

July 8, 2009

Testimony of

Arthur C. Johnson

On Behalf of the

AMERICAN BANKERS ASSOCIATION

Before the

Subcommittee on Financial Institutions

Of the

Committee on Banking, Housing and Urban Affairs

United States Senate



**Testimony of Arthur C. Johnson
on behalf of the
American Bankers Association
before the
Subcommittee on Financial Institutions
of the
Committee on Banking, Housing and Urban Affairs
United States Senate
July 8, 2009**

Chairman Johnson, Ranking Member Crapo, and members of the subcommittee, my name is Arthur C. Johnson. I am Chairman and Chief Executive Officer of United Bank of Michigan, headquartered in Grand Rapids, Michigan. I serve as Chairman-Elect of the American Bankers Association (ABA), and I chair the ABA Community Bank Solutions Task Force, a committee dedicated to finding ways to address problems most acutely affecting community banking during this economic downturn. I am pleased to be here today representing ABA. ABA brings together banks of all sizes and charters into one association. 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 \$13.5 trillion in assets and employ over 2 million men and women.

We are pleased to share the banking industry's perspective on the current economic situation in rural America and the effects the recession is having on rural community banks. We strongly believe that community banks are one of the most important resources supporting the economic health of rural communities. Not surprisingly, the banks that serve our nation's small towns also tend to be small community banks. ***Less well known is that over 3,500 banks – 41 percent of the banking industry – have fewer than 30 employees.***

This is not the first recession faced by banks; they have been in their communities for decades and intend to be there for many decades to come. My bank, United Bank of Michigan, was chartered in 1903. We have survived the Great Depression and all the other ups and downs for over a century. We are not alone, however. ***In fact, there are 2,556 other banks – 31 percent of the***

banking industry – that have been in business for more than a century; 62 percent (5,090) of banks have been in existence for more than half a century. These numbers tell a dramatic story about the staying power of community banks and their commitment to the communities they serve. My bank's focus, and those of my fellow bankers throughout the country, is on developing and maintaining long-term relationships with customers. We cannot be successful without such a philosophy and without treating our customers fairly.

In spite of the severe recession, community banks located in rural communities have expanded lending. In fact, during 2008 – the first year of the recession – loans from banks headquartered *outside* of metropolitan statistical areas¹ increased by \$17 billion, or 7percent. Loan growth last year was also reflected in a smaller subset of community banks: farm banks. Lending for these banks expanded by \$4.7 billion, or 9.2 percent, in 2008.

Considerable challenges remain, of course and these trends are not likely to be sustained. While many areas of our country have benefited from strong exports which have helped agricultural exports in particular, other rural areas of the country have not been as lucky. The downturn has continued to impose hardships on small businesses and manufacturers. In my home state of Michigan, we are facing our eighth consecutive year of job losses. The necessary – but painful – restructuring of the auto industry will likely cause this job erosion to continue for some time, leading to a long recovery in these areas. Other rural areas with a manufacturing employment base are also suffering similar problems.

In this environment, it is only natural for businesses and individuals to be more cautious. Individuals are saving more and borrowing less. Businesses are reevaluating their credit needs and, as a result, loan demand is also declining. Banks, too, are being prudent in underwriting, and our regulators demand it. Accordingly, it is unlikely that loan volumes will increase this year, and in fact, the total loans in rural areas declined slightly in the first quarter.

With the economic downturn, credit quality has suffered and losses have increased for banks. Fortunately, community banks entered this recession with strong capital levels. As this committee is aware, however, it is extremely difficult to raise new capital in this financial climate. Without access to capital, maintaining the flow of credit in rural communities will be increasingly difficult.

¹ Metropolitan statistical areas are defined as areas that have at least one town over 50,000 inhabitants.

We believe there are actions the government can take to assist viable community banks to weather the current downturn. The success of many local economies – and, by extension, the success of the broader national economy – depends in large part on the success of these banks. Comparatively small steps taken by the government now can make a huge difference to these banks, their customers, and their communities – keeping capital and resources focused where they are needed most.

Importantly, the amount of capital required to provide an additional cushion for all community banks – which had nothing to do with the current crisis – is tiny compared to the \$182 billion provided to AIG. ***In fact, it takes only about \$500 million in new capital today to bring all banks under \$10 billion in assets above the well-capitalized levels for Tier 1 capital.*** Even under a baseline stress test, the additional capital needed is less than \$3 billion for all these smaller banks to be well-capitalized. Without new capital, banks under \$10 billion in assets would have to ***shed nearly \$9 billion in loans*** to achieve the same capital-to-assets ratio. Simply put, capital availability means credit availability. A small investment in community banks is likely to save billions of dollars of loans in local communities.

Before discussing these points in more detail, I did want to thank members of the subcommittee for their tireless support of S. 896, the Helping Families Save Their Homes Act of 2009, legislation that expanded the insurance limits for deposits to \$250,000 for four years and expanded FDIC's line of credit with the Treasury from \$30 billion to \$100 billion. Expanding the deposit insurance limit provided additional protection to small businesses, retirees, and other bank depositors that need to protect their payrolls or life-savings. Expanding the FDIC's line of credit helped to reduce banks' expenses, thus preserving resources in communities across this nation. Without this expanded line, the FDIC would have imposed a special assessment on the banking industry totaling more than \$15 billion dollars. By enacting this expanded line of credit, the FDIC has an additional cushion to rely upon – particularly for working capital purposes necessary to resolve bank failures quickly and to ensure that depositors have immediate access to their money. This increase in borrowing authority enabled the FDIC to make good on its promise to ***cut the special assessment in half***.

The original special assessment would have devastated the earnings of banks, particularly community banks, just at the time funds are needed most in their communities. Of course, the industry still bears a considerable financial burden from both the regular quarterly premiums and the

final special assessment. The vast majority of banks that will bear this cost are well capitalized and had nothing to do with the subprime mortgages that led to our financial and economic problems. Yet these banks bear much of the costs of cleaning up the problems created. We will continue to work with you to find ways to reduce the costs imposed on healthy banks and to build a strong base to support new lending as our economy emerges from this recession.

In my statement, I would like to focus on the following points:

- Banks in rural communities continue to lend in this difficult economic environment, but the broadening economic problems will make this more difficult in the future.

- New and expanded programs directed at community banks can help rural America cope with the current downturn, including broadening capital programs to enable participation by a broader cross section of viable but struggling banks. Moreover, regulators should ensure that their regulatory and supervisory responses are commensurate to the risks they are seeing in banks, and that they avoid inappropriate, pro-cyclical responses that make bad situations worse.

- ABA believes that it is critical for this subcommittee and Congress to focus on creating a systemic regulator, providing a strong mechanism for resolving troubled systemically important firms and filling gaps in the regulation of the shadow banking industry. Such significant legislation would address the principal causes of the financial crisis and constitute major reform. We believe there is a broad consensus in the need to address these issues.

I will address each of these points in turn.

I. Banks in rural communities continue to lend in this difficult economic environment, but the broadening economic problems will make this more difficult in the future.

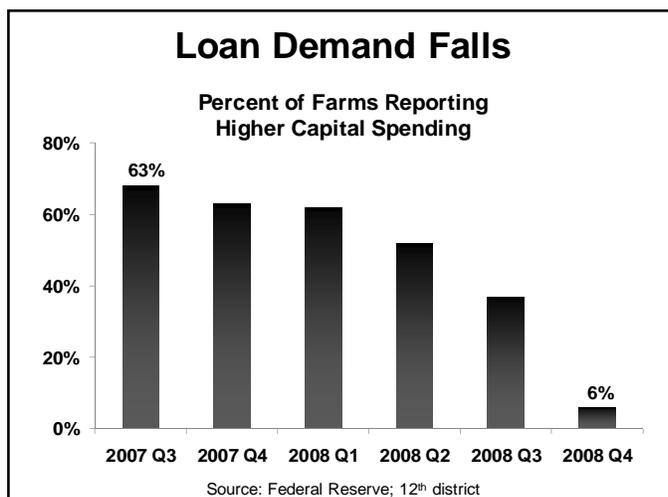
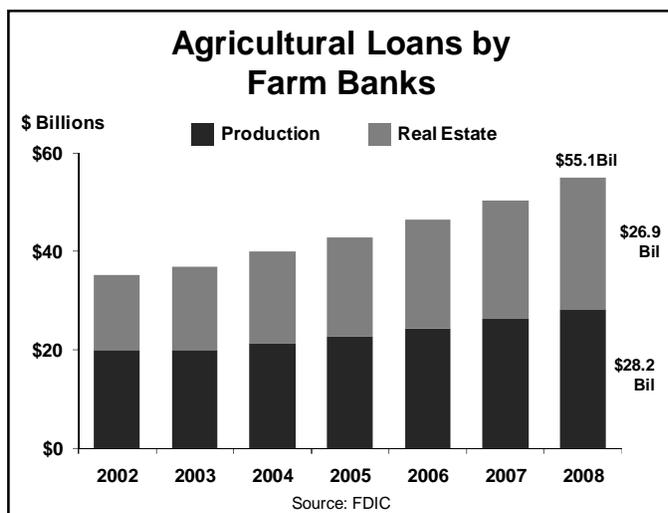
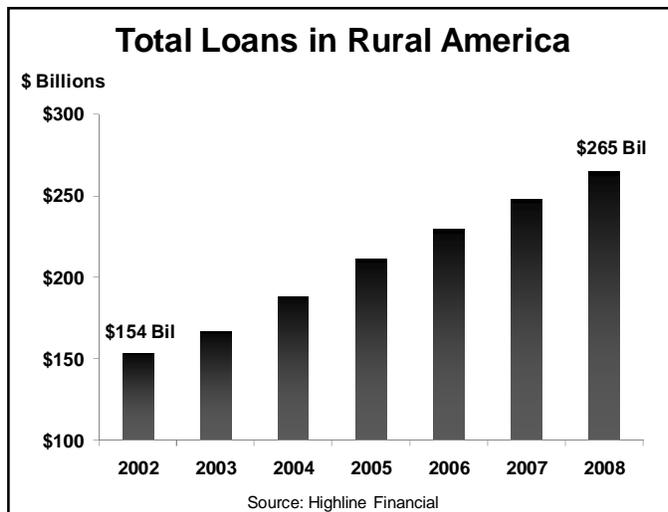
Rural America has been bolstered in recent years by an agriculture sector that experienced one of the longest periods of financial prosperity in history. In 2007 and 2008, American farmers and ranchers in the aggregate enjoyed some of their most profitable years ever. The balance sheet for U.S. agriculture at the end of 2008 (according to USDA) was the strongest it has ever been, with a debt to asset ratio of less than ten percent. USDA projects that, at year end 2009, farm and ranch net worth will be \$2.171 trillion. This unprecedented high net worth is due in part to a robust increase in farm asset values (mainly farm real estate) – values which have not suffered the dramatic fluctuation as in some sectors during this time of crisis – but the high net worth is equally due to solid earned net worth as farmers used their excess cash profits to retire debt.

However, while the past ten years may be looked back upon by historians as an era of farm prosperity, not all sectors of the farm economy are doing well in 2009. Pressured by increases in the price of grain, the livestock sector is under considerable financial pressure. Dairy prices have dropped to below break-even levels for many producers, as demand has declined and dairy production continues to increase. The cattle feeding business has lost money for over twenty-four months. Poultry producers have been hurt by lower prices and by the collapse of the largest poultry integrator in the country in 2008. The hog industry, which was poised to recover from low prices in 2008, has been badly hurt by misguided fears of the H1N1 virus and the subsequent closure of some key export markets.

Fortunately, rural America was well positioned at the beginning of 2009 to face the trying times they have encountered as a result of the economic crisis and other world events. In this environment, we sometimes hear that banks are not lending money. This is simply not true. As the charts on the next page show, bank lending in rural America has risen steadily over the last half-dozen years, and even during the first year of the recession, bank lending in rural areas has increased. As noted above, maintaining an expanding volume of credit will be a considerable challenge this year as the economy continues to weaken.

While overall banks have continued to lend throughout this recession, that does not mean much to an individual borrower having difficulty obtaining financing. In many of these individual cases, however, upon further investigation, it appears that the primary reason for not receiving funding was either that the borrower's financial condition was vulnerable (perhaps weakened by local economic conditions), or the borrower expected to borrow money at pre-recession terms when the risk of lending was considerably lower and funds available for lending were more accessible. Of course, every loan application is unique and must be evaluated that way. One thing that has clearly happened is that banks are looking carefully at the risk of a loan and re-evaluating the proper pricing of that risk. This is a prudent business practice and one expected by our bank regulators.

Against the backdrop of a very weak economy and in light of the troubles in the agricultural sector, it is only reasonable and prudent that all businesses – including banks and farms – exercise caution in taking on new financial obligations. In fact, farmers and ranchers have been very conscious of this financial cycle, and wisely used their excess cash profits to retire debt and to acquire new plant and equipment during the boom years.



Both banks and their regulators are understandably more cautious in today's environment. Bankers are asking more questions of their borrowers, and regulators are asking more questions of the banks they examine. This means that some higher-risk projects that might have been funded when the economy was stronger may not find funding today.

II. New and expanded programs directed at community banks can help rural America cope with the current downturn.

The vast majority of community banks had absolutely nothing to do with the current crisis, yet as their communities have suffered, so have they. In spite of the strong agricultural economy which has helped to shield many parts of this nation from the recession, the economic decline – and its global impact – will surely be felt over the course of the next several years. There has never been a more important time to put in place solutions that will help all community banks as they manage through this downturn.

The many programs that have been initiated to calm the markets and provide capital for lending have helped to stabilize financial markets. As an example, the announcement of the Capital Purchase Program on October 14 caused risk spreads to decline from their pinnacle of 457 basis points on October 10 to 249 basis point on October 22, **a drop of 45 percent**. Clearly, the program to inject capital in healthy banks had a dramatic and immediate impact, and the trends begun then continue to narrow margins even further – back nearly to pre-crisis spreads. (See the charts on the following page.)

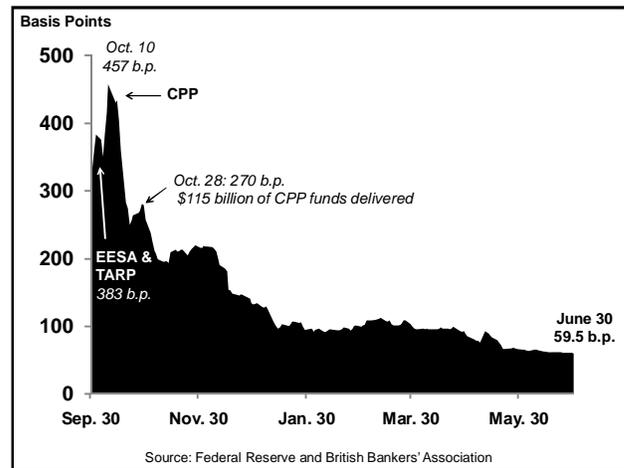
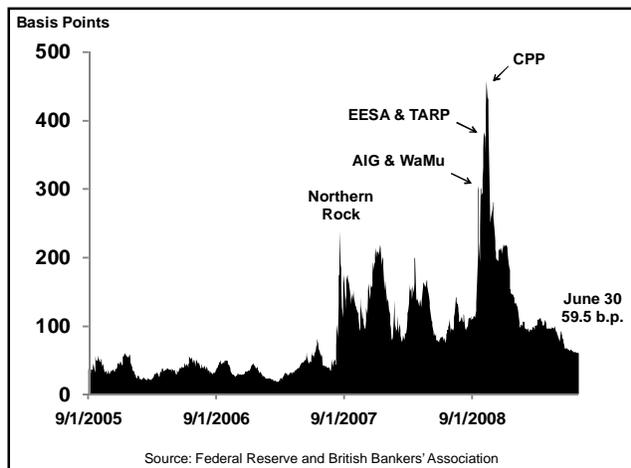
However, the focus of the CPP and other stimulus programs has been on the largest banks and was only slowly made available to smaller banks. The changing nature of this program and the restrictive selection process has meant that banks that could have benefited from the program were unable to do so. As a result, to maintain reasonable capital levels, these banks have been forced to limit, or even reduce, their lending.

As I emphasized at the outset, the amount of capital required to provide an additional cushion for all community banks is small. To reiterate, it takes only about \$500 million in new capital today to bring **all** banks under \$10 billion in assets above the well-capitalized levels for Tier 1 capital. Even under a baseline stress test to assess future needs, the additional capital needed is less than \$3 billion for all banks to be well-capitalized. Without new capital, banks under \$10 billion in assets would have to

shed nearly \$9 billion in loans to achieve the same capital-to-assets ratio. Thus, a small injection of capital goes a long way to keeping credit flowing in rural communities.

Capital Purchase Program Helped to Reduce Risk-Premium Spreads

Spread between the 3-month LIBOR and the 3-month Treasury



Given the continued weakness in this economy and the challenges we will face in the next 18 months, it is a critical time to focus on strategies for helping community banks. ABA recommends that new programs be developed – and existing programs be expanded – to help banks in rural America. Several key changes that are needed include:

- Broadening capital programs to enable participation by a broader cross section of banks.
- Revising the risk-based capital rules to more accurately reflect the risks presented by these investments.
- Avoiding appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards.

Broaden capital programs to enable participation by a broader cross section of banks

The Capital Purchase Program (CPP) has been implemented in a way that ignores community banks that are viable but that are experiencing significant – yet temporary – problems. The Capital Assistance Program has not yet been implemented for community banks, but reportedly will apply the same eligibility criteria that have been used with the CPP. The Legacy Loans Program has the potential to help, but the FDIC recently announced a delay in implementing the Legacy Loans Program that calls into serious question its viability outside the possible use in failed bank situations. The Legacy Securities Program is still struggling to get off the ground as well. Program after program either has failed to meet the needs of viable community banks or has languished.

ABA believes that this problem can be solved through several modifications:

1. Permit banks with up to \$1 billion in total assets to participate in the expanded CPP.
2. Publish the eligibility criteria for participating in the CPP and CAP.
3. Provide funding to viable banks that have significant – yet manageable – issues.
4. Revive the Legacy Loans Program and implement the Legacy Securities programs in a way that expands the universe of eligible assets to include trust preferred securities, “real estate owned,” and other real estate-related loans. The programs also should be implemented in a way that avoids effectively shutting small banks out (for example, minimum sizes on asset pools that no community bank could meet).

The comparatively small sums of money that would be invested in these struggling but viable banks would pay big returns for the communities they serve.

Revise the risk-based capital rules to more accurately reflect the risks presented by banks’ investments

Congress should use its oversight powers to assure that the regulators have rules and regulations that accurately reflect the risks that banks face. For example, banks’ investment in mortgage backed securities and collateralized debt obligations are being severely downgraded by ratings agencies, largely due to liquidity issues (not credit or repayment risk). When the investments are downgraded below investment grade, an inappropriately conservative capital charge applies that can cause a risk weighting to go from 100 percent to 1250 percent, regardless of the performance of

the security and regardless of the amount of subordinate positions that will absorb loss before a given bank's position. Mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) are securities whose performance depends on multiple obligors; the default by one borrower is not likely to impact the performance of other borrowers whose debt has been bundled in the security. Despite this – because ratings are based primarily on the probability of loss of the first dollar – any loss in an MBS or CDO adversely affects the rating of the security. This, in turn, can trigger higher capital requirements for banks, ***regardless of the likelihood that a holder of an interest in the security may be repaid at 100 cents on the dollar.*** Moreover, the current application of the Uniform Agreement on the Classification of Assets and Appraisal of Securities causes the entire face amount of a debt security with some degree of impairment to be classified, rather than requiring classification only of the portion of the security that reflects potential loss to the banking organization.

ABA believes that two changes will help this situation considerably:

1. Revise the risk-based capital rules to more accurately reflect the risks presented by these investments.
2. Classify only that portion of the security that represents the credit risk-related expected loss on the exposures underlying the security, adjusted for any credit enhancements and further adjusted for recoveries and expected loss severity.

An additional problem related to bank capital is that the risk weighting of debt issued by Fannie Mae and Freddie Mac is too high. Prior to those institutions being placed into conservatorship, the debt was risk-weighted at 20 percent. Given the stated intent of the United States government to support these GSEs, a lower risk weight is appropriate and would help offset to a small degree the adverse impact that the conservatorships had on those banks that invested in Fannie and Freddie stock. The risk weight of GSE debt should be reduced to below 20 percent. The agencies proposed to lower the risk weight of Fannie and Freddie debt to 10 percent, but this rulemaking has been pending since October of last year.

A third issue related to capital concerns is the extent to which a bank's allowance for loan and lease losses (ALLL) is included in the bank's capital. The agencies' capital rules permit a bank's ALLL to count as Tier 2 capital, but only up to 1.25 percent of a bank's risk-weighted assets. This fails to adequately recognize the loss-absorbing abilities of the entire allowance and creates a disincentive to banks reserving more. Both the ALLL and "core" capital are available to absorb

losses. The Comptroller of the Currency recently acknowledged this, stating, “loan loss reserves are a front line of defense for absorbing credit losses before capital must do so. ... Given their primary, capital-like loss-absorbing function, loan loss reserves should get greater recognition in regulatory capital rules, a result that would help remove disincentives for banks to hold higher levels of reserves.”²

These changes suggested in response to these three issues would result in a more accurate reflection of the health of institutions. ABA fully supports the system of risk-based regulation and supervision, but when the rules no longer reflect risk, the system breaks down. Our suggestions are intended to address instances where a bank’s risk of loss is not fairly reflected in the rules. In the case of downgraded debt securities, the rules can, in extreme cases, threaten the viability of institutions that are directed to raise significant additional capital in a short period of time. It is bad policy to require a bank to raise capital to address the appearance of a shortfall but not the reality of one. When a rule requires more capital than the actual risk to the bank would suggest, the rule should be changed.

Avoid appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards

In my role as Chairman-Elect and as chairman of the ABA Community Bank Solutions Task Force, I have heard numerous stories from bankers about issues that are coming up in exams. Banks are being told to write down the value of assets based on the sales prices of assets being dumped on the market at distressed prices. Appraisals of property that are based on comparable sales are particularly problematic when the sales do not involve a willing buyer and a willing seller. Valuations by a banker acting reasonably and in good faith are likely to be more accurate than appraisals in those situations. ABA frequently hears that examiners either are not using FASB-compliant valuation methods or are using “personal formulas” to downgrade or reevaluate portfolio values, even when stated values are supported by timely appraisals. We also hear that examiners are applying new, unpublished, and seemingly arbitrary “rules of thumb” for how much a bank must put in its allowance for loan and lease losses (ALLL). For example, in some cases examiners require 25 percent of every substandard asset; 75 percent of nonperforming assets; etc.

² Remarks by John C. Dugan, Comptroller of the Currency, Before the Institute for International Bankers, March 2, 2009.

ABA believes there are several steps that the regulators should be taking to remedy this situation and we urge this subcommittee to use its oversight authority to encourage them:

1. Issue written guidance affirming that banks should not use distressed sales values when analyzing “comparables.” Guidance should address proper appraisal documentation, particularly where foreclosures or auction sales comprise a majority of the comparable transactions. Moreover, this guidance should state that banks may rely, in appropriate situations, on bank management’s judgment about the value of a property.
2. Allow institutions that have rented properties at market rates to exclude them from "non-performing loans."
3. Apply clear and consistent standards to the maintenance of the ALLL that reflect a realistic assessment of the assets’ likely performance.

These changes are necessary to confront the natural inclination of examiners to be conservative in order to avoid the inevitable second-guessing that would arise if a bank were to fail on their watch. We are not suggesting that examiners use forbearance or otherwise relax their examination standards; rather, we are suggesting that the examiners not be harder on banks than circumstances warrant. The regulators can make things worse in their efforts to make things better. Insisting upon punitive, pro-cyclical steps at a time when a bank is working through issues can push an otherwise viable bank over the edge.

There are many more actions that could be taken to help banks throughout this period. ABA would be happy to discuss this further with the committee.

III. Creating a systemic risk regulator, providing a mechanism for resolving troubled systemically important institutions, and filling gaps in the regulation of the shadow banking industry should be the focus of Congressional action.

One of the most critical needs today is a regulator with explicit systemic risk responsibility. ABA strongly supports having such a regulator. There are many aspects to consider related to the authority of this regulator, including the ability to mitigate risk-taking from systemically important

institutions, authority over how accounting rules are developed and applied, and the protections needed to maintain the integrity of the payments system.

ABA believes that systemic risk oversight should utilize existing regulatory structures to the maximum extent possible and involve a limited number of market participants, both bank and non-bank. Safety and soundness implications, financial risk, consumer protection, and other relevant issues need to be considered together by the regulator of each institution.

To be effective, the systemic risk regulator must have some authority over the development and implementation of accounting rules. No systemic risk regulator can do its job if it cannot have some input into accounting standards – standards that have the potential to undermine any action taken by a systemic regulator. Thus, a new system for the establishment of accounting rules – one that considers the real-world effects of accounting rules – needs to be created in recognition of the critical importance of accounting rules to systemic risk and economic activity.

Moreover, there must be a mechanism for the orderly resolution of systemically important non-bank firms. Our regulatory bodies should never again be in the position of making up a solution on the fly to a Bear Stearns or AIG, or not being able to solve a Lehman Brothers. The inability to deal with those situations in a predetermined way greatly exacerbated the crisis.

A critical issue in this regard is too-big-to-fail. Whatever is done on the systemic regulator and on a resolution system will set the parameters of too-big-to-fail. In an ideal world, no institution would be too big to fail, and that is ABA's goal; but we all know how difficult that is to accomplish, particularly with the events of the last few months. This too-big-to-fail concept has profound moral hazard implications and competitive effects that are very important to address. We note Chairman Bernanke's statement: "Improved resolution procedures...would help reduce the too-big-to-fail problem by narrowing the range of circumstances that might be expected to prompt government action..."³

Finally, a major cause of our current problems is the regulatory gaps that allowed some entities to completely escape effective regulation. It is now apparent to everyone that a critical gap occurred with respect to the lack of regulation of independent mortgage brokers. Questions are also being raised with respect to credit derivatives, hedge funds, and others.

³ Ben Bernanke, speech to the Council on Foreign Relations, Washington, D.C., March 10, 2009.

As these gaps are being addressed, Congress should be careful not to impose new, unnecessary regulations on the traditional banking sector, which was not the source of the crisis and continues to provide credit. Thousands of banks of all sizes, in communities across the country, are scared to death that their already-crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to non-banks while they will be rigorously applied – down to the last comma – to banks.

Conclusion

I want to thank you, Mr. Chairman, for the opportunity to present the views of the ABA on the challenges ahead for rural communities and the banks that serve them. These are difficult times and the challenges are significant. In the face of a severe recession, however, bankers are working hard every day to assure that the credit needs of our communities are met. As you contemplate major changes in regulation – and change is needed – ABA would urge you to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again? Addressing these issues will provide the most constructive avenue to assure that rural communities throughout this nation will continue to have access to credit by local financial institutions. We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our nation's banks.