Statement for the Record

on behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions

of the

Committee on Financial Services

United States House of Representatives

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Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, the American Bankers Association appreciates the opportunity to submit this statement for the record on legislation recently proposed by Congressman Posey, H.R. 1723, the Common Sense Economic Recovery Act of 2011 and by Congressman Westmoreland, H.R. 2056, regarding the impact of FDIC bank failure resolutions. The ABA represents banks of all sizes and charters and is the voice of the nation's $13 trillion banking industry and its two million employees.

ABA appreciates the effort being made by this Subcommittee – and the whole Financial Services Committee – to deal with the regulatory crisis that banks are facing and to create an environment where banks can extend credit to creditworthy borrowers. Actions taken to enhance the checks and balances related to the authority of the Consumer Financial Protection Bureau is one example of the important work of this Subcommittee.

The recognition of the problems facing banks across this country, and the willingness to address these issues – as Congressman Posey intends with H.R. 1723 – is very important if we are to re-energize the economic engine of this country. While we may disagree with how best to implement changes, there is no disagreement that the industry – indeed the economy – can benefit from changes that stimulate lending, not discourage it. We appreciate the efforts by Congressman Posey to do this and his willingness to work with the industry to find reasonable solutions to the regulatory overload faced by banks today.

There is no question that the last several years have been challenging to businesses (including banks) and individuals. While the official statistics tell us that the recession was over more than two years ago, that is little comfort to individuals, businesses, and banks in communities that are still suffering greatly. Banks are a reflection of their local economies and are not immune to the economic downturn. Job losses and business failures have resulted in greater problem loans and in much higher loan losses. Nonetheless, banks are working every day to make credit available.

Banks' efforts are made more difficult by regulatory pressures that exacerbate, rather than help to mitigate, the problems. The ABA has raised the issue of overzealous examiners in hearings over the last several years and through letters to the banking agencies. While the agency heads in Washington have said the right things about encouraging reasonable judgment by field examiners, we continue to hear that examiners are taking an overly aggressive approach in their analysis of asset quality and are consistently requiring downgrades of loans whenever there is ***any*** doubt about the loan's condition – even in cases where loans are fully performing.

This, we believe, is part of the problem that H.R. 1723 is trying to address by stopping regulators from assigning performing loans to non-accrual status for banking regulatory purposes. Non-accrual loans are generally those where the payment of interest and principal has lapsed or those where full payment of principal and interest is not expected. Congressman Posey is rightfully concerned about how regulatory rules are being applied to classifying "troubled" loans. In some instances, the application of the rules represents overkill and results in the need for banks to raise capital in situations that may be unwarranted.

We all want fair treatment of what is truly a troubled loan. However, the problem is bigger than the question of nonaccruals. For example, how loans are classified as problem assets for regulatory purposes; how those loans are required to be valued (including those loans subject to modifications characterized as "troubled debt restructurings"); and how capital is calculated as a result of these classifications are major issues. How each of these is done can have significant consequences for a bank's ability or willingness to make loans in their communities. Overkill in any of these areas means far less credit will be extended, which translates into slower economic growth for this country.

This seems to be a particular issue with the classification of commercial real estate (CRE) loans. For example, bankers have told us that regulators generally classify the ***entire*** loan if the ***secondary*** source of repayment is impaired – even in cases where the borrower continues to make principal and interest payments. While an impairment of the secondary source – such as a decline in the collateral value of the underlying real estate – does raise concerns about potential losses, classifying the entire loan as troubled makes no sense for many loans. Moreover, the loss on a loan backed by collateral (as is the case with CRE loans) is typically much smaller than the full amount of the loan, and that assessment and any necessary impairment is recorded by the bank under generally accepted accounting principles (GAAP). Even with the drop in the collateral value (which has certainly taken place over the last several years), the property continues to have positive value and the bank would not lose the entire amount of the loan should it ultimately default. Thus, by classifying the entire loan as troubled, rather than just a conservative value of anticipated loss, the extent of the problems are overstated – vastly overstated in some cases.

For example, suppose a bank has a $10 million loan on a commercial property (non-owner occupied and leased) valued at $16 million at the time the loan was made. Even with significant equity by the borrower, the decline in CRE property has been 40 percent on average nationwide. Thus, a current appraisal might have this property valued at $9.6 million. While this is less than the loan, the borrower may – as is often the case – still be making principal and interest payments as promised on the loan. Even if the leasing is slow on the property and even with a conservative discount on the appraisal (in case the property had to be sold quickly or in recognition of still-declining market values), the collateral backing the loan still has considerable value. If the borrower does end up defaulting, the loss would not be $10 million, i.e., the original loan amount. Classifying as troubled the entire $10 million loan dramatically overstates the anticipated loss on this loan if it were to default (as is evidenced by the loss recorded under GAAP) – and the vast majority of such loans will continue to perform as expected and never default. But how this loan and other similar loans are treated by regulators, along with the need in some cases to raise additional capital as a consequence, will dramatically affect the ability and willingness of the bank to lend.

Not only is the level of classified assets overstated, but bankers have reported that the regulators are using fixed ratios of classified loans to capital plus reserves as a determinant of exam ratings and as a driver to require the bank to increase capital levels. Even profitable community banks with capital-to-asset ratios at or above those of their peers – and at or above the regulatory guidelines – and without significant asset quality problems, are being told their capital is inadequate and to increase it.

As capital is particularly scarce in today's environment – particularly for smaller banks – the only course of action is for banks to stop lending and to shrink in order to meet the required capital-to-asset ratio prescribed by the regulators. Banks shrink by making fewer loans. This clearly has a dramatic and negative impact on the bank and means less credit will be provided to creditworthy borrowers.

Exacerbating this problem is that the conclusions and recommendations of local field examiners – who annually visit banks to conduct extensive examinations lasting several weeks – are often being overruled by their superiors at the regional or even national level. Thus, the observations and conclusions by the regulators who have thoroughly examined our banks – and who understand the local markets and the strength and experience of bank management – are overturned by those who we have never personally examined the banks or visited the communities they serve. This has lead to a system where each regulator has an incentive to be tougher than the next.

This has significant consequences for communities. On one hand bank agency heads and Washington policy makers are urging banks to lend, but on the other hand the actions taken are saying don't lend, don't lend, don't lend. This means that good loans to creditworthy borrowers may not be made.

In short, H.R. 1723 is focused on these very serious problems affecting banks' ability to serve their customers and benefit the economy. However, we are concerned about legislating changes in accounting standards, even if they are only intended to be for regulatory use. Banks are issuers of financial statements – upon which our investors rely – as well as heavy users of financial statements of our borrowers. We need to make sure that all parties can rely on the accuracy of financial statements.

Thus, while we cannot support H.R. 1723 as drafted, the legislation is a direct response to very real problems. ABA urges this Subcommittee to use its oversight powers to ensure that the regulators are applying reasonable standards in determining what constitutes a classified loan, and even more importantly, ensure that consequences of the classifications do not inadvertently stop banks from making loans to creditworthy borrowers. We shall also continue to work with Rep. Posey and this Subcommittee on specific proposals to address these concerns.

Regarding Congressman Westmoreland's bill, H.R. 2056, we believe that a careful study of how bank failure resolutions have affected other surviving banks and their communities has merit. There is no question that some areas of this country, including Rep. Westmoreland's home state of Georgia, have suffered greatly from the economic downturn and many banks have failed. How these bank failures are resolved does have an impact on local communities. It can dramatically impact the value of residential and commercial real estate depending on how the assets of the failed banks are disposed of. This, in turn, impacts all property owners and other lenders in the community. We also believe that since the surviving banks pay all the costs of banks that fail – indeed all the costs of running the FDIC – it is important to have an independent validation of resolutions to assure that the FDIC is resolving failures in the least costly way, consistent with current law.

In conclusion, Madame Chairman, we appreciate this Subcommittee's sensitivity to the serious issues that face banks and the communities they serve. We applaud the efforts of Representatives Posey and Westmoreland to bring these issues to light. We look forward to working with these congressmen and this Subcommittee on finding reasonable solutions that will assure credit will flow to communities across our nation.