INDEPENDENT COMMUNITY BANKERS of AMERICA

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]

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[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

[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.