Testimony of

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On behalf of the

Independent Community Bankers of America

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House of Representatives
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Hearing on

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Chairman Frank, Ranking Member Bachus, Members of the Committee, my name is Michael Menzies, and I am the President and CEO of Easton Bank and Trust Company, Easton, MD, and the Chairman of the Independent Community Bankers of America. [1] Easton Bank is a state-chartered community bank with $150 million in assets. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on President Obama's proposals to restructure and reform the nation's financial regulatory system and address consumer abuses mainly perpetrated by unregulated institutions that contributed to the financial crisis.

Less than 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 the American consumer over $7 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 were too big to fail.

Congress has already passed legislation at great cost to the taxpayers intended to deal with that crisis and the recession. It is now this committee's job to craft a program that will reduce the chances that risky and irresponsible behavior by large or unregulated institutions will again lead us into economic crisis.

ICBA commends you and President Obama for tackling this important task. The President's plan takes strong steps toward addressing systemic risks posed by too-big-to-fail financial firms. We offer detailed recommendations to make them even stronger. It is critical to remember that taking measures to reduce systemic risk and eliminating

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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.

too-big-to-fail is the best way to protect consumers. Millions of Americans have suffered economic hardship, losing their jobs, their savings and their homes as a result of the crisis. ICBA believes other consumer protection aspects of the plan should be refocused to target those who perpetrated the abuses and improved so that it does not add unnecessary burdens those institutions that have always treated their customers with respect and fairness.

Addressing Systemic Risk

ICBA supports President Obama's plan 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 President's plan could be enhanced to better protect the taxpayers and safeguard the financial system. ICBA believes that systemically risky holding companies should pay fees for their supervisory costs and to fund – in advance – a new systemic risk fund. The President's plan calls for funding only after an institution fails.

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 remaining or becoming "too big to fail." However, if these enhancements are not enough, the President's plan sensibly calls for a plan to resolve failing institutions. Our testimony details how Congress can further improve the 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.

Protecting Consumers

Unregulated individuals and companies perpetrated serious abuses on millions of American consumers. This committee and the President are completely justified in your efforts to prevent these kinds of abuses in the future. Community banks already do their utmost to serve consumers and comply with consumer protections. Therefore, ICBA strongly recommends that new legislation ensure that otherwise unregulated or

unsupervised people and institutions are following existing law. We strongly believe that – in contrast to the Administration's proposals – rule writing and supervision for community banks should remain with agencies that also must take safety and soundness into account. Clearly a financial institution that does not adhere to consumer protection rules also has a safety and soundness problem.

Improving Policy Making

Since the onset of the thrift crisis in the late 1980s, the Treasury Department's role in policy making for financial institutions has grown substantially. Before that time, it was more focused on broad national and international financial markets; the executive branch generally left financial institutions policy making to the various supervisory agencies. ICBA urges Congress to update the Treasury's organizational structure to add an assistant secretary for community financial institutions to provide an internal voice for Main Street concerns. The "Administrative Support and Oversight for Community Financial Institutions Act of 2009" (H.R. 2676) introduced by Rep. Dennis Cardoza will provide that important balance between Wall Street and Main Street within the Treasury.

Summary of ICBA Key Recommendations

Designate the Federal Reserve as the primary systemic risk regulator.

Give the Financial Services Oversight Council 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.

Give the Federal Reserve, in consultation with the Council, the authority to declare an institution insolvent when capital falls below an established level 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 and strengthen the 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

Downsize financial institutions that continue to pose a systemic danger below systemic danger limits within five years, or impose harsh monetary and management penalties.

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.

Retain the system of federal and state bank chartering and do not create a single, monolithic federal regulator.

Maintain the federal thrift charter and if the Office of Thrift Supervision and Office of the Comptroller of the Currency are merged, then a separate division for thrift supervision should be established in the new National Bank Supervisor.

Focus new consumer protections on otherwise unregulated people and institutions, and avoid adding extra burdens to community bankers. We strongly oppose proposals that would strip rule writing and supervision for community banks from agencies that also must take safety and soundness into account.

Establish an Assistant Treasury Secretary for Community Financial Institutions.

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 improved 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 the President's proposal to designate the Federal Reserve as the primary systemic risk regulator. The Federal Reserve is the agency 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

Therefore, the proposed Financial Services Oversight Council should have the power to set clear policy and have oversight authority over the Federal Reserve, including establishing 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 Large Complex Financial Institutions (LCFIs) that 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 which will form the core of the proposed Tier 1, but at the margins, defining systemically important institutions by asset size alone is insufficient. Institutions that are not

[2] Harvard Business Review, August 2009

systemically risky may become so through growth or complexity. 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 Tier 1 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 Tier 1 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. This will help mitigate any "advantage" they might receive. 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, higher capital will protect taxpayers.

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:

o Provision of systemically essential services within the economy.

o Use of leverage – both traditional and embedded in derivatives.

o Status as a major client and/or counterparty of LCFIs.

o Overall level of participation/integration with capital markets, especially high risk activities such as proprietary trading activities.

o Trade in derivative instruments which can potentially multiply risk exposures as well as mitigate, especially writing of derivatives contracts.

o Dependence on short-term non-depository funding from capital markets such as commercial paper.

o Off-balance sheet activities.

o Rate of asset growth.

o Deposit concentration.

o 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 Federal Reserve, in consultation with the Council, must have the authority to declare an institution insolvent when capital falls below an established level 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 clearer guidelines than provided in the Administration's plan for resolving failing Tier 1 institutions leading to restructuring and downsizing through sales of assets. At a minimum, Tier 1 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 Tier 1 FHCs. 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. Tier 1 FHCs should have an insolvency

[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*

contingency plan which the resolution authority can use in the event of failure. 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 Tier 1 FHCs, which could result in the perpetuation of the too-big-to-fail doctrine. One of the goals of 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 recent speech 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.[4]

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." [5] 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."[6]

Strengthen Deposit Concentration Cap

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

The 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 must be immediately reduced and strengthened. 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. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger.

Downsize Systemic Risk Institutions

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 "Tier 1" 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. [7] 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 – 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,

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

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 $700 billion in stimulus to rescue the economy, and the Federal Reserve has also dedicated hundreds of billion 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 Tier I 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, 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.

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 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 in more closely linked to risks. 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 consumer 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 the 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 Federal Regulatory Structure

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. 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." [8]

Retain the Federal Thrift Charter; Subject Unitary Thrift Holding Companies to the BHCA; Close ICL Loophole

The federal thrift charter must be maintained. The U.S. financial system benefits from a charter dedicated to housing and consumer lending. Certain large banking institutions intent on engaging in risky, nontraditional banking activities used a thrift charter to do so, but this was not the fault of the charter but of the business plan of those institutions. Unlike Washington Mutual or Countrywide Financial, most thrift institutions are well run

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

community institutions that are heavily engaged in making prime residential mortgage loans in their communities and were never engaged in subprime, interest-only or other types of alternative residential mortgage lending. Mr. Chairman, we appreciate your expressed support for the thrift charter.

The Office of Thrift Supervision should be retained since we need a regulator that has the expertise to supervise and regulate institutions like thrifts and mutual institutions that focus on housing lending. If the OTS is merged into the proposed National Bank Supervisor, at a minimum, existing federal thrift charters should be preserved or grandfathered, and a Division of Thrift Supervision should be established within the NBS to regulate institutions that want to maintain their federal thrift and mutual institution charters. For example, it would be a substantial hardship for existing mutual institutions organized as federal thrifts to convert to commercial bank charters. This could force some of them to convert to stockholder-based entities. No mutual institution should be pressured into converting or denied the option of mutuality.

We agree that 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.

Protecting Consumers

Community bankers put their customers first. It's just the way we do business. ICBA strongly agrees that consumers must have comprehensible information that they need to make informed, responsible financial decisions and must be protected from abusive, unfair or deceptive practices.

Community bankers believe that the best way to protect consumers is to end the too-big-to-fail concentration risks that cost the consumer over $7 trillion in economic worth. No disclosure or product approval system could offset the damage done by a few behemoth financial entities that brought our economy to its knees.

Unregulated individuals and companies perpetrated serious abuses on millions of American consumers. Therefore, new legislation should focus on otherwise unregulated people and institutions, and avoid adding extra burdens to community bankers who treat their customers fairly and honestly and did not engage in the behavior that fed the financial crisis. In addition, we strongly oppose proposals that would strip rule writing and supervision for community banks from agencies that also must take safety and soundness into account.

Mr. Chairman, we appreciate that your recently introduced legislation establishing the Consumer Financial Protection Agency (CFPA), H.R. 3126, does not transfer enforcement authority over the Community Reinvestment Act (CRA) to the new agency. This is a common-sense step that allows current prudential regulators to maintain their authority over this law. CRA is intended to ensure that banks are providing services to all segements of the community. Similarly, other fair lending statutes, such as the Equal Credit Opportunity Act (ECOA) and Home Mortgage Disclosure Act, should also remain with the current financial regulatory agencies that will be conducting safety and soundness examinations. Of course, fair lending is good lending and good business. But regulators must consider safety and soundness considerations when they impose specific requirements to achieve these goals.

This applies more broadly. For community banks, safety and soundness and consumer protection are not mutually exclusive functions. Not only must these elements co-exist and be balanced in order maintain effective financial services regulation and enforcement, but also because the community banking model rests on the unique long-term relationships community bankers develop with their customers. Customers are attracted to do business with community banks because they are common sense, responsible lenders with local decision-making. Our common sense approach is also why community banks have not gotten into trouble through the use of exotic lending products that led other large firms into bankruptcy or partial government ownership. This relationship is symbiotic: Instilling confidence in our customers that they will be treated honestly means a community banker is not going to take excessive risks, and will certainly not engage in an abusive practice to drive customers away. It also explains why community bankers never relaxed their lending standards simply to compete with the megabanks and non-bank lenders.

The proposed CFPA regrettably splits the safety and soundness and consumer protection functions, going so far as to place this new agency as the ultimate arbiter of any dispute between a prudential regulator and itself. While community banks go above and beyond to protect their customers, allowing consumer protection to trump safety and soundness is a dangerous precedent. Bank regulators have expertise in balancing safe and sound operation with the need to provide consumers information they need to make informed financial decisions and protect them from unfair and harmful practices. Furthermore, if stripped of their consumer protection personnel and authorities, existing agencies would be deprived of the ability to properly determine CAMEL ratings. Regulators today give consideration to consumer protection and compliance when

evaluating a bank's Capital and Management during a safety and soundness exam, a critical task rendered impossible under this legislation.

The proposed agency will be responsible for regulating and enforcing actions against a universe of entities more diverse, complex, and numerous than any other existing agency is responsible for. Congress and taxpayers will need to determine how to pay for this agency's activities. It is particularly worrisome to community bankers that one of the recommended means of funding the CFPA is through a new series of fees levied on consumer products and individual transactions. It seems contradictory that an agency with a mission to protect consumers would fund itself by directly raising the cost of everyday consumer products.

Community bankers are particularly concerned that they and their customers could bear a considerable share of this added funding burden. Banks already pay significant fees for their regulation, and this proposal could well increase them.

This proposal highlights a long-standing challenge facing community banks, namely encouraging policymakers to distinguish between large and small financial institutions and not to assume that a one-size-fits-all approach is an appropriate way to legislate or regulate the financial sector. If the current economic crisis has proven anything, it is that there are significant disparities between the way large firms and smaller firms do business. Regulation for community banks should be proportional. Yet, in its current form, the CFPA is not required to make any distinction between large banks, non-bank financial firms, and community banks. In fact, only the proposed National Bank Supervisor – a regulator focused on the well-being of the largest banks in our country – is given a seat on the Agency's board.

In recent Congressional testimony, administration officials pointed out the disparity between the existing regulatory regimes for federally insured banks and those for non-bank financial firms. We agree that the lack of sufficient regulatory oversight of many unregulated firms, particularly those in the mortgage industry, contributed significantly to our financial crisis. However we disagree with a response that, instead of focusing on regulatory gaps and augmenting existing systems, places community banks into an entirely new regime with only vague limits and checks on its powers.

We also disagree with the notion that community banks would be better served under a new regulator that has no definitive mandate to consider the differences between the products offered by a large, national bank and a community bank operating exclusively in a small geographic area. For example, many community banks have for years offered short-term balloon loans to members of their communities. This was not done to be predatory, but rather because that type of product made most sense for the individual needs of a select group of bank customers in a defined geographic area. Such a product would likely fall outside the agency-approved definition of a "standard" financial product, and would be subject to stricter and costlier regulation. While community banks generally offer sensible, simple products, this one example highlights how our unique understanding of the needs of our community will often not coincide with the one-size-fits-all product parameters defined by the proposed CFPA in Washington.

Community bankers need the flexibility to offer the products and services best suited to the specific needs of their customers, and a regulator able to balance this need with safety and soundness. This proposed agency, by separating these two regulatory functions and enforcing product mandates and adding new costs to consumer products, will unquestionably reduce the ability of small community banks to operate effectively in their communities.

By divorcing safety and soundness regulation from consumer protection regulation and mandating specific products, this proposal sets the stage for the broadest, most substantial increase in regulatory burden on community banks our industry has ever experienced. The CFPA as proposed will dramatically reshape the operating and regulatory environment for community banks in a way that will inevitably make it difficult for community banks to continue to efficiently serve their local economies.

Congress has an historic opportunity to greatly enhance consumer financial protection but the current proposal does not do this. It could well make financial products more expensive – or even unavailable – for community bank customers.

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 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 have paid 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 less than ten community banks, when, in fact, the actions wiped at large amounts of capital of 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 that H.R. 2676 be included in the regulatory reform legislation.

Conclusion

ICBA appreciates this opportunity to testify on the President's plan 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. Your plan should strengthen President Obama's proposals 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.