officers on bank lending practices showed that credit continued to remain tight during the final three months of 2008.

However, the survey said credit was not getting any tighter: a smaller percentage of institutions toughened their lending standards for consumers and commercial customers during the fourth quarter of 2008 than during the previous quarter. About 45 percent of the survey respondents reported weaker demand for consumer loans of all types, similar to the percentage in the previous quarter.

A second report from the Fed, a statistical release on consumer credit dated February 6, 2009, said consumer credit decreased at an annual rate of 3 percent in the fourth quarter of 2008.

III. Facets of the Problem

a. The Swinging Pendulum

It is clear today that during the recent housing boom, credit was extended to too many borrowers who lacked the ability to repay their loans. For home mortgages, some consumers received loans based on their ability to pay introductory teaser rates, an unfounded expectation that home prices would continue to skyrocket, inflated income figures, or other underwriting practices that were not as prudent as they should have been. Many of these mortgages might have worked out fine if housing prices had continued moving upward, but as we know, home prices in many parts of the country have dramatically fallen and the consequences of weak underwriting have caused significant distress for many financial institutions, homeowners and businesses.

Given this recent history, some tightening in credit is expected and needed. Borrowers must have adequate capacity to repay the loans they receive. An absence of sound underwriting can have a severe, negative impact on financial institutions, consumers and the economy.

At the same time, we must ensure that the pendulum does not swing too far in the other direction and restrict credit availability to an unhealthy level.

b. Economic Contraction, Capital and Loan Loss Reserves

The fallout from current economic deterioration has had an impact on credit availability in a variety of ways. For example, the number of nonbank businesses offering credit has declined as many of these highly leveraged, under-regulated companies that engaged in consumer and business lending — often with loose underwriting standards — have gone out of business.

The economic contraction has also prompted some financial institutions to exit entire lines of business. In one prominent example, a large bank announced earlier this month that it will no longer write new consumer loans in the U.S. and will shut down its U.S. lending unit over the next five years due to the collapse of the subprime mortgage market. In October, another bank discontinued accepting mortgages originated by outside mortgage brokers.

To meet the challenges facing them, U.S. financial institutions are building capital and setting aside additional reserves as buffers against the effects of future losses. Decreases in asset quality, and increases in delinquencies and charge-offs for mortgages, credit cards and other types of lending, require institutions to supplement loan loss reserves and augment capital to preserve safety-and-soundness. Although these needs may place a strain on institutions' ability to lend, strengthening capital and reserves provides a critical foundation for maintaining institutions' stability and continued health.

Also, the freeze-up of the market for non-government-sponsored-enterprise mortgages has forced financial institutions to hold more loans on their books. To carry these loans, the institutions need to maintain higher capital levels.

Although the Treasury Department's Troubled Asset Relief Program, or TARP, is making capital available to institutions, access to capital from other sources remains constrained.

Regarding capital standards, I would like to dispel some inaccuracies receiving recent attention. The first is the notion that federal bank and thrift examiners are raising capital requirements for the financial institutions they regulate. This incorrect assertion has been circulated perhaps because the financial services industry generally is facing significant challenges and, at the OTS, this stress has resulted in a marked increase in formal enforcement orders related to safety-and-soundness. Under such actions, which include cease-and-desist orders, institutions are often required to maintain capital levels above the well-capitalized standard. Although these types of cases are increasing, they remain relatively few in number and the requirements are necessary to provide a counter-balance to the elevated risks confronting these institutions.

A second inaccuracy in public circulation is the assertion that federal banking regulators are raising capital standards for financial institutions that receive TARP funds. That is not the case. Funds under TARP are provided to viable banks and thrifts. By definition, these institutions are considered healthy before receiving TARP support. In some cases, the OTS is requiring institutions to raise private capital before receiving TARP support. The additional private capital is necessary for these institutions to be considered healthy before receiving that support.

c. Consumer Confidence and Complaints

Because the economic crisis has driven consumer confidence lower, many consumers are reluctant to borrow for homes, cars, or any other major purchases. In large part, they are hesitant to spend money on anything beyond daily necessities.

Rising job losses are making some would-be borrowers unable to qualify for loans. Steep declines in the stock market have reduced many consumers' ability to make down payments for home loans and drained consumers' financial strength. Sliding home prices are cutting into home equity. In reaction to their declining financial "net worth," many consumers are trying to shore up their finances by spending less and saving more.

One key question is whether the recession will prompt consumers to make lifestyle changes that will continue to have an impact for many years after recovery. Financial shocks can produce psychological changes that endure. The economic downturn may shape consumer spending habits for the long term.

For consumers who continue to seek credit, tight conditions prevail. OTS consumer complaint data show that consumers seeking extensions of credit from OTS-regulated thrifts are in some cases experiencing problems and those reported problems have grown significantly in recent years.

According to OTS data from 2006 to 2008, consumer complaints to the agency about declines in available credit increased by more than 50 percent from 2006 to 2007 (from 43 complaints to 66 complaints), and by more than 350 percent from 2007 to 2008 (to 301 complaints). By far the largest number of such complaints centered on credit cards (267 complaints over the three-year period), followed by home equity lines of credit (101 complaints) and fixed-rate mortgages (25 complaints).

The OTS responds to all consumer complaints and strives to resolve each one in an equitable manner. The agency also uses consumer complaint data in important ways during the supervisory process. Before every comprehensive examination of an OTS-regulated thrift, the exam team reviews complaint data for the institution to find out where to look further during the exam. The OTS also analyzes complaint data to spot trends for problems at individual institutions, as well as trends within the thrift industry. Patterns in consumer complaints can lead to OTS guidance to the industry, enforcement actions and agency regulations, such as the recent interagency rule on unfair credit card practices.

d. Appraisals and Loan Modifications

One question that the Committee asked is whether the federal banking regulators are requiring appraisals for loan modifications and, if so, whether such a requirement is hampering the ability of distressed borrowers to obtain modifications.

In fact, loan modifications by savings associations to avoid foreclosure are not considered "new transactions" under OTS's appraisal regulation and related guidance. Therefore, thrifts are not required to obtain appraisals for such modifications. An institution may elect to use other methods to estimate the value of the security property.

When working constructively with a borrower who is in default or whose default is reasonably foreseeable, a federal savings association is expected to perform a realistic assessment of the value of the security property. The institution will weigh the cost and time to modify a mortgage against the need to facilitate a sound and streamlined modification process. Consistent with sound policies and procedures, savings associations must be able to demonstrate that the collateral valuation methods used in loan modifications are appropriate and reliable.

e. Reductions in Home Equity Lines of Credit

A home equity line of credit is a form of revolving credit in which the borrower's home serves as collateral. As home prices have declined in communities across the country and financial institutions are feeling pressure to shrink their balance sheets,

institutions have been curtailing, suspending, or terminating customers' home equity lines of credit, and consumer complaints to the OTS about these actions have been increasing.

The OTS received no consumer complaints about home equity lines in 2006 and only two such complaints in 2007, according to the agency's consumer complaint database. In 2008, the number of such complaints spiked to 99.

Last August, the OTS issued guidance to its regulated institutions emphasizing that such actions must comply with federal laws and rules designed to protect customers, including regulations implementing the Truth in Lending Act, Equal Credit Opportunity Act, Fair Housing Act and the OTS nondiscrimination rule.

The OTS also issued a "CEO letter" to OTS-regulated thrifts on ensuring consumer protection when institutions cut back on home equity lines of credit, or HELOCs.

"To actively manage the credit risk within their HELOC portfolios, savings associations often structure HELOC plans so that the available credit limit may be reduced, suspended, or terminated," said the letter by Timothy T. Ward, OTS Deputy Director for Examinations, Supervision and Consumer Protection. "In carrying out these actions to manage credit risk, associations must follow the federal laws and rules designed to protect HELOC customers."

Specifically, such a credit line can be cut back based on a valuation of the borrower's particular home, not more general home prices in the zip code or surrounding community. The reduction can be based on a home value determined by an automated valuation model, but the model must be properly calibrated for accuracy and the data fed into it must be valid; for example, the comparable properties selected for comparison purposes must be truly comparable. When the home value goes back up, the home equity line must be restored.

Consumer complaints to the OTS center on issues such as whether the home value determined by the valuation model is accurate and whether comparable properties chosen for the valuation are really comparable.

OTS examiners are following up on this guidance by checking whether OTS-regulated thrifts that cut back on these lines of credit are following the rules. When examiners find problems, the OTS is noting the issues in exam reports, discussing remedies with thrift managers and boards of directors and, in some cases when managers and boards do not rectify problems adequately, taking enforcement actions.

For example, the OTS issued a Notice of Charges against a thrift earlier this month saying that the institution violated the Truth in Lending Act by sending notices to nearly 95 percent of its home equity line customers freezing their credit lines without the required documentation to support its action.

IV. Actions That Can Help

As mentioned earlier, the problem of tight credit can be solved fully only when the economy rebounds. However, there are steps that are being taken now and steps that can be taken in the future to ease the credit crunch.

One action that the government could take would be to prioritize government assistance, such as under TARP, to institutions that show a willingness to be active lenders. The OTS is already collecting information from thrifts applying under TARP on how they plan to use the funds. The OTS makes recommendations to the Treasury Department on whether to approve TARP applications but the final decision is up to Treasury.

Another way to improve the situation is to continue to explore ways of meeting liquidity needs of all banks and thrifts in these times when credit availability is key to their lending operations.

The federal government has already taken significant steps to bolster liquidity through programs including the Capital Purchase Program under TARP, the Commercial Paper Funding Facility, the Temporary Liquidity Guarantee Program and the Term Asset-Backed Securities Loan Facility.

Recent events illustrate that many insured depository institutions need to improve their liquidity risk management. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, insufficient cash flow projections and a lack of viable contingency funding plans.

OTS is working with the other U.S. banking agencies to issue updated interagency guidance on funding liquidity risk management. The revised guidance will incorporate the recent lessons learned and the liquidity guidance issued by the Basel Committee on Banking Supervision. As part of this guidance, the agencies will reiterate the need for diversified funding sources, stress testing and an unencumbered cushion of highly liquid assets that are readily available and are not pledged to payment systems or clearing houses. This increased emphasis on high-quality liquid assets is important because many firms had a misconception about the extent to which decreases in market and funding liquidity are mutually reinforcing. As market liquidity erodes, so does the availability of funding. The regulatory agencies plan to release the revised guidance with a notice for public comment in the first half of 2009.

OTS is also strengthening its examination and supervision of savings associations with high-risk business models or reliance on volatile funding sources. In some cases, OTS is obtaining daily liquidity monitoring reports from financial institutions to identify cash in-flows and out-flows and the availability of unpledged collateral. We are also stressing the need for institutions to test the actual availability of lines of credit and to

work actively with their respective Federal Home Loan Banks to ensure sufficient borrowing capacity. OTS is also conducting a review of liquidity risk management to identify best practices and issue guidance to savings associations. The agency is using the review to develop additional liquidity metrics as a tool for examiners to use to identify institutions with developing liquidity problems.

The OTS and the other federal banking regulators urged regulated institutions to make credit more available to consumers in November 2008 by issuing an interagency statement on meeting the needs of creditworthy borrowers.

The statement emphasized that the Agencies expect banks and thrifts to fulfill their fundamental role in the economy by providing credit to consumers, businesses and other creditworthy borrowers. Problems in financial markets were causing the economy to become increasingly reliant on banking organizations to provide credit that purchasers of securities formerly provided or facilitated, the statement said.

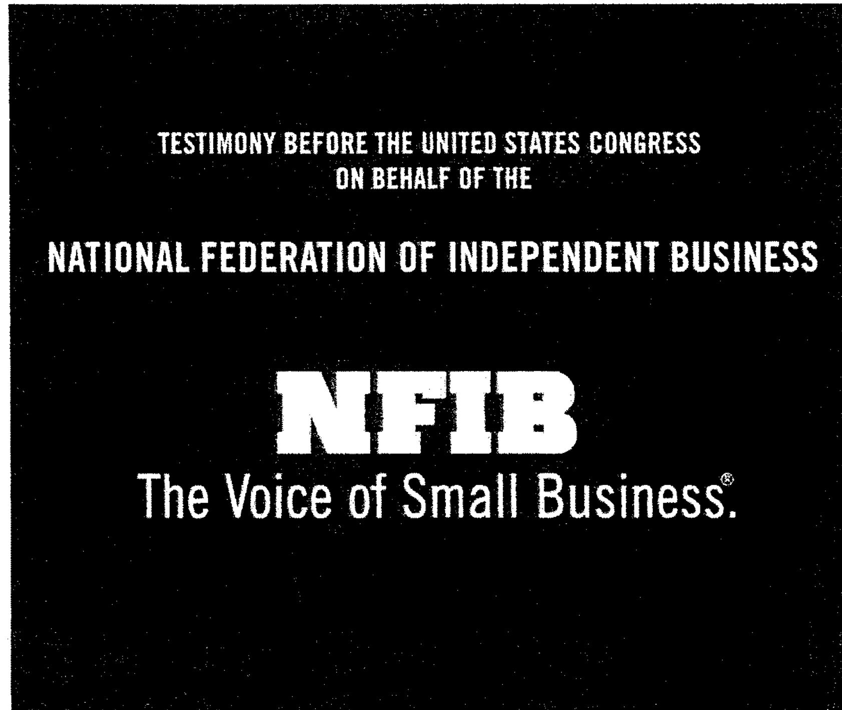
The statement reminded banks and thrifts to follow prudent lending practices but warned that excessive tightening in underwriting standards could make market conditions worse, leading to slower growth, potential damage to the economy, and harm to the long-term interests and profitability of banks and thrifts.

It may be too soon to determine the effectiveness of the interagency statement. However, data from the thrift industry's Thrift Financial Reports show encouraging trends: a 29 percent decrease in foreclosures in the fourth quarter of 2008 from the third quarter and a 14 percent increase in troubled debt restructurings.

Extending credit in times of financial and economic stress might require a more "hands-on approach" to lending by banks and thrifts. The use of models — such as credit scoring models — has become common for loan originations. However, we have learned over the past two years that models, and the assumptions used in those models, are not infallible. Banks should have processes in place to review loans that are "kicked-out" by loan origination model tools. This would help ensure the accuracy of models and help ensure that creditworthy borrowers have access to funds. Banks should also have processes in place to field consumer complaints about being denied credit. The existence of such processes would serve as a quality check on institutions' loan origination and review functions.

V. Conclusion

Thank you again, Mr. Chairman, for the opportunity to testify today. I look forward to working with you on these important issues in the future and I am happy to respond to your questions.



Testimony of

Mr. Randall Truckenbrodt

before the

House Financial Services Committee

on the date of

March 25, 2009

on the subject of

Exploring the Balance between Increased Credit Availability and Prudent Lending Standards

Mr. Chairman and members of the committee, I want to thank you for allowing me the chance to tell my story. My name is Randall Truckenbrodt, and I am a small businessman and member of the National Federation of Independent Business. I and my employees have felt the economic downturn, and I am doing everything I can to stay in business and keep my employees working.

While many policy leaders have talked about improving access to credit for small business, my problem, like most small businesses, has been just trying to keep doors open and my employees on the payroll. Unfortunately, my experience with Bank of America has made that prospect more difficult.

I started doing business with Bank of America about 7 years ago in Ft. Lauderdale, Florida. The relationship started with a small line of credit ($250,000) with a company that was in need of rebuilding. After accomplishing that feat, the lending officer was impressed and wanted to do more deals. Over the years, we have done quite a few mortgages with Bank of America.

In August of 2008, I received a call from an executive at the bank's headquarters stating that I was in their workout department. The workout department of the bank is where they work on non-performing or under-performing loans. I asked why I would be in a workout department since I have never missed a payment on any loan with Bank of America or for that matter any bank in the 32 years that I have been in business. The executive stated that I was in the workout department because one of my companies, American Equipment Rental in Pompano Beach, Florida, was operating at a loss. To which I replied -- So What? I reminded him that I have never missed a payment with the bank and have no intention of stopping payment going forward.

We discussed the probability of the company making a profit going forward. I explained that forecasting a profit is difficult to predict due to the credit markets

holding up construction projects and the fact that the real estate market was overcooked for years. I further explained that we were changing some things to help the recovery process and that I have a pretty good track record of fixing our businesses when they come under outside pressures.

After several months, Bank of America advised me that it would be sending me terms for a waiver letter to be issued. I have had 25-30 waiver letters issued by banks through the years, and they have always been issued at no charge. Waiver letters protect the bank's rights while allowing a customer to work their way back into compliance.

Since late November, Bank of America has sent three proposals explaining their terms for issuing a waiver letter. In the first letter, the Bank of America executive indicated he would charge my company $55,000 in fees and require the company to reappraise all the mortgaged properties (at an estimated cost of $25,000). So the bank was proposing to impose all these fees on an unprofitable company that he is measuring profits against. I have never heard of anything so ridiculous. The rest of the conditions of this waiver terms included a statement that I would agree not to sue Bank of America. The natural question is why would I be asked not to sue them if they are doing things right.

We received three of these demand letters over a period of 6 weeks. Each one offered to lower the fees in order to get this waiver letter issued. The last letter indicated that it would waive all fees and costs if we would agree to change the maturity of the loan document from 2025 to April, 2009 and that I had to sign a statement that I won't sue Bank of America.

I refused to agree to their terms. One of my concerns was the difficulty in getting these small business loans placed elsewhere, and what it would cost the business. These tactics are very troubling, especially since they are directed at a small business that has always paid its debts. It bothers me that these tactics might be

directed at small business owners all over the country, some of who might not put up a fight or even understand that they can fight back.

Imagine if the large banks were doing this to a homeowner who was granted a mortgage based on a certain income level but then lost his job. Would the bank then demand additional fees even though the homeowner continued paying his mortgage from savings? Would the bank start reappraising the property and charging the homeowner the cost? In my case, it feels as though Bank of America is doing everything in its power to drive my company towards bankruptcy.

Over the past six weeks, the bank has initiated without my consent the reappraisal of our properties, and they have not communicated any information about these appraisals after numerous requests. I want to know how the bank intends to use these appraisals. In 32 years I have never had an appraisal of real estate where a request for more capital wasn't the basis (i.e. refinance). Finally, I was instructed last week that they intend to raid our accounts for the cost of the appraisals. I will fight these fees in court, if necessary, and have advised Bank of America of my intent.

Bank of America has received billions of dollars in taxpayer bailout money. It was my understanding that the money was supposed to be used to help individuals and businessmen through this rough economy. I have never asked for or expected help from the government, but I also wasn't expecting an attack on my business from a bank where all my bank loans are current. It seems to me that Bank of America is trying to pull cash out of my business to benefit theirs, and I wonder if I am the only small business they are doing this to?

Small business has led our country out of past recessions, and we stand ready to do so again. We are not responsible for the financial mess we find ourselves in, and are not asking for bailouts and handouts from the government. If we are left to our own devices, we will make it through the recession and come out stronger.

March 25, 2009

Testimony of

Stephen Wilson

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Financial Services

United States House of Representatives

Testimony of Stephen Wilson
On Behalf of the
American Bankers Association
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Chairman Frank, Ranking Member Bachus and members of the Committee, my name is Stephen Wilson, Chairman and CEO, LCNB Corp. and LCNB National Bank, Lebanon, Ohio, and Chairman of the Government Relations Council of the American Bankers Association (ABA). LCNB National Bank is a full-service bank offering trust and brokerage services, along with insurance through a subsidiary. We have over $650 million in assets, and our bank has served our community for 131 years. I am pleased to be here today on behalf of ABA. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.9 trillion in assets and employ over 2 million men and women.

We appreciate the opportunity to testify on the current status of the Capital Purchase Program (CPP) and the mixed messages and government policies that on the one hand encourage bank lending and on the other discourage it. Everyone is frustrated about the current confused situation – the public, the Congress, and, I can assure you, traditional banks. We had hoped that the mixed messages and disincentives would have disappeared by now, but in fact, they are worse today than they have ever been. If programs to stimulate the economy are to reach their full potential, the confusion must be clarified and disincentives corrected.

Conflicting messages have characterized the Troubled Asset Relief Program (TARP) and CPP program from the outset. Originally, the TARP funds were to be used for buying toxic assets. That focus changed virtually overnight to investment of capital in healthy banks through the CPP program. The banking industry was – and banks individually were – actively encouraged by Treasury and banking regulators to participate. Indeed, many healthy banks decided to participate even though they were already very well capitalized and even though they were nervous at the time that the program requirements could change dramatically and unilaterally at the will of Treasury or Congress.

My bank – which is well capitalized – applied for and received $13.4 million of CPP capital on January 9, 2009. I am proud to point out that we were given the opportunity to receive these funds because of our past and current performance in providing loans to those in the communities we serve. We are strong and secure. The CPP funds add to the $58 million already in our bank's capital account and enable us to respond to our customers when they need help in the form of loans. In fact, we continue to make loans, sticking to our traditional commitment to making responsible loans that make good economic sense for both the borrower and our bank. For example, in January 2009 we approved $11.6 million in loans to individuals, $6.9 million in loans to businesses, and $18.4 million in loans to municipal governments, and we purchased $25 million in Government Guarantee Mortgages.

My bank, and the other 316 banks that received CPP money before January 23, 2009, paid our first dividend to Treasury on February 15, 2009. My dividend payment was $67,000, and the entire 317 banks' first dividend payment is estimated to be around $2.4 billion. This dividend payment shows quite clearly that this program is an investment by government. The government will receive these dividend payments for several years now, and also have the benefit of warrants to share in any appreciation of bank stocks.

However, over the last few weeks, banks have received messages that are very much discouraging participation. The government designed the Capital Purchase Program to be available to every healthy bank in the country. However, to date only 509 out of the nation's 8,300 banks have received funding. Given the public's growing resentment to the idea of "government bailouts," it is likely that many banks that otherwise would have been interested in the CPP will decide not to participate. Indeed, several that already have been approved have decided not to sign contracts and others that have received funding are trying to return it.

The impact of these unclear messages, however, is not just limited to the banks that have received the capital injections; the entire industry is unfairly suffering from the perception of weakness perpetuated by the government-created mixed messages. Banks hear the message to continue to lend to help stimulate the economy. But they also hear messages that pull them back: from field examiners that may apply overly conservative standards; from FDIC premium assessment rules that penalize banks that use Federal Home Loan Bank advances for short-term liquidity; and from accounting rules that overstate economic losses.

I want to take this opportunity to thank this Committee for the bipartisan effort to address the issue of mark-to-market. Your action can significantly aid in the economic recovery. In response to your efforts, the Financial Accounting Standards Board (FASB) issued two proposals to attempt to

make repairs that address the problems of "Other Than Temporary Impairment" (OTTI) – unfortunately, the proposals do not go far enough. Several changes are still needed: (1) OTTI should be based on credit impairment, rather than an estimate of the market's current perception of loss, (2) the new OTTI rules should apply to existing OTTI rather than future OTTI, and (3) any recoveries of OTTI should be reversed upon recovery.

We are also very concerned about an FDIC proposal to charge banks a one-time special assessment of 20 basis points on total domestic deposits (which is an addition to the regular quarterly premium payments paid to FDIC). There is no question that the industry stands behind the financial health of the FDIC, and indeed, has been responsible for all its costs since it was created in 1933. But the large assessment, totaling over $15 billion in the second quarter of 2009, will significantly reduce earnings for most banks -- even wiping out all of 2009 earnings in some cases -- making it harder to build new capital and raise deposits to fund new loans. This is the ultimate in mixed messages and has the potential to seriously reduce the effectiveness of other programs.

Any one of these challenges could be handled on its own, whether it is the impact of misplaced accounting rules, severe regulatory pressure for asset write-downs, significantly higher FDIC insurance premiums, or changing rules for CPP participants; but taken collectively, the impact is a nightmare for banks. All of these forces work against lending that is so critical to our economic recovery.

Before I talk about these mixed messages in more detail, let me highlight why clarity is so important right now. The continued speculation of further government involvement continues to unnecessarily erode consumer confidence in our nation's banking system. I cannot say strongly enough that investment of private capital will not return until the fear of further government involvement or dilution of private equity investments in the banking system has significantly abated. Investors will remain on the sidelines if there is continued speculation that the government may step in and undercut their investment. Private capital, rather than taxpayer money, is the foundation of our entire economic system. More government involvement is not the solution to the problems in the financial markets. We believe that this whole discussion, even speculation about "nationalization," is impairing the financial sector and making the credit situation worse. This is why it is so critical that the role of the government be clearly defined and limited. We hope the recent clarification by the Administration and Chairman Bernanke will help stem this speculation, but further disincentives being considered are sending another chill through the capital markets.

Let me now turn to address the messages that run counter to encouraging lending today, including:

- The application by field examiners of overly conservative standards, in spite of the consistent statements by their agency heads to support prudent lending;
- The significant special assessment proposed by the FDIC assessments will impact earnings, hinder capital accumulation, and raise the cost of funds for banks – all of which makes it more difficult for banks to lend;
- Failure to make repairs to market-to-market rules has, in combination with current market illiquidity, resulted in overstating economic losses; and
- The changing nature and requirements of the CPP program which are resulting in unintended consequences for participants and discouraging others from participating.

I will discuss each of these in turn.

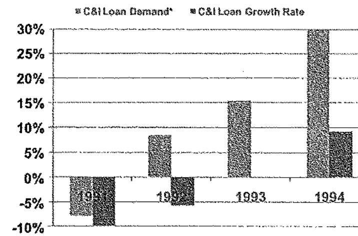
I. In the face of a weak economy and falling loan demand, it is critical that the regulators not make things worse by applying overly conservative standards

The current regulatory environment is unquestionably impacted by the regulatory concerns flowing from the housing market and economic downturn. A natural reaction is to intensify the scrutiny of commercial banks' lending practices. It is extremely important, however, that scrutiny does not discourage lending to creditworthy borrowers. The heads of the banking agencies have consistently emphasized that the goal of supervision and examination is not to stop new lending, but to assure that whatever lending is done follows prudent underwriting standards. The agencies have met with the ABA and other industry representatives to discuss the problems that have emerged and ways they can be addressed. We appreciate these efforts and are hopeful that this will prevent a regulatory overreaction that can quickly chill an already fragile credit market. However, we continue to hear from bankers around the country – and those particularly in areas where the economy is considerably stressed – that field examiners are being excessively hard on even the strongest banks in the area.

The risks are very real. One needs only to look back at the early 1990s to see what can happen when there is a regulatory overreaction to an economic recession with roots in residential and commercial real estate problems. At that time, whether intended or not, the loud and clear message that bankers received from the regulators and Congress was that only minimal levels of lending risk would be tolerated. On the surface, this might have seemed reasonable – there is little doubt that economic consequences of a banking system with too much risk are not acceptable. But just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious economic consequences.

Overly-aggressive attempts to wring out risk from bank loan portfolios will mean that only the very best credits will be funded. This is clearly contrary to the current public policy goals – and the CPP program in particular – of encouraging lending to facilitate an economic recovery. The regulatory overreaction in the early 1990s led to a significant decline in lending in spite of rising demand for bank loans (see the chart on the right). As a consequence, the recovery was slower than it might have been.

Regulatory-Induced Credit Crunch Decreased Bank Business Lending



* Net Percent of Respondents Reporting Stronger Demand for bank C&I Loans
Sources: Federal Reserve Senior Loan Officer Opinion Survey and FDIC Quarterly Banking Profile

A comparable scenario may be developing in today's regulatory environment. Accounting rules and excessive regulatory demands are acting together to limit the ability of banks to make loans and in some cases to continue existing funding arrangements. For example, one of the major concerns of the industry is the prospect of bank examiners appraising banks into insolvency. This could occur from a number of interrelated causes. We hear reports from our bankers of examiners demanding that banks obtain new appraisals on properties for fully performing loans, i.e., loans where the borrowers are current and meeting their obligations to the bank. Given existing market prices, it is not surprising to find that values are down, so that such appraisals could result in banks having to downgrade fully performing loans as being in some degree troubled, giving rise to what many refer to as "non-performing performing loans." Together, the revaluations and downgrades discourage banks from lending for similar projects.

In other instances, we hear of examiners forcing banks to mark the value of collateral to current market values even though there is little expectation that the bank will be relying on the collateral for repayment of the loan. A bank can reach the point (as many did in the 1980s and 1990s) where such actions significantly reduce bank resources available to fund new loans. Thus, taking a snapshot of a bank's assets during the low point of an economic cycle and forcing the bank to reflect the worst-case scenario on its books runs the risk of bringing about the very consequences that the banks and their examiners are trying to prevent -- causing the bank to retrench, reducing banking lending overall. To avoid this outcome, we have been urging the regulators to keep in mind that markets are cyclical and that not every worst-case scenario will occur if the market is left to function without inappropriately restrictive intervention.

Fortunately, bank agency heads are sensitive to this potential problem and have pledged to avoid a repeat of the early 1990s. The great challenge may be to ensure that the measured approach expressed by agency leadership is being applied by regulatory personnel out in the field. Increasingly, we are hearing troubling reports from our membership that regulatory mistakes of a decade ago are playing out again today. This issue can be addressed, at least in part, by more communication by the heads of the agencies to the field examiners – in writing and shared with the entire industry – about finding the right balance in the examination of a bank and the importance of preserving relationships that banks have built up over the years. Banking, and bank examination, requires the application of judgment to a myriad of different scenarios. It is important that bankers and examiners alike feel that they can exercise that judgment in a manner that is consistent with the industry continuing to meet the needs of communities even during the hard times.

What the regulators want for the industry is what the industry wants for itself: the maintenance of a strong and safe banking system. To achieve that goal, we need to remember the vital role played by good lending in restoring economic growth and not allow a credit crunch to stifle economic recovery.

II. The FDIC Special Assessments Will Significantly Impact Earnings, Capital, and Cost of Funds – All of Which Makes it Far More Difficult to Lend

The FDIC is proposing to siphon funds out of the banking system at precisely the same time that it and other parts of the government are trying to pump money in. This will significantly undermine the effectiveness of the other programs. It would be far better to adopt a plan that will

enable banks to fund the system at a time when higher insurance premiums will not jeopardize an already fragile economy.

There are two key decisions that have been made recently by the FDIC that will surely reduce lending. First is the special assessment imposed for the second quarter on all banks. Let me be very clear here: the banking industry fully supports having a strong FDIC fund and stands behind the efforts to assure FDIC's financial health. We appreciate the difficult situation that the FDIC is in and understand that rising losses from bank failures have created short-term funding needs. The industry has always taken our obligation to the FDIC seriously and banks will honor the obligation to support the FDIC.

However, it is critically important that costs are spread over a longer period of time because the additional cost will have an impact. In fact, the cost is so high that many banks will be less willing to raise new deposits. With fewer deposits, banks will be unable to renew or make new loans. The high expenses make it harder to raise new capital, either from retained earnings or through new investors, limiting still further the ability to meet customer needs. The money to pay such high expenses cannot be created out of thin air. It will mean that banks will also be forced to look at ways to lower the cost of other expenses, which means less sponsorship of community activities and fewer donations to local charities. Some banks have said that it may even mean cutting jobs. The implications for this significant FDIC charge will impact every community. Alternatives are clearly needed to help ease this burden on all banks.

There are some options emerging that may help to reduce this. For example, the FDIC has said that if its line of credit to Treasury were expanded from $30 billion to $100 billion, it would have the necessary access to working capital and, therefore, would not need to obtain as much a buffer from the industry to offset losses. ABA supports this position, and strongly urges that this change be enacted quickly.

Another option policymakers should consider to help stretch out the repayment period for banks is to use a funding source like the Financial Corporation (FICO) bonds that were issued from 1987 to 1989 to pay for the costs incurred by the Federal Savings and Loan Insurance Corporation (FSLIC) from savings association failures in the late 1980s. These were a series of 30-year bonds with an aggregate principal of $8.2 billion. This helped to spread out the cost of failures at that time. Another important option that ABA has suggested is a capital investment by banks in the FDIC. This would provide the necessary capital to the FDIC without having it being a costly expense against earnings. Having options in place is important so that there is a viable mechanism to provide the

FDIC with capital to offset losses, yet have the commitment of the banking industry to repay any temporary funding needs over a long period of time.

The second important decision made by the FDIC relates to changes made in the risk-based system that will make liquidity more difficult and expensive for some banks. In particular, the FDIC actions will discourage the use of Federal Home Loan Bank advances. While the FDIC did make some improvements that will lower the penalty rate, it still means that many banks that have used advances as a stable and reliable source of funding will pay an extra cost for these funds. The Federal Home Loan Banks have played an extremely important role throughout the last year in providing short-term liquidity. FHLB advances are as stable as core deposits, and are not vulnerable to short-term promotions in the local market or surging returns on alternative assets. In fact, we believe that the use of FHLB advances does ***not*** increase the risk of a bank failing, but rather ***reduces*** it. Thus, not only is the FDIC making the cost of deposit funding more expensive, it is making other sources of funding more expensive as well.

III. Failure to make repairs to market-to-market rules has, in combination with current market illiquidity, resulted in overstating economic losses

Mixed messages are also emanating from so-called mark-to-market accounting, which has caused dramatic swings in financial statements that are completely divorced from the underlying economic reality. This has led to misleading capital positions and public financial reporting, preventing existing capital from supporting additional lending so critical in today's economy and creating uncertainty in the markets.

ABA believes there are situations when mark-to-market can be useful, such as if an entity's business model is based on fair value. However, for entities whose business models are not based on buying and selling in the markets, such as traditional commercial banks, mark-to-market is neither the most relevant nor reliable information; it will not necessarily reflect the expected cash flows and earnings; and it will result in misleading the readers of banks' financial statements. Mark-to-market information is already disclosed in footnotes, which are an integral part of financial statements, and footnote disclosure is a more suitable format for providing mark-to-market information.

Recent changes to the definition of fair value, in combination with current market illiquidity, have resulted in overstating economic losses, and immediate repairs are needed in these areas: (1) the definition of fair value, and (2) the definition of "other than temporary impairment" or OTTI. Some

have suggested that these repairs be made to regulatory capital rules; however, the publicly reported financial statement reporting must also be improved as soon as possible, as this will have a positive result on both the transparency of financial statements and on the markets.

In today's illiquid market, the results of improper OTTI rules can be severe: (1) capital is artificially eroded despite solid fundamental credit performance, (2) the lending capability of a bank is reduced as much as $7 for every $1 of needless OTTI, and (3) the accounting formula is driving economic outcomes -- including reduced availability of consumer and small business credit, with a negative impact on the health of individual institutions -- and does not reflect economic reality. The resulting misleading information is contributing to the uncertainty in the markets and the freezing of investment.

The Securities and Exchange Commission (SEC) has recognized the problems with these issues and requested in October 2008 that FASB "expeditiously address issues that have arisen in the application of the OTTI model." ABA has provided its recommendations to the Financial Accounting Standards Board, the SEC, and the banking agencies, including the point that U.S. accounting rules generally result in higher losses than the international accounting rules, placing U.S. companies at a disadvantage. Finally, we are very much in agreement with the recommendations of Group of 30 on fair value accounting in its *Financial Reform: A Framework for Financial Stability* that suggests that these accounting standards be reviewed:

(1) to develop "more realistic guidelines for dealing with less-liquid instruments and distressed markets";

(2) by "prudential regulators to ensure application in a fashion consistent with safe and sound operation of [financial] institutions"; and

(3) to be more flexible "in regard to the prudential need for regulated institutions to maintain adequate credit-loss reserves".

As I mentioned at the outset, the two proposals of FASB are a step in the right direction to deal with the OTTI problem, but do not go far enough. It is important that the following changes be adopted: (1) OTTI should be based on credit impairment, rather than an estimate of the market's current perception of loss, (2) the new OTTI rules should apply to existing OTTI rather than future OTTI, and (3) any recoveries of OTTI should be reversed upon recovery.

IV. Mixed Messages are Severely Impacting the CPP program and Discouraging Participation

Much of the confusion about the CPP program is a result of the ever-changing nature of TARP and the various uses of TARP funds. As ABA has stated in several recent hearings before this committee, the current confusion is harmful as it continues to erode public confidence and undermines efforts to turn around the economy. ABA strongly recommends that Congress and the Administration establish clear-cut programs within TARP. In particular, the CPP should be clearly separated from a program to address potential failures of systematically important institutions. Only by clearly identifying the programs can there be proper Congressional oversight and effective policymaking.

The CPP program ***is different***. It is a program that encourages FDIC-insured banking institutions that are healthy to sell a specifically designed capital instrument to the government. Its purpose is to increase the capital position of the banking sector (even though the great majority of banks are well capitalized) in order to provide the strong foundation on which an economic recovery can be built through the increased provision of sound credit. This is a role America's banks are committed to carry out.

The announcement of the program really harmed the perception of our banking industry. The lack of clarity about the program since then did nothing to reverse this and the changes made recently are making the situation even worse. Commentators continue to focus on the government's involvement with banks, and investors are sitting on the sidelines because they cannot be sure what new restrictions will be imposed, or worse, what additional involvement the government will take in directing the activities of banks.

It must clearly be stated that the CPP program is to provide capital to ***strong*** banks and its purpose was to ***promote the availability of credit***. It must be made clear that the institutions that are voluntarily accepting this new source of capital did not create the problems and are the most likely to be the first responders to provide credit to return our economy to health. This message is getting lost in the rhetoric about executive compensation and other restrictions and, since no effort is being made to differentiate the CPP recipients from other systemic risk support under TARP, it only reinforces the incorrect perception that this capital is a "bailout."

Unless there is clarity, there will not be broad participation. This will limit the effectiveness of the program. We believe that very few new banks will now participate in light of the recent changes to the program – which add significant legal and reporting costs – and the increasing risk and negative

perception surrounding the program. This means that far fewer banks will end up participating in a program that was intended to support ***all*** healthy banks. It also has the very real consequence of depriving some communities that are served by smaller banks from having additional capital to support new lending. There are several illustrations of recent changes that show how even simple changes can send mixed messages or have negative unintended consequences.

- ***Additional Reporting and Record Retention Requirements by SIGTARP***

  On February 6, 2009, Neil Barofsky, the Special Inspector General, Troubled Asset Relief Program (SIGTARP), wrote to all CPP-participating banks asking for a large body of data on how CPP capital is being employed, the banks' implementation plans, the types of records that must be kept, and the need to have the accuracy of all statements certified. Certainly, the inspector general needs to have information about the activities of the institutions receiving CPP capital, but the requirements mandated by the SIGTARP have raised questions about the extent of its oversight of a bank's activity. We are encouraged that the office of the Special Inspector General is willing to work with the industry to provide clarity on its role. However, many questions remain. For example, what level of response is expected of the industry to the data collection requested by SIGTARP? What references to specific sources are required for statements made? Would it include ***all*** potentially relevant documents? What is the basis for plans to deal with executive compensation requirements when there still are conflicting guidelines already and rules that have yet to be promulgated? What authority does SIGTARP have to examine CPP banks and override the authority of the bank's primary regulator?

  The potential record retention requirements are extensive: "segregate and preserve all documents referencing your use or anticipated use of TARP funds such as any internal e-mails, budgets, or memoranda regarding your anticipated or actual use of TARP funds." While we understand that the SIGTARP is looking for a good faith effort to demonstrate how the bank is leveraging the capital provided by the government, this request signals to many the beginning of a scrutiny that will be unnecessarily burdensome. In fact, this record retention requirement is similar to the type of legal holds firms undertake when subject to law suits or other administrative enforcement actions. This request leaves the impression that banks will be subject to legal action – an impression reinforced by the requirement that the bank "certify the accuracy of all statements, representation and supporting information provided, subject to the requirements and penalties" which include fines and possible imprisonment.

Banks are already subject to intense supervision by their primary regulator; banks already provide a large amount of data to their regulators; and the largest CPP recipients are providing monthly details on how the capital is being deployed. We are concerned that this extra layer of oversight – in a document that explicitly reminds banks of the possibility of criminal sanctions – is causing several banks to rethink the advisability of accepting the CPP funds.

- ***Executive compensation rules enacted in the stimulus package are complex and unclear.*** Title VII of the American Recovery and Reinvestment Act of 2009 (ARRA) is very complex in its reach and its effect on institutions of all sizes, including small community banks. There is great uncertainty creating unintended consequences. Our industry is badly in need of immediate clarification. For example:

Complying with requirements for which rules are not yet promulgated: There is great confusion about the effective date of the executive compensation provisions contained in ARRA. We believe that several of the executive compensation and corporate governance provisions are effective upon the Treasury's ***issuance*** of standards, yet other provisions of that Title may be currently in effect.[1] This uncertainty has made some banks unwilling to participate, and others that are participating to consider withdrawing from the program.

No clear definition of "compensation" or what employees are affected makes it difficult to determine which employees are covered: Lack of clear definition is creating significant problems. For example, banks are unclear as to whether the provisions apply to bonuses earned in 2008 but paid out after ARRA was signed into law. Additionally, community banks employ small numbers of employees and are uncertain whether the incentive compensation clawback provisions apply even to their employees who have no executive, managerial or policy-making functions, such as branch managers. Moreover, some bank presidents have no need for written employment contracts as they have invested almost all of their entire net worth into the institution. This creates inequities relative to those institutions that have such contracts with their senior executives and are, thus, not as severely impacted by these

[1] Section 7001 of ARRA amends Section 111 of the Emergency Economic Stabilization Act of 2008 (EESA) to provide that TARP recipients shall be subject to "the standards established by the Secretary" and directs the Secretary to "require each TARP recipient to meet appropriate standards for executive compensation and corporate governance." Because the Act ties compliance with the executive compensation provisions directly to standards that have not yet been established and issued by the Secretary, we believe it is clear that these provisions are not effective until these standards are established.

provisions. Furthermore, community bank holding companies are often "shell" holding companies that only have a few shared employees with the subsidiary banks. Holding companies may also have more than one bank subsidiary. How are the Act's restrictions to apply in such cases? How would the Act's restrictions apply in the case of a non-CPP bank that seeks to acquire a CPP-recipient bank?

Pension plans will have to be amended: Changes in compensation can also have dramatic effects on pension plan agreements. For example, are institutions able to pay death benefits included in a pension plan to the spouse of a deceased executive employee under the golden parachute payment prohibition? Without regulatory certainty, our members are put in the position of possibly violating employee compensation and pension contracts.

Furthermore, do the golden parachute provisions prohibit all severance payments, even those made to employees who have no management or policy making responsibilities? If so, how does a bank enforce a non-compete agreement without appropriate consideration? It is very typical for a community bank to have such provisions to compensate an employee for agreeing to a non-compete clause in exchange for the severance.

Are employees paid only through commissions at risk? Many banks have employees that earn the bulk of their compensation through commissions, such as loan officers. These individuals could become the highest compensated employee in the bank for that particular year, but this would not be known until the end of the year. Would the restriction on incentive compensation apply in these situations? Would these employees be expected to give a substantial portion of their commissions back? These top producers are critical to meeting the community's credit needs and, in turn, enhance the profitability of the financial institution. They are an important asset to shareholders – including the government.

Will there be SEC-type disclosures rules for non-SEC reporting companies? ARRA requires that shareholders be given a nonbinding vote on executive compensation through the proxy process ("say-on-pay"). This provision is generally applicable for all preliminary and definitive proxy statements filed with the SEC after the date of the Act's enactment or February 17, 2009. What is unclear, however, is the extent to which the Act's "say-on-pay" provisions apply to private, non-public companies. Moreover, public disclosure of senior executive officer compensation could create problems in small local communities, as neighbors and fellow employees learn what their friends and colleagues

are making. This is not fair and certainly not the intent of restrictions on compensation imagined by the sponsors of this provision.

Changes may drive some banks to return CPP capital

These are only some examples of the kinds of questions that will continue to be raised. It serves to point out that regardless of how simple the changes are thought to be, there are considerable unintended consequences that will impact many individual and institutions that were not the subject of the rules. More critically, the chilling effect these changes have – ***raising the cost of compliance and the risk of legal action*** – will discourage any participation in the CPP program. This means that the benefits hoped for with the program will not be fully realized.

As I mentioned at the outset, some banks have returned and others are seriously considering returning the capital they have already received due to the rising risk of government involvement. While returning capital sounds simple, the reality is that most CPP recipients did put much of that capital into action immediately upon receiving the funds. Moreover, in other cases, the regulators may not allow it or would take a long time to approve it, even if the bank would still be well capitalized. The government expected the capital to be employed quickly, and the banks had a financial interest to do so, as they are required to pay the Treasury a quarterly dividend at a five percent annual rate.

The CPP banks have put this capital to work extending lines of credit, renewing short-term loans that business borrowers use to meet daily expenses, and making new loans. In fact, while the media was reporting that loan volumes had decreased slightly in the fourth quarter, the recent Treasury release for the largest CPP banks shows how important it is to get behind those numbers to fully appreciate the impact that banks are having through extending new lines of credit, renewing short-term loans that have been repaid, and extending new loans. The Treasury data show that loan originations for the top 20 CPP recipients totaled $714 billion in the fourth quarter – over three times the amount of capital invested by Treasury. Over $226 billion was renewing short-term loans that were repaid by businesses and commercial real estate borrowers. This continued support for existing customers to be able to fund their operations is a critical and often overlooked type of lending banks are doing in this difficult economic environment. Thus, to pay back the CPP investment would mean that future leveraging of this capital for lending would be impossible.

Besides the fact that the capital is already being deployed and returning it reduces the benefits already underway, there are practical considerations that make returning it difficult. For example, if a bank closes on a CPP deal next week, can it really withdraw from the program and repay the

government the amount invested without first having to replace the funds from other sources as provided under the executive compensation provisions contained in the stimulus package? What conditions are the banking regulators and Treasury likely to impose on any such withdrawal? Moreover, if a private bank that received its CPP money last week wants to repay it this week, does it still have to pay the five percent premium built into their warrants, which were exercised at closing by Treasury? This additional five-percent consideration was provided as a way to make investments in the privately held banks equivalent to those made in publicly traded companies. However, because there is a market in the stock of the publicly traded companies, Treasury had no need to exercise at closing the warrants associated with these transactions. With an extra five percent early repayment cost for private banks the ability to withdraw may well prove to be more easily attainable for publicly traded CPP recipients. Placing such a burden on community banks serves absolutely no public policy objective.

Conclusion

There are many mixed messages in the current environment, all of which are discouraging participation in the CPP program and more generally, lending by all banks. The mixed messages continue on the extent of government involvement in banks, the changing rules and penalties, the impact of mark-to-market accounting when no reasonable market exists to determine "fair" values, and the conflict between boosting new lending and overly conservative underwriting emphasized by some field examiners.

Many banks were interested in participating in the CPP as they believed it would help to ensure greater flexibility in the face of a deteriorating economy. Indeed, the banking regulators strongly encouraged participation so that banks could "take advantage of the benefits of the Capital Purchase Program." ABA expressed concern when the CPP was introduced that the Treasury could unilaterally alter the program terms at any time, which would expose the recipients to greater risk and higher costs. Our fears were realized with the recent changes and the continued confusion swirling around this program. Now many banks are wondering if the benefits outweigh the compliance costs, legal risks, and continued intervention by the government.

It is important to recognize the much broader implication of the government involvement and the lack of confidence created by it. It is also important to recognize the unintended consequences that even seemingly simple changes can have. The recent changes signal to any strong, viable bank – whether already participating or considering it – that any involvement of the government in the business of private enterprise brings with it significant risk and costs, not the least of which is the

potential that the rules can be changed unilaterally, at any time. The intention of the Capital Purchase Program was to provide capital to healthy, well-run banks to weather the economic storm and be the stimulus for new lending. Unless clarity is provided to help limit such risks and stop the mixed messages, few banks will participate and the benefit of the program will fall short of its potential.

The ABA appreciates the opportunity to testify today and we stand ready to work with this Committee in finding ways to bring clarity to the government programs and help restore confidence of the public and investors in our financial system.

March 25, 2009

The Honorable Barney Frank
Chairman, House Financial Services Committee
2252 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank:

On behalf of the National Bankers Association (NBA), I would like to offer a few suggestions for regulatory reform as it relates to minority banks.

Our first concern, Mr. Chairman, is that our country's financial crisis was not caused by minority and community banks but it appears that the response from federal regulators and examiners are creating disproportionate burdens for minority and community banks.

From the recently announced Special Assessment tax to new rules governing capital requirements, minority and community banks, which have fewer resources and who are least guilty of violating safe and soundness principles, are being asked to shoulder a disproportionate amount of the burden and endure more scrutiny of their standard banking practices.

Many of the lending rules that were violated (i.e., subprime lending) occurred primarily with the nation's largest financial institutions and, therefore, most regulatory reform should be focused on those institutions.

In addition, even when federal funds are made available, like the Capital Purchase Program, the terms and interest rates tend to discourage rather than promote more lending to consumers, small businesses and real estate investors in the communities that our bankers serve.

Congress passed the Financial Institution Reform, Recovery and Enforcement Act in 1989 and the Government Accounting Office (GAO) studied the impact of the behavior of federal regulators in 1993. The inescapable reality that minority banks face – even in light of the Congressional mandate to preserve minority banks and the GAO's findings – regulators still do not appear to calibrate their examining strategies to reflect the unique challenges of minority banks when they observe management practices, capital challenges and the compounded burden of serving some of America's most economically distressed communities.

The Special Assessment is the most recent example of federal regulators lack of sensitivity to how their requirements can wreck havoc on the bottom line results (e.g., return on assets) of many minority and community banks whose profit margins tend to be marginal at best.

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March 25, 2009
The Honorable Barney Frank
Page 2

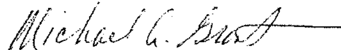
TARP money, because of the strings attached to it – the interest rate of 5%, the time period for pay back, rules governing executive compensation, the requirement for regulatory approval before early pay-back is possible and the anxiety surrounding the possibility of some additional regulations to be imposed on those financial institutions who have taken TARP money – have caused a lot of community banks, who could have used the capital for lending – to not accept the funds.

In conclusion, the overarching issue that we present before your hearing today, Mr. Chairman, is this: large banks (assets in excess of ten billion dollars) operate in a different universe than minority and community banks. Many of those who contributed to our nation's financial crisis are the mega-banks. It is our sincere hope that all efforts at regulatory reform will be measured responses that do not make minority and community banks suffer unduly because of the misguided practices of the banking behemoths. While the NBA acknowledges that many of these impacts are unintended consequences from sincere efforts to reform our nation's banking system, the reality is that they are having an injurious effect on this very important segment of the banking industry that is striving to remain strong and viable.

Thank you for your genuine interest in repairing what has been broken in our country's financial infrastructure.

Respectfully,

NATIONAL BANKERS ASSOCIATION



Michael A. Grant, J.D.
President

cc: Robert P. Cooper, Chairman
National Bankers Association

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December 29, 2008

The Honorable John C. Dugan
Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

Dear Comptroller Dugan:

I know most of the top bankers from East Tennessee and several others throughout the State.

They are all telling me the same thing in stronger terms than I have ever heard before. As the President of one bank, with which I have no connection whatever, said, holding one hand up much higher than the other: "What they are saying at the top is not getting down here to the bottom."

In other words, when the President, the Secretary of the Treasury and other top officials are trying to unfreeze the credit market and urging banks to make loans, the bank examiners at the local level are making it almost impossible to do so.

The examiners, almost none of whom have ever been in the banking business and thus do not fully appreciate how difficult it is, are writing up the best, safest loans on the books. They are doing this even though all payments are current and even on loans to upper-income people who have more than sufficient assets to cover the loan.

A banker who used to do a lot of business with Senator Corker in Chattanooga when the Senator was in business there said he talked to him about it and gave him some specific examples. But when Sen. Corker asked him to put it in writing he said he could not because the examiners then would have destroyed his bank.

Another bank official told me this past Saturday that there are 230 banks in Tennessee that are having serious problems. Now I believe he probably was exaggerating but someone from almost

every bank in East Tennessee has told me over the last three months or so that the examiners have just gotten ridiculous.

Another banker said banks cannot make even very good loans now "strictly because of the examiners" and their "CYA" attitude.

In 2000, Fortune Magazine said the Knoxville area had become the most popular place to move to in the whole Country based on the number moving in in relation to the number moving out. Almost all of East Tennessee has very large numbers moving here from the Midwest and Florida.

The economy here is still strong and will continue to be unless these bank examiners shut us down. If you think I am exaggerating, please have some independent polling firm ask bankers all over the Nation to tell you their stories in a way they can be assured there will not later be repercussions.

If you do not do this, I am afraid the troubles we are having now are going to grow much worse.

With kindest regards, I am

Yours truly,

JOHN J. DUNCAN, JR.
Member of Congress

JJD:jg

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SUBCOMMITTEES:
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GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

March 23, 2009

The Honorable Spencer Bachus
Ranking Member
House Committee on Financial Services
B371a Rayburn House Office Building
Washington, D.C. 20515

Dear Ranking Member Bachus:

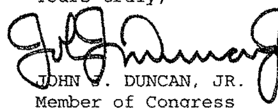
As you prepare for your upcoming hearing, "Increased Credit vs. Lending Standards," I would like to call to your attention a letter I recently sent to the top four federal banking and financial industry regulators - the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). I am enclosing a copy of one of these letters.

I am not opposed to bank regulators and examiners doing their jobs, but they need to be reasonable and do their part in allowing banks and other lenders to make loans. It is very simple - banks need to be lending and businesses and individuals need the loans to get our struggling economy back on track.

I appreciate your consideration of these matters and I hope that you will keep my thoughts in mind during your upcoming Committee hearing.

With kindest regards, I am

Yours truly,



JOHN J. DUNCAN, JR.
Member of Congress

JJD:lp

Response to questions from the Honorable Alan Grayson
by Martin J. Gruenberg, Vice Chairman,
Federal Deposit Insurance Corporation

Q1. How many new bank charters have you issued since January 1, 2009?

A1. While the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the various State Authorities hold the authority to grant bank or thrift charters, the FDIC is solely authorized to make determinations regarding deposit insurance. The table below presents the number of deposit insurance applications approved during 2006, 2007, 2008, and through March 31, 2009. The table also includes information regarding the number of approved applications that have consummated since approval; for ease of comparison, the number of applications consummated is attributed to the year the respective applications were approved rather than the year consummated.

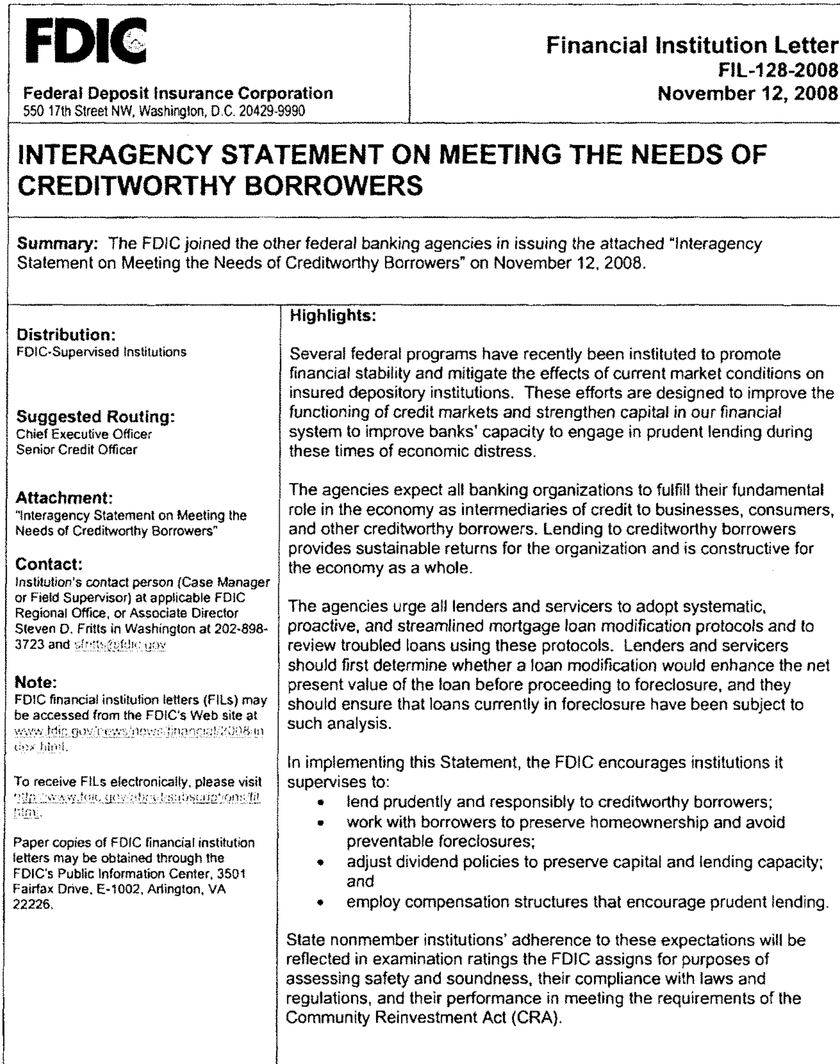
	Deposit Insurance Applications			
	2006	2007	2008	3/31/2009
Approved	183	191	101	7
Consummated	183	186	79	2

Q2. What are you doing to make sure that developers who hold land loans and inventory and are current on all their interest charges are not forced to pay down principal before the properties are sold or developed?

A2. The FDIC understands the strain that builders and developers are under during this challenging environment, and we have encouraged banks to work with these borrowers given the sluggish demand for real estate at this time. Over the past year, we have issued guidance to FDIC-supervised institutions encouraging them to continue making loans available to creditworthy borrowers and to work with borrowers experiencing difficulty. The following directives issued to FDIC-supervised institutions are attached to this document:

FDIC Financial Institution Letter 128-08, *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*
http://www.fdic.gov/news/news/financial/2008/fil08128.html

FDIC Financial Institution Letter 22-08, *Managing Commercial Real Estate Concentrations in a Challenging Environment*
http://www.fdic.gov/news/news/financial/2008/fil08022.html



FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
FIL-128-2008
November 12, 2008

INTERAGENCY STATEMENT ON MEETING THE NEEDS OF CREDITWORTHY BORROWERS

Summary: The FDIC joined the other federal banking agencies in issuing the attached "Interagency Statement on Meeting the Needs of Creditworthy Borrowers" on November 12, 2008.

Distribution:
FDIC-Supervised Institutions

Suggested Routing:
Chief Executive Officer
Senior Credit Officer

Attachment:
"Interagency Statement on Meeting the Needs of Creditworthy Borrowers"

Contact:
Institution's contact person (Case Manager or Field Supervisor) at applicable FDIC Regional Office, or Associate Director Steven D. Fritts in Washington at 202-898-3723 and sfritts@fdic.gov

Note:
FDIC financial institution letters (FILs) may be accessed from the FDIC's Web site at www.fdic.gov/news/news/financial/2008/index.html.

To receive FILs electronically, please visit http://www.fdic.gov/about/subscriptions/fil.html.

Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 3501 Fairfax Drive, E-1002, Arlington, VA 22226.

Highlights:

Several federal programs have recently been instituted to promote financial stability and mitigate the effects of current market conditions on insured depository institutions. These efforts are designed to improve the functioning of credit markets and strengthen capital in our financial system to improve banks' capacity to engage in prudent lending during these times of economic distress.

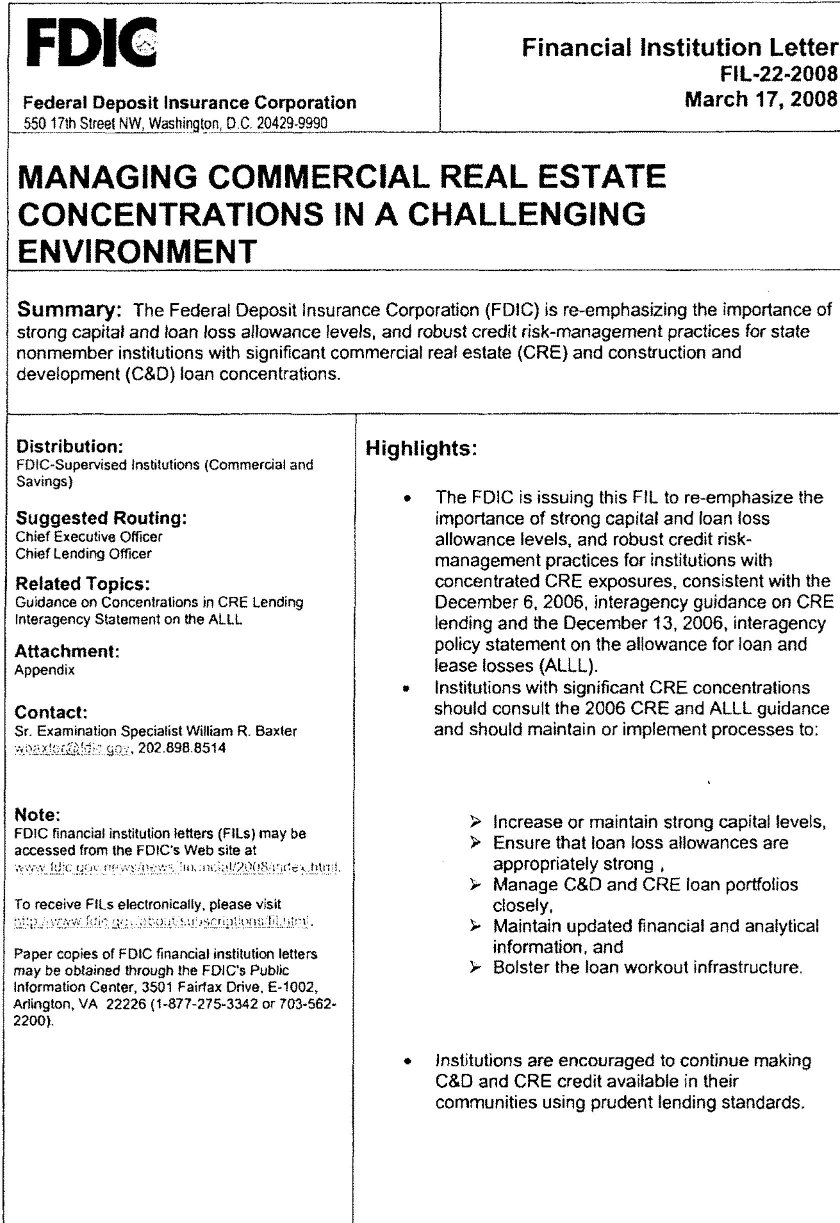
The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers. Lending to creditworthy borrowers provides sustainable returns for the organization and is constructive for the economy as a whole.

The agencies urge all lenders and servicers to adopt systematic, proactive, and streamlined mortgage loan modification protocols and to review troubled loans using these protocols. Lenders and servicers should first determine whether a loan modification would enhance the net present value of the loan before proceeding to foreclosure, and they should ensure that loans currently in foreclosure have been subject to such analysis.

In implementing this Statement, the FDIC encourages institutions it supervises to:

- lend prudently and responsibly to creditworthy borrowers;
- work with borrowers to preserve homeownership and avoid preventable foreclosures;
- adjust dividend policies to preserve capital and lending capacity; and
- employ compensation structures that encourage prudent lending.

State nonmember institutions' adherence to these expectations will be reflected in examination ratings the FDIC assigns for purposes of assessing safety and soundness, their compliance with laws and regulations, and their performance in meeting the requirements of the Community Reinvestment Act (CRA).



FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
FIL-22-2008
March 17, 2008

MANAGING COMMERCIAL REAL ESTATE CONCENTRATIONS IN A CHALLENGING ENVIRONMENT

Summary: The Federal Deposit Insurance Corporation (FDIC) is re-emphasizing the importance of strong capital and loan loss allowance levels, and robust credit risk-management practices for state nonmember institutions with significant commercial real estate (CRE) and construction and development (C&D) loan concentrations.

Distribution:
FDIC-Supervised Institutions (Commercial and Savings)

Suggested Routing:
Chief Executive Officer
Chief Lending Officer

Related Topics:
Guidance on Concentrations in CRE Lending
Interagency Statement on the ALLL

Attachment:
Appendix

Contact:
Sr. Examination Specialist William R. Baxter
wbaxter@fdic.gov, 202.898.8514

Note:
FDIC financial institution letters (FILs) may be accessed from the FDIC's Web site at www.fdic.gov/news/news/financial/2008/index.html.

To receive FILs electronically, please visit http://www.fdic.gov/about/subscriptions/fil.html.

Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 3501 Fairfax Drive, E-1002, Arlington, VA 22226 (1-877-275-3342 or 703-562-2200).

Highlights:

- The FDIC is issuing this FIL to re-emphasize the importance of strong capital and loan loss allowance levels, and robust credit risk-management practices for institutions with concentrated CRE exposures, consistent with the December 6, 2006, interagency guidance on CRE lending and the December 13, 2006, interagency policy statement on the allowance for loan and lease losses (ALLL).
- Institutions with significant CRE concentrations should consult the 2006 CRE and ALLL guidance and should maintain or implement processes to:
  - Increase or maintain strong capital levels,
  - Ensure that loan loss allowances are appropriately strong ,
  - Manage C&D and CRE loan portfolios closely,
  - Maintain updated financial and analytical information, and
  - Bolster the loan workout infrastructure.
- Institutions are encouraged to continue making C&D and CRE credit available in their communities using prudent lending standards.

Financial Institution Letter
FIL-22-2008
March 17, 2008

Managing Commercial Real Estate Concentrations in a Challenging Environment

Recent weakness in the housing and the construction and development (C&D) markets have increased the FDIC's overall concern for state nonmember institutions with concentrations in commercial real estate (CRE) loans, and in particular, C&D loans. The purpose of this Financial Institution Letter is to re-emphasize the importance of strong capital and loan loss allowance levels, robust credit risk-management practices, and to recommend several key risk-management processes to help institutions manage CRE loan concentrations in this challenging environment.

On December 6, 2006, the FDIC joined the Federal Reserve Board and the Office of the Comptroller of the Currency (the agencies) in issuing final guidance on CRE entitled *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (CRE Guidance). It was intended to help ensure that institutions pursuing a significant commercial real estate lending strategy remain healthy and profitable while continuing to serve the credit needs of the community. The CRE Guidance provided a framework for assessing CRE concentrations; risk management, including board and management oversight, portfolio management, management information systems, market analysis and stress testing, underwriting and credit risk review; and supervisory oversight, including CRE concentration management and an assessment of capital adequacy. The CRE Guidance was issued at a time when there was abundant liquidity in the credit markets, a strong global economy, and a number of what became known as "hot real estate markets" in major metropolitan areas. These factors led to a significant increase in CRE lending, especially in the C&D sector. The favorable market conditions led to relatively low borrowing costs, an overall boom in construction and sales activity, particularly in the residential and condominium sectors, and many institutions chose to relax loan terms and covenants to compete in the CRE mortgage market.

In addition, on December 13, 2006, the agencies and the Office of Thrift Supervision issued an *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (ALLL Policy Statement) to revise and replace a 1993 policy statement on this subject. The ALLL Policy Statement reiterates key concepts and requirements pertaining to the allowance for loan and lease losses (ALLL) included in generally accepted accounting principles (GAAP) and existing supervisory guidance. It describes the nature and purpose of the ALLL; the responsibilities of boards of directors, management, and examiners; factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound credit grading system. The ALLL Policy Statement notes that determining the appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment. An institution's process for determining the ALLL should be based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio that considers all significant factors that affect collectibility. That analysis should include an assessment of changes in economic conditions and collateral values and their direct impact on credit quality. If declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity.

Since the CRE Guidance and ALLL Policy Statement were issued, market conditions have weakened, most notably in the C&D sector. The housing market is experiencing a slowdown, credit market liquidity has deteriorated, lending terms have tightened, and certain residential markets in the United States are overbuilt. While the vast majority of FDIC-insured institutions are well-capitalized, some institutions have significant CRE concentrations in areas with surplus housing units amid declining home prices. In addition, examiners have noted a few instances of potential underwriting weakness whereby institutions are inappropriately adding extra interest reserves on loans where the underlying real estate project is not performing as expected. This practice can erode collateral protection and mask loans that would otherwise be reported as delinquent.

The FDIC is increasingly concerned that institutions with concentrated CRE exposures may be vulnerable to a sustained downturn in real estate and should ensure that capital and ALLL levels are strong, and that credit risk management and workout processes are robust. It is strongly recommended that, as market conditions warrant, institutions with CRE concentrations (particularly in C&D lending) should increase capital to provide ample protection from unexpected losses if market conditions deteriorate further.

Recommendations for Managing CRE Concentrations

Institutions with significant CRE concentrations are reminded that strong capital and ALLL levels are needed, and that overall credit risk-management processes should reflect the principles of the 2006 CRE Guidance. Institutions with significant CRE concentrations are described in the CRE Guidance as those institutions reporting loans for construction, land development, and other land representing 100 percent or more of Total Capital; or institutions reporting total CRE loans representing 300 percent or more of Total Capital where the outstanding balance of CRE has increased by 50 percent or more during the prior 36 months.[1]

The FDIC suggests five key risk management processes to help institutions with significant C&D and CRE concentrations manage through changes in market conditions:

1. **Increase or Maintain Strong Capital Levels** – Capital provides institutions with protection against unexpected losses, particularly in stressed markets. Institutions with significant C&D and CRE exposures may require more capital because of uncertainty about market conditions, causing an elevated risk of unexpected losses. As market conditions warrant, directorates and management should take steps to increase capital levels to support significant CRE concentrations. Capital protection for C&D and CRE concentrations should be a strategic priority when contemplating the declaration of cash dividends.

2. **Ensure that Loan Loss Allowances are Appropriately Strong** – Institutions are expected to determine their ALLL in accordance with GAAP, their stated policies and procedures, management's best judgment, and relevant supervisory guidance. At least quarterly, institutions should analyze the collectibility of CRE and all other exposures and maintain an ALLL at a level that is appropriate to cover estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses in

[1] For the purposes of this FIL, C&D and CRE concentrations have the same meaning as stated in the CRE Guidance.

the remainder of the loan portfolio. In reviewing their ALLL methodology, institutions with significant C&D and CRE concentrations should consult recent supervisory guidance.[2]

3. **Manage C&D and CRE Loan Portfolios Closely** – Institutions should maintain prudent, time-tested lending policies and understand C&D and CRE concentrations. Management information systems should provide the board and management with effective data resources on concentrations levels and market conditions. A strong credit review and risk rating system that identifies deteriorating credit trends early should be enhanced or implemented. Institutions should also effectively manage interest reserve and loan extension accommodations, reflecting the borrower's condition accurately in loan ratings and documented reviews.

4. **Maintain Updated Financial and Analytical Information** – Institutions with CRE concentrations should maintain recent borrower financial statements, including property cash flow statements, rent rolls, guarantor personal statements, tax return data, global builder and other income property performance information. Global financial analysis of obligors should be emphasized, as well as the concentration of individual builders or developers in a loan portfolio. As real estate market conditions change, management should consider the continued relevance of appraisals performed during high growth periods, and update appraisal reports as necessary.[3]

5. **Bolster the Loan Workout Infrastructure** – Institutions should ensure they have sufficient staff and appropriate skill sets to properly manage an increase in problem loans and workouts. Management should develop a ready network of legal, appraisal, real estate brokerage, and property management professionals to handle additional prospective workouts.

The FDIC believes that CRE can be a profitable business line for institutions; however, as with any asset exposure, significant concentrations can lead to losses and capital deficiencies in a stressed environment. The Corporation's examiners recognize the challenges facing institutions in the current CRE environment, and will expect each board of directors and management team to strive for strong capital and loan loss allowance levels, and implement robust credit risk-management practices. Institutions are encouraged to continue making C&D and CRE credit available in their communities using prudent, time-tested lending standards that rely on strong underwriting and loan administration practices.

Sandra L. Thompson
Director
Division of Supervision and Consumer Protection

[2] Institutions should refer to the ALLL Policy Statement, and the July 6, 2001, *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Institutions and Savings Institutions.*
[3] All appraisals should be consistent with the FDIC's appraisal rules in Part 323 of the FDIC's Rules and Regulations, 12 CFR 323.

APPENDIX

The following guidance and information should be consulted for additional details about matters discussed in this Financial Institution Letter.

Supervision

- *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, December 6, 2006, http://www.fdic.gov/news/news/press/2006/pr06114.html

- *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, December 13, 2006, http://www.fdic.gov/news/news/press/2006/pr06115.html

- *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Institutions and Savings Institutions*, July 6, 2001, http://www.fdic.gov/news/news/financial/2001/fil0163.html

Response to questions from the Honorable Erik Paulsen
by Martin J. Gruenberg, Vice Chairman,
Federal Deposit Insurance Corporation

It is my understanding that discussions are underway between the FDIC and the SEC staffs seeking to resolve issues associated with the ability of broker-dealers to invest client cash held in Special Reserve Accounts in the Temporary Liquidity Guarantee Program (TLGP) Notes. This type of multi-agency collaboration can result in constructive solutions so critical as we address the economic challenges facing our nation. For instance, the SEC affirming that TLGP Notes are qualified securities and eligible for investment of Broker-Dealers' Special Reserve Accounts will provide additional earning with minimal risk for these financial institutions while enhancing the market for insured institutions' debt. I believe this is consistent with the FDIC's ongoing stabilization initiatives.

I am hopeful [the FDIC and the SEC] can quickly expedite a favorable resolution on this matter.
Q1: Do you concur? When do you think we could expect a resolution on this matter?
Q2: What other steps need to be taken/who else needs to be involved?
Q3: Could you please keep me apprised as this issue progresses?

Answer: Thank you for your interest in the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program (TLGP). As you noted, staff members from both the FDIC and the SEC have been discussing whether debt securities guaranteed by the FDIC under the TLGP constitute a "qualified security" for purposes of SEC Rule 15c3-3 under the Securities Exchange Act of 1934. Our understanding, based on discussions with staff of the SEC's Division of Trading and Markets, is that registered broker-dealers are required to maintain special reserve accounts (SRAs) for the benefit of their customers, and that such SRAs are required to consist of cash and "qualified securities." Qualified securities include securities issued by the United States and securities "in respect of which principal and interest are guaranteed by the United States."

The FDIC has been responding to the SEC's questions concerning the TLGP, including questions concerning the operation of the FDIC's guarantee, the risk-based capital treatment afforded to FDIC-guaranteed debt, and how payment would be made in the event of default. While the FDIC recognizes that it is up to the SEC to interpret its own statute and regulations, the FDIC is hopeful that the SEC and the Financial Industry Regulatory Authority, the self-regulatory organization for securities firms, will agree that FDIC-guaranteed debt constitutes a qualified security and that broker-dealers will therefore be permitted to keep a significant percentage of their SRAs in FDIC-guaranteed debt.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ELIZABETH A. DUKE
MEMBER OF THE BOARD

March 30, 2009

The Honorable Bill Posey
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am writing to provide further clarification about the approval process for new bank charters that you raised during the recent hearing on "Exploring the Balance between Increased Credit Availability and Prudent Lending Standards" before the U.S. House Financial Services Committee.

While the Federal Reserve does not issue bank charters, it does approve Federal Reserve System membership applications associated with new bank charters. Generally, our analysis is completed within 60 days. However, the Federal Reserve does not issue an approval until the chartering authority (State Banking Agency for state charters, or the Office of the Comptroller of the Currency or the Office of Thrift Supervision for national charters) has issued a preliminary approval and the Federal Deposit Insurance Corporation (FDIC) has indicated that it will grant approval of the related insurance application.

In normal times, the chartering process can take from nine months to a year but recently with the economic downturn, the processing of new bank charters has taken considerably longer. The Federal Reserve approved five membership applications associated with de novo banks in 2008 and one in 2009. Currently, there are four pending membership applications associated with de novo banks.

You may be interested to know that a new expedited process has been established for organizations that do not currently own a bank to apply for a "shelf charter." This is an inactive charter that can be used to bid on failing banks. If a shelf charter wins a bid it becomes active when it acquires the failing bank.

The chartering agencies, FDIC and the Federal Reserve have been closely coordinating on these proposals so that a shelf charter can be issued in 45-60 days due to the overriding public benefit associated with a failing bank acquisition. A formal bank holding company application is not required to establish a shelf charter as it is not an active bank. However, we do receive information regarding the ownership structure of the organization and its proposed business plan in order to identify and resolve any potential issues. The Federal Reserve would receive a bank holding company application if the shelf charter wins a bid on a failing bank. Due to the nature

The Honorable Bill Posey
Page Two

of the bidding process, we usually have two to three days in which to act on the application so that is why we try to work out any potential issues during the processing of the shelf charter.

I hope that this clarification is helpful to you. Please let me, or Federal Reserve staff, know if you need further information.

Sincerely,

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