Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Committee on Financial Services

United States House of Representatives

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November 18, 2008

Chairman Frank and members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (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 $13.3 trillion in assets and employ over 2.2 million men and women.

We appreciate the opportunity to testify on the current status of the Emergency Economic Stabilization Act, and more specifically, the Troubled Asset Relief Program (TARP). The TARP Program has served to calm the financial markets and does have promise to promote renewed economic growth. However, it is also a source of great frustration and uncertainty to banks. Much of the frustration and uncertainty is because of the significant and numerous changes to the program and misperceptions that have resulted on the part of the press and the public.

This confusion is understandable given what has happened, but it is potentially very harmful. It can lead to misdirected public policy and public perceptions. There is a broad consensus that the crisis grew out of a housing bubble fed by mortgage loans that never should have been made, which were securitized and sold to investors who did not properly analyze or understand the risk. Excess leverage on Wall Street and in other financial centers greatly exacerbated the crisis. There were many other contributing factors such as: regulatory gaps; lack of transparency; breakdowns in the ratings process; and, ABA strongly believes, the application of mark-to-market accounting in dysfunctional markets.

ABA greatly appreciates the consistent statements by members of this committee, and particularly its leadership, that the regulated banks were not the cause of the problem and have generally performed well. Not only did the regulated banks not cause the problem, they are the primary solution to the problem as both regulation and markets move toward the bank world. Thousands of banks across the country did not make toxic subprime loans, are strongly capitalized, and are ready to lend; but they cannot do so if misguided policies increase their regulatory costs and provide disincentives to lend. Banks already face significantly higher costs from deposit insurance premiums. And banks are already receiving contradictory government signals about lending, being told to use capital to make new loans and, in some cases, being told by bank examiners not to because the risk is too great.

As I detail in my statement, the emergency program was driven by severe problems at firms that were ***not*** banks, such as Bear Stearns, Fannie Mae and Freddie Mac, and AIG. The U.S. actions were also responding to foreign governments acting to support institutions that were far less capitalized than U.S. banks. However, commentators often failed to realize the situation was different: the vast majority of U.S. banks were well-capitalized and had nothing to do with making toxic mortgage loans. Unfortunately, when the capital program was announced, the headlines read "Bank Bailout" when clearly it was not. To my knowledge, no one in the banking industry requested a capital program, and the ABA certainly did not.

Now that the program is in place, there are additional actions that need to be taken to improve it. Just last week, Treasury Secretary Paulson announced other likely uses of TARP funds in addition to the current Capital Purchase Program (CPP). To a large degree, these are policy choices for the Congress and the current and future Administrations. However, several comments are in order:

First, we urge the Treasury to ensure that sufficient money remains to fully fund the CPP for community banks accepted into the program. It would be most unfair, and would result in competitive inequality, for the community bank program not to be fully funded.

Second, ABA supports further action to directly address the housing market (which has not stabilized and is the root cause of the problem) and foreclosures (which are so harmful to communities). The ABA supports a four-pronged approach to the housing and foreclosure issues:

- ***Use Some TARP Funding for Distressed Homeowners***

  The ABA supports use of some TARP funding to help distressed homeowners and lessen the number of foreclosures. Such a program would have to be carefully crafted. One great concern to bankers is that any foreclosure prevention program should minimize the risk that more borrowers will be encouraged to default. It is a very difficult balance, but a very important one. An approach that provides lenders additional tools, such as guarantees in case of a second default, appears to be worth pursuing. However, we would suggest that such a program first be carefully vetted with lenders to make sure it is going to be used and that it does not result in more borrowers defaulting in order to receive write-downs they do not need.

- ***Address Foreclosures Connected with Securitized Mortgages***

  The ABA supports addressing foreclosures of loans that have been securitized. As was amply demonstrated in last week's hearing before this committee, it is often much more difficult to create a system for modifying loans that are securitized because so many parties may be involved and because of the fear of litigation. ABA would be pleased to work with the Committee on ways to address this issue.

- ***Take Action to Lower Interest Rates on Mortgage Lending***

  While other interest rates have come down as the Federal Reserve lowered short-term interest rates, mortgage rates have not. There is a severe dislocation between mortgage rates and other interest rates, caused in part by market uncertainty and skittishness with respect to Government Sponsored Enterprises' (GSE) securities. If the traditional relationship between mortgage rates and other rates could be restored, there would be a dramatic impact on housing and on the ability to refinance troubled borrowers.

- ***Use Part of Any Stimulus Package to Directly Address Housing Problems***

  We would encourage Congress to use part of any stimulus package to directly address housing. Two programs deserve consideration: (1) an effective temporary tax credit for the purchase of a house by someone who will live in it – the current program is too small and complicated to be effective; and (2) a tax incentive, such as a more robust depreciation allowance to encourage entrepreneurs to buy properties and rent them out. While housing markets may still be overpriced in some areas, many buyers are sitting on the sidelines because they read that there will be more price decreases. Buyers need to be encouraged to buy in the near term.

Finally, I would like to reiterate the points in my last testimony before this committee concerning mark-to-market accounting. Since TARP is now focused on creating additional capital, it must be noted that the misapplication of mark-to-market accounting in today's situation, when there is no functioning market, has unnecessarily destroyed billions of dollars in capital. ABA greatly appreciates your comments, Mr. Chairman, at the last hearing, and the recent letter from Ranking Member Bachus on the mark-to-market issue.

On a related matter, the recent action by the Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) to address the concept of "Other Than Temporarily Impaired" (OTTI) was very inadequate. The SEC attempted to resolve this issue, but FASB's interpretation muddled it again. As a result, banks may be required to write down securities – which have no threat to principal or to cash flow – because the markets are dysfunctional.

Mark-to-market accounting badly needs to be addressed in the short-term. Furthermore, ABA once again urges this committee to address the way accounting rules are made in its regulatory restructuring legislation next year.

To further address the subject of this hearing, I would like to make several key points:

- **Greater clarity is needed regarding TARP to assure that banking institutions and the public understand how the program works and how it will meet the objectives of strengthening our financial system.**

- **The TARP should allow all healthy banks, regardless of their corporate structure or charter type, to participate.**

- **Banks continue to lend, and the TARP Program can help to further stimulate expanded banking services by healthy banks.**

- **The TARP program must work in tandem with other programs so as to avoid conflicting messages and incentives to lend.**

Greater clarity is needed regarding TARP to assure that banking institutions and the public understand how the program works and how it will meet the objectives of strengthening our financial system.

There is great confusion about TARP, particularly with the public. More clarity is needed. The confusion is understandable, as this program has had more twists than a mountain road.

As the crisis developed, the government was forced, in different ways, to support the acquisition of Bear Stearns, put Fannie Mae and Freddie Mac into a government supported conservatorship, and rescue AIG. Lehman Brothers was allowed to fail. ***None of these are banks.*** Bank failures have been handled through the bank-funded FDIC. Money market mutual funds for the first time were given a federal guarantee.

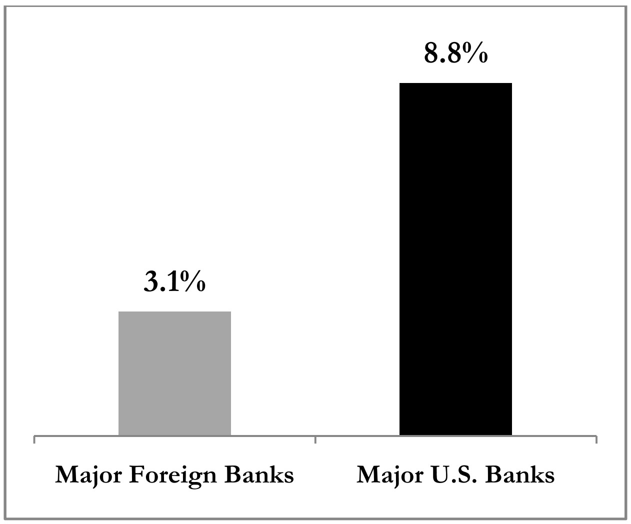
Then, on September 19, 2008, in response to a total loss of confidence in the international financial markets that led to a freezing of the world's credit markets, the Treasury and the Federal Reserve suddenly proposed what became TARP. After improvements made by Congress, TARP was passed. While provisions were added by Congress to allow capital infusions, almost all the justification for TARP was based on asset purchases.

Then in a matter of days, everything changed. After some European countries announced that governments were going to put capital in banks and, apparently, foreign government pressure for the U.S. to do the same, overnight the policy shifted to putting capital in U.S. banks. As is widely known, the leaders of nine large banks were called to Washington with no notice and "requested" to take the capital. These nine banks had not asked for the capital and several of them had just raised private capital.

To my knowledge, no one in the banking industry requested a capital program; the ABA certainly did not. The announcement of the program really harmed the perception of our banking industry over the next few days. Commentators jumped to the conclusion that many banks must be capital deficient and in trouble. They did not understand that U.S. banks were much more heavily capitalized than the European banks receiving capital, nor that about 95 percent of the U.S. banks were well capitalized. Also, the purpose of the program, as announced at that time, was to unfreeze the international credit markets, particularly the interbank lending market. The idea of increasing domestic lending was not at the forefront.

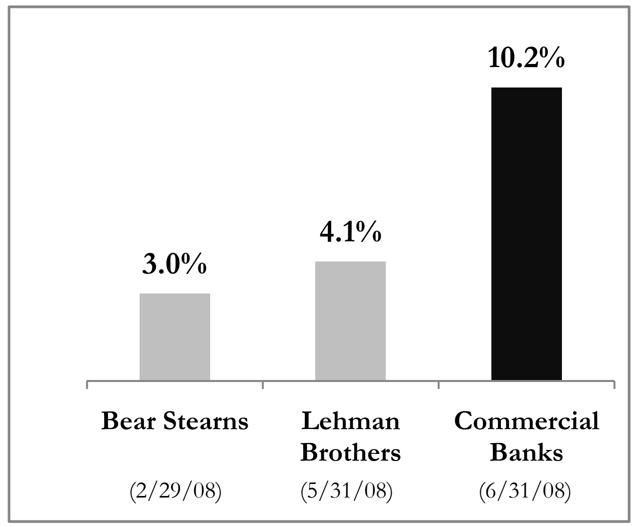
Equity Capital to Assets Comparisons

Foreign and Domestic Banks



Source: FDIC & SEC

Investment and Commercial Banks



Source: FDIC & SEC

As the program was extended beyond the initial nine banks to other banks, it gradually became clearer that the program was to focus on ***healthy*** banks and its purpose was to ***promote the availability of credit***. ABA was extremely frustrated by the lack of clarity and said so in a letter to Secretary Paulson. The press, the public, Members of Congress, and banks themselves, were confused. Many people, understandably, did not differentiate between this voluntary program for solid institutions and "bailouts." Bankers, for a few days, were not sure of the purpose; although they were sure their regulators were making it clear it was a good idea to take the capital.

Now, of course, Treasury has announced that there may be additional uses of TARP money, but that asset purchases – the original purpose – are unlikely to take place. It is quite possible that the latest iteration of the program is its best use, but it has once again created enormous confusion.

Put yourself in the place of a community banker. You are well capitalized and profitable. Your regulator is calling you to "suggest" taking CPP capital is a good idea. You can see that it might be put to good use to support lending growth. But you have many questions about what could well be a decision that dramatically impacts the future of your bank. For example:

- ***What will my customers think?*** Will they be mad that I took government capital, thinking it is not fair? Or if I do not take the capital, will they think I am too weak to qualify? If I do not take it and my competitors do, will customers think those banks must be stronger than mine because the government invested in them or, conversely, that those banks needed government help?

- ***What will the markets think?*** Will there be an advantage to higher capitalized banks (at levels above "well-capitalized"), even if the extra capital came from the government?

- ***What restrictions will be added?*** I can see what is on the table now, but how can I be sure that there will not be changes that severely damage my bank through increased regulatory costs, or counter-productive dividend restrictions, or even attempts to push me to make unsafe loans? The people running the program now will not even be in charge in two months.

  This confusion is compounded by the fact that the Treasury purchase agreement contains a clause, 5.3, which basically allows the Congress to add anything it wants after the fact. This clause will cause a number of banks to avoid participating and should be dropped.

More than anything, bankers need to know exactly what the program is, what its purpose is, and what restrictions and requirements will apply. And they need the public to have a better understanding as well. Everyone concerned – including Members of Congress, the regulators, and the banking industry – must try to put the current actions in context. Otherwise, the absence of clarity in this volatile environment exposes banks to the risk of runs from customers who misperceive a bank as either so weak that it needs a "bailout" or too weak to receive one.

The TARP should allow all healthy banks, regardless of their corporate structure or charter type, to participate.

Another aspect of the program that needs to be addressed is the fact that it is still unavailable to the majority of banks. While we understand a term sheet is soon to be released for private C corporations (and, we presume, for the non-exchange traded public companies), term sheets for many other banks, including S corporation banks and mutual institutions, have not been issued. This is unfair to these banks, and it undermines the effectiveness of the program.

As these corporate structures may not be well understood by some policymakers, let me describe briefly the structure of them. Take private C corporation banks, for example. They generally have fewer than 500 shareholders and are, therefore, not required to become a public company subject to SEC periodic reporting requirements. In addition, while these banks have issued common stock to their shareholders, they may or may not have the authorization to issue preferred stock. As a result, those institutions not authorized to issue preferred stock will need time to obtain shareholder approval to issue preferred stock as required under the TARP. Further, and in order not to push them over the 500 shareholder level, these institutions need assurances that they and their shareholders will have a right of first refusal to purchase both the preferred and the common stock underlying the warrants before Treasury sells the securities into the marketplace.

Many smaller community banks, that are public but not traded on a national securities exchange, face some of the same issues that the private C corporations do. For example, they may not be authorized to issue preferred shares and, like the private C corporations, will have to seek shareholder approval. Because they are a public company, however, they must comply with the SEC's proxy rules, which will add time to the process of gaining shareholder approval.

Finally, because there is either no or a very thinly traded market for the common stock in private C corporations and non-exchange traded public companies, respectively, these institutions have questioned how the initial exercise price for the warrants will be set.

S corporations are subject to many restrictions, including on the number of shareholders, which is limited to 100, and on the type of stock they may issue. S corporations may only issue a single class of stock. The senior preferred stock that Treasury has requested would constitute a second class of stock, so S corporations would not be able to participate. ABA proposes that Treasury allow S corporation banks to issue a different type of debt obligation with non-deductible interest, so that it would be on the same level as other participants. This would allow many more institutions to participate in the program.

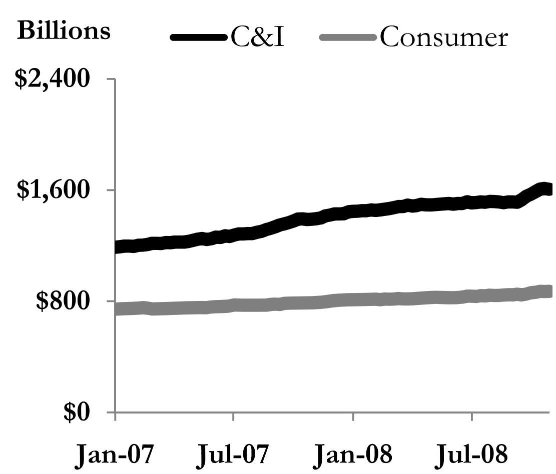
There are about 735 banks organized under mutual ownership, of which about 175 are in the form of mutual holding companies. Those without mutual holding companies cannot issue shares. Some mutual holding company structures have issued minority shares, but must retain a majority interest in the hands of the mutual ownership interest if they are to remain mutually owned. Even if they have the capacity to issue additional preferred shares, they may not be able to comply with requirements established by Treasury for exchanged-traded, SEC filing companies. Finally, a majority of mutual holding companies has not been authorized to issue minority shares, and cannot comply with the terms currently available under the TARP. We propose two alternatives. Instead of preferred stock, subordinated debt could be used as a replacement investment with some type of redemption fee. Alternatively, mutual capital certificates could be used. Mutual capital certificates are subordinate to all deposit accounts and debt obligations, and are entitled to be paid dividends.

Regardless of the corporate structure, all banks provide vital services to their communities. It would be patently unfair to exclude healthy institutions from having the choice of whether or not to use the TARP capital to enhance their banking services. And it would potentially increase the risk of hostile takeover bids by participating institutions for those who are left out.

Banks continue to lend, and the TARP Program can help to further stimulate expanded banking services by healthy banks.

First, it is important to dispel the misperception that banks are not lending. Banks are lending (see the Federal Reserve chart on bank business lending). In fact, many banks have said that they are seeing borrowers that used to rely on non-bank financing or Wall Street coming to their doors. This would be expected with the severe problems in credit markets, including securitization. Thus, many of the stories about the lack of credit

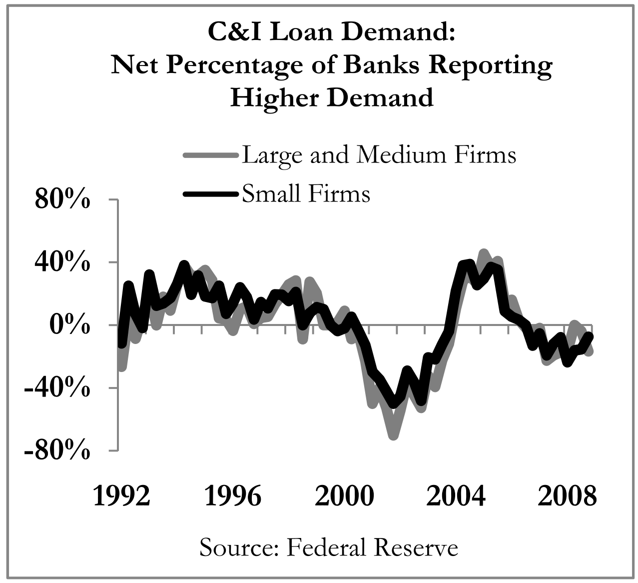
Bank Lending Continues to Grow



Source: Federal Reserve

are due to the weakness of non-bank lenders. Naturally banks are following prudent underwriting standards to avoid losses in the future. But even with more careful underwriting, only 6 percent of small businesses (according to an October survey by the National Federation of Independent Businesses) reported problems in obtaining the financing they desired.

Borrowers are also being more careful, and the overall demand for loans is declining, although this varies by market. However, as the economy starts to grow again, the growth will be stunted if adequate credit is not available. As experience has shown in previous economic slowdowns, it is the banks that end up providing most of the needed credit to support a recovery. Banks are anxious to meet the credit needs of businesses and consumers, and we know that such capital is vital to an economic recovery in communities large and small across the country.



The availability of capital through the Capital Purchase Program provides added flexibility to help assure these borrowing needs are met. There is so much confusion about the program that it may be helpful to provide some simplified examples as to how it can work to increase lending, which both Treasury and Congressional leaders have said is the purpose of the program. In these examples, I will use hypothetical community banks with $100 million in assets and $10 million in capital. The hypothetical banks will then sell $2 million in equity to the government.

In these examples, it is important to note several factors where there is a great deal of misperception. First, as a general rule, only strongly capitalized, healthy banks are eligible, as noted previously. This is the exact opposite of the capital injection programs in Europe and elsewhere; it is also the opposite of other uses of TARP and other government funds.

Second, the government money is a capital injection; it is not money that is used directly for lending. What capital does do is to allow banks to employ the deposits of their customers more fully. In fact, banks are able to support $10 of assets with $1 of capital. Even though loan losses have increased, which has caused capital ratios to fall somewhat, the vast majority of banks are still well-capitalized, which is the highest rating the regulators can give. In fact, the FDIC stated in its second quarter 2008 report (the latest available) that "despite the slowdown in capital growth and the erosion in capital ratios at many institutions, 98.4 percent of all institutions (accounting of 99.4 percent of total industry assets) met or exceeded the highest regulatory capital requirements at the end of June [the most recent data available]." Certainly, this number has gone down somewhat since then as the economy has weakened and loan losses increased. Under normal circumstances, banks would go to the private capital markets for additional capital, but those markets are now extremely tight. Thus, without additional capital to back more loans, banks might not be able to grow lending; others might even shrink lending in order to boost the capital-to-assets ratio.

Example 1: Well-Capitalized Bank With Growing Loan Demand

Consider a well capitalized bank in a market where loan demand is currently growing. That growth is a combination of some economic growth and the fact that, in current markets, other non-bank sources of credit have dried up. Additional deposits to fund lending can also be acquired as money is seeking the safer haven of insured deposits. There are a large number of banks in this category, although the level of local economic growth can obviously vary.

This bank starts with $100 million in assets and 10 percent capital. After obtaining $2 million in additional CPP capital, the bank can grow to $120 million and still have 10 percent capital. This shows how $2 million in capital can support $20 million in additional lending. If there are lending opportunities available, as there are in our example, the extra credit can be made available fairly quickly. However, as discussed further later, there are two caveats here. One, this example assumes that regulatory capital ratios are not increased. We are concerned that a number of banks are being told that their capital ratio should be increased above previous requirements. While that may be appropriate in individual circumstances, a general move in that direction will negate the CPP program. Note that if the regulatory capital level in this example is raised to 12 percent, the new capital will not support any increase in lending. Two, the bank must apply sound credit standards to its lending programs; there should be no pressure to push out loans as that will just lead to more defaults.

Example 2: Well-Capitalized Bank with Shrinking Loan Demand

Like the bank in Example 1, this bank is well-capitalized but is in an area where the economy is not growing or is shrinking. There are, of course, many areas of the country that look like this. Here, a well-capitalized bank could also increase loans by 20 percent, but it would be unsafe to do so quickly as there are just not that many creditworthy borrowers available. This bank may not be able to grow its deposits to fund the loans rapidly either, as job loss may be high and income growth low. However, importantly, with additional capital this bank is now in a position to fund loans as the local economy begins to grow and thereby ***accelerate*** the economic recovery.

Example 3: A Solid Bank With Losses Affecting Capital

The great majority of banks are covered in the first two examples. However, there are some banks that are still in good financial shape, but that have taken a capital hit. For example, some banks that were well capitalized and profitable took a hit when the value of their preferred shares in Fannie Mae and Freddie Mac were virtually wiped out overnight. In this example, our bank had to write off a $2 million loss, and therefore its capital level was reduced to 8 percent. Since it cannot raise capital in current markets, this bank must ***shrink*** to get back to 10 percent. In fact, it will have to shrink to $80 million in assets, which means it will generally stop making loans – including not rolling over loans to existing customers and reducing lines of credit. The bank may even try to sell loans, which, in this market would be difficult to do. If this bank had $2 million in new CPP capital, it would not have to stop making loans and would be able to continue meeting the needs of its local businesses.

Example 4: A Strong Bank Would Use Capital to Acquire a Weak Bank

This example is one that has raised some controversy. It is clearly not the intent of Congress that the TARP funds be used to support acquisitions generally. However, when there are banks that are weak enough that they cannot increase or even maintain lending levels, facilitating their acquisition may well increase overall lending. In this example, a well capitalized $100 million bank with 10 percent capital is interested in acquiring a weak bank of the same size in a neighboring town. However, in acquisitions, the value of the assets of the acquired bank must generally be immediately written down. In our example, we assume a $2 million write-down. (This is another area where current applications of accounting rules are causing problems.) Instead of 10 percent capital, this acquired bank will only have 8 percent. Thus the combined entity will have only 9 percent capital on its $200 combined assets. The acquisition will probably not take place. If $2 million in CPP capital are infused into the acquiring bank to help facilitate the merger, the new combined entity will have 10 percent capital, the acquisition can take place, and lending can be maintained in the neighboring town.

The point of these four examples is to show that there are many ways that the capital infusion can be effectively deployed by the accepting banks. While different, all have the effect of stabilizing credit availability, expanding lending in the near-term to meet demand, and making credit available as the economy turns the corner and new business opportunities arise for bank customers. Treasury needs the flexibility to invest in banks like those in the examples and banks need the ability to deploy this capital in the most appropriate way to facilitate economic growth in their communities. Most banks in this country have been in existence for decades, and often for more than a century. They expect to be in those communities for the next 100 years and understand the needs for credit to promote economic growth. The TARP program can help each participating bank in its own way.

However, misperceptions need to be addressed if the TARP program is to succeed. As previously noted, a major cause of the misperceptions has been the ever-changing nature of the TARP program. Another cause has been the failure to distinguish between the bank CPP program – ***a voluntary program for healthy banks*** – and the use of TARP and other program funds for direct bailouts of failing institutions, like AIG, in other parts of the financial sector. It is important to note that the great, great majority of banks that will receive CPP capital never made the toxic subprime loans, are strongly capitalized, are well regulated, and are being requested by their regulators to participate in the program. ***Requirements and restrictions that may be appropriate for other companies that are being saved are not appropriate in these cases.*** They would be unfair and counterproductive.

In our examples, the CPP capital funds go into the capital accounts of the banks. This money is not directly lent. Rather, it allows greater use of deposits gathered by banks. The increase in capital can support up to ten times the amount in additional loans. There has been a lot of talk about banks possibly using this money for dividends or bonuses. That is just not the way that the system would function.

The CPP capital would go into a capital account and raise the capital ratio – in our example from 10 percent to 12 percent. That percentage would then come back down, as loans grow, to 10 percent. ***Dividends and compensation are paid out of the income earned from the bank, not from capital.*** That will be the case for the great majority of participating banks. It is possible that in a few cases, there could be a temporary period where income does not cover all costs and, therefore, there would be a temporary dip into capital accounts However, banks are heavily regulated and such a situation would be allowed by the regulators only temporarily. If it goes on for several quarters, or if regulators believe it will, then the bank will be required to undertake a program, among other things, to raise capital and/or cut dividends. Excess compensation would also not be allowed if it would caused capital to be impaired. The regulators have reiterated in clear form this traditional banking policy in last week's guidance, and ABA supports this regulatory approach.

It is important that banks not be cut off from reasonable dividend and compensation policies. These policies are necessary to support the stock price and business of the bank. Many banks joining the program have been paying regular dividends for years – even decades – without interruption. Dividends are particularly important for bank stocks, which are known for paying solid dividends. That is why many people in retirement and pension plans often invest in bank stocks. These investors should not be punished by having the dividends needlessly cut out. Furthermore, the dividend supports the stock price and the ability to raise capital, and eliminating it would be exactly contrary to the purpose of the CPP program. Finally, the taxpayers would be hurt because the value of the warrants would be undermined.

Bonus compensation systems are widely used in the private sector to attract and keep good employees and to incentivize success. While we recognize that there are legitimate questions and concerns about the way some compensation programs have been structured on Wall Street and elsewhere, the TARP program already addresses this. In addition, the recent guidance for the banking agencies addresses these issues specifically for banks.

The fact is that the great majority of banks would not participate in the CPP if prohibited from paying dividends or reasonable compensation, including bonuses. Again, it is essential that policy makers distinguish between capital infused in healthy banks and money provided to weakened institutions outside the banking industry, where such restrictions make sense.

Banks of all sizes, shapes and locations will be participating in the program. The only things they will have in common are that they are strongly regulated and are solid, not weak, banks. The recent regulatory guidance, building on traditional regulatory principles, provides the right roadmap and flexibility to address concerns about dividends, compensation, and other issues. We strongly urge Congress not to put additional restrictions on banks participating in the CPP after those banks, which did not ask for the program, have already signed up. To do so would be unfair and counterproductive.

Another misperception is that this program will be very costly to the government. In fact, this is an investment by the government in healthy banking institutions that will be the engines of the economic recovery. The Treasury has allocated $250 billion to invest in bank preferred stock. The preferred stock will pay a dividend rate of 5 percent for the first 5 years and then go to 9 percent. It is highly likely that almost every bank will try to exit the program, substituting private capital, within five years.

To finance the purchase of the stock, the Treasury will have to issue debt. Assuming the debt matures in five-years and a yield of 2.51 percent (the rate on the 5-year Treasury bond on November 10, 2008), the net cash inflow to the Treasury from Treasury's investment would equal almost $31.4 billion. Additionally, publicly traded institutions that participate in the CPP will have to issue warrants to purchase common stock within the next 10 years, and we expect non-publicly traded institutions to have to issue instruments that yield comparable economic benefits for Treasury. These warrants have a positive value. We conservatively estimate that the value of these warrants could range between $10 billion to $15 billion. Thus, in total, the government's return on this investment is likely to range between $40 billion and $45 billion. This, of course, does not include the benefit to small and large businesses (and indirectly, the taxpayers) that will have available credit and will continue to make money, pay taxes and keep people employed.

In this regard, we would request that TARP funds used for the banking institutions be segregated from other uses for record-keeping purposes. It is important that the government and public know the costs of various parts of the program.

The TARP program should work in tandem with other emergency programs so as to avoid conflicting messages and incentives to lend.

Given the decision to adopt TARP and the CPP, and the goal to support availability of credit, ABA supports last week's regulatory guidance. We do emphasize, however, that it should not become an additional regulatory burden on banks or be applied in some one-size-fits-all fashion.

The guidance basically reiterates the approach that banks are already taking toward capital, dividends, compensation, and lending; and the normal examination and reporting process is sufficient to monitor bank compliance with guidance. For example, to saddle thousands of community banks that do not have material foreclosure issues with policies designed for large institutions dealing with thousands of foreclosures makes no sense.

However, we must add that, not only have banks been receiving ***confusing*** messages, they have been receiving ***conflicting*** messages. As has often been the case, there may well be a disconnect between the regulatory headquarters in Washington and the examiners in the field. It is a matter of achieving the right balance between making sure banks are following sound policies and discouraging innovation and lending. Regulators certainly should be carefully reviewing banks and their capital, borrowing, and lending policies. However, our members have informed us of several problematic areas:

- ***Capital:*** As previously discussed, some banks have basically been told that current definitions of well-capitalized no longer apply. It has been strongly "suggested" that higher capital levels should be reached, even in the case of banks that far exceed the threshold of well capitalized. For banks that received such suggestions, this additional capital from the CPP would be required to be used to support the higher ratio on ***existing*** levels of assets, not to support new assets (loans). Certainly additional capital is appropriate in some circumstances, but there are cases where this will unnecessarily curtail lending.

- ***FDIC's Guarantee Program of Senior Unsecured Debt and Transaction Accounts:*** The ABA recognizes the importance of taking action to address the financial disruptions that have occurred in the last several months and appreciates the FDIC's involvement in the process. The actions taken represent a significant departure from the traditional role of the FDIC. The systemic risk exception has been used in a way that no one would have anticipated, and while it is available to deal with such extraordinary circumstances, we believe that the actions taken should not become a permanent facility. As the banking industry must bear the costs of these initiatives, it is important that the risk be closely monitored, the pricing be subject to change so that those that participate pay a fair price to cover costs (and not impose costs on those that choose not to participate), and the program be unwound in a way that is least likely to be disruptive or create additional problems or costs for the industry.

Moreover, because the program and its implementation have occurred so quickly, it is highly likely that there will be negative unintended consequences. It is very important, for example, that the changes adopted do not create competitive imbalances that would favor banks of different sizes or types. Moreover, those that choose not to participate in the program should not be disadvantaged or punished in any way for that decision. Because of these concerns, ABA is urging the FDIC to be flexible and make adjustments to improve the program and quickly correct any problems that arise. This would include both the flexibility to change the elements of the guarantee (including debt covered, pricing, and terms) and the ability of banks to participate or not in the program.

- ***The Danger of a Regulatory Overreaction:*** A natural reaction in the current economic environment is to intensify the scrutiny of commercial banks' lending practices. However, a regulatory overreaction that signals to banks to stop certain types of lending – particularly commercial real estate lending – will only exacerbate the credit crunch. 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.

  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, we hear that some banks are being asked to obtain new appraisals on properties for fully ***performing*** loans, i.e., loans where the borrowers are current and meeting their obligations to the bank. 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. As these asset mark-downs are reflected on a bank's books, the bank's capital is reduced. As I have stated above, this has the consequence of reducing lending in order to improve the capital-to-assets ratio.

- ***Doubling of FDIC Premiums***: Our members understand the importance of having a financially sound FDIC insurance fund. Banks are prepared to meet their obligation to keep the fund strong. The industry expects that the premium assessment schedule will rise in the short run in order to pay for current bank failures; provide reserves for the future; and in general rebuild the fund's reserve ratio. Since banks are responsible for the fund's financial health, the ultimate cost to the industry will be virtually the same no matter what recapitalization plan is implemented. At issue is the ***timing*** of payments to rebuild the fund. It is critical to achieve the right balance so that the fund can remain strong without pulling funds unnecessarily from banks that need them to support loans in their communities.

At the end of June (the most recent quarter for which data are available) the FDIC fund was $45 billion – which reflected the losses for IndyMac and other bank failures for the first half of this year. Thus, there are considerable resources available to cover losses, without excessive increases in premium costs. Under the FDIC's plan, which doubles premiums for most banks, about $10 billion will be sent to Washington in 2009, taking valuable resources away that could have supported lending. Certainly, some additional premiums are needed, but ABA believes that premium rates should be lower than what is proposed. In fact, Congress specifically gave FDIC the authority to extend the recapitalization plan under "extraordinary circumstances." A phased-in increase in the assessment schedule over the next few years may be appropriate, considering that the present economic recession and financial turmoil will likely ebb in the future.

- ***Discouraging the Use of Federal Home Loan Bank Advances***: The lack of liquidity has been central to the credit crunch problem and the focus of Congressional and regulatory resolution efforts. One critical source of funding for many banks – both during and well before the current financial crisis – has been Federal Home Loan Bank advances. These are stable sources of liquidity that allows banks to manage the overall cost of funding. FHLB advances often are a cost effect way to raise funds, help banks manage interest rate risk by match-funding to the term of the loan, and often facilitate community development loans. Under the FDIC's proposal to raise premiums, there will be a significant penalty for some institutions that use advances. This simply raises the cost of funding with no change in the risk of assets that are funded.

- ***Discouraging Retention of Local Deposits:*** The FDIC proposes to charge higher premiums to banks that use elevated levels of brokered deposits. While some recently failed or troubled banks have used brokered deposits to grow rapidly and fund risky assets, the FDIC proposal fails to distinguish among ***different*** types of brokered deposits. This is critical as some so-called "brokered deposits" are designed to maintain relationships with customers and provide safe, stable and low-cost funding for banks. For example, many banks participate in networks of banks that exchange deposits in order to provide greater deposit insurance protection for their customers. These reciprocal deposit programs allow banks to maintain relationships with their customers and keep funds within the local community. Other banks regularly sweep cash from a brokerage account to a deposit account within the same organization. These are considered "brokered" yet they help customers manage their money and helps banks maintain the customer relationship.

  Unfortunately, these and reciprocal deposits are currently defined as "brokered deposits" and have been unfairly painted with the same brush as "hot money" deposits. These are very stable deposits. In fact, without programs like these, depositors are likely to withdraw money from local banks and spread it on their own or through brokers to banks that truly are higher risk and paying high interest rates. Thus, it is unfair to include reciprocal deposits and deposits swept from affiliates in with other, more volatile, forms of brokered deposits. Most importantly, doing so would only serve to increase the cost of funding loans and encourage funds to leave local markets – which reduce the ability of banks that use these products to make loans.

There are two other issues that are hurting the effectiveness of the CPP. First, the deadline should be extended. Given the changing nature of the program, and its complexity, many banks did not have adequate time to apply. Second, the SEC needs an expedited program to approve the process a number of banks must take to achieve needed approvals to comply with the CPP – for example, shareholder approval to issue the preferred stock. We have heard from banks that the SEC is causing delays and imposing needless requirements, treating these actions individually rather than as a common approach to a government program.

Conclusion

Mr. Chairman, we appreciate the opportunity to present the views of the American Bankers Association today on the emergency legislation. While the actions taken are positive and promise to have the desired effect of simulating credit availability, there are improvements that are very much needed to enhance their effectiveness. It is also important that any initiatives be consistent and not send conflicting messages or undermine the effort to extend new credit. Finally, the system of banking regulation, while certainly stressed, has shown great resilience and is the model for reform. The banking industry has strong supervisory oversight, a method of handling problems and failures (paid for by the industry), and emergency provisions in the event of a systemic problem. It is no wonder that the problems in other financial industry sectors have led firms to seek out a banking charter. As policymakers continue to evaluate what further actions need to be taken, it is critical that the healthy banking institutions that had nothing to do with the current crisis not suffer additional regulatory burdens that will inevitably lend to less credit and fewer services to local communities.