Testimony of

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Modernizing Bank Supervision and Regulation, Part II

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Mr. Chairman, Ranking member Shelby and Members of the Committee, my name is William Attridge, I am President and Chief Executive Officer of Connecticut River Community Bank. I am also a member of the Congressional Affairs Committee of the Independent Community Bankers of America.[1] My bank is located in Wethersfield, Connecticut, a 350-year-old town of over 27,000 people. ICBA is pleased to have this opportunity to testify today on the modernization of our financial system regulatory structure.

Summary of ICBA Recommendations

ICBA commends the Chairman and the Committee for tackling this issue quickly. The current crisis demands bold action, and we recommend the following:

- Address Systemic Risk Institutions. The only way to maintain a vibrant banking system where small and large institutions are able to fairly compete – and to protect taxpayers – is to aggressively regulate, assess, and eventually break up institutions posing a risk to our entire economy.
- Support Multiple Federal Banking Regulators. Having more than a single federal agency regulating depository institutions provides valuable regulatory checks-and-balances and promotes “best practices” among those agencies – much like having multiple branches of government.
- Maintain the Dual Banking System. Having multiple charter options -- both federal and state -- is essential for maintaining an innovative and resilient regulatory system.
- Access to FDIC Deposit Insurance for All Commercial Banks, Both Federal and State Chartered. Deposit insurance as an explicit government guarantee has been the stabilizing force of our nation’s banking system for seventy-five years.
- Sufficient Protection for Consumer Customers of Depository Institutions in the Current Federal Bank Regulatory Structure. One benefit of the current regulatory structure is that the federal banking agencies have coordinated their efforts and developed consistent approaches to enforcement of consumer regulations, both informally and formally, as they do through the Federal Financial Institutions Examination Council (FFIEC).

[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA’s website at www.icba.org.

- Reduce the Ten Percent Deposit Concentration Cap. The current economic crisis illustrates the dangerous overconcentration of financial resources in too few hands.
- Support the Savings Institutions Charter and the OTS. Savings institutions play an essential role in providing residential mortgage credit in the U.S. The thrift charter should not be eliminated and the Office of Thrift Supervision should not be merged into the Office of the Comptroller of the Currency.
- Maintain GSEs Liquidity Role. Many community bankers rely on Federal Home Loan Banks for liquidity and asset/liability management through the advance window.

The following will elaborate on these concepts and provide ICBA's reasons for advocating these principles.

State of Community Banking is Strong

Despite the challenges we face, the community bank segment of the financial system is still working and working well. We are open for business, we are making loans, and we are ready to help all Americans weather these difficult times.

Community banks are strong, common sense lenders that largely did not engage in the practices that led to the current crisis. Most community banks take the prudent approach of providing loans that customers can repay, which best serves both banks and customers alike. As a result of this common sense approach to banking, the community banking industry, in general, is well-capitalized and has fewer problem assets than other segments of the financial services industry.

That is not to suggest community banks are unaffected by the recent financial crisis. The general decline in the economy has caused many consumers to tighten their belts thus reducing the demand for credit. Commercial real estate markets in some areas are stressed. Many bank examiners are overreacting, sending a message contradicting recommendations from Washington that banks maintain and increase lending. For these reasons, it is essential the government continue its efforts to stabilize the financial system.

But, Congress must recognize these efforts are blatantly unfair. Almost every Monday morning for months, community banks have awakened to news the government has bailed out yet another too-big-to-fail institution. On many Saturdays, they hear the FDIC has summarily closed one or two too-small-to-save institutions. And, just recently, the FDIC proposed a huge special premium to shore up the Deposit Insurance Fund (DIF) to pay for losses caused by large institutions. This inequity must end, and only Congress can do it. The current situation – if left uncorrected – will damage community banks and the consumers and small businesses we serve.

Congress Must Address Excessive Concentration

ICBA remains deeply concerned about the continued concentration of banking assets in the U.S. The current crisis has made it painfully obvious the financial system has become too concentrated, and – for many institutions – too loosely regulated.

Today, the four largest banking companies control more than 40% of the nation's deposits and more than 50% of the assets held by U.S. banks. We do not believe it is in the public interest to have four institutions controlling most of the assets of the banking industry. A more diverse financial system would reduce risk, and promote competition, innovation, and the availability of credit to consumers of various means and businesses of all sizes.

Our nation is going through an agonizing series of bankruptcies, failures and forced buy-outs or mergers of some of the nation's largest banking and investment houses that is costing American taxpayers hundreds of billions of dollars and destabilizing our economy. The doctrine of too big – or too interconnected – to fail, has finally come home to roost, to the detriment of American taxpayers. Our nation cannot afford to go through this again. Systemic risk institutions that are too big or inter-connected to manage, regulate or fail should either be broken up or required to divest sufficient assets so they no longer pose a systemic risk.

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.[2]

FDIC Chairman Sheila Bair, in remarks before the ICBA annual convention last Friday 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."[3] 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,

[2] Financial Reform to Address Systemic Risk, at the Council of Foreign Relations, March 10, 2009
[3] March 20, 2009

nationwide limits on deposit concentration should be considered at a level appropriate to individual countries."[4]

The 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 should 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.

Congress should not only consider breaking up the largest institutions, but order it to take place. 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.

Banking and Antitrust Laws Have Failed to Prevent Undue Concentration; Large Institutions Must be Regulated and Broken Up

Community bankers have spent the past 25 years warning policy makers of the systemic risk that was being created in our nation by the unbridled growth of the nation's largest banks and financial firms. But, we were told we didn't get it, that we didn't understand the new global economy, that we were protectionist, that we were afraid of competition, and that we needed to get with the "modern" times.

Sadly, we now know what modern times look like and the picture isn't pretty. Our financial system is imploding around us. Why is this the case, and why must Congress take bold action?

One important reason is that banking and antitrust laws fail to address the systemic risks posed by excessive financial concentration. Their focus is too narrow. Antitrust laws are designed to maintain competitive geographic and product markets. So long as the courts and agencies can discern that there are enough competitors in a particular market that is the end of the inquiry.

This type of analysis often prevents local banks from merging. But, it has done nothing to prevent the creation of giant nationwide franchises competing with each other in various local markets. No one asked, is the nation's banking industry becoming too concentrated and are individual firms becoming too powerful both economically and politically.

[4] "Financial Reform; A Framework for Financial Stability, January 15, 2009, p. 8.

The banking laws are also subject to misguided tunnel vision. The question is always whether a given merger will enhance the safety and soundness of an individual firm. The answer has been that "bigger" is almost necessarily "stronger." A bigger firm can – many said – spread its risk across geographic areas and business lines. No one wondered what would happen if one firm, or a group of firms, decides to jump off a cliff as they did in the subprime mortgage market. Now we know.

It is time for Congress to change the laws and direct that the nation's regulatory system take systemic risk into account and take steps to reduce and eventually eliminate it. These are ICBA specific recommendations to deal with this issue:

Summary of Systemic Risk Recommendations

- Congress should direct a fully-staffed interagency task force to immediately identify financial institutions that pose a systemic risk to the economy.
- These institutions should be put immediately under prudential supervision by a Federal agency – most likely the Federal Reserve.
- The Federal systemic risk agency should impose two fees on these institutions that would:
  - compensate the agency for the cost of supervision; and
  - capitalize a systemic risk fund comparable to the FDIC's Deposit Insurance Fund.
- The FDIC should impose a systemic risk premium on any insured bank that is affiliated with a firm designated as a systemic risk institution.
- The systemic risk regulator should impose higher capital charges to provide a cushion against systemic risk.
- The Congress should direct the systemic risk regulator and the FDIC to develop procedures to resolve the failure of a systemic risk institution.
- The Congress should direct the interagency systemic risk task force to order the break up of systemic risk institutions over a five year period.
- Congress should direct the systemic risk regulator to review all proposed mergers of major financial institutions and to block any merger that would result in the creation of a systemic risk institution.
- Congress should direct the systemic risk regulator to block any financial activity that threatens to impose a systemic risk.

The only way to maintain a vibrant banking system where small and large institutions are able to fairly compete – and to protect taxpayers – is to aggressively regulate, assess, and eventually break up those institutions posing a risk to our entire economy.

Identification and Regulation of Systemic Risk Institutions

ICBA recommends Congress establish an interagency task force to identify institutions that pose a systemic financial risk. At a minimum, this task force should include the agencies that regulate and supervise FDIC-insured banks – including the Federal Reserve – plus the Treasury and Securities and Exchange Commission. This task force would be fully staffed by individuals from those agencies, and should be charged with identifying specific institutions that pose a systemic risk. The task force should be directed by an individual appointed by the President and confirmed by the Senate.

Once the task force has identified systemic risk institutions, they should be referred to the systemic risk regulator. Chairman Bernanke's March 10^{th} speech provides a good description of the systemic risk regulator's duties: "Any firm whose failure would pose a systemic risk must receive especially close supervisory oversight of its risk-taking, risk management, and financial condition, and be held to high capital and liquidity standards." Bernanke continued: "The consolidated supervisors must have clear authority to monitor and address safety and soundness concerns in all parts of the organization, not just the holding company."

Of course, capital is the first line of defense against losses. Community banks have known this all along and generally maintain higher than required levels. This practice has helped many of our colleagues weather the current storm. The new systemic risk regulator should adopt this same philosophy for the too-big-to-fail institutions that it regulates.

Clearly, the systemic risk regulator should also have the authority to step in and order the institution to cease activities that impose a systemic risk. Many observers warned that many players in the nation's mortgage market were taking too many risks. Unfortunately, no one agency attempted to intervene and stop imprudent lending practices across the board. An effective systemic risk regulator must have the unambiguous duty and authority to block any financial activity that threatens to impose a systemic risk.

Assessment of Systemic Risk Regulatory Fees

The identification, regulation, and supervision of these institutions will impose significant costs to the systemic risk task force and systemic risk regulator. Systemic risk institutions must be assessed the full costs of these government expenses. This would entail a fee, similar to the examination fees banks must pay to their chartering agencies.

Resolving Systemic Risk Institutions

Chairman Bair and Chairman Bernanke have each recommended the United States develop a mechanism for resolving systemic risk institutions. This is essential to avoid a repeat of the series of the ad hoc weekend bailouts that have proven so costly and infuriating to the public and unfair to institutions that are too-small-to-save.

Again, Bernanke's March 10th speech outlined some key considerations:

> The new resolution regime would need to be carefully crafted. For example, clear guidelines must define which firms could be subject to the alternative regime and the process for invoking that regime, analogous perhaps to the procedures for invoking the so-called systemic risk exception under the FDIA. In addition, given the global operations of many large and complex financial firms and the complex regulatory structures under which they operate, any new regime must be structured to work as seamlessly as possible with other domestic or foreign insolvency regimes that might apply to one or more parts of the consolidated organization.

This resolution process will, obviously, be expensive. Therefore, Congress should direct the systemic risk regulator to establish a fund to bear these costs. The FDIC provides a good model. Congress has designated a minimum reserve ratio for the FDIC's Deposit Insurance Fund (DIF) and directed the agency to assess risk-based premiums to maintain that ratio. Instead of deposits, the ratio for the systemic risk fund should apply as broadly as possible to ensure all the risks covered are assessed.

Some of the systemic risk institutions will include FDIC-insured banks within their holding companies. These banks would certainly not be resolved in the same way as a stand-alone community bank; all depositors would be protected beyond the statutory limits. Therefore, Congress should direct the FDIC to impose a systemic risk fee on these institutions in addition to their regular premiums.

The news AIG was required by contract to pay hundreds of millions of dollars in bonuses to the very people that ruined the company point to another requirement for an effective systemic risk regulator. Once a systemic risk institution becomes a candidate for open-institution assistance or resolution, the regulator should have the same authority to abrogate contracts as the FDIC does when it is appointed conservator and receiver of a bank. If the executives and other highly-paid employees of these institutions understood they could not design employment contracts that harmed the public interest, their willingness to take unjustified risk might diminish.

Breaking up Systemic Risk Institutions & Preventing Establishing New Threats

ICBA believes compelling systemic risk regulation and imposing systemic risk fees and premiums will provide incentives to firms to voluntarily divest activities or not become too big to fail. However, these incentives may not be adequate. Therefore, Congress should direct the systemic risk task force to order the break up of systemic risk institutions over a five-year period. These steps will reverse the long-standing regulatory policy favoring the creation of ever-larger financial institutions.

ICBA understands this will be a controversial recommendation, and many firms will object. We do not advocate liquidation of ongoing, profitable activities. Huge conglomerate holding companies should be separated into business units that make sense. This could be done on the basis of business lines or geographical divisions. Parts of larger institutions could be sold to other institutions. The goal is to reduce systemic risk, not to reduce jobs or services to consumers and businesses.

Maintain a Diversified Financial Regulatory System

While ICBA strongly supports creation of an effective systemic risk regulator, we oppose the establishment of a single, monolithic regulator for the financial system. Having more than a single federal agency regulating depository institutions provides valuable regulatory checks-and-balances and promotes “best practices” among those agencies – much like having multiple branches of government. The collaboration required by multiple federal agencies on each interagency regulation insures all perspectives and interests are represented, that no one type of institution will benefit over another, and the resulting regulatory or supervisory product is superior.

A monolithic federal regulator such as the U.K.’s Financial Service Authority would be dangerous and unwise in a country with a financial services sector as diverse as the United States, with tens of thousands of banks and other financial services providers. Efficiency must be balanced against good public policy. With the enormous power of bank regulators and the critical role of banks in the health and vitality of the national economy, it is imperative the bank regulatory system preserves real choice, and preserves both state and federal regulation.

For over three generations, the U.S. banking regulatory structure has served this nation well. Our banking sector was the envy of the world and the strongest and most resilient financial system ever created. But we have gotten off the track. Non-bank financial regulation has been lax and our system has allowed – and even encouraged – the establishment of financial institutions that are too big to manage, too big to regulate, and too big to fail.

ICBA supports a system of tiered regulation that subjects large, complex institutions that pose the highest risks to more rigorous supervision and regulation than less complex community banks. Large banks should be subject to continuous examination, and more rigorous capital and other safety and soundness requirements than community banks in recognition of the size and complexity and the amount of risk they pose. They should pay a “systemic risk premium” in addition to their regular deposit insurance premiums to the FDIC

Community banks should be examined on a less intrusive schedule and should be subject to a more flexible set of safety and soundness restrictions in recognition of their less complex operations and the fact that community banks are not “systemic risk” institutions. Public policy should promote a diversified economic and financial system upon which our nation’s prosperity and consumer choice is built and not encourage further consolidation and concentration of the banking industry by discouraging current community banking operations or new bank formation.

Congress need not waste time rearranging the regulatory boxes to change the system of community bank regulation. The system has worked, is working, and will work in the future. The failure occurred in the too-big-to-fail sector. That is the sector Congress must fix.

Maintain and Strengthen the Separation of Banking and Commerce

Congress has consistently followed one policy that has prevented the creation of some systemic risk institutions. The long-standing policy prohibiting affiliations or combinations between banks and non-financial commercial firms (such as Wal-Mart and Home Depot) has served our nation well. ICBA opposes any regulatory restructuring that would allow commercial entities to own a bank. If it is generally agreed that the current financial crisis is the worst crisis to strike the United States since the Great Depression, how much worse would this crisis have been had the commercial sector been intertwined with banks as well? Regulators are unable to properly regulate the existing mega financial firms, how much worse would it be to attempt to regulate business combinations many times larger than those that exist today?

This issue has become more prominent with recent Federal Reserve encouragement of greater equity investments by commercial companies in financial firms. This is a very dangerous path.

Mixing banking and commerce is bad public policy because it creates conflicts of interest, skews credit decisions, and produces dangerous concentrations of economic power. It raises serious safety and soundness concerns because the companies operate outside the consolidated supervisory framework Congress established for owners of insured banks. It exposes the bank to risks not normally associated with banking. And it extends the FDIC safety net putting taxpayers at greater risk. Mixing banking and commerce was at the core of a prolonged and painful recession in Japan.

Congress has voted on numerous occasions to close loopholes that permitted the mixing of banking and commerce, including the non-bank bank loophole in 1987 and the unitary thrift holding company loophole in 1999. However, the Industrial Loan Company loophole remains open.

Creating greater opportunities to widen this loophole would be a serious public policy mistake, potentially depriving local communities of capital, local ownership, and civic leadership.

Maintain the Dual Banking System

ICBA believes strongly in the dual banking system. Having multiple charter options – both federal and state – that financial institutions can choose from is essential for maintaining an innovative and resilient regulatory system. The dual banking system has served our nation well for nearly one hundred and fifty years. While the lines of distinction between state and federally-chartered banks have blurred in the last twenty years, community banks continue to value the productive tension between state and federal regulators. One of the distinct advantages to the current dual banking system is that it ensures community banks have a choice of charters and the supervisory authority that oversees their operations. In many cases over the years the system of state regulation has worked better than its federal counterparts. State regulators bring a wealth of local market knowledge and state and regional insight to their examinations of the banks they supervise..

The Current Federal Bank Regulatory Structure Provides Sufficient Protections for Consumer Customers of Depository Institutions

One benefit of the current regulatory structure is the federal banking agencies have coordinated their efforts and developed consistent approaches to enforcement of consumer regulations, both informally and formally, as they do through the Federal Financial Institutions Examination Council (FFIEC). This interagency cooperation has created a system that ensures a breadth of input and discussion that has produced a number of beneficial interagency guidelines, including guidelines on non-traditional mortgages and subprime lending, as well as overdraft protection, community reinvestment and other areas of concern to consumers.

Perhaps more important for consumer interests than interagency cooperation is the fact that depository institutions are closely supervised and regularly examined. This examination process ensures consumer financial products and services offered by banks, savings associations and credit unions are regularly and carefully reviewed for compliance.

ICBA believes non-bank providers of financial services, such as mortgage companies, mortgage brokers, etc., should be subject to greater oversight for consumer protection. For the most part, unscrupulous and in some cases illegal lending practices that led directly to the subprime housing crisis originated with non-bank mortgage providers. The incidence of abuse was much less pronounced in the highly regulated banking sector.

Retain the Savings Institutions Charter and the OTS

Savings institutions play an essential role in providing residential mortgage credit in the United States. The thrift charter should not be eliminated and the Office of Thrift Supervision should not be merged into the Office of the Comptroller of the Currency. The OTS has expertise and proficiency in supervising those financial institutions choosing to operate with a savings institution charter with a business focus on housing finance and other consumer lending.

Government-Sponsored Enterprises Play an Important Role

Many community bankers rely on Federal Home Loan Banks for liquidity and asset/liability management through the advance window. Community banks place tremendous reliance upon the FLHBs as a source of liquidity and an important partner in growth. Community banks also have been able to provide mortgage services to our customers by selling mortgages to Fannie Mae and Freddie Mac.

ICBA strongly supported congressional efforts to strengthen the regulation of the housing GSEs to ensure the ongoing availability of these services. We urge the Congress to ensure these enterprises continue their vital services to the community banking industry in a way that protects taxpayers and ensures their long-term viability.

There are few “rules of the road” for the unprecedented government takeover of institutions the size of Fannie and Freddie, and the outcome is uncertain. Community banks are concerned that the ultimate disposition of the GSEs by the government may fundamentally alter the housing finance system in ways that disadvantage consumers and community bank mortgage lenders alike.

The GSEs have performed their central task and served our nation well. Their current challenges do not mean the mission they were created to serve is flawed. ICBA firmly believes the government must preserve the historic mission of the GSEs, that is, to provide capital and liquidity for mortgages to promote homeownership and affordable housing in both good times and bad.

Community banks need an impartial outlet in the secondary market such as Fannie and Freddie – one that doesn’t compete with community banks for their customers. Such an impartial outlet must be maintained. This is the only way to ensure community banks can fully serve their customers and their communities and to ensure their customers continue to have access to affordable credit.

As the future structure of the GSEs is considered, ICBA is concerned about the impact on their effectiveness of either an elimination of the implied government guarantee for their debt or limits on their asset portfolios. These are two extremely important issues. The implied government guarantee is necessary to maintain affordable 30-year, fixed rate mortgage loans. Flexible portfolio limits should be allowed so the GSEs can respond to market needs. Without an institutionalized mortgage-backed securities market such as the one Freddie and Fannie provide, mortgage capital will be less predictable and more expensive, and adjustable rate mortgages could become the standard loan for home buyers, as could higher down payment requirements.

Conclusion

Mr. Chairman, to say this is a complex and complicated undertaking would be a great understatement. Current circumstances demand our utmost attention and consideration. Many of the principles laid out in our testimony are controversial, but we feel they are necessary to preserve and maintain America's great financial system and make it stronger coming out of this crisis.

ICBA greatly appreciates this opportunity to testify. Congress should avoid doing damage to the regulatory system for community banks, a system that has been tremendously effective. However, Congress should take a number of steps to regulate, assess, and ultimately break up institutions that pose unacceptable systemic risks to the nation's financial system. The current crisis provides an opportunity to strengthen our nation's financial system and economy by taking these important steps. ICBA looks forward to working with this Committee on these very important issues.