

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



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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.

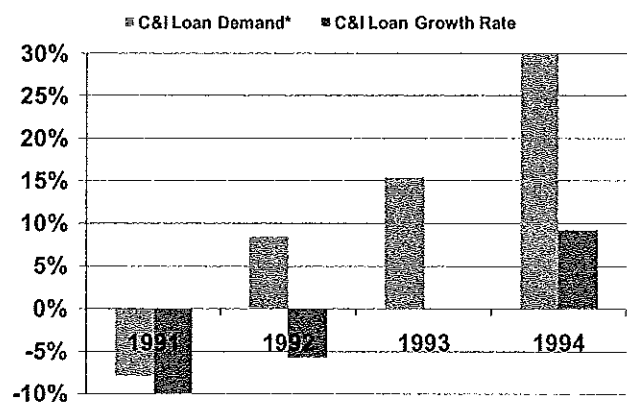
I. In the face of a weak economy and falling loan demand, it is critical that the regulators not make things worse by applying overly conservative standards

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.