Testimony of

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On behalf of the

Independent Community Bankers of America

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"Systemic Regulation, Prudential Matters, Resolution Authority and Securitization"

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Introduction

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, Maryland, 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 proposals to address systemic financial risks to our economy.

Too-big-to-fail institutions and the systemic risk they pose were at the heart of our financial and economic meltdown. Just over one year ago, due to the failure of our nation's largest institution's to adequately manage their highly risky activities, key elements of the nation's financial system nearly collapsed. Other parts – especially our system of locally owned and controlled community banks – were not in similar danger. But community banks, the cornerstone of our local economies, have suffered; both from the steps government had to take to deal with the crisis – especially steps taken to subsidize too-big-to-fail institutions – and from our severe recession.

This was, as you know, a crisis that community banks did not cause. A crisis driven by a few unmanageable financial entities that nearly destroyed our equity markets, our real estate markets, our consumer loan markets, the global finance markets and cost Americans more than $12 trillion in net worth. A crisis that forced the federal government to inject almost $10 trillion in capital and loans and guarantees to large complex financial institutions whose balance sheets were over leveraged and lacked adequate liquidity to offset the risks they had taken. A crisis that has brought the world markets to a point where they even question if the U.S. dollar should be retained as the reserve currency of the world. A crisis driven by the ill conceived logic that some institutions should be allowed to exist even if they are too big to manage, regulate and fail.

This committee is now engaged in the monumental and historic task of crafting legislation that will reduce the chances that risky and irresponsible behavior by large or unregulated institutions will again lead us into economic crisis.

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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.

ICBA commends you and President Obama's Administration for tackling this important undertaking. The President's plan takes strong steps toward addressing systemic risks posed by too-big-to-fail financial firms. This testimony provides detailed recommendations to make them even stronger. In addition, an addendum to my statement includes ICBA's specific reactions to the discussion draft which the Committee and Treasury released on October 27. Community bankers believe that the best way to protect consumers is to end the too-big-to-fail concentration risks.

Addressing Systemic Risk

ICBA supports the proposal to identify specific institutions that may pose systemic risk and to subject them to stronger supervision, capital, and liquidity requirements. Our economy needs more than an "early warning" about possible problems; it needs a real cop on the beat.

But, the plan could be enhanced to better protect taxpayers and safeguard the financial system. ICBA believes that systemically risky holding companies should pay fees for their supervisory costs and fund – in advance – a new systemic risk fund. ICBA also strongly supports the "Bank Accountability and Risk Assessment Act of 2009" introduced by Rep. Luis Gutierrez (H.R. 2897) which would require the FDIC to impose an additional fee on any insured bank affiliated with a systemic risk institution. This would better account for the risks these institutions pose and strengthen the Deposit Insurance Fund.

These strong measures are not meant to punish those institutions for being large, but to guard against the risks they pose and to protect the taxpayers and the public. They would hold these large institutions accountable and discourage them from taking on extraordinary risky behavior or benefiting from being "too big to fail." However, if these enhancements are not enough, the President's proposal sensibly calls for a plan to resolve failing institutions. Our testimony details how Congress can further enhance the President's plan.

But to truly prevent the kind of financial meltdown we faced last fall, and to truly protect consumers, the plan must go further. It should direct systemic risk authorities to develop procedures to downsize the too-big-to-fail institutions in an orderly way.

ICBA is pleased that the plan maintains the state banking system and believes that any final bill should also maintain the thrift charter. Both charters enable community bankers to follow business plans that are best adapted to their local markets and pose no systemic risk.

Summary of ICBA Key Recommendations

The following key points summarize ICBA's position on dealing with systemic risk institutions:

- Create a systemic risk regulator (either the Federal Reserve or in conjunction with a council of regulators) to monitor and supervise all institutions that pose a threat to our financial stability.
- The systemic risk regulator should be headed by a presidential appointee, subject to Senate confirmation, in order to assure the body's independence from political pressures.
- If the Federal Reserve is given priority in serving this role, provide the Financial Services Oversight Council with clear policy setting and oversight authority over the Federal Reserve, including the power to establish capital, liquidity and other requirements for systemic risk firms, the power to over-rule Fed decisions by a majority vote of the Council, and the power to force the Fed to take actions.
- Identify institutions that potentially pose systemic danger and make them subject to substantially higher capital and liquidity requirements, plus more rigorous supervision and stress testing.
- Give the systemic risk regulator the authority to declare an institution insolvent when capital falls below well-capitalized and the institution cannot raise new private capital.
- Grant receivership, conservatorship and bridge bank authority to the FDIC to operate an insolvent institution and develop a restructuring, downsizing or dissolution plan.
- Eliminate too-big-to-fail so the future failure of a systemic risk institution would not threaten the stability of our economic system.
- Reduce the 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, and strengthen the cap by eliminating loopholes permitting organic growth.
- Downsize financial institutions that continue to pose a systemic danger below systemic danger limits within five years, by selling assets or bank units to other qualified entities, including community banks.
- Consider reinstating the Glass-Steagall Act, prohibiting the common ownership of commercial and investment banks, to reduce risk and downsize systemically important institutions.
- Impose a systemic risk premium on all "Tier I" financial holding companies, broadly defined to include all large complex financial firms that have the potential of posing a systemic risk.
- Require all FDIC-insured affiliates of large complex financial firms to pay a systemic risk premium to the FDIC in addition to their regular FDIC premiums to compensate the FDIC for the increased risk they pose.
- Broaden the assessment base used by the FDIC to determine a bank's premium by including total assets minus tangible equity for the assessment base, rather than domestic deposits. A broader assessment base would result in a fairer assessment system reflecting a banks' risk.
- Retain the system of federal and state bank chartering and do not create a single, monolithic federal regulator.

Enhance Systemic Risk Regulation

The Administration's proposal expands the authority of the Federal Reserve to supervise all institutions that could pose a threat to financial stability, including non-banks, and creates a Financial Services Oversight Council to identify emerging systemic risks in firms and market activities and improve interagency cooperation. These proposals are a substantial improvement over the current system, but can be enhanced to truly protect consumers, local communities and our economy.

Make Federal Reserve the Primary Systemic Risk Regulator

Our nation needs a strong and robust regime of systemic risk regulation and oversight. It is clear that reckless lending and leveraging practices by too-big-to-fail institutions were the root of the current economic crisis. The only way to maintain a vibrant banking system where small and large institutions can fairly compete – and to protect taxpayers – is to aggressively regulate, assess and eventually downsize institutions that pose a risk to financial stability.

ICBA supports creating a systemic risk regulator, and we have no problem with designating the Federal Reserve as the primary systemic risk regulator or creating a systemic risk council to serve in that capacity. The Federal Reserve is the agency currently best equipped to take on this new role. However, we share the concerns expressed by some in Congress that without proper direction and oversight, the Fed may be slow or reluctant to act to address systemic risks. Some Members of Congress have justifiably criticized the Fed for its slow response to the congressional mandate to promulgate new rules to govern the unregulated segments of the mortgage industry or for its promotion of the Basel II capital agreement. Indeed, one of the weaknesses of the Administration's proposal is that the Federal Reserve is given too much new power with no accountability for enforcement.

Enhance Duties of Council

The proposed Financial Services Oversight Council must have strong powers to be effective. The Council should have the power to set clear policy and have oversight authority over the Federal Reserve, including the power to establish capital, liquidity and other requirements for systemic risk firms, the power to over-rule Fed decisions by a majority vote of the Council, and the power to force the Fed to take actions. In addition, the Fed should be required to report to Congress on a regular and frequent basis, so that Congress can also exercise oversight to ensure that the Fed is properly and appropriately implementing its new authority.

The Council should be responsible for identifying gaps in regulation and recommending institutions that should come under consolidated supervision by the Federal Reserve. It is critical to extend supervision and oversight to those non-bank entities that contributed to the current financial crisis largely because they did not fall under any agency's regulatory umbrella.

Identify Systemic Risk Institutions

Generally speaking, systemic risk institutions are sufficiently large that diversification no longer mitigates risk. Instead, their risk profiles increasingly come to resemble that of the financial market itself, leaving them vulnerable to any major shock to the financial markets.

When companies like Morgan Stanley and Goldman Sachs and Lehman Brothers are leveraged 25 to 34 to one, when they have less than 4 cents at risk for every dollar in assets, their success or failure determines the future of the markets. According to Bridgewater Financial Group (HBR August 2009)[2] in September of 2008 the Bank of America was leveraged 73 to 1 and if it were to capitalize all of its off balance sheet entities it would have been leveraged 134 to 1. That means less than 1 penny of capital at risk for every dollar of assets.

Congress and the Council must establish clear principles to identify systemic risk institutions. It is not difficult to identify the handful of mega-bank financial institutions that are systemically risky,, but at the margins, defining systemically important institutions by asset size alone is insufficient. Institutions that are not systemically risky may become so through growth, complexity, and counterparty risk. Flexibility ensures that the systemic risk regulator can respond to changes in the market, but they should always operate under clearly articulated principles.

Some contend that systemic risk institutions should not be publicly identified because that would give them an unfair advantage in the marketplace. We disagree. Institutions that potentially pose systemic risk must be identified. Supervision by specific regulators and the enforcement of any rules designed for systemic risk institutions might make this obvious anyway. Status as a systemic risk institution should not be a signal to markets that an institution will not be allowed to fail, but rather that its failure would raise systemic concerns.

The fundamental purpose would be to make clear that these institutions will be subject to substantially higher capital and liquidity requirements, plus more rigorous supervision in order to protect the financial system and the economy. They also should support a systemic risk fund to prevent taxpayers from being first on the hook to pay for a troubled systemic risk institution. This will help mitigate any "advantage" they might receive from being too big and too risky. In addition, more liquidity and better supervision will decrease the chance that an institution will fail in the first place. And, in the event of failure, the systemic risk fund and higher capital will protect taxpayers.

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[2] Harvard Business Review, August 2009

Systemic Risk Guidelines

ICBA suggests as a guideline that a systemic risk financial institution is one that has more than $100 billion in assets, and has a risk profile that is susceptible to one or more risk factors. While not all institutions with more than $100 billion in assets are by definition systemically significant, all institutions in excess of $100 billion in assets should be examined closely to determine their systemic importance with special attention paid to the following factors:

- Provision of systemically essential services within the economy.
- Use of leverage – both traditional and embedded in derivatives.
- Status as a major client and/or counterparty risk and guarantees.
- Overall balance sheet exposure and liability.
- Overall level of participation/integration with capital markets, especially high risk activities such as proprietary trading activities.
- Trade in derivative instruments which can potentially multiply risk exposures as well as mitigate, especially writing of derivatives contracts.
- Dependence on short-term non-depository funding from capital markets such as commercial paper.
- Off-balance sheet activities.
- Rate of asset growth.
- Deposit concentration.
- Organizational complexity and capability of management.

Give FDIC Sole Resolution Authority

We must take measures to end too-big-to-fail by ensuring there is a mechanism in place to declare an institution in default and appoint a conservator or receiver that can unwind or sell off the institution's operations in an orderly manner. In order to maintain market discipline, as part of the process, shareholders and management responsible for the institution's demise should not be protected. The systemic risk regulator, in consultation with appropriate bank regulatory agencies, must have the authority to declare an institution insolvent when capital falls below well-capitalized and the institution cannot raise new private capital. Agencies insulated from politics – not the Treasury as proposed by the Administration – should make these calls.

We strongly support the Administration's proposal to grant receivership, conservatorship and bridge bank authority to the FDIC to operate an insolvent institution, including its holding company and affiliates, and develop a restructuring, downsizing or dissolution plan. The FDIC should have sole authority to determine how a systemically important institution should be resolved. The FDIC has extensive experience resolving banks and has the infrastructure in place to exercise conservatorship and receivership powers over financial companies.

The FDIC should have clear guidelines for resolving failing systemic risk institutions leading to restructuring and downsizing through sales of assets. At a minimum, systemic risk financial holding company shareholders should not be protected. Government must re-establish credibility that shareholders of financial institutions will bear the full loss in any insolvent financial institution. This core principle of capitalism has been repeatedly violated or in the often cited words of Allan H. Meltzer[3], "Capitalism without failure is like religion without sin – it doesn't work."

Clear seniority must be established among types of uninsured financial institution creditors. Uninsured creditors should not be supported like bank depositors – they receive market rates of return and should bear the risks of the marketplace. In the event of a failure, they should have their claims written down or become the new equity holders as they would in bankruptcy.

Congress should also modify the Administration's plan to give the FDIC resolution authority over all bank holding companies regardless of size in order to promote consistent and efficient resolution of all bank holding companies, not just systemic risk FHCs.[4] The current bifurcated resolution authority between the FDIC and the bankruptcy courts has added significant costs to many receiverships and resolutions.

Require Insolvency Contingency Plan

As the Lehman Brothers failure demonstrated, subverting market expectations, especially too-big-to-fail expectations, can be extremely destabilizing. Therefore a clear, rules-based process must be followed. Systemic risk FHCs should have an insolvency contingency plan which the resolution authority can use in the event of failure. Firms determined to be systemically important should be required to have a pre-approved plan worked out with the systemic risk regulators in advance and in place to deploy in the event of receivership or conservatorship. This plan should include close monitoring of their counterparty exposures for possible spillover effects. Regulators should ensure systemic risk institutions are organized so they can continue to perform systemically important functions during a resolution process.

End Too-Big-To-Fail

Ending too-big-to-fail is one of the most critical issues facing our nation. The only way to truly protect consumers, our financial system, and the economy is by finding a solution to rein in too-big-to-fail institutions. One of the weaknesses in the Administration's proposal is that it assumes special treatment for systemic risk FHCs, which could result in the perpetuation of the too-big-to-fail doctrine. One of the goals of

[3] University Professor of Political Economy at Carnegie Mellon University, and Visiting Scholar at the American Enterprise Institute, author of *A History of the Federal Reserve, Volume 1: 1913-1951*

[4] S.1540, the Resolution Reform Act of 2009, provides for this authority.

any regulatory restructuring plan should be to eliminate too-big-to-fail so the future failure of a systemic risk institution would not threaten the stability of our economic system.

Indeed, implicit in the FDIC's role in resolving insolvent institutions is the end of the too-big-to-fail doctrine, which has driven the creation of systemic risk institutions and given too-big-to-fail institutions an unfair competitive advantage.

In a speech earlier this year, Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> [T]he belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.[5]

FDIC Chairman Sheila Bair, in remarks before the ICBA annual convention in March, 2009, said, "What we really need to do is end too-big-to-fail. We need to reduce systemic risk by limiting the size, complexity and concentration of our financial institutions." [6] The Group of 30 report on financial reform stated, "To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries."[7]

What has become painfully apparent during this financial crisis is that the failure of some firms would, indeed, have systemic consequences with national and even global implications. That is why Congress last fall reluctantly authorized $700 billion, with not so much as a hearing, to keep some of these institutions afloat.

It is clear that without a mandated downsizing and restructuring of these too-big-to-fail institutions, if they faced insolvency in the future, the government would have no choice but to bail them out again. That is unacceptable.

The only way to truly and effectively eliminate too-big-to-fail is to eliminate institutions that are so large and so complex that their failure would pose a grave threat to our financial system and national economy. That means, quite bluntly, that Congress must

[5] Financial Reform to Address Systemic Risk, at the Council of Foreign Relations, March 10, 2009
[6] March 20, 2009
[7] "Financial Reform; A Framework for Financial Stability, January 15, 2009, p. 8.

require institutions that currently fall into that category must be restructured and downsized to the point where they no longer pose a systemic risk, and their failure would no longer threaten our national economic well-being.

My testimony will discuss several ways this can be accomplished.

Consider Reinstating Glass-Steagall

One way to downsize too-big-to-fail banks and reduce their complexity is to separate banks according to the type of business they conduct. Up until 1999, the Glass-Steagall Act of 1933 prohibited the common ownership of commercial banks and other financial institutions such as investment banks and insurance companies. The Gramm-Leach-Bliley Act of 1999 repealed Glass-Steagall, paving the way for the formation of trillion-dollar financial conglomerates.

Some world-renowned economists are now calling for the reinstatement of the Glass-Steagall Act as a way to reduce both risk in the banking industry and the size of institutions.

Earlier this year, former Federal Reserve Chairman and current advisor to the President Paul Volcker suggested the idea of separating retail banking from investment banking in a Group of 30 report he authored. More recently, Bank of England Governor Mervyn King suggested that splitting the core aspects of banking from its riskier elements could help avoid future financial crises and their attendant public cost.

ICBA, which opposed the repeal of Glass-Steagall when it was first introduced, believes Congress should consider reinstating the Glass-Steagall Act. There are significant conflicts of interest when a single institution both grants credit through lending and uses credit through investing. Investment activities are by their nature risky activities that could lead to enormous losses. And even though there are theoretical firewalls that separate commercial from investment banking activities, in times of stress, it is virtually impossible to keep them distinct.

Reinstating Glass-Steagall would serve the dual purpose of reducing risk and forcing institutions to downsize. ICBA thinks it should be seriously considered.

Strengthen Deposit Concentration Cap

Another way to reduce the size of too-big-to-fail institutions is to immediately reduce and strengthen the 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The current cap is insufficient to control the growth of systemic risk institutions the failure of which will cost taxpayers dearly and destabilize our economy.

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Even after the financial meltdown, TBTF banks are getting even bigger and financial resources are becoming even more concentrated in fewer firms. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger with even higher deposit concentrations.

Congress should consider reducing the nationwide deposit concentration cap by one percent per year for the next five years. Congress also should strengthen the cap by eliminating loopholes that permit organic growth. Institutions that exceed the cap should be required to downsize within five years through selling assets and bank units to other qualified entities, including community banks. Banks that fail to comply with this requirement in a timely manner should be subject to severe monetary and non-monetary penalties until such time that they come into compliance.

Downsizing Systemic Risk Institutions is Essential

Congress should make clear that downsizing of systemic risk institutions is not only desirable, it is essential if we are to avoid future financial calamities. It is clearly not in the public interest to have so much power and concentrated wealth in the hands of so few, giving them the ability to destabilize our entire economy.

The Administration's plan includes valuable incentives to encourage downsizing. ICBA strongly supports the Administration's proposal to subject systemic risk FHCs to stricter and more conservative prudential standards than those that apply to other bank holding companies – including higher standards on capital, liquidity and risk management. Capital requirements should be graduated for institutions $100 billion in assets and larger to protect against losses, and act as a disincentive to growth that increases systemic risk. The imposition of systemic risk fees, which will be discussed later, also should serve as a disincentive to unbridled growth.

Financial institutions that continue to pose a systemic risk should be required to downsize to below systemic risk limits within five years, or face harsh monetary and management penalties. Any dissolution plan should include breaking up the institution and selling off pieces to other institutions, including community banks.

Research suggests that economies of scale and scope in banking are exhausted at much smaller sizes, but size does yield monopoly (market) power, 'synergies of conflict of interest' and an implicit subsidy provided by the taxpayer guaranteeing the bank against default and insolvency. [8] These abuses must end for a vibrant, competitive financial services marketplace to emerge from this crisis.

The Justice Department should have the authority to downsize systemic risk institutions through reinvigorated and reformed antitrust policy. Regulators should closely examine

[8] Buiter, Too Big To Fail Is Too Big.

– and deny – new merger applications that would result in the creation of new too-big-to-fail institutions.

Impose Systemic Risk Premiums

Large complex financial institutions created the most severe economic crisis in the United States since the Great Depression through poor underwriting practices, predatory credit practices and a system of financial interdependence that no one, even in these companies, understood. Since last October, Congress has invested $700 billion in the Troubled Asset Relief Program and over $700 billion in stimulus to rescue the economy, and the Federal Reserve has also dedicated hundreds of billions of dollars to aide the failing economy. Out of these funds, the Federal government has dedicated more than $150 billion in taxpayer and FDIC funds to shore up the nine largest banks and $70 billion in assistance and guarantees to AIG. Although some of these institutions have repaid the assistance, the current financial crisis illustrates the enormous risk that large complex financial institutions pose to taxpayers and the FDIC. As a result, ICBA urges Congress to impose two types of systemic risk fees against large complex financial institutions to compensate the taxpayers and the FDIC fund for this risk exposure.

Holding Company Premiums. First, Congress should impose a systemic risk premium on all systemic risk financial holding companies, broadly defined to include all large complex financial firms that have the potential of posing a systemic risk. Part of this first premium would pay for improved regulation of systemic risk. Additionally, part should be made available to the FDIC to fund the administrative costs of systemic resolutions and other costs associated with an orderly unwinding of the affairs of a failed institution.

Bank Premiums. Second, Congress should require all FDIC-insured affiliates of large complex financial firms to pay a systemic risk premium to the FDIC in addition to their regular FDIC premiums to compensate the FDIC for the increased risk they pose. Because their depositors and creditors receive superior coverage to the coverage afforded depositors and creditors of community banks, the largest financial institutions should pay an additional premium. The FDIC's Deposit Insurance Fund is ultimately responsible for insuring the deposits in those institutions. Enhancing resources available to the FDIC through a systemic-risk premium would reduce the risk that taxpayers would be called on to resolve a systemic risk depository institution.

The Bank Accountability and Risk Assessment Act of 2009, H.R. 2897, introduced by Financial Institutions Subcommittee Chairman Luis Gutierrez, would impose just such an annual systemic risk premium on all banks and thrifts that are part of systemically significant holding companies.

H.R. 2897 addresses other deposit insurance issues, which should be part of regulatory restructuring legislation. In addition to a systemic risk premium, the legislation would create a system for setting rates for all FDIC insured institutions that is more sensitive to risk than the current system. First, the legislation requires the FDIC to examine risks throughout a bank's holding company, when the FDIC establishes rates for a bank. Recent history has demonstrated that the risk to the FDIC and taxpayers cannot be determined solely by looking at a depository institution in isolation. Second, the bill requires the FDIC to consider the amount of assets and liabilities, not just the categories and concentrations of assets and liabilities.

Modernize Assessment Base

Finally, H.R. 2897 would create an assessment base that is more closely linked to the risks in insured institutions and would create greater parity between large and small banks. The current assessment formula which is based on domestic deposits was created in 1933 when most banks relied on domestic deposits as a source of funding. That is no longer true. Large banks today use brokered deposits, foreign deposits, and other sources, for funding, to the point where domestic deposits only account for a little more than 50 percent of their deposit base. Community banks, which generally don't have access to the same capital markets, still rely primarily on domestic deposits. Over the years, this has placed an inequitable burden on community banks to fund the Deposit Insurance Fund, while our nation's largest banks pay proportionally less. The assessment base needs to be brought up to date to reflect the realities of today's financial marketplace.

The bill would broaden the assessment base used by the FDIC to determine a bank's premium by including total assets minus tangible equity for the assessment base, rather than domestic deposits. A broader assessment base would result in a fairer assessment system with the larger banks paying a share of the assessments that is proportional to their size rather than their share of total deposits.

Under the current system that assesses only domestic deposits, banks with less than $10 billion in assets pay approximately 30% of total FDIC premiums although they hold approximately 20% of total bank assets. Furthermore, 85-95 percent of the funding for these community banks comes from domestic deposits, while for banks with $10 billion or more in assets the figure is approximately 52 percent. Thus, while community banks pay assessments on nearly their entire balance sheets, large banks pay on only half. Under H.R. 2897, banks with less than $10 billion in assets would pay about 20% of FDIC premiums, which is in line with their share of bank assets.

Moreover, the proposed base is more closely linked to risk. The amount of assets that a bank holds is a more accurate gauge of an institution's risk to the DIF than the amount of a bank's deposits. Bad assets, not deposits, cause bank failures, and all forms of liabilities, not just deposits, fund a bank's assets. Most of the $18 billion in actual losses that the DIF incurred in 2008 came from the resolution of IndyMac Bank F.S.B., a bank with $32 billion in assets including many subprime loans and mortgage-backed securities but only $19 billion in deposits.

The proposed assessment base of assets minus tangible equity was used by the FDIC for the special assessment adopted this May. The bill would establish assets (minus tangible equity) as the assessment base for all regular and special FDIC assessments. The change would reduce the assessments of 98% of the banks with less than $10 billion in assets, keeping millions of dollars in community banks, which continue to lend to small businesses and consumers throughout America.

Improve Financial Markets

A risk-retention requirement for mortgage-backed securities could be a useful tool in regulating risk associated with the securitization process, if coupled with an exemption from the retention requirement for mortgages subject to comprehensive standard underwriting requirements, such as loans sold to the housing government sponsored enterprises or guaranteed by the Federal Housing Administration.

ICBA endorses stronger regulation of over-the-counter derivatives because of the central role credit default swaps played in the current financial meltdown.

ICBA also supports further hedge fund regulation including requiring hedge funds to (1) register with the Securities and Exchange Commission (2) disclose appropriate information on an ongoing basis to allow supervisors to assess the systemic risk they pose individually or collectively.

Enhance Supervision of Systemically Important Payment, Clearing and Settlement Systems

ICBA supports the Administration’s proposal to provide the Federal Reserve with new authority to identify and regulate systemically important payment, clearing and settlement systems. This expanded authority would allow the Federal Reserve, in conjunction with a system’s primary federal regulator, to collect applicable information and to subject covered systems to regular, consistent, and rigorous on-site safety and soundness examinations to enforce compliance with applicable risk management standards.

The recent financial crisis highlighted the ineffectiveness of a patchwork regulatory structure for systems critical to the clearance and settlement of financial transactions and confidence in our financial markets. The Federal Reserve has a wealth of relevant expertise and resources that should be extended to all systems deemed systemically important. These systems should also have access to Reserve bank accounts, financial services, and the discount window for emergencies.

Additional Structural Issues

Maintain Dual Banking System and Do Not Create a Monolithic Federal Regulator

ICBA is pleased that the President's plan retains the system of federal and state bank chartering and does not recommend creating a single, monolithic federal regulator. We also very much appreciate Chairman Frank's recent pledge to preserve the thrift charter and a diverse regulatory system with checks and balances.

The current system provides valuable checks and balances in policy making and implementation. We should no more eliminate these checks and balances in the current bank regulatory system than eliminate the multiple branches of government that are the foundation of our country. Overwhelming concentration of power in any governmental or economic sector is counterproductive and unwise. Further, ICBA supports independent bank regulatory agencies because they are more insulated from political pressures, and can deal more objectively with those they are charged to regulate. If a single regulator were to go off in the wrong direction, there would be no offsetting regulatory voices, as we have today.

The single bank regulator concept solves a problem that we simply do not have; it was the <u>unregulated</u> parts of the financial industry, such as Wall Street investment houses and mortgage brokers, which caused the problems in our economy. Congress and the Administration must focus on addressing these challenges. New regulatory restructuring rules should target systemic-risk institutions to reduce the dangerous concentration of financial and economic assets. The regulated community banks are the victims and have held up remarkably well in this severe recession. Abolishing a regulatory system that worked makes no sense at all.

As the single Federal bank chartering agency, it would continuously tilt the playing field in favor of national banks at the expense of the state banking system. Having both state and federal regulators creates a flexible system of checks and balances that promotes innovation, preserves consumer choice and fosters overall systemic resiliency. In fact, our dual banking system has served our nation in times of prosperity and crisis remarkably well for nearly 150 years.

A single Federal regulator would focus its attention on the nation's largest institutions – its key clients. Community banks would be an afterthought. Congress should maintain a bank regulatory system that recognizes the importance of community banks and Main Street America, and gives all community banks enforcement parity, proportional regulation and equal access with the Wall Street firms.

The current system of bank supervision – though admittedly complicated on paper, has weathered the current crisis reasonably well. It provides substantial uniformity of capital and supervisory standards, but also different perspectives and essential checks and balances.

Some have complained that these advantages also give institutions the opportunity to engage in "regulatory arbitrage," playing one regulator against another. Let me be completely clear on this, no institution should be able to escape a regulatory action, such as a cease and desist or similar order, by changing charters. In fact, the Federal Financial Institutions Examination Council recently issued a statement that provides "that charter conversions or changes in primary federal regulator should only be conducted for legitimate business and strategic reasons." It goes on to say that, "Conversion requests submitted while serious or material enforcement actions are pending with the current chartering authority or primary federal regulator should not be entertained." [9]

In addition, we would require the systemic risk regulator, or the council, to harmonize regulatory standards (i.e., capital, margin, derivatives, etc.) to ensure no regulatory arbitrage based on charter or entity type.

Subject Unitary Thrift Holding Companies to the BHCA; Close ILC Loophole

Unitary thrift holding companies should be regulated as bank holding companies, supervised and regulated by the Federal Reserve on a consolidated basis, and subject to prohibitions on commercial activities. Many commercial entities used the unitary thrift loophole to get into the banking business. Unfortunately, the Gramm-Leach-Bliley Act of 1999 grandfathered existing thrift holding companies that qualified as unitary thrifts. By escaping the Bank Holding Company Act, these unitary thrifts have been able to evade consolidated supervision by the Federal Reserve and the long-standing policy of separating banking from commerce. This loophole should be shut down and unitary thrifts should be given a definite period of time to divest their commercial activities once they become subject to the Bank Holding Company Act.

Of course, the same must be said about the industrial loan company loophole, which remains open. Under this loophole, commercial companies may acquire or establish banks in several states. Administrative action and economic conditions have discouraged this activity in recent months, but unless the Congress acts, commercial companies could soon begin seeking banking charters again. Just imagine if major commercial firms had been heavily involved in the banking business last fall. The Administration has proposed the safest course – close the loophole in connection with this legislation.

Assistant Treasury Secretary for Community Financial Institutions

The current economic downturn has revealed just how critical community banks are to our country's financial system and why we need to give them appropriate consideration when devising national policies and programs. Recent reports by the FDIC indicate that even when the biggest banks have stopped lending, community banks have seen an increase in their loans. Despite the fact that they are a vital part of our nation's banking

[9] **FFIEC Statement on Regulatory Conversions;** FIL-40-2009, July 7, 2009

system, there is no Assistant Secretary at the Department of Treasury to coordinate federal policy for smaller financial institutions.

For more than two decades, Treasury has taken the lead in crafting the Federal government's response to crises in the banking sector and formulating regulatory reforms to prevent reoccurrences of the crises. Because Treasury plays a central role in Federal banking and economic policy, it is important that community banks have a voice inside Treasury advising the Secretary on how policies will impact community banks. Two actions by the Bush Treasury Department in response to the current financial crisis highlight the need for a community bank advocate inside Treasury.

First, Treasury created a money market mutual fund insurance program overnight with almost no statutory authority. The fees charged to the mutual fund industry for the guarantee were minimal compared to the price that banks pay for deposit insurance. Treasury's action gave a community bank competitor a significant advantage. The original plan would have given unlimited coverage to money market funds, which would have devastated community bank liquidity with runs on deposits. Although Treasury eventually limited coverage to amounts already in the funds, thanks to intervention by the FDIC and the banking industry, these events illustrate how the Treasury can overlook the community banking sector.

Second, when Fannie Mae and Freddie Mac were put in conservatorship last year, Treasury drastically misjudged the impact of the conservatorship on community bank holders of GSE preferred shares. Prior to the conservatorship, regulators had encouraged community banks to purchase GSE preferred shares as a safe investment that supported housing. Treasury believed that the conservatorship would impact few community banks, when, in fact, the actions wiped out large amounts of capital for hundreds of community banks. While we appreciate the limited tax relief Congress provided community bank preferred shareholders, many community banks are still burdened by the loss of capital caused by the devaluation of their GSE preferred shares.

H.R. 2676, the Oversight for Community Financial Institutions Act of 2009, introduced by Rep. Dennis Cardoza, would create an Assistant Treasury Secretary for Community Financial Institutions. H.R. 2676 would ensure that community banks – including minority-owned institutions – are given appropriate and balanced consideration in the Treasury policy-making process. This is absolutely vital to the continued health and strength of our nation's community banks and the communities they serve. ICBA urges Congress to include H.R. 2676 in the regulatory reform legislation.

Conclusion

ICBA appreciates this opportunity to testify on legislative proposals to restructure and reform our nation's system of financial regulation. It is vital that Congress take action, but it is essential that you take the right actions so that when America emerges from this current crisis, our citizens continue to enjoy a vibrant economy and the ability to build a strong financial future. This committee should adopt strong legislation to deal with systemic risk and properly focus the effort to protect consumers.

We must end too-big-to-fail and reduce systemic risk in order to protect consumers, local communities, our financial system and the economy from the destabilizing effects that occur when a giant institution runs into trouble. Community banks are the very fabric of our nation. We fund growth, drive new business development, help families buy homes, finance education. We are not responsible for the current state of our economy but are the victim of others' bad practices. Yet, we continue to help the people and businesses in our communities recover from this crisis and find a way back to prosperity. ICBA looks forward to supporting a plan that embodies our recommended improvements.

Addendum

ICBA Testimony on Systemic Risk

October 29, 2009

Introduction

This addendum presents a preliminary analysis of the discussion draft dated October 27, 2009 presented by the House Financial Services Committee and the Treasury Department.

ICBA believes that this draft meets a substantial number of ICBA's key policy goals as expressed in our testimony. We will be reviewing this draft in more detail in the coming days, but what follows is our reaction to key aspects of the draft and some recommendations for further improvement.

Enhancing Regulation and Supervision of Systemically Risky Institutions

ICBA strongly supports the provisions of the discussion draft that designate the Federal Reserve as the systemic risk regulator and that appear to give it sufficient authority to carry out its responsibilities. We also support the enhanced authority of the Financial Services Oversight Council over the Federal Reserve's decisions. While the Federal Reserve has the expertise and experience to deal effectively with these matters, they are so critical that other agencies must be involved as well.

The discussion draft appears to provide the Federal Reserve the full range of authority over the activities of systemically risky institutions, as we recommend in our testimony. We will review this further and make any further recommendations if we believe them to be necessary.

ICBA had recommended that the Council and the Federal Reserve identify systemically risky institutions. The discussion draft adopts this recommendation with a clear prohibition that the Fed not publically name these institutions. This is an appropriate clarification that attempts to avoid the possibility that these institutions will benefit from this designation. Of course, there is the possibility that market participants could infer that an institution has been identified as systemically risky as a result of regulatory filings, e.g., SEC disclosures.

Downsizing Systemically Risky Institutions

ICBA is especially pleased that the discussion draft provides the Federal Reserve the authority to require a systemically risky holding company to sell assets or terminate activities if they pose a threat to the company's safety and soundness or the nation's financial stability (Section 1104(a)(5)). This authority gets to the heart of many of the problems that led to the nation's financial meltdown. Some institutions have become so large that they cannot be effectively managed or regulated and must simply be downsized. ICBA recommends that the legislation direct the Federal Reserve to study each identified financial holding company to determine if it should be subject to this new authority.

Resolving Failing Institutions

The draft legislation gives the FDIC authority to responsibly resolve systemically risky holding companies. The bill gives the Treasury Secretary the sole authority to appoint the FDIC as receiver for a failed holding company. However, this vests a politically appointed official with tremendous power over the nation's economy. ICBA recommends that the legislation specifically empower the FDIC, as an independent agency, to recommend to the Secretary that he or she exercise this authority. Congress should also consider giving similar authority and responsibility to an institution's primary regulator.

Funding Resolutions

In our main testimony, ICBA recommends that funding for the resolution process be provided by the largest institutions in advance. We believe that a pre-funded resolution process has a number of advantages:

- It avoids an initial call on taxpayer funds that would be likely if an institution were to fail unexpectedly (which is – of course – the way these events typically unfold).
- It places the cost on institutions that may later fail, rather than only on institutions that haven't failed, providing an important equitable balance.
- Pre-funding avoids pro-cyclical effects; tapping the industry for modest, predictable contributions when times are good.

The FDIC's Deposit Insurance Fund provides a good example of how this could work. While there is much concern about the DIF's current funding levels, the fact is that the fund has operated exactly as intended. Even a full year into the deepest recession since the Great Depression, it maintained a positive balance through at least the first half of this year. (Even now, the DIF retains a robust cash balance, though much has been set aside for anticipated losses.) The Congress had many months to deliberate on legislation to enhance the FDIC's Treasury borrowing authority. And, the FDIC believes that the industry itself can recapitalize the fund without taxpayer resources. This is a commendable record and reflects well on the industry, the FDIC, and the Congress for establishing the system.

A pre-funded systemic risk fund could compile a similar record. It would not be necessary for it to accumulate enough cash to deal with every possible contingency.

But, it could have enough to tide the economy through another crisis such as we faced last fall. At that time, most policy makers believed Congress had to move with astonishing speed to address the crisis. An existing fund would allow the government to act quickly – under clear statutory authority – and allow the Congress time to review the situation in a deliberate fashion if even more resources are needed.

The post-funding system in the discussion draft should be a backstop to a pre-funded fund, but relying on post-funding when the entire system is collapsing is problematic. Post funding appears to work well in the context of state insurance regulation, where it is designed to deal with individual failures. In those cases, policy holders in an insurance company that fails due to mismanagement or fraud (rather than a systemic problem) can be made whole by contributions by the remaining healthy companies. In the case of widespread failures dues to a systemic situation, this concept does not work as well.

The discussion draft attempts to deal with this by stretching out the post-funding over 60 months. The downside of this approach is that the taxpayer funds are at risk and the failed institutions are – obviously – in no position to pay their fair share.

Nevertheless, ICBA strongly supports the provision in the draft that provides that only institutions over $10 billion in assets be assessed under this plan. This is clearly appropriate, since any institution smaller than that would not have had any role in creating the next systemic risk event. Congress should index this amount to address likely asset growth over time, particularly if this provision is not used until after a systemic event that will – all must hope – take place some time in the future.

Closing the ILC Loophole

ICBA strongly supports the provisions in the discussion draft that block the creation of additional industrial loan companies that may be owned by commercial firms. While we supported the Administration's proposal to completely close of the loophole – requiring the divestiture of existing commercially-owned ILCs – we recognize that Congress does not generally adopt such measures. When Congress closed the nonbank bank loophole in 1987 and the unitary thrift loophole in 1999, it included similar grandfathering language. These effectively prevented the establishment of dangerous combinations, such as a "Bank of Wal-Mart." We expect the discussion draft will have a similar effect, while not disrupting existing businesses.

Maintaining the Federal Thrift Charter

Even though the OTS would be merged into the OCC, ICBA is particularly pleased that the discussion draft retains the federal thrift charter, establishes a Division of Thrift Supervision within the OCC, and maintains key elements of the charter. As we indicated in our testimony, the vast majority of federal thrifts have served their communities in a responsible manner and there was no reason to force them to adopt an entirely new charter.

We also support the draft's preservation of the dividend waiver process for mutual holding companies. This provision would allow, for the most part, the continuation of the dividend waiver policy under the Federal Reserve, subject to certain conditions. Under this policy, mutual holding companies that are owned partially by the public can pay dividends to those public stockholders just like most other publicly held companies. This helps them maintain their holding company structure, which helps them raise capital and yet remain a mutual institution.

Tightening Securitization Process

Section 1502 of the discussion draft would require an originator to retain an economic interest in any loan that it transfers to a third party. The bill would require securitizers of asset-backed securities to retain an economic interest in the underlying assets, unless the originators have retained an economic interest. In general, at a minimum, the retained interest would be a credit risk of between 5 and 10%. The federal banking agencies, jointly with the Securities and Exchange Commission can adjust the risk retention requirements or exempt loans from the risk retention requirements.

ICBA agrees that if the secondary mortgage market had required that all market participants have some skin in the game, the current crisis would not be as severe. Lawmakers need to be careful, however, to address the problems that created the subprime crisis without unnecessarily burdening mortgage and other types of credit. While the accounting treatment of the risk retention requirement is not entirely clear, it is clear that an originator will have to hold capital against its retained interest for the life of the loan. Over time, the retention requirement will limit an institution's capacity to originate loans.

The Mortgage Reform and Anti-Predatory Lending Act (H.R. 1728) adopted by the House this year, contains a 5% risk retention requirement for non-qualified mortgages. Among the features of H.R. 1728 is authority for regulatory agencies to treat mortgages under various government-related programs, such as FHA and Fannie and Freddie as "qualified mortgages", which are not subject to the 5% risk retention requirement. If H.R. 1728 is not incorporated in the legislation, then beneficial provisions from H.R. 1728, such as the exemptive authority for FHA and GSE loans should be incorporated in this legislation. In addition, we urge the Committee to include similar exemptive authority for similar loan programs, such as Farmer Mac. We are concerned that a bank could lose the flexibility to sell whole loans outside a securitization transaction, when that is in the best interest of the bank, such as when a bank is exiting a line of business. This flexibility should be retained.