Testimony of

Cynthia Blankenship
Vice Chairman/COO, Bank of the West

On behalf of the
Independent Community Bankers of America

Before the

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House of Representatives
Committee on Financial Services

Hearing on

"Priorities for the Next Administration: Use of TARP Funds Under EESA"

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Chairman Frank, Ranking Member Bachus, Members of the Committee, my name is Cynthia Blankenship and I am the Chief Operating Officer and Vice Chairman of Bank of the West in Grapevine, Texas, and the Chairman of the Independent Community Bankers of America[1]. Bank of the West is a state-chartered bank with $250 million in assets and is part of a two-bank holding company. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on "Priorities for the Next Administration: Use of TARP Funds Under EESA."

Introduction & Summary

Today's hearing is focused on the use of Troubled Asset Relief Program's Capital Purchase Program and other provisions under the Emergency Economic Stabilization Act of 2008. The TARP is a key element of the nation's economic recovery plan. My testimony addresses the following issues:

- Treasury's delay in providing CPP funds to community banks;
- The increasingly difficult examination and accounting environment community banks are facing;
- Our comments on the foreclosure mitigation process; and
- Deposit insurance issues Congress must address in 2009.

We believe each of these issues will have a direct impact on the prospects for a strong recovery.

It is vital to note at the outset that community banks had no role in creating the current problems we face. They did not engage in irresponsible subprime lending and have remained strongly capitalized. Therefore, our members are well-positioned to drive economic recovery in their communities.

That is why we urge Congress to direct the Treasury to quickly provide funds for Subchapter S and mutual institutions, which have not been eligible for funds under the existing terms of the CPP. While the vast majority of community banks generally have enough capital to serve their current customers, additional capital from the CPP for interested banks would help them serve additional consumers and businesses.

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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 $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

We also recommend that the bank regulatory agencies adopt a more flexible and reasonable examination policy, particularly with respect to real estate lending, so that community banks can meet their communities' credit needs. To get at the heart of the current crisis, ICBA believes current foreclosure mitigation programs such as Hope for Homeowners, the voluntary FHA programs and the FDIC's proposed plan can be made more workable. The Chairman's proposed changes to Hope for Homeowners and proposal to use TARP funds for foreclosure mitigation should significantly enhance the government's foreclosure mitigation efforts. Finally, Congress and the FDIC should address expiring deposit insurance coverage and glaring inequities in the deposit insurance system so community banks will have continued access to local deposits, which are the main source of lendable funds.

We applaud the Chairman for addressing many of these issues by introducing the TARP Reform and Accountability Act of 2009 (H.R. 384), and ICBA urges its swift passage. The bill contains many provisions important to community banks. The bill requires the Secretary of the Treasury to promptly allow access to the CPP by Subchapter S banks and mutual FDIC-insured banks, and to do so on terms comparable to those applicable to the largest banks that have already received capital infusions under the TARP. ICBA applauds the Chairman for including a provision to give the banking industry more time to recapitalize the FDIC Deposit Insurance Fund – an idea the ICBA has strongly advocated. The bill makes permanent the increase in deposit insurance coverage from $100,000 to $250,000. And as the ICBA recently advocated in a comment letter to the FDIC, the bill makes clear bank holding companies with significant non-bank subsidiaries will pay their fair share of any deficit in the FDIC Temporary Liquidity Guarantee Program.

Limited Availability of Community Banks to TARP/CPP Must be Addressed

There are more than 8,000 community banks nationwide, and they are well positioned to extend lending to their communities using capital from the Capital Purchase Program. Including interested banks in the Capital Purchase Program will stimulate additional lending in local communities throughout the country.

However, ICBA has had significant concerns with the pace of implementation of the Troubled Asset Relief Program's CPP. ICBA members are growing increasingly concerned that only $60 billion is left uncommitted from the $250 billion Capital Purchase Program and still more than 3,000 financial institutions cannot qualify for the CPP. Half of the CPP's $250 billion was quickly provided to just nine of nation's largest banks. Notably, an additional $40 billion was granted to insurer American International Group from the general TARP funds.

Large institutions, such as credit card company American Express and auto lender GMAC, have also converted to bank holding companies so they too may access TARP funds. This follows the rapid conversion of the gigantic investment firms such as Goldman Sachs and Morgan Stanley into bank holding companies

after being battered in the markets. All the while thousands of traditional community banks stand ready willing and interested in TARP CPP access to help boost lending but they have been largely shut out.

The Treasury's term sheets released so far do not work for Subchapter S banks and mutual institutions because of statutory constraints and organizational structures peculiar to each of these types of institutions. ICBA and others provided Treasury concrete suggestion to overcome the obstacles to term sheets for these smaller banks. We were pleased Treasury issued a term sheet for certain privately held banks, but have been disappointed that Subchapter S and mutual banks are still waiting on workable CPP terms to access the program. These institutions play critical roles in their communities, particularly in small towns and in the New England states where they are the predominant local and small business lenders.

ICBA is pleased H.R. 384 directly addresses these concerns. It explicitly directs the Treasury "to promptly make funds available for smaller community institutions." It is entirely feasible to craft workable terms for Subchapter S and mutual banks so they can access CPP funds under similar economic terms as the big publicly traded banks. We urge Treasury to act quickly to include all community banks in the CPP.

We are pleased that the Chairman's draft would not apply most of the new conditions for the receipt of TARP capital to Subchapter S and mutual banks, which, through no fault of their own, have been unable to apply for TARP capital infusions. H.R. 384 recognizes that applying such conditions retroactively would have placed an unfair burden on community banks.

Allowing all community banks to participate in the TARP CPP and help boost lending to families and small businesses. For every dollar in new capital a community bank can raise it will help facilitate an additional seven to ten dollars of lending in their communities. The cost of this CPP capital is not inexpensive for community banks, at some 7.5% tax effective rate in the first five years with additional warrant-related costs on top. So community banks using this capital will put it to good use by doing what they do best – lend on Main Street.

Banks nationwide interested in expanding lending through the Capital Purchase Program are rightly concerned about a provision in the CPP agreement that will allow the Treasury to retroactively change any of the contract terms of the established Securities Purchase Agreement should there be a change to a federal statute. ICBA suggests this provision be modified to say that only future changes to federal law that apply to all financial institutions, not those changes directed solely at institutions participating in the CPP program, could be incorporated into the agreement retroactively. This would ameliorate the concern of community banks that significant terms of the agreement could be changed retroactively.

TARP Funds & Consolidation

Many in the community banking sector have become concerned that TARP capital infusions can be used to fuel unnecessary consolidation within the industry. We are pleased that the Chairman has included a provision in his bill that addresses the use of TARP funds for the acquisition of healthy community banks. The bill would require any acquisition of another depository institution by an institution receiving TARP funds be conditioned on a finding by Treasury, in consultation with the relevant bank regulatory agencies, 1) that the acquisition reduces the risk to taxpayers or, 2) that the transaction could have been accomplished without funds provided under the TARP.

Commercial Real Estate

On a technical matter, we note that section 403 of the bill, relating to commercial real estate loans, clarifies the TARP authority to purchase commercial real estate loans, including those in asset backed securities. We recommend that the statutory language explicitly provide clarification that whole real estate loans can be purchased under the TARP, since community banks are more likely to hold commercial real estate assets in that form.

Difficult Exam and Accounting Environment is Exacerbating the Credit Crunch and Impeding Economic Recovery

Examinations

Economic recovery will be delayed if banks are discouraged from making good loans to consumers and businesses. ICBA is hearing from community bankers across the country about overzealous and unduly overreaching examiners who are, in some cases, second guessing bankers and professional independent appraisers and demanding overly aggressive write-downs and reclassifications of viable commercial real estate loans and other assets. This will lead to a contraction in credit as community bankers avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital.

Therefore, ICBA commended the banking agencies last fall for issuing their Interagency Statement on Meeting the Needs of Creditworthy Borrowers. It is very important that all banking organizations and their regulators work together to ensure that the needs of creditworthy borrowers are met. Given the fact that most community banks are well capitalized and have appropriate dividend, compensation, and loss mitigation policies, ICBA believes that the community banking industry generally will have few problems complying with the guidance set forth in the Interagency Statement. As you know, community banks play a significant role in meeting the credit needs of households and small business and stand ready to work with the regulators to continue to meet that objective.

However, for the Interagency Statement to have its intended effect regarding lending, the agencies must address the current examination environment. We have had many reports from community bankers of examiners requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have not been criticized before; and substituting their judgment for that of the appraiser.

While we expect examiners will be more thorough and careful with their examinations during a credit downturn, based on what we have heard from our members, we believe that in many cases examiners have gone too far. Unfortunately, excessively tough exams that result in potentially unnecessary loss of earnings and capital can have a dramatic and adverse impact on the ability of community banks to lend, impairing their ability to support economic growth. Since community banks are the prime engine behind small business lending, any contraction of lending would further exacerbate the current economic downturn and impede attempts by the regulators to keep loans flowing to creditworthy borrowers to help foster an economic recovery.

Community banks are ready to meet the objectives stated in the Interagency Statement of lending to creditworthy households and businesses, but they cannot meet those objectives without a change in the current examination environment. In addition to the issuance of the Interagency Statement, we urge the bank regulatory agencies to adopt a more flexible and reasonable examination policy particularly with respect to real estate lending so that community banks can meet the credit needs of their communities.

Accounting

Congress should direct regulators to temporarily suspend the misapplication of mark-to-market and “Other Than Temporary Impairment” (OTTI) concepts to financial institutions during these extraordinary abnormal market circumstances. These requirements must be suspended until the financial markets return to more normal operations to prevent further destruction of capital and lendable funds in the economy. Congress gave the SEC the power to suspend mark-to-market accounting to avoid this race to the bottom. More needs to be done to ensure a proper understanding of what fair value is and is not, and to ensure that it is being properly applied so that there is less likelihood for different interpretations among statement preparers, auditing firms, analysts, examiners and ultimately the markets. The SEC and FASB should reconsider accounting for impairments, including the current restrictions on the ability to record increases in value when market prices recover and the development of additional guidance for determining the fair value of investments in inactive markets where market prices are not readily available.

Foreclosure Mitigation Steps

Community banks are truly invested in long-term relationships with their customers and their communities. When community banks service mortgages, they have a strong interest in maintaining those relationships, and not just guarding the interests of investors. Community banks' involvement in finding solutions for consumers extends beyond their own customers as community banks have offered refinancing to troubled borrowers with loans from other institutions as well.

Community banks played no role in causing the current crisis because, by and large, they did not engage in the subprime lending practices at the heart of the current crisis. As a result, community banks are not currently experiencing unusual levels of mortgage defaults. And, ICBA members are still making mortgage loans. Community bank mortgage originations have remained steady throughout 2008 year. ICBA Mortgage Corporation helped 1,000 community banks write approximately 40,000 mortgages totaling $6.2 billion. Assuming that ICBA Mortgage Corporation's market share of the community bank market is five percent, we estimate community banks have originated approximately 800,000 mortgage loans for an aggregate principal amount of approximately $125 billion for 2008.

But we agree that minimizing foreclosures is an important part of the effort to stabilize the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes.

Community banks that service their own mortgages monitor payment activity for changes that might signal a borrower could have difficulty paying the mortgage. If that occurs, they contact the borrower quickly to avoid potential problems. Community banks do not rush to foreclosure, which has significant negative consequences for both borrowers and lenders.

Community banks will continue to work with individual borrowers to find the best solution to keep the borrowers in their homes, including through a loan modification under the Hope for Homeowners Program or under any new government programs that would support mortgage modification.

The pending bill will make significant improvements to the Hope for Homeowners Program and will provide $50 billion of TARP funds to bolster the government's foreclosure mitigation efforts. We have some additional concerns and suggestions for foreclosure mitigation.

Hope for Homeowners and FDIC Program

Loan to Value Determination –- Any program depends on a credible valuation of the property. The agencies in charge of loan modification support programs

should work with the lending community to establish a procedure to determine the value of a property, and once the value of a home is determined, there should be an agreement by the banking regulators that they won't second guess the value of the collateral in a subsequent bank examination, at least for a reasonable period of time.

Regulatory and Accounting Forbearance – When a lender modifies a mortgage, it must recognize a loss on the original loan. There should be a relaxation of accounting standards for the recognition of the losses, and the banking regulators should relax regulatory capital standards vis-à-vis these losses.

FDIC Program[2]

More Generous Loss Sharing in High Foreclosure Areas – The FDIC loss sharing begins to phase out at 100% LTV and disappears at 150% LTV. For areas with high foreclosure rates, the loss sharing should be more generous above 100% LTV. Home values are particularly depressed in those areas and there could be many more modifications above 100% LTV.

Borrower Eligibility for Significant Changes in Condition -- The FDIC proposal only makes eligible loans that are 60 days past due. We understand that some contracts between investors and servicers prevent the servicer from working with borrowers who are current. Nevertheless, the FDIC program should be flexible enough to allow a borrower who has lost a job or has other significant changes in condition to qualify for a modified mortgage before he or she becomes delinquent. At the very least, this feature should be available for servicers and lenders who are not constrained by contract from pursuing a modification before default.

Congress Should Address Deposit Insurance Issues for 2009

The Emergency Economic Stabilization Act temporarily increased deposit insurance coverage from $100,000 to $250,000 (coincidentally, the level for certain retirement accounts). Separately, the FDIC Temporary Liquidity Guaranty Program temporarily provides full coverage for transaction accounts.

This additional coverage has helped many community banks serve their communities and compete with banks that are too big to fail. We recommend that Congress enact legislation to make these increases permanent. It should also consider a corresponding increase in retirement account coverage. Now, more than ever, it is essential that middle class Americans have a safe place for their retirement dollars.

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[2] The FDIC's proposed program is designed to make mortgages more affordable to homeowners through interest rate reduction, amortization term extension, and/or principal forbearance.

Community banks fully recognize that the banking industry must pay for this additional coverage. Indeed, we note that all the funds that the FDIC provided during this crisis have been paid in advance by the banking industry. We urge that Congress provide the FDIC additional time to recapitalize the Deposit Insurance Fund to the full 1.25 percent reserve ratio beyond the current 5-year time horizon. An extension would take into account the extraordinary losses the DIF has incurred, and the cost of the additional coverage levels that we have endorsed. Unless the industry has additional time to restore the reserve ratio, the FDIC will be forced to charge high deposit insurance premiums and remove funds from communities at a time when they need as much capital as possible to support local lending. We commend the Chairman's approach of increasing the period for recapitalization of the DIF from five years to eight years.

We would like to bring to the Committee's attention one issue that may take Congressional action to address. The FDIC used its systemic risk authority to establish the TLGP. The net costs of any activity under the systemic risk authority must eventually be borne by all FDIC-insured banks and thrifts through an assessment based on the institutions' assets minus equity. The statute does not expressly authorize the FDIC to assess non-bank and non-thrift affiliates, including holding companies. The Debt Guarantee Program has been extended to holding companies because much of the bank debt is issued at the holding company level. However, should a special assessment be needed to make up for any deficit in the TLGP, the FDIC cannot levy an assessment against the non-bank assets of a holding company. We applaud the Chairman and the FDIC for their support of a provision in the bill that would allow the FDIC to ensure holding companies with significant non-bank assets pay their fair share of any deficit in the TLGP.

Premiums on Too-Big-to-Fail Banks; Break-Up of Systemic Risk Institutions

Congress should also direct the FDIC to assess special premiums on banks that are so large or interconnected with the financial system that the government will not allow them to fail. These too-big-to-fail institutions have a deposit insurance product that is better than traditional FDIC coverage – 100 percent coverage for all liabilities. They should pay for it through a systemic risk premium.

Even if Congress enacts this reform, ICBA remains deeply concerned about the continued concentration of banking assets in the U.S. Today, the four largest banking companies control more than 40% of the nation's deposits and more than 50% of the assets held by U.S. banks, posing an enormous systemic risk not only to the FDIC Bank Insurance Fund but also to our historically diversified economic system. We do not believe it is in the public interest to have four institutions controlling most of the assets of the banking industry. Our nation just went through an agonizing series of bankruptcies, bank failures, forced mergers, and recapitalizations of some of the nation's largest banking and investment

houses costing American taxpayers hundreds of billions and resulting in the government becoming a major stockholder of many of our financial institutions. Our nation cannot afford to go through that again.

Unfortunately, short-term crisis management last fall led to the creation of even larger institutions. To prevent a recurrence of this crisis, Congress should break up the systemic risk institutions or require them to divest sufficient assets so they no longer pose such a significant risk to our economy. It is not enough to block further mergers; the largest institutions need to be broken into more manageable firms. Too-big or too-interconnected-to-fail then could be eliminated from the American lexicon.

Conclusion

ICBA appreciates this opportunity to testify on these critical issues. We look forward to working with this Committee and Congress on these and other steps that will help us emerge from this current crisis and improve our financial system for the long run.