



PENNSYLVANIA ASSOCIATION OF COMMUNITY BANKERS

THE VOICE FOR COMMUNITY BANKING IN PENNSYLVANIA SINCE 1876

Re: White Paper to Support PACB Letter to President-elect Obama

I. Purpose of this White Paper.

The purpose of this White Paper is to present to President-elect Obama the Pennsylvania Association of Community Bankers' Recommendations and Possible Solutions to Assist in Solving the Problems of the Banking and Mortgage Banking Industry. These recommendations are stated in the context of the current challenging economic situation facing our Nation.

The main part of this White Paper containing our recommendations is Section IV titled "PACB's Recommendations and Possible Solutions to Assist in Solving the Problems of the Banking and Mortgage Banking Industry." In summary, our recommendations are as follows:

1. **Address "Too Big To Fail" to protect the taxpayers and the overall economy.**
 - a. **Break up the Big Banks or effectively mitigate the systemic risk of the Big Banks.**
 - b. **Establish a Special Federal Regulator for banks posing systemic risks.**
 - c. **Assess a risk-based FDIC premium to cover potential systemic disasters.**
 - d. **Establish the Office of Assistant Secretary of Treasury for Community Banking.**
2. **Regulate the unregulated and tax all financial firms alike.**
3. **Return to cost based accounting and disclosure of fair value through the notes to the financial statements.**
4. **Maintain separation of banking and commerce and charter choice.**
5. **Improve market disclosures and rating agency practices.**
 - a. **Improve market transparency.**
 - b. **Require market rating agencies to perform due diligence and hold them accountable for their ratings.**
6. **Implement GSE reform and reinforce the SBA Program.**
 - a. **Prohibit Fannie Mae and Freddie Mac from purchasing non-conforming mortgages.**
 - b. **Reinforce the FHLB system as the primary provider of bank liquidity.**
 - c. **Temporarily expand Federal Reserve funding on equal terms for Community Banks.**
 - c. **Revitalize the SBA.**
 - d. **Put lending back in the hands of banks, where existing regulations protect the consumer.**
7. **Think outside the box and stimulate discussion and debate on:**
 - a. **Giving regulators tools to support weakened financial firms without losing taxpayers dollars.**

- b. Promoting the Federal Reserve Bank to use new broader powers to influence long-term interest rates by becoming a temporary bankers' bank in economic emergency circumstances versus the lender of last resort.**

As stated, these Recommendations are discussed in greater detail in Section IV below.

II. Background on the Pennsylvania Association of Community Bankers.

We represent the Community Bankers in the Commonwealth of Pennsylvania. Our constituency totals approximately 150 banks, savings banks, and saving and loan associations with approximately 40,000 employees. As the voice for Community Banking in Pennsylvania, we appreciate the support this committee has given to our industry during this current session and in previous years. We know you recognize and share our appreciation for what Community Banks do each and every day in their local communities. Collectively, we represent over \$90 billion being invested and reinvested across this Commonwealth. We have survived wars, depressions, recessions, boom markets and bust markets and continue to be anchors on the Main Streets of Pennsylvania towns and cities. We are unique in such exclusive representation. Our Community Banks did not originate or purchase subprime mortgages. We are to be distinguished from Big Banks including those "Too Big To Fail." (Pursuant to the "Too Big To Fail" doctrine, the federal government can, at its discretion, rescue any failed Big Bank when continued operation of such Big Bank is deemed by the government as essential to providing adequate banking service in the community.) We are to be distinguished from large credit unions that are operated more like commercial banks, not as true cooperatives, and that do not pay taxes. We are to be distinguished from non-depository mortgage bankers and brokers that originated many of the no doc/low doc subprime mortgage loans that, along with aggressive securitization of those loans, precipitated the current economic crisis.

Our Community Banks are local, responsive, responsible, and community oriented. We know our customers. We pay taxes. We pay deposit insurance premiums. We continue to carefully lend and underwrite our loans by conducting real and meaningful due diligence on our prospective borrowers. We cooperate with the ICBA at the national level.

III. Summary Background on the Problems for the Mortgage Banking Industry and Banking Industry - From Subprime Mortgage Crisis to a Broader Economic Crisis: The Perfect Storm.

The Perfect Storm was a convergence of new financial products (most of which were aggressively securitized, but were poorly underwritten), a lack of transparency of the market risks associated with those products, a rating agency system that failed to identify those risks, an accounting system that failed to properly account for or disclose those risks, and a regulatory system that failed to appreciate through appropriate regulation or to identify those systemic risks. There were too many parties that either made sizable bonuses at each step of the process or purchased those securities or were borrowers who pinned their hopes on ever-increasing real estate prices and expected to reap above average rates of return to slow down before the train wreck. Ultimately, there was a lack of leadership at some of the Big Banks that played a substantial role in causing the subprime mortgage crisis. What Big Bank's or Wall Street Investment Bank's senior management team from 2004 through 2007 was going to stop a process that was producing sizable annual bonuses to the entire spectrum of employees from loan

originators to account executives to the CEOs as well as record profits to shareholders? These senior management teams approved, when not otherwise prohibited by regulation, borrowings that produced leverage ratios in the mid-thirties and in many cases, investments in those very securities whose values have so precipitously fallen during the last year. The resulting economic collapse of several credit markets necessary to maintain our economic system required the federal government and the Federal Reserve to take extraordinary actions to prevent a total collapse of those markets, but by doing so had to rely on the "Too Big To Fail" Doctrine to address those systemic risks. While such actions in the short term may have been necessary, we believe the long term impact to our free markets, if those short term policies are continued, will lead to distortions in our credit markets and will ultimately be detrimental to our country. The country is best served by a financial intermediary system that primarily has its own "skin in the game," so that it is economically motivated to properly underwrite loans and understand the inherent risks in its portfolios rather than only being liable for breaches of representations and warranties as each part of the financial product is passed down the line to the ultimate purchaser of a securitized loan or other financial product. The underpinning of this Perfect Storm included not only subprime mortgages, but also other types of securitized loans, commercial paper, complex interest derivatives improperly used, and credit default swaps. Each has played its own unique part in this Perfect Storm.

From the Community Banker perspective, the current economic crisis principally began with subprime mortgage products. There was greed and/or bad judgment in the issuance, acceptance, rating, and underwriting of subprime mortgages by borrowers, investors, investment bankers, rating agencies, insurance companies, and Big Banks. There was a lack of oversight by regulators and securitizations by Fannie Mae, or Freddie Mac, which were taken into conservatorship in 2008, the other GSEs and the private sector that contributed to the subprime mortgage availability and tremendous volume which then itself contributed to the housing bubble of continuing increasing home prices. This subprime mortgage debacle has resulted in huge taxpayer, stockholder, and home borrower losses as well as closed and bailed out banks, insurance companies, and investment banker firms. The subprime mortgages allowed certain sectors of the financial services industry and investors to earn huge income and fees, and allowed many borrowers to acquire houses that in the end they could not really afford and others to engage in pure speculation in the real estate market.

There was a lack of proper mortgage loan underwriting from no doc/low doc mortgage loans originated by non-depository mortgage lenders and brokers which either sold those loans directly to Wall Street investment banks or were part of Big Banks and their affiliates' own securitization programs. There was a lack of regulation of banks, particularly Big Banks including some of which are known as "Too Big To Fail," resulting in their unsafe and unsound massive originations through non-depository affiliates of junk subprime mortgages and purchases of junk subprime mortgage securitizations that had inaccurately high ratings from rating agencies. Fannie Mae and Freddie Mac went beyond their mission to support the housing market. Fannie, Freddie, Big Banks, and institutional investors provided a secondary market for greed and mischief in the form of the sale of junk subprime mortgages.

Banks owning shares in Fannie and Freddie were harmed when the real value of the securitizations was discovered as they engaged in more and more risky secondary home mortgage market purchase and securitization activities by purchasing subprime home mortgages.

Federal banking regulators at various times recommended the ownership of Freddie and Fannie securities by Community Banks. All companies underwriting junk subprime mortgage securitizations were harmed by relying on inaccurately high ratings from rating agencies that did not perform proper due diligence when reviewing prospective securitization pools. This was caused in part because the default projections were based on historic default experiences from portfolios with different underwriting standards.

Investment bankers caused great harm to institutional and individual investors by securitizing junk subprime mortgages with inaccurately high ratings from rating agencies and selling them to the world, including America's largest banking institutions. Also, both the Big Banks and investment banks that packaged and securitized these subprime mortgages could not resist the pressure of maintaining short term profits and purchased these securities for their own portfolios.

Big Banks, meaning those deemed "Too Big To Fail," bought the subprime home mortgage securitizations to their detriment. But Community Banks neither originated nor purchased subprime mortgages, and did not cause the subprime mortgage meltdown.

Reliance on rating agencies that no longer engaged in meaningful due diligence review of mortgage securitizations caused great harm to the investors in those securitizations and to stockholders of institutional investors, public and private, from big banks to holders of Fannie and Freddie stock.

Barely regulated non-depository mortgage lenders and brokers who were allowed or were not stopped from originating no doc/low doc loans were the fissure in the financial system that was subsequently exploited by investment banks, rating agencies, insurance companies, and Big Banks, all of which received huge fee income until the bottom fell out of the subprime mortgage market and its multiple securitization pools. There was no recognition of the systemic risk by either regulators or the rating agencies. As a result, neither the regulatory system nor market forces acted as a brake to the Federal Reserve's generally expansive monetary policy.

There is federal funding to other types of non-depository lenders that creates an uncompetitive, uneven playing field against Community Banks. GMAC, the financing affiliate of General Motors and Cerebus that was approved by order of the Federal Reserve issued December 24, 2008 to become a bank holding company with GMAC Bank converted from a Utah industrial bank to a commercial bank, received \$5 billion in Treasury Asset Recovery Program ("TARP") funds from the U.S. Treasury which provided an additional \$1 billion to General Motors itself. Press reports indicate that GMAC said it would begin making loans immediately to borrowers with credit scores of 621 or higher, which is substantially less than the 700 minimum score that GMAC previously used. General Motors indicated that GMAC would offer a new round of low-rate financing, including zero percent interest on some models. If this lending were done by the commercial bank now owned by GMAC, such lending program would in our view violate the prohibitions in Section 23A of the Federal Reserve Act against transactions with affiliates. Assuming this lending program is done by GMAC itself or a non-depository subsidiary under the statutory authority in the Federal Reserve's Reg Y, we still question whether such a lending program would meet the Federal Reserve's general "safe and

sound practices” requirement. Such favored lending by the Treasury to a non-depository car lender newly in bank holding company structure instead of to Community Banks demonstrates an uncompetitive environment in which large non-depository lenders affiliated with large commercial entities receive TARP money instead of providing TARP money to Community Banks that have not already received a TARP infusion of funds. Lowering lending standards will result in bad loans being originated to less qualified borrowers, which in turn will result in defaulted car loans potentially in the volume that could cause GMAC to fail. But if the government deems GMAC to be “Too Big To Fail,” then the government will bail out GMAC in the future. Community Banks cannot originate zero interest rate car loans to low credit quality borrowers or else the Community Banks would be criticized by their banking regulators because such zero percent interest car lending would constitute an unsafe or unsound lending practice. Such an uneven playing field is uncompetitive. To be fair, GMAC and any other non-depository lenders should be made subject to safety and soundness standards and regulatory oversight to the same extent as Community Banks when it comes to originating loans.

Borrowers took on more debt mortgage than they could handle from subprime mortgage loans. When the artificially low, adjustable, teaser interest rates later were locked in at a higher fixed rate, borrowers could no longer handle the home mortgage loan. The low interest rates at the origination of the subprime mortgage loans led to a broader economic crisis, resulting in a housing bubble of inflated home prices.

The results of the subprime mortgage crisis leading to the broader economic crisis include the following items:

1. Adjustable teaser low rate mortgage resets to higher rates that could not be afforded by the home buyers who were financed with subprime mortgages.
2. There has been a massive increase in delinquent home mortgage loans resulting in a vast increase in home mortgage foreclosures.
3. A huge increase in personal bankruptcies is occurring due in large part to the resetting of subprime mortgage interest rates from the initial teaser rate to the substantially higher interest rates in the midst of record layoffs and unemployment.
4. Overpriced home values are now plummeting due to the bursting of the housing bubble of inflated home prices. The cause of the sudden decrease in home values is from the massive numbers of delinquencies in home mortgages including subprime mortgages.
5. Defaulted home mortgage borrowers who financed with subprime mortgages and/or are losing their jobs in the current difficult economy are "under water" on their mortgage loans and correspondingly are abandoning their homes and their home mortgages.
6. Failed banks and thrifts and bailout packages are costing taxpayers billions of dollars that may or may not be recoverable. Such failures and bailouts are costing the Federal Deposit Insurance Corporation (“FDIC”) deposit insurance fund billions in present and potential liabilities and straining FDIC's future ability to insure deposits. This has led to higher FDIC insurance premiums which have a disproportionate impact on

Community Banks that have conservative business models with lower interest margins.

7. A seven basis point initial increase for 2009 in the FDIC deposit insurance premiums due from Community Banks and larger banking institutions is a direct result of the perceived weakness of large “Too Big To Fail” banking and thrift institutions.
8. Fannie Mae and Freddie Mac had to be taken over and bailed out by the federal government, costing taxpayers and investors in Fannie and Freddie stock billions of dollars in outright losses.
9. Emergency government action has been taken by the U.S. Congress, FDIC, Treasury Department, Federal Reserve, Federal Home Loan Banks (“FHLB”), Federal Housing Administration (“FHA”), Fannie Mae, Freddie Mac, and state governments. Such emergency government action includes the following:
 - Housing and Economic Recovery Act of 2008.
 - Emergency Economic Stabilization Act of 2008 (provides for TARP money).
 - FDIC temporary increase in deposit insurance from \$100,000 to \$250,000.
 - Bank capital infusion from the Treasury Asset Recovery Program.
 - FDIC Temporary Liquidity Guarantee Program (Senior Unsecured Debt Guarantee Program; Unlimited Deposit Insurance for Non-Interest Bearing Transaction Accounts Program).
 - Various federal and state mortgage refinance programs for homeowners in default on their home mortgages.
 - There is a cost of funds problem for bankers seeking loans from the FHLB and other funding sources.
 - Losses to financial services industry have resulted, negatively affecting banks, insurance companies, investment banks, non-depository mortgage lenders, and other financial services firms.
 - Loan demand has slowed.
 - Willingness to lend has decreased.
 - Consumer confidence has fallen.
 - The general economy is suffering from lack of demand: from Main Street to Wall Street, including the financial services, automobile, housing, and retailer industries to name a few.

IV. PACB’s Recommendations and Possible Solutions to Assist in Solving the Problems of the Banking and Mortgage Banking Industry.

- 1. Address “Too Big To Fail” to protect the taxpayers and its impact on the overall economy.**

Banking institutions that are “Too Big To Fail” are those which upon failure would purportedly cause systemic risk to the banking industry and potentially the economy at large. There are a small number of banking

institutions that are of such a substantial size that they are viewed or are known as “Too Big To Fail.” Of the 8,403 FDIC-insured commercial banks in the United States, the 4 largest banks now control almost 40% of deposits. The 10 largest banks in the nation still control 42% of all bank deposits. The 4 largest banks in the nation control 55% of all banking assets in the United States.

The “Too Big To Fail” doctrine essentially states that when a bank gets to a certain size, it cannot be permitted to fail which is a means of protecting other market participants. In recent months and presently, we are watching what happens when a large corporation such as Lehman Brothers fails and the markets negatively react. One corollary to that choice is that 35-to-1 leverage ratios will be a thing of the past as each holding company will be subject to Federal Reserve capital requirements. The only limitation that was on leverage ratios of non-depository financial institutions was what the market would accept in lending to them. No longer will those senior management teams be allowed to place such large bets on interest rate movements implicit in their respective business models. As evidenced by Bear Stearns and AIG, the “Too Big To Fail” Doctrine has been expanded to include investment banks, insurance companies and their holding companies. Evidence that there is too much Big Bank, investment bank, or insurance company systemic risk on our markets is found in the numerous taxpayer-funded financial institution bailouts that have occurred including the TARP Program issued pursuant to the Federal Emergency Economic Stabilization Act of 2008 through the U.S. Treasury Department.

The existing TARP Program was sold to the public by stating that a huge capital injection was needed to start Main Street lending by assisting some weakened financial giants. This message was clearly sent when the Administration required the top ten financial firms to take capital so as not to disclose which ones were weak. The reality is that after capital is pushed upon the nation’s largest banking companies, the banking regulators are now recommending only strong banks be given the remaining capital and encouraging them to buy other banks. The result is, the large become even larger and the “Too Big To Fail” risk grows even more. In some instances, we believe TARP capital was given with the expectation that it would be used to fund a particular acquisition. This changes the tenor of the program from purporting to support general economic activity to the Federal government picking winners and losers in the banking industry beyond the historic role of the FDIC closing depository financial institutions that fail to meet capital requirements or other statutory standards and either merging or otherwise selling the assets and liabilities to other depository institutions by the processes and procedures provided by current law.

While the federal government may want to encourage lending by banking institutions, such banks receiving TARP capital will not originate loans that may be considered risky under the current economic climate when lending rules still require loans to be made in a safe and sound manner by regulators. Lending requirements in today’s economy would automatically make a wide range of loans substandard when originated by banks. But GMAC is provided federal

TARP money to originate loans to persons with relatively low credit scores (as low as 621, lowered from GMAC's previous minimum 700 credit score requirement) at potentially zero interest rate, which for banks would be unsafe, unsound, and unprofitable. Since GMAC works in tandem with a commercial entity, General Motors Corporation, the zero interest rate can be factored as a net win when originated in conjunction with the sale of a motor vehicle manufactured by General Motors. Such favored federal funding of GMAC when there are hundreds of Community Banks available to originate car loans is uncompetitive and unfair to Community Banks. In short, TARP money is being used as a subsidy for GMAC and General Motors, which operates to the competitive detriment of Community Banks.

This preference for federal capital injections into Big Banks viewed by the federal government as "Too Big To Fail" creates a competitive disadvantage for the Community Banks that are the real Main Street banks. The Community Banks did not create the systemic risk that plagues the United States today. It is Wall Street that stopped lending while Main Street has continued to lend. With the capital injection, the Big Banks become larger and increase systemic risks, if that capital is not used wisely. With few federal guidelines, there are no assurances that the capital will be used for increasing lending as opposed to acquisitions of competitor banking institutions. It is interesting to note that when Congress made inquiries of the uses of the new capital, the response was either "No response," or "We don't track that information."

Once in the capital base, the use of funds by a senior management team under our economic system is to put capital to its best use for the benefit of its shareholders. If Congress wanted lending to increase, the TARP should have been so designed. There is a little of a chicken and egg issue for the Big Banks in that even with increased capital, lending should only be increased if it can be done in a safe and sound manner. Issues with the rating agencies and accounting system make it harder to evaluate credit requests in the current market. **Now, the poorly run Big Banks, the new investment banks, and insurance companies structured into bank holding companies are rewarded so that they can make the same or new mistakes again, now using taxpayer money as their capital injections from the U.S. Treasury Department.** We believe a better policy would be to provide capital to the small, well-run Community Banks so that they can handle more of the economy's lending needs without creating systemic risk. This is because Community Banks have closer ties to their borrowers and are in a better position to evaluate and monitor risks. While credit needs to be available to all segments of our economy, Community Banks are best situated to provide safe and sound lending to Main Street. Long term policies that favor Big Banks over Community Banks, in our view, effectively undermines providing credit to Main Street.

In addition to the short term negative impact on increasing current lending, as evidenced by the propensity of the Community Banks versus the Big Banks to lend, there are long term implications if the "Too Big To Fail" policy is

continued. The primary impact is a cost of funds issue to support future activity. Make no mistake about it, if the market perceives that any institution is “Too Big To Fail,” its costs of funds will ultimately be lower to reflect that implicit governmental guarantee.

Another aspect of “Too Big To Fail” is the commercial paper market and the Federal Reserve’s recent decision to purchase or guarantee commercial paper. While we understand the necessity of maintaining the viability of this market and its importance to providing short term credit to industry and other firms, including some Big Banks and investment banking firms, these programs are generally a subsidy for this funding source. If continued in the long term, government indirect guarantees or purchases of commercial paper (thereby making the firms issuing it “Too Big To Fail”) will widen the cost of funds differential between Big Banks and Community Banks with its correspondent impact on lending to Main Street unless the end users of this credit bear the true cost of the subsidy. The banking system as a whole lost this short term lending market in the late 1960s when the then current interest rate regulations made it unprofitable to provide that service and Wall Street created the commercial paper market as a substitute source of credit for this form of unsecured lending. In addition, it is unfair for investors in money market funds to unknowingly take on such huge risks from the commercial paper short-term loans that comprise those money market funds. Federal guarantees of commercial paper for firms deemed “Too Big To Fail” will lead to bad investments in weak commercial paper resulting in defaults and a larger commercial paper problem underwritten by the Treasury (meaning the taxpayers). Will we ever learn that guarantees for “Too Big To Fail” entities will make those entities much larger and much less responsible and result in larger future bailouts at taxpayer expense?

The contribution of Community Banks to small business lending is significant, and should not be overshadowed or ignored relative to lending by the Big Banks. Small business lending are those loans of \$1 million or less to business entities. **Community Banks overall provide 12% of the small business lending in the United States.** The share of the number of larger small business loans (\$100,000 - \$1 million) made by multi-billion dollar lending institutions has declined since 2005, from 42% to 32.3 % in 2007. This gap is being filled by Community Banks and lenders other than Big Banks. Accordingly, Community Banks should be allowed an even playing field in terms such as: (i) being allowed timely access to TARP money, and (ii) requiring non-depository lenders such as GMAC Bank Holding Company and its non-depository affiliates to be subject to the same safety and soundness and lending rules as Community Banks. Regulatory pressure, including fear of regulatory enforcement, prohibits Community Banks from originating loans to persons or small businesses that are “on the edge” in terms of credit quality. To jump start lending, some regulatory leeway equal to the leeway available to non-depository lenders should be provided to Community Banks. In the alternative, non-depository lenders should be made subject to lending and safety and soundness rules as strict as those applicable to Community Banks so that Community Banks

can be allowed to compete on a fair and even playing field with the non-depository lenders such as GMAC.

We have the following recommendations and possible solutions to the “Too Big To Fail” problem.

a. Break up the Big Banks or effectively mitigate the systemic risk of the Big Banks.

Allowing banks that are “Too Big To Fail” to merge with troubled banks that are “Too Big To Fail” merely creates a larger “Too Big To Fail” problem that could wipe out the FDIC deposit insurance fund in one fell swoop.

Presently, federal law imposes a ten (10%) percent concentration limit on the total amount of deposits that any one depository institution may hold nationwide and a thirty (30%) percent deposit concentration limit in any single state following an interstate merger transaction. The nationwide deposit concentration limits must be applied not only to banks but also to thrift institutions proposed to be merged with and into banks.

These comments are not meant to prohibit big banks from growing large in foreign markets and being able to compete with foreign banking institutions in those foreign markets. Rather, the concern of Community Banks is the antitrust implication in the domestic market. In that regard, the very generous ten (10%) percent nationwide concentration limit on interstate merger transactions of banks and the thirty (30%) percent statewide deposit concentration limit must be strictly enforced without federal banking regulators using emergency exceptions ultimately to create a larger “Too Big To Fail” banking institution problem. As Citibank straddles the ten percent (10%) national limit, we understand there will be calls to loosen that standard. Those calls should be resisted.

Regarding additional antitrust considerations indirectly related to deposit concentration limits, we note that the U.S. Department of Justice apparently is requiring 50 bank branches of National City Bank in the Pittsburgh area to be sold as a block upon the anticipated acquisition of National City Corporation and National City Bank by PNC Financial Services Group Inc. As is normal in antitrust enforcement, the Justice Department is seeking to prevent an over-concentration of deposits being held in the Pittsburgh area by one financial institution, which is why PNC will have to divest 50 branches of National City Bank. The Justice Department is prohibiting Community Banks from being able to individually bid to acquire bank branches in their existing western Pennsylvania market. This extraordinary block sale requirement is highly unfair and uncompetitive by locking Community Banks out of the bidding for Pittsburgh area branches of National City Bank. Accordingly, we do not see the justification for the Justice Department to require a 50 branch block sale as

part of the PNC Financial Services Group Inc. and National City Corporation proposed merger transaction.

From a business perspective, the government is creating an unfair market condition between Community Banks and Big Banks when a cost of funds federal subsidy is provided to the Big Banks. It is harmful to Community Banks and therefore to the small business to which Community Banks lend when the cost of funds to Big Banks is made cheaper than to Community Banks based on the Federal Reserve providing guarantees of commercial paper issued by Big Banks. Community Banks reasonably anticipate and are beginning to lose market share because of such an uncompetitive cost of funds environment caused by what amounts to federal subsidization of Big Banks' cost of funds. This subsidization of Big Banks is the opposite of a competitive banking environment, as such it does not benefit small business borrowers, and in the aggregate expands the "Too Big To Fail" problem by allowing Big Banks less risk of failure and therefore a larger incentive to originate high risk loans that upon default create a larger risk to the FDIC deposit insurance fund. In other words, the cost of funds subsidy from the Federal Reserve for Big Banks creates a larger risk to the FDIC deposit insurance funds from the potentially higher risk future lending activities of Big Banks.

In conclusion, we recommend that the nationwide and statewide limits on deposit concentration be strictly enforced and that smaller limits be considered. We also recommend a commission be established to study and determine how best to address the problem of banks that are "Too Big To Fail" and their being allowed to become even larger in emergency economic circumstances thereby causing greater systemic risk. The commission should study regulatory burdens relative to the differences between Community Banks and Big Banks. Until such a study is completed, we recommend that the Federal Reserve and the FDIC monitor the "Too Big To Fail" banking institutions for systemic risk and communicate and coordinate such monitoring with other appropriate federal banking regulatory agencies.

b. Establish a special federal regulator for banks posing systemic risks.

The behemoth "Too Big To Fail" systemic risk to the FDIC deposit insurance fund is far in excess of the approximately \$45 billion held (as of September 25, 2008) in the FDIC deposit insurance fund. Accordingly, we recommend that a special federal regulator be established to supervise and ensure safe and sound banking practices from Big Banks that are so large, complex, and far flung that they create systemic risk to the banking industry. We are concerned that such a special regulator not be provided with conflicting powers, such as determining and projecting macroeconomic policy while also having regulatory oversight, examination, and enforcement power over Big Banks. Such conflict of authority is reminiscent of the authority provided to the Federal Home Loan Bank Board before establishment of the Office of Thrift Supervision was precipitated by the savings and loan industry

crisis of the 1980s and early 1990s. If such a conflicting role would be allowed in one special federal regulator, it would need to be specially structured to eliminate conflict of interest between policy-setting for the banking industry, versus regulatory enforcement authority over the Big Banks.

c. Assess a risk based FDIC premium to cover potential systemic disasters.

It is unfair for Community Banks to have to shoulder a disproportionate deposit insurance premium as compared to the premium paid by the Big Banks. It is the Big Banks, not the Community Banks, which originated and purchased subprime mortgages directly or through their affiliates and that presently pose a systemic risk to the banking system and the Federal Deposit Insurance Fund. Among other factors, it is the large size of the “Too Big To Fail” banking institutions that makes them so unwieldy and difficult to operate and regulate that poses systemic risk to the banking industry and the Federal Deposit Insurance Fund.

For 2009, the FDIC is assessing a seven basis point premium increase on Community Banks regarding deposit insurance, and no separate additional premium risk insurance amount against the “Too Big To Fail” banks that are in deep financial trouble. This shows that a disproportionately large amount of the deposit insurance premium is being assessed against Community Banks. Community Banks did not cause the subprime mortgage problem or its subsequent fallout that has negatively affected the Big Banks and large thrift institutions. The IndyMac Bank failure cost the FDIC \$8 billion. The Washington Mutual \$300 billion asset institution being taken into receivership by FDIC and sold to JP Morgan Chase created a larger “Too Big To Fail” problem. When CitiGroup Inc. agreed to acquire the bulk of Wachovia Corporation’s assets and liabilities (before Wells Fargo & Company eventually bid, won, and merged December 31, 2008 with target Wachovia), part of that deal structure was an FDIC loss sharing agreement regarding a pool of Wachovia Bank loans. Specifically, FDIC bravely agreed to absorb any losses beyond the \$42 billion loss threshold for Citigroup Inc. up to the entire \$312 billion pool of Wachovia Bank loans. If the CitiGroup-Wachovia deal had been consummated, and the FDIC would have had to actually provide such agreed-to loss sharing involving the combination of two Big Banks (Citibank and Wachovia), the cost could have reached \$270 billion to the FDIC deposit insurance fund, which would have wiped out the FDIC deposit insurance fund (balance of \$42 billion as of September 25, 2008). Fortunately for the FDIC deposit insurance fund, Wells Fargo & Company came in with a superior bid to buy Wachovia and the Federal Reserve approved the Wells-Wachovia merger which was consummated December 31, 2008. Separately, allowing poor loan underwriting by GMAC in order to jump start car lending and car sales for General Motors and Cerebus (that owns Chrysler) creates a larger “Too Big To Fail” risk now that GMAC has been allowed to form a bank holding company and has been awarded TARP money from the Treasury Department. The point of these examples of

bailouts for Big Banks is that Community Banks are being assessed more than their fair share of deposit insurance premiums and that Big Banks should be required to pay proportionately greater deposit insurance premiums than Community Banks in order to reflect the increased risk that “Too Big To Fail” Big Banks have on the FDIC deposit insurance fund.

These are just some of the examples of “Too Big To Fail” and the potential financial problems it imposes not only the FDIC Deposit Insurance Fund but also on Community Banks that seek to compete and are being prevented from doing so by financial regulations that favor Big Banks.

Based on the foregoing, we recommend a special separate risk-based premium to be paid by Big Banks such as Bank of America, JP Morgan Chase, Wells Fargo, and Citibank to cover and reflect the huge systemic risk that they pose to the FDIC deposit insurance fund and the banking industry and U.S. economy at large.

d. Establish the Office of Assistant Secretary of Treasury for Community Banking.

We are concerned that the focus of the Treasury Department is Wall Street and not Main Street. Treasury appears to be composed at its highest levels by persons with Wall Street experience and who may not have the appreciation or understanding of Main Street that is needed in order to cause positive financial interaction by the federal government with Community Banks. We note the rapid infusion of capital into Big Banks through the TARP Program versus the later infusion to some mid-sized regional type banks and to some Community Banks.

As a solution to the problem of Treasury being more Wall Street focused than Main Street focused, we recommend and request that upon or shortly after taking office that President Obama issue an Executive Order or otherwise establish an Office of Assistant Secretary of the Treasury for Community Banking. Such a new position at Treasury would be established to serve as advisor and advocate for Community Banks within the Treasury Department. We would hope that the establishment of such an office could be followed up with the reduction of regulatory burden to Community Banks as compared with the regulatory burden more properly imposed on the Big Banks that pose a giant systemic risk to the banking industry. For example, there has been a reduction of regulatory burden in the Community Reinvestment Act (“CRA”) area which reflects in part the capacity of small banks versus Big Banks to impact a community with its CRA policies. We would hope to participate in identifying for the Treasury and the federal regulators other areas in which regulatory burden should be reduced for Community Banks. In addition, we recommend that a tiered regulatory structure be created to reflect the differences between Community Banks and the Big Banks.

There are 651 mutual institutions and 2,505 Subchapter S banks nationwide. One of the first tasks should be the issuance of procedural and eligibility guidelines for Subchapter S banks and mutual depository financial institutions to apply for TARP capital infusions. Treasury has yet to issue any such guidelines and thus none of these entities currently has access to TARP capital. This is another example of the disparate treatment between Big Banks and Community Banks. It is unfair for the federal government, through the Treasury Department, to create an unfair playing field in which large investment banks and non-depository lenders such as GMAC received favored treatment to quickly become bank holding companies making them eligible for TARP money which then is quickly provided to them, **while Community Banks such as Subchapter S banks and mutual depository institutions have not yet received TARP money.** It is not easy to understand the federal government providing TARP money to former investment banks and GMAC that have formed bank holding companies approved by the Federal Reserve, versus not providing such TARP money in as timely or at all to date to Community Banks generally with less than \$1 billion in assets that are in Subchapter S or mutual form. The federal government should not provide Big Banks, investment banks, GMAC or other non-depository lenders with favored cost of funds subsidies, regulatory treatment in terms of lending rules, and access to TARP money, unless the same favored treatment is provided to Community Banks. Community Banks should not be forgotten, ignored, or treated as second-tier financial entities by the federal government when we provide so much to our local communities, individuals, and small businesses in terms of lending and other financial services.

2. Regulate the unregulated and tax all financial firms alike.

It is the lack of regulation coupled with industry hubris that allowed no document and low document subprime mortgage loans to be originated by non-depository mortgage bankers and mortgage brokers. It is the same lack of regulation and industry hubris that allowed subprime mortgages to be securitized and sold by investment banks, Fannie Mae, and Freddie Mac, based in part on unrealistically high ratings of the securitization pools from rating agencies and related insurance provided by insurance companies.

Insurance companies and investment banks are not regulated by the federal government to the same extent commercial banks are, and their clients do not understand the organizational risks or the product risks to the extent that they understand them when interacting with commercial bank products. AIG, Bear Stearns, Lehman Brothers, and others are clear illustrations of the risk present in today's markets. The 1999 Gramm Leach Bliley Financial Modernization Act allowed the affiliation between commercial banks, investment banks, and insurance companies to be permitted by federal statute for the first time since such affiliations were prohibited during and following the Great Depression. While such affiliations and general authority are not objected to by the PACB, the

integrity of the financial market and economy now dictates that all financial services businesses be run in a safe and sound manner.

The promotion of safety and soundness standards applicable to banking institutions takes into account the very aggressive styles and higher risk taking motivation and actions of investment banks and large integrated Big Banks versus the conservative and lower risk taking styles of Community Banks. If the financial services industry continues on this combination path of commercial banking, investment banking, and insurance affiliations, then the federal government needs to regulate all financial services businesses at the organizational and product level on a safety and soundness basis similar to commercial bank regulation. In other words, we must assure that the investments of depositors and financial market participants are safe and that investment risks are properly disclosed.

Based on the present financial crisis and the subprime mortgage lending that precipitated it, we recommend that non-depository mortgage lenders and mortgage brokers, investment banks, insurance companies, rating agencies, and credit unions all be made subject to safety and soundness standards similar to those to which commercial banks, including Community Banking institutions, are subject. Also, we recommend that credit unions that act like banks be taxed like banks, which we believe would create a proper even playing field between banks and certain credit unions that act on a scope comparable to banks.

3. Return to cost based accounting and disclosure of fair value through the notes to the financial statements.

As a historical matter for many years, financial statements were prepared using cost basis as the proper accounting method. Academics and others have successfully pushed the accounting profession and the government to migrate from the cost basis to the fair market value accounting basis. Such change has been slow and methodical over the last 20 years. The goal of the fair market value recording of assets and liability is that the investor is provided a more realistic and fair presentation of a firm's financials.

There are two separate ramifications to the fair market value approach that make this approach inappropriate for Community Banks. The first ramification of the fair value approach is that it places an emphasis on valuing the bank as if the bank were only worth the sum of its financial assets at any given point in time. Banks have a long term approach and do not need a daily valuation to confirm their viability. This is contrary to the case for securities broker/dealers regulated by the Securities and Exchange Commission for whom daily valuations carry an important and meaningful regulatory purpose. The accounting approach to reconciling historic cost and current valuation is the concept of impairment. Current accounting principles take into consideration those factual circumstances under which it is appropriate to write down the value of an asset. But not every daily fluctuation in the value of an asset deserves an immediate reflection on a

balance sheet for those banks with a going concern value. Such a system has a disproportionate impact on the disposition of financial institutions that have specific capital requirements. Such volatility makes capital planning difficult. The second ramification of the fair value approach is that many assets, (especially the securitized subprime mortgages) do not have reliable valuations to use. FAS 157 attempts to address this problem but there are still many subjective determinations inherent in that process.

One major problem with solely utilizing fair market accounting is the volatility in the market, which, in turn, would then require adjustments to capital positions on a daily basis. Such volatility in capital requirements would require Community Banks to maintain their balance sheets with assets that are not subject to such volatility, with the net result that there would be less lending or holding of securities that had loans as their underlying assets. This is clearly not in the public interest. If fair value accounting still is a goal for public disclosure purposes, that purpose could be accomplished through footnotes to financial statements without imposing the negative regulatory capital implications. The inference that a fair value (or in essence a liquidation value), at all times, provides a more meaningful and realistic presentation of a Community Bank's financial condition when it has a going concern basis is just misplaced. The FDIC has current statutory authority to deviate from GAAP in its setting of regulatory accounting principles. This is an appropriate situation for the FDIC to use that statutory authorization regardless of what the U.S. Securities and Exchange Commission does.

Another major problem with using fair value accounting is that it makes it very difficult for small business financial statements to be understood by potential lenders seeking to evaluate the financial wherewithal of the small business as a potential borrower. Accounting standards impact financial statements which impact safety and soundness requirements as interpreted by financial institutions and their regulators.

Valuing the assets of a company at fair market value is an estimate, not an exact consistent value. For example, Company A can own half of a joint venture and Company B can own the other half of the same joint venture. Fair market value means we adjust the asset value on the balance sheet each year for each company based upon an appraisal. In industry practice and reality, appraisals for each of the parties in the joint venture would provide different results, depending on factors such as whether the firm is a closely held strong small company, or a much larger company that may or may not be as strong. Factored into the value of the assets held by each company can be items that drive the rate of return assumption to different percentage ranges. Thus, the inherent estimate of fair market value differs from the consistency and lack of volatility present in the cost accounting system. There is value to knowing both the steady and basically absolute original cost of an asset versus the present and potentially volatile subsequent fair market value of the asset. Such value includes that consistent comparisons can be made of different products, assets, and companies, using the

cost accounting method, secondarily supported by notes identifying the fair market value of assets and companies.

Changing the accounting system to cost accounting, with notes indicating the fair market value, could reduce the fear factor that occurs in a volatile market when solely fair market value reductions are considered.

Based on the foregoing, we recommend a return to cost accounting combined with footnotes of fair market value accounting on core financial statements like the balance sheet and the income statement. Such cost accounting practices would constitute a conservative means of valuing assets and investments on a level basis through which comparisons between different companies' financial statements can more easily be made than on a market value basis. Such a change would enhance the disclosure required in financial statements by allowing broader disclosure of the original value of assets and then notes to the financial statements would provide disclosure of the present fair market value of such assets.

4. Maintain separation of banking and commerce and charter choice.

We remain staunchly opposed to combining banking and commercial entities by any ownership affiliation. Combining banking and commerce would feed into the "Too Big To Fail" concern by making banks susceptible to the financial troubles and goals of affiliate commercial entities and vice versa. Community Banks do not believe that it is fair or good for the economy to allow entities such as Wal-Mart or Home Depot to own banking institutions. The steering of commercial loans into high fees and interest rates, or loan conditions inherently protecting the affiliate commercial entity, is a potential negative factor that would harm small business entities seeking loan funds from banks affiliated with large commercial entities. Main Street businesses, which already are having enough difficulty and challenges from behemoth commercial entities, would become subject to unfair competition if they could not access Community Bank lenders who do not have affiliate commercial entities. The banks with commercial entities, and non-depository lenders such as GMAC that is affiliated with General Motors and Cerebus (that owns Chrysler) that have access to the commercial paper market and federal guarantee/subsidy of such commercial paper from the Fed's guarantee thereof, also would have an unfair pricing advantage as compared to Community Banks that do not have the scale to access funds at as low a cost as the behemoth bank-commercial affiliated entities.

Based on the foregoing, we recommend and implore you and Congress to maintain and promote the maintenance of strong walls of separation between banking and commerce.

Charter choice remains a very important feature of the U.S. banking system that Community Banks would like to see remain in place. As background, it is a business decision when members of a Board of Directors of a Community

Bank decide whether to accept a state charter or a federal charter for its banking institution. Times come along when reasons arise to switch charters, depending on all sorts of factors such as: overhead assessments by the regulator, federal versus state statute powers for the banking institution, preference for a regulatory scheme and level of contact that corresponds to the banking business goals of the banking institution, and other factors. Reducing the banking system to only one federal regulatory entity and no state regulatory entities would be very harmful to the Community Banks, many of which prefer to have as their primary regulator either a federal agency such as the Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, or Federal Reserve, versus those that would prefer to have a state banking regulatory agency as primary regulator.

Based on the foregoing, we recommend that charter choice between federal versus state regulatory agencies remain available to the Community Banks.

5. Improve market disclosures and rating agency practices.

Market transparency is the most important component in having an honest and fair financial marketplace. Investors must be allowed to see and evaluate properly prepared and accurate information regarding banking products and investment products. Rating agency practices involving the setting of unrealistically high ratings, without conducting truly meaningful due diligence to determine whether such ratings are warranted, constitute the opposite of market transparency. Much of this problem was the failure to understand the systemic risks. For example, the early securitizations of the subprime mortgages rated by the rating agencies utilized historic default rates for mortgage portfolios that were very differently underwritten. Another example is the failure of the rating agencies to understand the risks inherent in issuing credit default swaps by the investment banks and some insurance holding companies. Due to the private nature of these transactions it was difficult to understand real exposures and under what circumstances collateral would be required to be posted to support those issued obligations. The net result was volatile ranking changes when the real risks became publicly known. As these firms were involved in either issuing commercial paper or underwriting others' commercial paper, that market was also impacted.

The quickly provided federal government guarantees of money market funds comprised of commercial paper assets for investment banks - without any insurance premium being paid or required from the investment banks - exposes the taxpayer to huge potential costs if the money market funds default. The sheer volume of such money market assets as guaranteed by the federal government creates systemic risk to the domestic financial system. Also, while in theory everyone who invests in a money market fund receives a disclosure that it is comprised of unsecured commercial paper, only the large investors (meaning institutional investors such as Big Banks who regularly are involved in the

commercial paper market) understand the risks of such investments. There is tremendous risk to the average investor from money market funds, as evidenced by their decline and the Federal Reserve's quick guarantee of money market funds of financially troubled investment banks. Commercial paper is an opaque problem that is being allowed to grow. Again, it is unfair to Community Banks that pay deposit insurance premiums for money market funds offered by investment banks to be guaranteed by the federal government with no insurance premium being paid by the investment banks since Community Banks are practically precluded from participating in the commercial paper market.

The above are examples of the cumulative nature of systemic risk and the problem of not understanding systemic risk throughout the economy. This is where an effective federal regulator with direct responsibility to measure and understand systemic risk can pay double dividends.

We recommend market disclosure practices that cause disclosure of essential information to be accomplished in a manner that is streamlined, accurate, and useful to investors and other financial firms as they interact and decide whether to invest in various financial products and companies. We also recommend rating agency reform as part of the overall recommendation toward market transparency.

a. Improve market transparency.

Market transparency is a fundamental requirement necessary in order to have healthy trading of banking and investment products.

Risky subprime mortgages and other unsound products created excess demand which drove up the price of houses beyond a sustainable level. The housing bubble occurred because unregulated products allowed the investment bankers' desire for high income to create an opaque market place by inaccurately disclosing the risk associated with the product being created and sold. Wall Street investment bankers downplayed the risk associated with subprime mortgages. Rating agencies did not perform proper due diligence and report such risks when providing ratings that were relied upon by insurance companies and investors including large commercial banking entities. When investors learned that the subprime mortgage products were much more risky than represented, they stopped participating. Then, the mortgage-backed securities market went into freefall, thereby driving down the value of houses in a bursting of the housing price bubble that had existed up to that point.

While we have referenced problems with the subprime mortgage-backed securities market and the lack of market transparency, there also has been a lack of transparency, or opaqueness, as well regarding non-commercial bank money market accounts.

There is a huge risk differential between an unsecured loan and cash or U.S. Treasury securities. This is the lack of transparency or opaqueness that can harm potential investors. A recent example of the truth about this risk is now evident to anyone who owned some of the Primary Reserve Fund. This was the money market fund that “broke the buck” as a result of having a larger position of Lehman Brothers corporate paper. The corporate paper (an unsecured loan) became worthless when Lehman Brothers filed bankruptcy and the fund could no longer guarantee the value at \$1/share. The orders to sell came in and the SEC had to freeze the fund so that the remaining investors would not become subject to a huge portion of worthless commercial paper. Word spread of the situation, the market fear originated from the risk being realized by investors, and a run on the money market funds began.

We recommend that full and accurate disclosure of all financial products, not just commercial banking products but also investment bank products and insurance products, be required of the financial services industry at large. In addition, we recommend that there should be regulation by simplification and disclosure of specific market products being sold in the financial market place so that market transparency through such clear disclosure of accurate information is provided in the future.

b. Require market rating agencies to perform due diligence and hold them accountable for their ratings.

There was a time when market participants and their advisors performed a thorough due diligence analysis before investing. Now, most everyone uses a rating agency to do their analysis. Whether the financial product is a stock, bond, corporate paper, mortgage-backed security, insurance company, or bank, a rating agency is telling everyone whether the investment is good or bad.

In the real world, the rating agencies create mathematical risk models. Then they gather financial information from various resources private or public, which could include a government regulator such as the SEC or the FDIC. Then, they plug the reported financial information into their rating agency mathematical risk models. Seldom is true due diligence performed by rating agencies anymore. This means that there is no investigation, no contact, no specific company understanding or analysis of the risks underlying a particular financial product or institution. The unfortunate result is that inaccurate ratings are issued, such as in the subprime mortgage crisis, and investors rely on such ratings to their detriment.

Based on the foregoing, we recommend that rating agencies be required to perform specific due diligence in order to provide information on financial products and companies that is as reasonably accurate and useful to investors as possible. We also recommend that rating agencies be made financially responsible for their actions, which we believe would deter them from not

performing appropriate due diligence when evaluating financial products and companies.

6. Implement GSE reform and reinforce the SBA Program.

a. Prohibit Fannie Mae and Freddie Mac from purchasing non-conforming mortgages.

In providing a secondary market for subprime mortgage loans, Fannie Mae and Freddie Mac took on an amount of risk in excess of their missions of responsibly promoting home ownership. The results for Fannie Mae and Freddie Mac, namely government takeover, were catastrophic for investors and the home finance and building industries. The Federal Housing Finance Agency ("FHFA"), which regulates Fannie Mae and Freddie Mac, reacted to the mortgage industry decline by increasing the maximum single family home loan dollar limit for loans that Fannie and Freddie can purchase in high cost real estate markets, to \$729,950 in 2008, and then reduced the maximum to \$625,500 for 2009. FHFA kept the limit for lower-cost metro area single family home loans that Fannie and Freddie can buy at \$417,000 for 2009. Trust has been lost in the home finance system among lenders, borrowers, and investors in stock of Fannie and Freddie and their subprime mortgage securitizations. It will take time, proper practices, and market and government oversight to build Fannie and Freddie into trusted partners in the financial services community.

It is recommended that Fannie Mae and Freddie Mac be prohibited from underwriting subprime mortgages in the future. However, Fannie Mae and Freddie Mac should be allowed to offer programs to promote home ownership for persons having difficulty obtaining a home, provided that full documentation on the borrower is obtained and meets loan underwriting guidelines that are reasonably consistent with safe and sound lending practices. Also, the maximum dollar amount on home mortgages purchased by Fannie and Freddie should not be so high as to be contrary to their mission to promote home ownership particularly for average Americans. These maximum dollar amounts, which are stated above, may vary depending on the local home prices and economic conditions of a given region or locality. In Pennsylvania, there is only one county, Pike County, out of 67 counties, that has a \$625,500 maximum loan amount that exceeds the floor amount of \$417,000 that Fannie and Freddie may purchase in 2009. It is unfair for the majority of the country to subsidize high cost real estate markets through secondary market purchases by Fannie and Freddie of jumbo type mortgages from those high cost real estate markets.

b. Reinforce the FHLB system as the primary provider of bank liquidity for Community Banks.

We recommend that the Federal Home Loan Banks be authorized to continue to serve their mission as the preferred and primary liquidity provider to the Community Banks. Since 1932, Federal Home Loan Banks have served as the preferred liquidity provider for Community Banks. Unlike other less predictable sources of liquidity, FHLBanks collateralized advances provide consistent funding during all economic cycles. As a cooperative owned by their member financial institutions, including the vast majority of Community Banks, the Federal Home Loan Banks remain responsive to the needs of Community Banking and will remain a vital resource for our Community Bank members.

c. Temporarily expand Federal Reserve funding on equal terms for Community Banks

We believe that it is important to ensure that the temporary expansion of Federal Reserve funding programs is available on equal terms to Community Banks. Community Banks understand that current bank liquidity lending by the Federal Reserve is designed to stabilize the financial system and may not always be consistent with the Federal Reserve's role over the nation's monetary policy. As long as these temporary options remain in place, Community Banks should have equal access to this emergency funding.

There is a separate issue with the coordination of lending between the Federal Home Loan Banks and the Federal Reserve. Currently the Federal Home Loan Bank takes blanket liens on bank assets but legally cannot accept U.S. Small Business Administration ("SBA") loans as collateral. This blanket lien creates risk for insurance reserves and poses problems for creating asset-backed securities. In turn, this creates a problem for Community Banks that do not want regulatory trouble when liquidating assets. The Federal Home Loan Banks have been slow to release their blanket-liens-on-bank-assets collateral when such SBA loans can be pledged to support Federal Reserve lending programs but cannot be pledged to support FHLB loans to Community Banks. These two agencies, the Federal Reserve and the FHLB, should coordinate these lending programs so each can be adequately secured, but in a manner that maximizes liquidity facilities for Community Banks. Also, in providing government assistance to a troubled bank, the Federal Reserve, FHLB, and FDIC should allocate resources to protect themselves as government agencies and the taxpaying public.

d. Revitalize the SBA.

Government guaranteed lending is imperative to jumpstarting a recessionary economy by seeding it with new business start-up lending. Without the SBA program running on all cylinders, high-risk lending from banks will not occur no matter how much capital the federal government injects into them.

In the current economic down turn, U.S. Small Business Administration lending is down. Usually, SBA lending increases when the economy weakens. The reason for the current reversal in the trend is that in the last few years, SBA has been centralized so that local decisions and interactions with participating banks have decreased and relationships between local lenders and SBA have been damaged. The centralization of SBA activities may reduce costs, but such centralization has caused direct contact to be lost with partner bank personnel. For example, a local bank incurred a loss from a restaurant-bar failure. The SBA reduced the bank's recovery because the bank didn't sell the unused liquor. At first blush this seems reasonable, except for the fact that in Pennsylvania, it is unlawful for the bank to sell the liquor. The SBA contends the bank should have broken the law so the SBA will not pay the guarantee. Banks stop using the SBA program as a result of this type of consternation. Locally assigned and available SBA personnel with authority to make decisions regarding local lending situations would help to promote communication, increase efficiency, and improve the damaged relationships between local lenders and the SBA.

When the SBA centralization was occurring, banks waited for months to collect guarantees. Then the banks just decided to stop using the SBA program. The current credit risk management rules that SBA has put into place are in direct conflict with the SBA mission. They motivate banks to only lend to high-quality credit risks with adequate collateral, i.e., a conventional bank credit. This defeats the whole purpose of the SBA loan guarantee program.

It is recommended that the SBA roll back the effect that the new credit risk management rules have on participation in the SBA lending program. Also, the SBA should provide local office personnel and allow them to have and exercise authority to make decisions without the inefficiency of overly centralized management regarding the approval and liquidation of loans. With such a local SBA approach, the SBA will be able to establish a close, personalized relationship with the local bank partners that will benefit the small business borrowers, the bankers, and the SBA.

e. Put lending back in the hands of banks where existing regulations protect the consumer.

Poor underwriting by non-depository lenders engaging in no document/low document lending practices, bordering on fraud, with no potential monetary liability to the secondary market, is a large part of the cause of the subprime mortgage market's existence, rise, and fall. Such poor underwriting has occurred in part because the lenders did not have or perceive any liability once the loan was sold into the secondary market. This needs to be changed.

Based on the foregoing, we recommend that lenders should be required to have investment risk (meaning “skin in the game”) such that when they sell a home mortgage loan, the lender has enough potential risk of loss to cause the lender to be honest in the loan application and approval process.

7. Think outside the box and stimulate discussion and debate on:

a. Giving regulators tools to support weakened financial firms without losing taxpayers dollars.

Commercial banks are heavily regulated, yet some do fail. The bank regulators monitor banks closely and will force a weak bank to merge into a strong one, normally, before failure occurs. However, many times the weak bank deteriorates too quickly. Every time there is a failure, depositors lose confidence in our system. The Big Banks create material risk to the FDIC Insurance Reserve. Many people criticize the regulators. Our direct experience is that regulators are the most thorough and conservative auditors in the banking environment. They watch and criticize banks routinely.

We would propose that the regulators do not have the tools at their disposal to save a weakened bank, especially the larger ones. To understand our comment, you must first understand how a Big Bank fails. First, either poor management practice or an operating environmental problem occurs to cause the bank to report a loss. The rating agencies or other banks speculate that losses may continue, so the bank is cut out of the low cost funds market or the federal funds market. Perhaps even the Federal Home Loan Bank may restrict wholesale funding. Word then hits the street and depositors become nervous and remove some funds. The bank is then forced to replace low cost funds with expensive funds in the CD markets that have FDIC Insurance guarantees. The bank’s cost of funds increases, but it is unable to increase revenue because a large portion of its revenue source is from fixed rate loans. Now it begins to lose money every month because the original business model cannot change quickly enough to recover from losing its low cost funds. Injecting new capital will do nothing but prolong the death even if the problems or environment that caused the initial loss are corrected. Now it is time to sell the assets and deposits to someone else before the equity in the bank is eaten up from operating losses and the FDIC Insurance Fund becomes exposed. If the regulators react too slowly or the deterioration occurs too fast, the FDIC Insurance Fund suffers.

If this death cycle could be interrupted early on, it would allow the regulator to stop or slow down the deterioration before the insurance fund was harmed. The regulator, such as the FDIC, could contact the Federal Reserve early on after the loss and/or capital fell to a level of serious concern. The regulator would recommend the Federal Reserve lend money directly to the bank at a below-market rate, but ideally, if possible, above Federal Reserve’s cost of funds. By accepting the low-cost funds, the weakened bank would

agree to freeze lending until the resultant profits guaranteed from the low cost loans were sufficient to pay back all government loans. The market would eventually allow the bank back into the low-cost funds market, and the repair would be complete after the loans were paid back. The other competitive banks would not mind because the weakened bank would have a lending freeze and would no longer be competitive in the market because it could not pick up new business and would lose existing clients who needed to grow. This would allow the regulators to have more time to fix the problem bank or to sell it knowing that the existing problem is not becoming worse.

If government loans were properly collateralized by the weakened bank's assets, the FDIC and other government regulators could dramatically reduce failures without sacrificing taxpayer monies. When you consider this cycle and how the regulators work to protect the FDIC fund, it is easy to see why the regulators want to see the TARP monies only be injected into strong banks and to promote the purchase of the weaker ones. The regulators know this makes the banking system more stable and protects the FDIC deposit insurance fund. However, the strong banks are already lending to any good risk that presents itself, so the TARP monies will not in and of themselves promote more lending. Forcing capital into healthy banks is primarily going to push strong banks to acquire others and not to lend to a greater extent. Lessons from The Great Depression proved this in the 1930's. The TARP Program will only restore lending to the healthy banks that took a hit to capital from losses. Other lenders will have cheap capital to make acquisitions, which was not the intent of Congress. These are the results that occur when desperate knee-jerk decisions are made at the federal government level instead of taking time to develop and coordinate a complete action plan with everyone involved.

We recommend that the regulators be given the authority to make low cost loans to financial institutions that are in trouble, require a freezing or reduction of lending, and a repayment of the government loan before resuming normal lending activity. This and similar flexibility could reduce draws on the FDIC deposit insurance fund.

b. Promoting the Federal Reserve Bank to use new broader powers to influence long-term interest rates by becoming a temporary bankers' bank in economic emergency circumstances versus the lender of last resort.

Under traditional economic theory the Federal Reserve's monetary open market policies are designed to impact directly short term interest rates and, through the public's perception of how it is addressing inflation, indirectly impact long term interest rates. With the Federal Reserve's direct participation in either supporting existing markets, e.g. commercial paper market, or the creation of new auctions and credit facilities designed to provide credit to a wide range of participants in financial markets, the Federal Reserve now has

new or enhanced means of influencing interest rates all along an interest rate yield curve. We encourage the Federal Reserve to explore other policies or programs to influence long term interest rates. This new power to influence the interest rate yield curve should be used to promote greater financial stability in banks by supporting a normal upward sloping yield curve.

The Fed's ability to move both short-term and long-term rates in conjunction with one another would yield greater power to implement economic stimulus or slowdown. This greater control on macroeconomic activity from managing the entire interest rate curve reduces the amount of rate change needed to influence activity, which reduces rate volatility, which increases the stability of most financial markets. There is plenty of room between the rates at which the federal government borrows versus at what rate it could mandate banks to lend. Utilizing this process will drive the market where the Fed wants it to go, while treating large banks the same as small Community Banks. When the Fed wants to reduce influence, it adjusts rates or collateral margins and lets the market kick in. The banks have access to market funds, either directly or indirectly through the Federal Home Loan Bank so the Fed action will drive all banks in and out of the market to source funds as the Fed desires, and adjust their lending rates accordingly.

We also support Federal Reserve policies that increase the amount of lending done by the banking industry as a whole. Over the last fifty years the banking industry's percentage of lending has been steadily reduced from approximately two-thirds to one-third. Although there are economic reasons for this historical migration of lending, it has resulted in a diminution in the Federal Reserve's ability to impact the general economy. With safety and soundness principles already imbedded in banking regulation, some of the problems currently existing may have been mitigated if the lending function had been done by banks and had been subject to a rigorous safety and soundness regulatory system.

Thank you for your time and consideration of this paper. Please contact PACB directly if you have any questions or comments. PACB is available to you as a resource. We wish you the best of luck in your upcoming Presidency.

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