TESTIMONY OF

JOSEPH A. SMITH, JR.

NORTH CAROLINA COMMISSIONER OF BANKS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

“EXAMINING THE STATE OF THE BANKING INDUSTRY”

Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

October 14, 2009, 2:30 p.m.

Room 538 Dirksen Senate Office Building

INTRODUCTION

Good afternoon, Chairman Johnson, Ranking Member Crapo, and distinguished members of the Subcommittee. My name is Joseph A. Smith, Jr. I am the North Carolina Commissioner of Banks and the Chairman of the Conference of State Bank Supervisors (CSBS).

Thank you for the opportunity to testify today on the condition of the banking industry. In the midst of a great deal of discussion about reform and recovery, it is very important to pause to assess the health of the industry and the factors affecting it, for good and ill.

My testimony today will present the views of state bank supervisors on the health of the banking industry generally and the banks we oversee in particular—the overwhelming majority of which are independent community banks. The states charter and regulate 73% of the nation's banks (Exhibit A). These banks not only compete with the nation's largest banks in the metropolitan areas, but many are the sole providers of credit to less populated and rural areas (Exhibit B). We must remember 91% of this country's banks have less than $1 billion in assets but share most of the same regulatory burdens and economic challenges of the largest banks which receive the greatest amount of attention from the federal government. Community and regional banks are a critical part of our economic fabric, providing an important channel for credit for consumers, farmers, and small businesses.

I will address: the key challenges that state-chartered banks face, regulatory policies that we are pursuing to improve supervision and the health of the industry, and recommendations to improve the regulation of our banks and ultimately the health of the industry.

CONDITION OF THE BANKING INDUSTRY

While the economy has begun to show signs of improvement, there are still many areas of concern. Consumer confidence and spending remains low, deficit spending has soared, and unemployment rates continue to slowly tick upward. The capital markets crisis, distress in the residential and commercial real estate markets, and the ensuing recession have greatly weakened our nation's banking industry. And despite recent positive developments, the banking industry continues to operate under very difficult conditions. While there are pockets of strength in parts of the state bank system, the majority of my fellow state regulators have categorized general banking conditions in their states as "gradually declining." Not surprisingly, the health of banks is directly affected by the economic conditions in which they operate. Times of economic growth will usually be fueled by a banking industry with sufficient levels of capital, a robust and increasing volume of performing loans, ample liquidity, and a number of new market entrants, in the form of de novo institutions. Conversely, this recession is characterized by a banking industry marred by evaporating capital levels, deteriorating and increasingly-delinquent loans, liquidity crunches, and a steady stream of bank failures.

The Federal Deposit Insurance Corporation (FDIC) reports in its most recent *Quarterly Banking Profile* that the banking industry suffered an aggregate net loss of $3.7 billion in the second quarter of 2009. These losses were largely caused by the increased contributions institutions made to their loan-loss provisions to counter the rising number of non-performing loans in their portfolios and realized losses. Further, additional writedowns in the asset-backed commercial paper portfolios and higher deposit insurance assessments impacted banks' earnings significantly.[1]

Across the country, my colleagues are experiencing deteriorating credit quality in their banks, which is straining earnings and putting extreme pressure on capital. Deterioration in credit quality is requiring greater examination resources as regulators evaluate a higher volume of loans. Concentrations in commercial real estate (CRE) loans in general, and acquisition,

[1] FDIC *Quarterly Banking Profile*, Second Quarter 2009: http://www2.fdic.gov/qbp/2009jun/qbp.pdf.

development, and construction (ADC) loans in particular, are posing the greatest challenge for a significant portion of the industry. This is an important line of business for community and regional banks. Banks with less than $10 billion in assets comprise 23% of total bank assets, but originate and hold 52% of CRE loans and 49% of ADC loans by volume. Reducing the concentrations that many of our institutions have in CRE lending is an important factor in restoring them to health; however, it is our view that this reduction needs to be done in a way that does not remove so much credit from the real estate market that it inhibits economic recovery. Striking an appropriate balance should be our goal.

Deteriorating credit quality has a direct and destructive effect on bank capital. Reduction in capital, in turn, has a direct and destructive effect on a bank's liquidity, drying up its sources of funding from secondary sources, including capital markets, brokered deposits, home loan and bankers' banks and the Federal Reserve. This drying up of liquidity has been a significant challenge for a substantial number of the failures.

CAPITAL IS KING

As we entered the financial crisis, we touted the overall strong capital base of the industry, especially compared to previous periods of economic stress. While this was true, banks are highly leveraged operations, and when losses materialize, capital erodes quickly. While this is true for all institutions, it is more pronounced in our largest banks. According to the FDIC, as of December 31, 2007, banks over $10 billion in assets had an average leverage capital ratio of 7.41%. This was 200 basis points (b.p.) less than banks with assets between $1 billion and $10 billion; 256 b.p. less than banks with assets between $100 million and $1 billion; and an astonishing 610 b.p. less than banks with assets less than $100 million. As the financial crisis was unfolding and the serious economic recession began, these numbers show our largest institutions were poorly positioned, leading to the extraordinary assistance by the federal government to protect the financial system. Even with this assistance, this differential continues today with the largest institutions holding considerably less capital than the overwhelming majority of the industry.

Last year, the Federal government took unprecedented steps to protect the financial system by providing capital investments and liquidity facilities to our largest institutions. Financial holding company status was conferred on a number of major investment banks and other financial concerns with an alacrity that was jaw-dropping. We trust the officials responsible took the action they believed necessary at that critical time. However, Federal policy has not treated the rest of the industry with the same expediency, creativity, or fundamental fairness. Over the last year, we have seen nearly 300 community banks fail or be merged out of existence, while our largest institutions, largely considered too big to fail, have only gotten bigger. State officials expect this trend to continue, with an estimated 125 additional unassisted, privately negotiated mergers due to poor banking conditions.

Additional capital, both public and private, must be the building block for success for community and regional banks. While TARP has provided a source of capital for some of these institutions, the process has been cumbersome and expensive for the community and regional banks, whether they actually received the investment of funds or not. There has been a lack of transparency associated with denial of a TARP application, which comes in the form of an institution being asked to withdraw. This should of deep concern to Congress. If TARP is to be an effective tool to strengthen community and regional banks, the Treasury must change the viability standard. We should provide capital to institutions which are viable **after** the TARP investment. Expanded and appropriate access to TARP capital will go a long way to saving the

FDIC and the rest of the banking industry a lot of money. To date, this has been a lost opportunity for the Federal government to support community and regional banks and provide economic stimulus.

There are positive signs private capital may be flowing into the system. For the six months ending June 30, 2009, over 2,200 banks have injected $96 billion in capital. While capital injections were achieved for all sizes of institutions, banks with assets under $1 billion in assets had the smallest percentage of banks raising capital at 25%.

There has been and, to our knowledge, there still is a concern among our federal colleagues with regard to strategic investments in and acquisitions of banks, both through the FDIC resolution process and in negotiated transactions. While these concerns are understandable, we believe they must be measured against the consequence of denying our banks this source of capital. It is our view that Federal policy should not unnecessarily discourage private capital from coming off the sidelines to support this industry and in turn, the broader economy.

SUPERVISION DURING THE CRISIS

There are very serious challenges facing the industry and us as financial regulators. State regulators have increased their outreach with the industry to develop a common understanding of these challenges. Banks are a core financial intermediary, providing a safe haven for depositors' money while providing the necessary fuel for economic growth and opportunity. While some banks will create—and have created—their own problems by miscalculating their risks, it is no surprise that there are widespread problems in banks when the national economy goes through a serious economic recession.

We will never be able, nor should we desire, to eliminate all problems in banks; that is, to have risk-free banking. While they are regulated and hold the public trust, financial firms are largely private enterprises. As such, they should be allowed to take risks, generate a return for shareholders, and suffer the consequences when they miscalculate. Over the last year, we have watched a steady stream of bank failures. While unfortunate and expensive, this does provide a dose of reality to the market and should increase the industry's self-discipline and the regulators' focus on key risk issues. In contrast to institutions deemed too big to fail, market discipline and enhanced supervisory oversight can result in community and regional banks that are restructured and strengthened.

Recognizing the Challenges

The current environment, while providing terrific challenges with credit quality and capital adequacy, has also brought an opportunity for us to reassess the financial regulatory process to best benefit our local and national economies. To achieve this objective, it is vital to step back and make an honest assessment of our regulated institutions, their lines of business, management ability, and capacity to deal with economic challenges. This assessment provides the basis for focusing resources to address the many challenges we face.

With regard to financial institutions, as regulators we must do a horizontal review and engage in a process of "triage" that divides our supervised entities into three categories:

I. Strong
II. Tarnished
III. Weak

Strong institutions have the balance sheets and management capacity to survive, and even thrive, through the current crisis. These institutions will maintain stability and provide continued access to credit for consumers. Further, these institutions will be well-positioned to purchase failing institutions, which is an outcome that is better for all stakeholders than outright bank failure. We need to ensure these institutions maintain their positions of strength.

Tarnished institutions are under stress, but are capable of surviving the current crisis. These institutions are where our efforts as regulators can make the biggest difference. Accordingly, these institutions will require the lion's share of regulatory resources. A regulator's primary objective with these institutions should be to fully and accurately identify their risks, require generous reserves for losses, and develop the management capacity to work through their problems. We have found that strong and early intervention by regulators, coupled with strong action by management, has resulted in the strengthening of our banks and the prevention of further decline or failure. By coordinating their efforts, state and federal regulators can give these banks a good chance to survive by setting appropriate standards of performance and avoiding our understandable tendencies to over-regulate during a crisis.

Weak institutions are likely headed for failure or sale. While this outcome may not be imminent, our experience has shown that the sooner we identify these institutions, the more options we will have to seek a resolution which does not involve closing the bank. It simply is not in our collective best interest to allow an institution to exhaust its capital and to be resolved through an FDIC receivership, if such an action can be avoided. Institutions we believe are headed toward almost certain failure deserve our immediate attention. This is not the same as bailing out, or propping up failing institutions with government subsidies. Instead, as regulators our goal is an early sale of the bank, or at least a "soft landing" with minimal economic disruption to the local communities they serve and minimal loss to the Deposit Insurance Fund.

AREAS REQUIRING ATTENTION

This is the time for us to be looking forward, not backwards. We need to be working to proactively resolve the problems in the banking industry. To do this, we need to ensure our supervisory approach is fair and balanced and gives those banks which deserve it the chance to improve their financial positions and results of operations. The industry and regulators must work together to fully identify the scope of the problems. However, I believe we need to consider the response which follows the identification. We should be tough and demanding, but the response does not need to send so many banks toward receivership. A responsive, yet reasonable approach, will take a great deal of time and effort, but it will result in less cost to the Deposit Insurance Fund and benefit communities and the broader economy in the long-run. I would like to highlight a few areas where I have concerns.

<u>Increase Access to Capital</u>

First, as discussed earlier, we need to allow capital to flow into the system. There is a significant amount of capital which is seeking opportunities in this market. We need to encourage this inflow through direct investments in existing institutions and the formation of new banks. To the extent that private investors do not themselves have bank operating experience or intend to dismantle institutions without consideration of the social and economic consequences, such shortcomings can and should be addressed by denial of holding company or bank applications or through operating restrictions in charters or regulatory orders. Where private equity groups have employed seasoned management teams and proposed acceptable business plans, such groups should be granted the necessary regulatory approvals to invest or acquire. While we cannot directly fix the capital problem, we should ensure the regulatory environment does not discourage private capital.

Expedite Mergers

Second, we need to allow for banks to merge, especially if it allows us to resolve a problem institution. Unfortunately, we have experienced too many roadblocks in the approval process. We need more transparency and certainty from the Federal Reserve on the process and parameters for approving mergers. To be clear, I am not talking about a merger of two failing institutions. Facilitating the timely merger of a weak institution with a stronger one is good for the system, good for local communities, and is absolutely the least cost resolution for the FDIC.

Brokered Deposits

Third, over the last several years the industry has explored more diversified funding, including the use of brokered deposits. Following the last banking crisis, there are restrictions for banks using brokered deposits when they fall below "well capitalized." I appreciate the efforts of FDIC Chairman Bair in working to provide more consistency and clarity in the application of this rule. However, I am afraid the current approach is unnecessarily leading banks to fail. We allowed these banks to increase their reliance on this funding in the first place, and I believe we have a responsibility to assist them in gradually unwinding their dependency as they work to clean up their balance sheet. My colleagues have numerous institutions that could have benefited from a brokered deposit waiver granted by the FDIC. As noted above, many of the recent failures of community and regional banks have been the result of a sudden and precipitous loss of liquidity.

Open Bank Assistance

Fourth, the FDIC is seriously constrained in providing any institution with open bank assistance. We are concerned that this may be being too strictly interpreted. We believe there are opportunities to provide this assistance which do not benefit the existing shareholders and allows for the removal of bank management. This is a much less disruptive approach and I believe will prove to be much less costly for the FDIC. The approach we suggest was essentially provided to Citibank and Bank of America through loan guarantees without removing management or eliminating the stockholders. As discussed previously, we believe that the Capital Purchase Program under TARP can be a source of capital for transactions that restructure banks or assist in mergers to the same effect. We are not suggesting that such support be without conditions necessary to cause the banks to return to health.

Prompt Corrective Action

Finally, Congress should also investigate the effectiveness of the Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act in dealing with problem banks. We believe there is sufficient evidence that the requirements of PCA have caused unnecessary failures and more costly resolutions and that allowing regulators some discretion in dealing with problem banks can assist an orderly restructuring of the industry.

LOOKING FORWARD

There will be numerous legacy items which will emerge from this crisis designed to address both real and perceived risks to the financial system. They deserve our deliberate thought to ensure a balanced and reasoned approach which provides a solid foundation for economic growth and stability.

The discussions around regulatory reform are well underway. We would do well to remember the instability of certain firms a year ago which put the U.S. financial system and economy at the cliff’s edge. We must not let the bank failures we are seeing today cloud the real and substantial risk facing our financial system—firms which are too big to fail, requiring extraordinary government assistance when they miscalculate their risk.

We need to consider the optimal economic model for community banks, one that embraces their proximity to communities and their ability to engage in high-touch lending. However, we must ensure lower concentrations, better risk diversification, and improved risk management. We need to find a way to ensure banks are viable competitors for consumer finance and ensure they are positioned to lead in establishing high standards for consumer protection and financial literacy.

We must develop better tools for off-site monitoring. The banking industry has a well-established and robust system of quarterly data reporting through the Federal Financial Institutions Examination Council's Report of Condition and Income (Call Report). This provides excellent data for use by all regulators and the public. We need to explore greater standardization and enhanced technology to improve the timeliness of the data, especially during times of economic stress.

Over the last several years, the industry has attracted more diversified sources of funding. This diversification has improved interest rate risk and liquidity management. Unfortunately, secured borrowings and brokered deposits increase the cost of resolution to the FDIC and create significant conflicts as an institution reaches a troubled condition. We need to encourage diversified sources of funding, but ensure it is compatible with a deposit insurance regime.

We need to consider how the Deposit Insurance Fund can help to provide a counter-cyclical approach to supervision. We believe Congress should authorize the FDIC to assess premiums based on an institution's total assets, which is a more accurate measure of the total risk to the system. Congress should revisit the cap on the Fund and require the FDIC to build the Fund during strong economic times and reduce assessments during period of economic stress. This type of structure will help the entire industry when it is most needed.

CONCLUSION

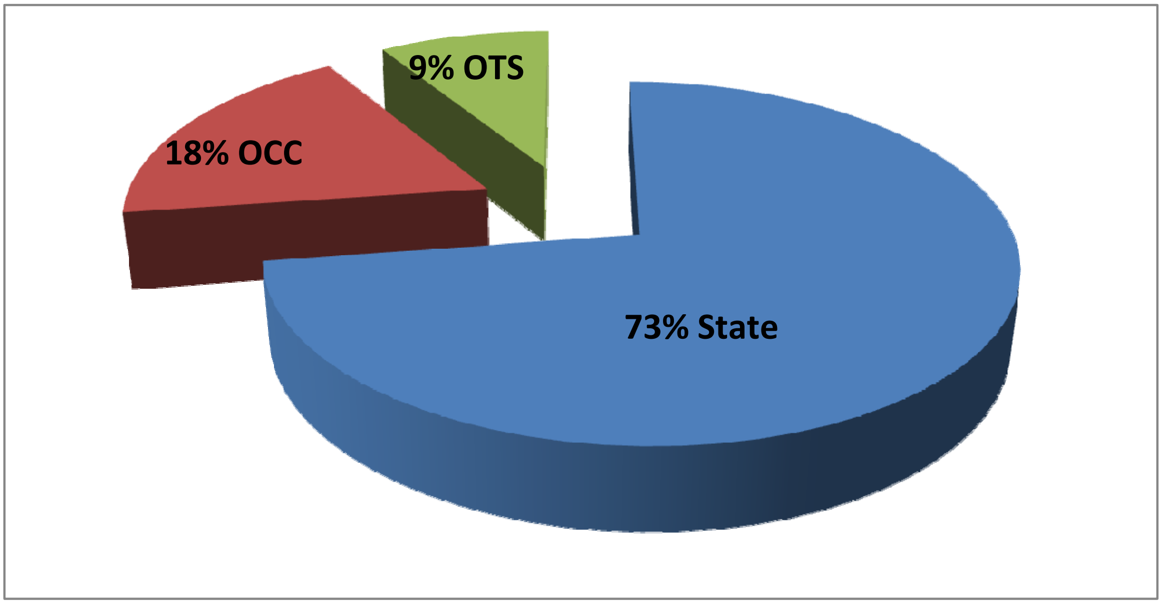
The banking industry continues to face tremendous challenges caused by the poor economic conditions in the United States. To move through this crisis and achieve economic stability and growth, members of Congress, state and federal regulators, and members of the industry must coordinate efforts to maintain effective supervision, while exercising the flexibility and ingenuity necessary to guide our industry to recovery.

Thank you for the opportunity to testify today, and I look forward to any questions you may have.

Exhibit A

Charters By Type

As of 6/30/2009

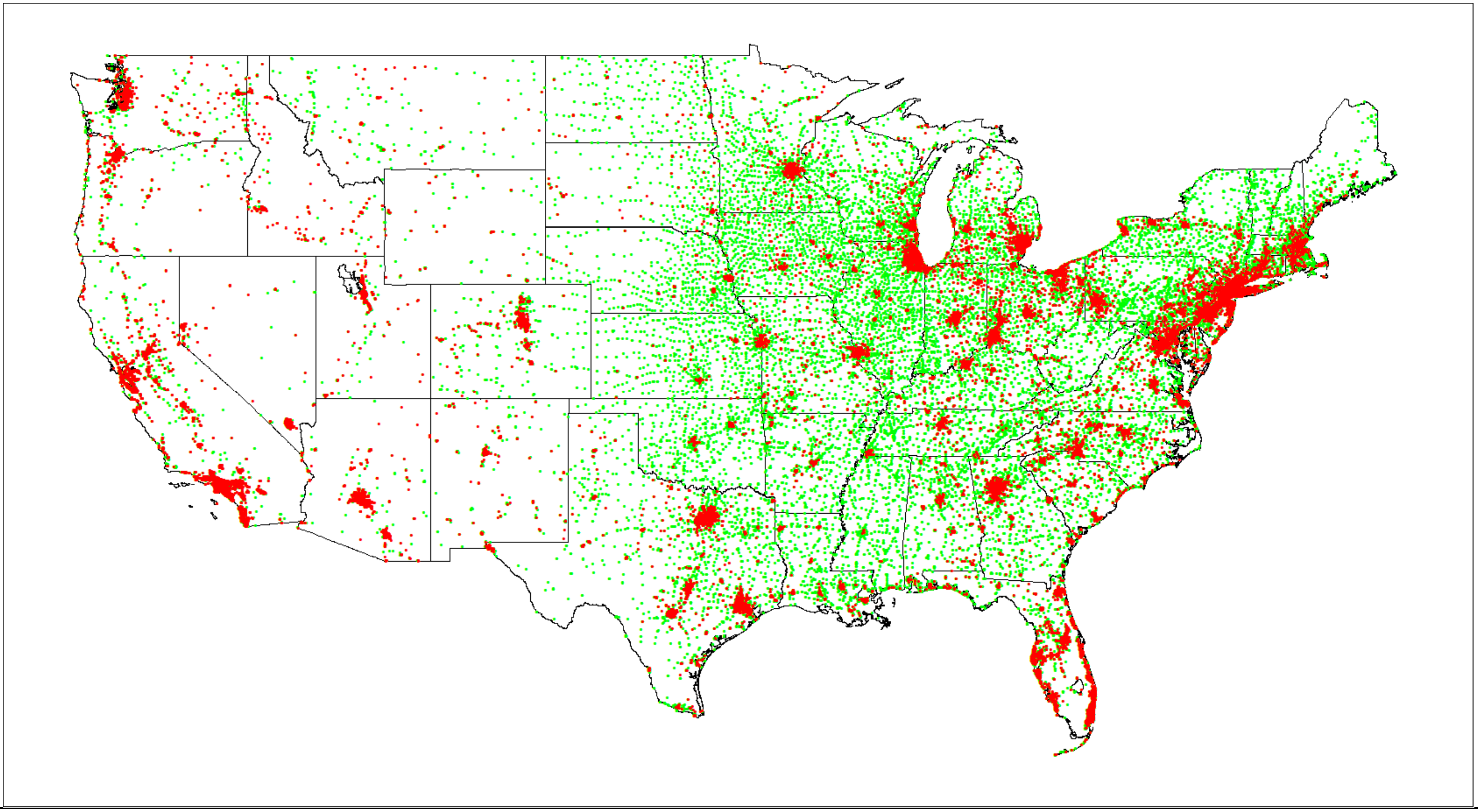


Numbers of Charters by Authority

	STATE	OCC	OTS	TOTALS
6/30/2009	5,968	1,508	728	8,204
12/31/2008	6,034	1,540	740	8,314
12/31/2006	6,216	1,723	768	8,707
12/31/2000	6,607	2,231	915	9,753
12/31/1995	7,676	2,858	1,171	11,705
12/31/1992	8,388	3,593	1,386	13,367

Exhibit B

Branch locations of Top 7 (red) overlaid on all others (green) as of March 16, 2009



FinPro
Building value together