

March 19, 2009

Testimony of

William Grant

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Financial Institutions

Of the

Committee on Banking, Housing and Urban Affairs

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Chairman Johnson, Ranking Member Crapo and members of the Subcommittee, my name is William Grant, Chairman and CEO of First United Bank and Trust. My bank is a 108-year old community bank, headquartered in Oakland, Maryland – a rural town in Appalachia with a population of about 2,000. We have assets of \$1.6 billion, and serve four counties in Maryland and four counties in West Virginia.

I am pleased to present the views of the American Bankers Association (ABA), where I am a member of the ABA's deposit insurance task force and where I serve on the America's Community Bankers Administrative Committee. 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 \$13.9 trillion in assets and employ over 2 million men and women.

We appreciate the opportunity to testify on The Depositor Protection Act of 2009, S. 541, introduced by Chairman Dodd and cosponsored by many other members of this subcommittee. That bill would increase the FDIC's line of credit to Treasury from \$30 billion to \$100 billion. The ABA strongly supports this bill as it would provide the FDIC with needed flexibility to manage the cash flows in handling bank failures and most importantly – because of this added flexibility – would allow the FDIC to significantly reduce the special assessment on the industry it has proposed for June 30, 2009.

Let me be very clear at the outset: the banking industry fully supports having a strong FDIC fund and stands behind the efforts to ensure FDIC's financial health. The industry has always taken our obligation to the FDIC seriously, and banks will honor the obligation to support the FDIC.

How this is accomplished is the critical question. The money to pay such high expenses cannot be created out of thin air. It is very important, therefore, to lower the upfront costs and spread the obligation to FDIC over time. S. 541 helps to accomplish this.

Let me illustrate the impact of the FDIC special assessment: the original proposed special assessment would pull over \$15 billion from the industry in the second quarter of this year. This is on ***top*** of the regular risk-based quarterly premium paid by the industry which will be between \$3 billion and \$4 billion each quarter. To give you a sense of the magnitude of this cost, the industry's full year 2008 net income was \$16 billion. Even at half the cost, which the FDIC has suggested is likely if S. 541 is enacted, it still will impose a substantial burden on banks at the very time that they are making every effort to get credit into local communities.

The special assessment is a significant and unexpected cost to all banks that has the potential to devastate earnings. We are already dealing with a deepening recession, accounting rules that overstate economic losses and unfairly reduce capital, regulatory pressure to classify assets that continue to perform, and a significant increase in regular quarterly FDIC premiums. Each of these is a big challenge on its own – but collectively, they are a nightmare. Adding another huge one-time cost compounds this burden dramatically. Thousands of banks like mine that never made a toxic subprime mortgage loan and have served our communities in a responsible way for years and years are being unfairly penalized. In fact, a small bank in Texas commented recently: “Is there not a better approach here than choking down the small community banks that still have prudent underwriting standards and are still trying to serve their long-term customers?”

Let me tell you the impact such a charge will have on my bank: the proposed special assessment would cost my bank \$2.47 million – all in second quarter of 2009. This will reduce the bank's capital – which is the base to support all our lending – by \$1.64 million. This very high and unexpected cost is in addition to the regular risk-based premium we pay to FDIC, which is expected to be about \$429,000 per quarter, or \$1.7 million for 2009. To put this in perspective, the regular premiums are four times greater this year than last – not including the large special assessment cost. This same story is being repeated across thousands of banks in our country. Moreover, some areas, where the economic conditions are even more problematic, this added burden will make any new lending practically impossible.

I do want to be clear in saying that First United Bank & Trust will meet its obligation to FDIC, regardless of the disposition of S. 541. In doing so, however, we will encounter limits on our ability to lend in our communities, support local functions and charities, and provide jobs.

In fact, the special assessment is completely at odds with banks' efforts to help communities rebuild from this economic downturn. This assessment makes the cost of raising new deposits much higher, and therefore, acts as a disincentive to raise new deposits. Fewer deposits will hinder our ability to lend. The reduction in earnings will make it harder to build capital when it is needed the most. Banks will also be forced to look at ways to lower other expenses, which may limit their ability to sponsor community activities or make charitable donations – something most banks have done year after year. Some banks have told us that they may even have to consider reducing bank staff in order to pay for this high cost. In fact, a small community bank in Wisconsin, with 11 employees, commented that: “The proposed assessment to us is equivalent to the cost of one full-time employee. We may not be able to afford to keep existing staff. I’m concerned that we will be forced to reduce our head count or certainly not be able to add staff as planned.”

The implications for this significant FDIC charge will impact every corner of my community, and indeed, every community the banking industry serves. It is patently unfair and harmful to burden a healthy bank like mine that is best positioned to help the economy recover. Given the impact that the proposed assessment will have on banks and their communities, it is critical to consider alternatives that would reduce the burden and provide the FDIC the funding it needs in the short-term. S. 541 is an extremely important step in this direction as it would enhance FDIC's ability to draw on working capital, if necessary, and enable the FDIC to reduce the special assessment considerably.

Importantly, the FDIC does not intend to use the line of credit at all unless the economy deteriorates even more dramatically than anticipated. If it does draw on it, it is a ***borrowing that must be repaid by the industry – with interest.*** This obligation of the industry is often lost in the discussion about government support and confused with taxpayer losses. Nothing is further from the truth. The banking industry stands fully behind the FDIC and remains committed to assuring its financial health. The FDIC has been funded completely by banking premiums since it came into existence in 1933. All the costs of bank failures and all the personnel and other program costs have been borne by the industry. It has been the healthy banks which have had nothing to do with the excessive risk-taking of banks that have failed that end up bearing the cost. While the industry is

prepared to meet its obligations, in this difficult time it is critical to reduce the impact and spread the cost over a long period of time. This is why enacting S. 541 is so important and so urgently needed.

In my statement today, I'd like to focus on three main ideas:

- **The banking industry is committed to assuring that the FDIC is financially secure.** Banks have always paid the full cost of FDIC. Since the industry will bear the full cost of any FDIC expenses, it is a question of *timing* of the payments and balancing the impact of any payment on the ability of banks to lend in their communities.
- **The FDIC special assessment is a significant burden that will impact earnings, capital, and cost of funds – all of which makes it far more difficult to lend.** The cost of rebuilding the deposit insurance fund needs to be reduced and spread out over time.
- **The \$100 billion line of credit is critical to reducing FDIC assessments on banks.** ABA fully supports S. 541 and urges quick action to enact it.

I will cover each of these in turn.

I. The Banking Industry is Committed to Assuring that the FDIC is Financially Secure

The banking industry knows how important deposit insurance is to our customers. In fact, the very rapid growth in deposits over the last quarter, indeed the last year, shows just how valuable this additional level of security is to bank customers. It is no wonder that depositors feel this way as no insured depositor in a failed bank has ever lost a penny. Perhaps less well-known is that *bank* premium payments have paid *all* the costs of the FDIC – including all the personnel and administrative costs to run the agency (which is in excess of \$1 billion per year) and all the bank failure costs.

The industry remains committed to assuring the financial strength of the FDIC. The industry had built up the Deposit Insurance Fund (DIF) to over \$50 billion by the end of 2007. The

housing market collapse and rapidly deteriorating economy have resulted in 25 bank failures last year and 17 this year. The IndyMac failure on July 11, 2008 was particularly costly – subtracting about \$10 billion from the DIF. As a result of these losses, the DIF reserve ratio (the fund divided by insured deposits) fell to 0.40 percent at the end of the last year. This was due not only to the rapid growth in insured deposits, but more importantly reflects the fact that the FDIC has set aside over \$22 billion from the fund to pay for losses expected in 2009. These reserves are *not* included in the calculation of the reserve ratio. Thus, in total, the FDIC has \$41 billion in resources – \$22 billion for possible failures plus \$19 billion in the fund to cover additional unexpected costs.

In February 2006, Congress made important improvements that allowed the FDIC greater flexibility to manage the insurance fund and authority to enhance the risk-based premium system. Unfortunately, there was little time to allow this system to become fully operational before this severe economic downturn began to take its toll. Nonetheless, the reform act of 2006 continues to provide a solid base for rebuilding and maintaining the FDIC deposit insurance fund.

Under the new rules, the banking industry pays quarterly premiums that are set to reflect differences in “risk” of the banks, determined by a combination of bank examiner ratings and financial ratios. Under that system, premiums paid this year will raise about \$12 billion. This represents a four-fold increase in premiums from last year. For banks located in more economically-distressed areas, the risk-based increase is likely to be even higher. Bank examiners have also been very critical of banks (particularly in these areas) even though most of the banks in these regions remain well-capitalized and ready to lend. The expense will adversely affect a bank’s earnings, perhaps leading to a CAMELS downgrade and a higher FDIC insurance premium, where the cycle begins again.

In spite of these challenges, banks had planned for and budgeted for the increase expected in quarterly premium assessments. However, the huge special one-time assessment announced on February 27, 2009 was unexpected. The negative consequences of this change – all at once – will be dramatic.

The industry is prepared to do its part and pay for 100 percent of the insurance needed to preserve confidence in our industry. The only issue is one of timing. S. 541 will be very helpful in providing the industry with the time needed to fund the DIF while at the same time enabling the industry to meet the needs of our communities.

II. The FDIC Special Assessment is a Burden That Will Significantly Impact Earnings, Capital, and Cost of Funds – All of Which Makes it Far More Difficult for Banks to Lend

The FDIC is proposing to siphon funds out of the banking system at precisely the time that it and other parts of the government are trying to pump money in. This is the ultimate in mixed messages and will significantly undermine the effectiveness of the other programs. It would be far better to adopt a plan that would enable banks to fund the system at a time when higher insurance premiums will not jeopardize an already fragile economy.

The \$41 billion already at the FDIC and \$12 billion a year (\$60 billion over five years) in risk-based premiums should be sufficient – under current economic assumptions – to cover the FDIC’s estimated \$65 billion in losses over the next five years and rebuild the DIF back to its normal operating range. The FDIC has told the industry, however, that the special assessment is needed as an additional layer of protection against the possibility that losses this year and next may be greater than anticipated, leaving the agency with less flexibility to manage the cash flow required to satisfy insured-depositor claims.

Let me again be very clear: the banking industry will meet its commitment to fully fund the FDIC. We appreciate the difficult situation that the FDIC is in, and understand that rising losses from bank failures have created short-term funding needs. The industry has always taken our obligation to the FDIC seriously and banks will honor the obligation to support the FDIC. It is a matter of timing that is the issue here, not the obligation. Thus, ***how the repayment is done, and over what time period, is the critical question.***

Here’s an example of how many bankers feel:

- From an Illinois community bank (\$425 million in assets): “The FDIC seems to be failing to realize that most community banks continue to serve as a stable foundation for lending to businesses and individuals. By imposing this assessment, the FDIC is placing further strain on the institutions that have great potential to help pull our nation out of this financial crisis. Wall Street has been rewarded, and now Main Street is being penalized.”
- From an upstate New York community bank (\$500 million in assets): “We annually provide over \$100 million in loans to a wide range of businesses, consumers and

homeowners. We truly operate the way a main street bank should, safely and profitably, all with an focus on supporting the community in every way possible. We never issued a subprime mortgage, purchased private label CMOs or MBSs. Basically, we did what we were supposed to do. This year we estimated that our FDIC insurance premiums were going to increase to \$610,000 up approximately \$410,000 from 2008. While we were extremely disappointed that banks that operated very poorly, without prudent controls and with an eye for ever greater profits at the expense of everything else, were the source of the increase, we understood that all must share in the pain if this Country is going to move forward. However, the increases in premiums being proposed now will increase our costs another \$950 thousand. This is not acceptable!

The money to pay such high expenses must come out of earnings or reductions in expenditures. Banks will also be forced to look at ways to lower other expenses, which means less lending, fewer sponsorship of community activities, fewer donations to local charities, and in some banks, reductions in staffing. The implications for this significant FDIC charge will impact every community. Spreading the costs over a long period of time is the best method to minimize disruptive effects. Alternatives are clearly needed to help ease this burden on all banks.

III. The \$100 Billion Line of Credit is Critical to Reducing FDIC Assessments on Banks

Enacting S. 541 will provide the necessary flexibility to the FDIC to continue to meet its responsibilities without extracting significant funds from the banking industry that could be better used to facilitate loans in banks' communities. S. 541 would increase the FDIC's line of credit to Treasury from \$30 billion to \$100 billion and provide for additional flexibility for the FDIC to borrow beyond that under extraordinary circumstances. What is not well understood is that the FDIC's ability to borrow for working capital (to handle the cash needs in resolving bank failures) is *directly* related to the level of the fund and the (current) \$30 billion line of credit. Thus, increasing that line to \$100 billion *significantly* increases the FDIC's working capital line.

The last time the line of credit was increased was in 1991, when Congress increased it from \$5 billion to \$30 billion in the FDIC Improvement Act. At that time, Congress also provided for working capital that, as I mentioned, is many multiples of (roughly nine times) the \$30 billion line of credit plus the fund balance. Since that time, the banking industry has more than tripled in total assets; thus, setting a new line of credit at \$100 billion is consistent with the growth of the industry.

By expanding the flexibility to access working capital, the FDIC has less immediate need for cash from the industry as a buffer against unexpected losses. Thus, rather than pull \$15 billion out of the industry, the FDIC has suggested that it could cut that level in half and have sufficient funding. Of course, even at half the proposed rate, the cost is significant, and we continue to look for ways to eliminate the upfront cost or, if it cannot be eliminated, at least lower it significantly and certainly spread it out over a much longer period of time. We emphasize that the special assessment is on top of significantly elevated risk-based premiums.

The FDIC should assess premiums to recapitalize the insurance fund over a reasonable period, keeping in mind the present need to keep capital in the system to increase stability and to bolster lending. Recently, the FDIC extended the recapitalization period for the reserve ratio to return to the statutory level of 1.15 percent from five years to seven years. The FDIC should consider extending the recapitalization period further, to at least ten years, and be reassured that the industry remains fully committed to bringing the fund back to required levels as conditions improve.

Policymakers should consider other options to help stretch out the repayment period for banks. One option to consider is a funding source like the Financial Corporation (FICO) bonds issued from 1987 to 1989 to pay for the costs incurred by the Federal Savings and Loan Insurance Corporation (FSLIC) from savings association failures in the late 1980s. These were a series of 30-year bonds with an aggregate principal of \$8.2 billion. This helped to spread out the cost of failures at that time. Other types of borrowing or even capital investments by banks in the FDIC should be considered. Having options in place is important so that there is a viable mechanism to provide the FDIC with capital to offset losses, yet have the commitment of the banking industry to repay any temporary funding over a long period of time.

On a final note, let me say that the banking industry, like all businesses, is working hard to cut costs and make sure our operations are as efficient as possible. We believe that the FDIC should do the same. Thus, we urge the FDIC to continue seeking the least-cost resolution of failed institutions and provide details so the industry and public understand the costs incurred. Moreover,

the FDIC should reduce all other unnecessary expenses, keeping in mind that every dollar the FDIC spends comes out of the insurance fund.

Conclusion

The ABA fully supports a strong, financially secure FDIC fund in order to maintain the confidence depositors have in the system. The banking industry has been responsible for all of the FDIC's cost since its inception in 1933. We appreciate the desire on the part of the FDIC to have an extra layer of protection in this difficult environment with so much uncertainty about the number and cost of bank failures. However, how this is done is very important to every bank and every community we serve. The special assessment is a significant and unexpected cost to banks that will devastate earnings and reduce lending so critical to our economic recovery. Therefore, the ABA fully supports S. 541 and urges quick action to enact it into law.