



TO: President-Elect Obama's Treasury Transition Team

FROM: The Independent Community Bankers of America

DATE: December 15, 2008

RE: Treasury Issues

Community Banking Industry –Background

More than 7,000 community banks and thrifts serve communities throughout the United States. These community banks provide vital consumer, small business, agricultural, commercial and mortgage credit to their communities. Community banks play an essential role in local economic development in rural, suburban and urban areas. ICBA estimates that as of September 30, 2008, community banks with up to \$1 billion in assets had outstanding \$660 billion in loans to small and medium size businesses, including commercial mortgages, business operating loans, farm loans and construction and development loans. Total loans for these banks were more than \$1 trillion. Community banks are disproportionate lenders to small business, which are critical to economic growth. According to the SBA Office of Advocacy, community banks provide 35 percent of the total dollar amount of loans to small businesses under \$1 million dollars.

Community banks, by and large, did not engage in the subprime lending practices at the heart of the current financial crisis. Community banks are common-sense lenders, who properly underwrite loans and do not place consumers and commercial customers into loans that they cannot afford. As a result of their common-sense approach to lending, community banks played no role in causing the current home foreclosure and credit crisis.

Issues and Recommendations

Community Bank Financial Institutions Assistant Secretary

- Typically, the Treasury Department financial institutions division has been heavily weighted with staff and appointees with “Wall Street” financial institution backgrounds, but not community banking backgrounds. Often policy decisions addressing Wall Street and big bank problems can create stress on community banks. ICBA believes a more holistic policy approach that considers the breadth of the financial services industry would result in more appropriate outcomes. The banking industry is comprised of 8,400

FDIC-insured banks, the vast majority of which are community banks. ICBA recommends the Treasury Department include an assistant secretary position for community financial institutions to ensure the impact of policy decisions on thousands of community banks and their small business and consumer customers has appropriate and balanced consideration in the Treasury policy-making process.

Exam Environment and Credit Availability

- Community bankers continue to report to ICBA about overzealous and unduly overreaching examiners second guessing bankers and appraisers and demanding overly aggressive write-downs and reclassifications of viable commercial real estate loans and other assets. Examiners are requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have not been criticized before; and substituting their judgment for that of the appraiser.
- This examination environment is exacerbating the contraction in credit as community bankers avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital. While it is expected that examiners will be more thorough and careful during a credit downturn, excessively tough exams that result in potentially unnecessary loss of earnings and capital can have a dramatic and adverse impact on the ability of community banks to lend, impairing their ability to support economic growth.
- Community banks are ready to meet the objectives of lending to creditworthy households and businesses but they cannot meet those objectives without a change in the current regulatory environment. Regulators should consider a more flexible and reasonable examination policy particularly with respect to real estate lending so that community banks can meet the credit needs of the communities they serve.

Access to Troubled Asset Relief Program

- ICBA is working with the current Administration to ensure that community banks can gain access to the Troubled Asset Relief Program (TARP), to boost capital and increase lending. Community banks come in many shapes and sizes. All of our member institutions including Subchapter S banks as well as mutual institutions want to play an active role in the recovery. To do so, they need access to the TARP. If term sheets for Subchapter S banks and mutual institutions are not completed by January 20, we encourage the Obama Administration to act quickly to provide these term sheets.
- The Treasury Department's September 7, 2008 action to place Fannie Mae and Freddie Mac into conservatorship was done in a way that effectively wiped out the value of Fannie Mae and Freddie Mac preferred stock held by community banks. The estimated value of these community banks preferred holdings was \$16 billion. In many cases,

regulatory examiners and outside accounting firms encouraged community banks to purchase GSE preferred stock as a good, low-risk asset for diversification. Affected community banks were forced to write-down the preferred shares taking a huge hit to their capital, resulting in reduced lending capacity. ICBA recommends Treasury consider all available remedies to help mitigate the damage to community banks and lending capacity caused by the conservatorship, including allowing the restoration of dividends or the government repurchasing these preferred shares at a reasonable value. The Emergency Economic Stabilization Act provides that banks suffering the most significant capital losses due to the devaluation of their Fannie and Freddie preferred stock investment should receive help under the Troubled Asset Relief Program (Section 103(6) of the Emergency Economic Stabilization Act of 2008). To date, Treasury has not implement this provision. We urge the Obama administration to offer this assistance.

Regulatory Restructuring

- The ICBA believes the logical first step to approach financial industry reforms is to root out the primary causes of the financial crisis we are in. ICBA recommends a bipartisan financial crisis commission similar to the National Commission on Terrorist Attacks Upon the United States (the “9-11 Commission”), to investigate the causes and weaknesses that resulted in the financial crisis. ICBA recommends an independent, bipartisan commission with a six-month mandate to oversee a complete accounting of the circumstances triggering the financial crisis and issue a report. The Financial Crisis Commission should also recommend changes to prevent systemic risk to the U.S. financial system.
- Any restructuring of our regulatory system of the financial sector should recognize the fact that the current system that applies to community banks has worked appropriately and the highly-regulated community banking sector did not trigger the current financial crisis. The Bush Treasury’s plan to eliminate the state bank charter and the current federal structure is unnecessary and would disrupt community banking.
- Reforms should focus on filling in regulatory gaps by regulating unregulated institutions and instruments, such as credit default swaps, and providing more effective regulation of under-regulated entities in the financial services sector, such as non-FDIC insured mortgage companies and mortgage brokers.
- We strongly urge the Obama Administration to reduce potential risk to the financial system by maintaining the separation of banking and commerce and by supporting a ban on commercial ownership of industrial loan companies (a specialized FDIC-insured bank), which is the last loophole to permit a mixing of banking and commerce. Our nation must also reduce the number of too-big-to-fail financial institutions to reduce systemic risk in the system or we will continue to endure taxpayer-funded bailouts and the destabilization of our economy when these institutions are mismanaged. Allowing large commercial firms, such as Wal-Mart, to own an industrial loan company would only create more too-big-to-fail institutions and spread the federal banking safety net to support commercial and retail operations.

Too-Big-To-Fail Disparity

- We urge President-elect Obama and the Congress to restore balance to the deposit insurance system. The disparity between too-small-to-save community banks and unlimited protection for large institutions will ultimately reduce capital on Main Street and cripple rural America, smaller towns and cities and the nation's small business sector. The FDIC should levy a too-big-too-fail premium on the largest institutions. The depositors, and often other liability holders and even shareholders, of too-big-too-fail institutions receive much superior protection from the government than the depositors, liability holders and shareholders of community banks. These large institutions should pay an appropriate premium for this expanded protection.
- Moreover, the current deposit insurance premium assessment system places a disproportionate burden on community bank liquidity. Currently, the law provides that the FDIC levy a premium against all domestic deposits, which is the principal source of liquidity for community banks. But large multinational institutions' foreign deposits, which are used for lending domestically, and other sources of liquidity and funding are not assessed a premium. ICBA believes a more equitable approach would base the premium on all liabilities instead of domestic deposits. Such a system would not favor one source of liquidity or funding over another. A liabilities-based approach would also more accurately reflect the risk a bank represents for the FDIC, as all liabilities fund the assets which are the principal source of risk in a bank.
- To mitigate some of the competitive disadvantage to community banks caused by more favorable government treatment of the too-big-to-fail banks, ICBA supports making the temporary statutory \$250,000 FDIC coverage and the temporary regulatory unlimited coverage of certain transaction accounts permanent. FDIC coverage of retirement accounts should be increased to \$500,000. The FDIC should be granted additional time to recapitalize the Deposit Insurance Fund beyond the current five-year statutory deadline.

Homebuyer Tax Credit

- ICBA encourages the Obama Administration to support changes to the current homebuyer tax credit to make the credit a more effective tool for stimulating home sales. The tax credit adopted last summer requires the taxpayer to repay the credit. This feature has made the tax credit unattractive to potential homebuyers. A properly structured homebuyer tax credit is a proven policy to jumpstart home sales and restoring stability in home values

Stimulate New Private Capital Investments in Community Banks

- ICBA urges the Obama Administration to include the following simple measures to encourage new investments of private capital in community banks: allowing Individual

Retirement Accounts to invest in Subchapter S businesses, increase the number of allowable shareholders in Subchapter S businesses and allowing Subchapter S businesses to issue preferred shares. New capital in community banks is essential to stimulate new lending to consumers and businesses. These changes will also provide other small business increased access to new capital, which is key to increasing jobs in the country.

Increase Community Banks' Ability to Support Local Infrastructure Projects

- Community banks play a vital role in supporting local government infrastructure projects through tax-exempt bank qualified bonds. The cap on bank qualified bonds should be raised from \$10 million per issuer to \$30 million per issuer.

Continue Efforts to Get Credit Markets Functioning

- Steps have been taken by the Bush Administration to stabilize the credit markets to make funds more accessible and bring down their cost to more normalized levels. While the availability of 30-year fixed rate mortgages has improved, other mortgage products such as jumbo mortgages remain out of the reach of many potential borrowers. Also, Federal Home Loan Bank funding costs have been unusually high as compared to those for comparable Treasury securities due to market conditions. We urge the Obama Administration to continue efforts to get the credit markets fully functioning again and pricing funds at more appropriate levels.

Resolution of Fannie Mae and Freddie Mac

- ICBA is also concerned with the future of Fannie Mae and Freddie Mac. Community banks rely on these institutions to serve as an impartial entry way into the secondary market. A reliable, impartial secondary lender is crucial to the mortgage lending of our nation's community banks.

Unfair or Deceptive Acts or Practices - Credit Cards and Overdraft Programs

- ICBA has serious concerns about the bank regulators' proposed rules that would ban or restrict certain practices for consumer credit cards and overdraft protection services. The potential unintended consequences of the rules would result in limited access to credit for many consumers. The potential costs and burdens inherent in the proposal, and the fact that the operational requirements, in many instances, would be impossible to meet (e.g. partial opt outs for overdraft protection), will raise costs and fees for consumers and discourage community banks from continuing to offer financial products and services welcomed by their customers.