Testimony of

Charles Funk

On behalf of the

American Bankers Association

for the hearing

"The Impact of the Volcker Rule on Job Creators"

before the

Committee on Financial Services

United States House of Representatives

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Chairman Hensarling and Ranking Member Waters, my name is Charles Funk, President and Chief Executive Officer of the MidWest One Financial Group. My bank is a $1.7 billion community bank headquartered in Iowa City, Iowa. We serve 19 communities with a total of 25 offices and have been in business since 1934. In several communities, there are only one or two banking offices in the community. I appreciate the opportunity to be here to represent the American Bankers Association (ABA) regarding the recently finalized Volcker Rule and some of the unintended consequences it is already creating. The ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees

Let me begin by thanking you, Mr. Chairman, Ranking Member Waters, and Subcommittee Chairman Capito and many other members of this Committee for your recent engagement with the regulators on the important issue related to the unnecessary and potential significant losses on collateralized debt obligations secured primarily by trust preferred securities. I would also like to thank Chairman Hensarling and Chairman Capito for introducing H.R. 3819—which ABA strongly supports—to provide relief to banks like mine that would suffer considerable losses on these assets under the rule finalized by the regulatory agencies.

For my bank, the immediate write down on our investment in collateralized debt obligations (CDOs) secured primarily by trust preferred securities (TruPS) issued by banks would be a loss of $1,050,000 and could be much larger since the entire market for TruPS CDOs will be in turmoil and values could decline if this problem is not addressed. For many smaller institutions the losses anticipated are devastating, resulting in a hit to capital that will inhibit them from lending to their community. Across the holders of these securities the losses are expected to be at least $600 million and likely to be much higher as this rule could create a sellers-only market.

The sad part is that we and most other banks intended to hold these investments until they mature (up to 30 years) and would likely see the values improve from today's low levels. But instead, by government fiat we will take losses now that would not only hurt our earnings, but more significantly hurt our ability to serve our community. Moreover, these investments would never be considered a concern that the Volcker Rule was intended to prevent.

Let me be clear at the outset. Like the Dodd-Frank Act, the Volcker Rule is the law of the land. While the banking industry has concerns with aspects of the rule, our focus now is to ensure that it be applied in a way consistent with its original intention to address systemic risk, not impose costs on banks like mine unrelated to systemic issues. We are very concerned that the agencies' rule is so broad that it has consequences far beyond what Congress intended and will hurt legitimate investments that not only are safe and sound choices for banks, but that support the credit availability and financial service needs of our customers.

It is remarkable that what began as an 11 page amendment in Dodd-Frank, designed to limit excessively-risky proprietary trading at the largest systemically important institutions, has transformed into a 936 page final rule that will have a real, measurable impact on banks of ***all*** sizes. By taking an overly broad approach, the regulations to implement the Volcker Rule impose serious unintended consequences that will fundamentally change the business of banking with little or no benefit to the stability of the financial system.

There is real irony in the fact that a rule designed to prevent banks from taking losses on short-term assets will instead force banks to sell long-term investments early, often resulting in a market loss. By forcing large numbers of banks to sell assets at discount prices, the government is picking winners and losers and inflicting pain without cause. The less regulated non-bank sector—which was complicit in the problems that led to the financial crisis—will have an opportunity to buy assets with recovering values at discount prices at the expense of the banks.

Simply put, the Volcker Rule should not impair traditional banking services that allow banks to meet the needs of their customers, nor impose unnecessary costs on any bank, particularly regional and community banks, where no argument of systemic risk can be justified.

In my testimony today I would like to make the following three points:

- The agencies' Volcker Rule has serious unintended consequences for banks of all sizes;
- Legislation—such as H.R. 3819— is important to address the imminent negative consequences faced by banks holding Trust Preferred Pooled Securities
- The agencies' Volcker Rule is likely to create unintended consequences beyond Trust Preferred Pooled Securities and Congress should be vigilant in assuring that rules are focused on the original intent to reduce systemic risk and not used to hinder the traditional business of banking: providing credit to customers.

I will discuss each of these in turn and offer some suggestions for ways that Congress can add clarity to achieve consistent implementation of the Volcker rule, beyond dealing with the emergency situation surrounding Trust Preferred Pooled Securities.

I. The Volcker Rule Has Serious Unintended Consequences for Banks of All Sizes

The purpose of the Volcker provision in Dodd-Frank was relatively simple—to prevent large systemically important banks from engaging in excessively-risky proprietary trading activities that put systemic financial stability at risk. The finalized agencies' Volcker Rule, however, took an overly broad approach to this issue resulting in serious consequences for banks of all sizes. Many of the activities covered by the final rule pose no risk to the financial system, and are engaged in by community, mid-size and regional banks. The rule will force many of these banks to write down or sell assets that they had never planned to sell at a significant loss and cease to provide lending options that they have safely offered to their customers for years.

At the time these affected investments were made, they were sound and legal choices, and in some cases (like issuing Trust Preferred Securities to boost the capital and lending capacity of small banks) encouraged by regulators. Now, by government fiat, the rules of the game have changed and these are now being artificially flagged as questionable investments.

I have seen this impact at my own bank. In 2005, we purchased $9.7 million in collateralized debt obligations (CDOs) secured primarily by trust preferred securities issued by banks. This was a well thought out and robustly discussed long-term investment. We only invested in floating rate trust preferred pooled securities that were rated A or better. It made sense for us at the time, as we were vulnerable to rising interest rates and had few floating rate loan opportunities.

These securities plummeted in market value as the financial crisis of 2008-09 worsened because of the financial stress of some community banks that had issued trust preferred securities that were packaged in these instruments. At year-end 2008, we had recorded an impairment loss and wrote the securities down to approximately $1.8 million. Even though this significantly diminished the bank's operating earnings for the year, we did not hesitate to take the charge, recognizing that the resulting balance reflects the ultimate amount we expect to collect. Although the security's market value at the time was far lower than $1.8 million book value, accounting rules required us to write down the investment only to the net realizable value because we are able to hold the investment to the recovery of that value.

Since then, we have evaluated the securities on a quarterly basis and have determined that no additional impairment has been necessary. Each quarter, we analyze the future cash flows for each debt obligation.

While the market value for these securities remains significantly below our recorded investment, what we have found for the past 18 months or so is that the securities' estimated future cash flows have hit bottom and have begun to improve. ***Most importantly, if we continue to hold these securities well into the future (10-15 years), we expect to eventually recover our current book value and could well recover more than current book on certain securities.*** Holding these securities was exactly what we planned to do, and with tangible common equity in our company of more than 9.5%, we have the staying power to hold these investments indefinitely.

The recent decision to disallow these securities as permissible investments comes as a surprise to our entire management team and Board of Directors and is contrary to the original intent of the Volcker Rule to prevent future risky behavior. During the comment period on the proposed Volcker Rule implementing regulations, we did not receive any signal that these investments would be disallowed. In fact, we thought they would be excluded from the rule.

While we acknowledge that the investment has performed below our initial expectations, the agencies' Volcker Rule arbitrarily and unnecessarily makes this much worse—at least a further ***immediate*** market-value write down of $1,050,000 and maybe more—with no hope to recover the value of our investment. This investment was a casualty of the economic crisis of 2008-09, but never can it be considered an adventurous investment or one that presented a systemic risk, and it certainly never should have been captured by the Volcker Rule.

To be forced to sell these investments by 2015 will come at a great cost, not just because it hurts our earnings, but because it necessarily strips away resources that would be channeled back into our community. For many smaller banks, the impact is even more severe than for my bank. ABA has heard from many banks about the problems they anticipate. For example:

- A community bank of just over $100 million in assets, with fewer than 30 employees, and serving five counties in rural Mississippi (with few other banks in their markets) purchased about $3 million of Federal Reserve designated "bank qualified" CDOs secured by trust preferred securities. If forced to sell, this community bank would take an immediate capital hit and would be forced to stop any new business lending.

- An Oklahoma bank with $300 million in assets expects to take $1.4 million in market-value losses if forced to divest their TruPS CDO portfolio today. If allowed to hold these securities to their maturity however, they expected to see a gain on their investment. For a bank with $300 million in assets that type of loss will significantly impact the services they provide to their community.

- A Connecticut based Mutual Bank with $1.4 billion in assets and 15 branches expects that immediate market-value write-downs on its portfolio of CDOs secured by trust preferred securities, resulting from the agencies' Volcker Rule, would cause their Tier 1 capital ratio to fall 100 basis points. Being a mutual institution, this bank has no access to outside capital, and can only increase capital through retained earnings, a challenge given the current economic environment.

- A $1.4 billion bank in Oklahoma, holding $13 million in CDOs secured by trust preferred securities expects it would take an immediate market-value loss of $4 million (4% of holding company capital) if required to sell its portfolio. Although this bank expects to remain well capitalized the OCC has placed additional capital requirements on the bank following its acquisition of a failed bank from the FDIC. As a result of this market-value loss, they will barely be able to meet these additional capital requirements. This will have a significant impact on how they are able to manage the bank and the loans they are able to make to local businesses that they have served for many years.

- A $100 million dollar bank, serving Marshal County Mississippi – one of the poorest counties in the state—currently holds $2.8 million in of CDOs secured by trust preferred securities. They expect that under the agencies' Volcker Rule they would need to write down $2.4 million in market value, which would reduce their bank's capital in excess of 20%, severely limiting their ability to serve their community.

- A $400 million bank in Louisiana holds about $8 million of CDOs secured by trust preferred securities, which they expect to sell for 15 cents on the dollar if required by the agencies' Volcker Rule. This cost would be a 200 basis point hit to their capital level, and erase their record earnings year with the stroke of a pen. While sales may not be required for 18 months, the market value loss must be taken now, leaving no incentive to hold the security any longer.

The important point is that all these losses are completely avoidable if the banks were allowed to hold these investments to maturity. It is only because these investments are captured under the agencies' final Volcker Rule that these losses have to be realized. These investments in no way resemble a trading asset, yet would have to be classified as such by a rule that forces their divestiture; a rule, by the way, intended by Congress to prevent losses to banks from ***trading*** activities. As the market values for these securities still do not reflect the actual value of holding these investments, the write-downs (which are caused solely by the requirement to dispose) are also unnecessarily punitive.

In many cases, implementing this rule hits community banks, which are often the only source of banking for rural communities and have very limited access to outside capital. This means a real impact for a community that depends on them for lending and other financial services to support community growth. For our bank, our management team has been very clear with our employees and board that as our company improves its profitability, we will increase our charitable giving to worthy organizations in the communities we serve. This has met with resounding praise both inside and outside the walls of our bank. ***There is no question that a charge to earnings of more than $1 million will mean less giving to such worthy causes as the United Way, local Food Banks and capital projects for our area schools that require private funding to complete.***

I have only addressed here the immediate and quantifiable unforeseen consequences relating to holdings of CDOs secured by trust preferred securities that are unnecessarily captured by the agencies' implementation of the Volcker rule. The ABA is already hearing from banks of all sizes that these and many other sound and legal investments in pooled assets are being forced to be sold, which will forego income they would have received and may create losses that could affect their capital position.

II. Legislation—Such As H.R. 3819— Is Important to Address the Imminent Negative Unintended Consequences Faced By Banks Holding Trust Preferred Pooled Securities

We applaud the leadership of this committee for introducing legislation that would provide relief from the sudden and unnecessary write downs of Trust Preferred Securities resulting from the agencies' Volcker Rule implementing regulations. ABA strongly supports H.R. 3819. Because of the timing of this rule, my bank and many other banks must—both unexpectedly and unnecessarily—record market value losses on Trust Preferred Securities for our year-end financial statements. Even though we previously intended to hold these securities to maturity, thus eliminating the need to recognize temporary pricing changes, accounting rules require full mark-to-market loss recognition upon the expectation of selling, which would be required under the agencies' Volcker Rule. Because we must file our financial statements within just a few weeks, there is considerable urgency to have relief and to enact these bills.

We understand there has been some discussion about imposing limitation on relief based on the size of the bank that holds CDOs secured by Trust Preferred Securities (TruPS CDO) investments. ABA believes that there should be no size limitation for relief for bank investments in TruPS. As I have mentioned above, issuing Trust Preferred Securities (TruPS) enabled community banks to raise long-term funds that the regulators allowed to count as capital. Most community banks have limited access to outside capital, so TruPS issuance was an important vehicle for them. Importantly, those banks could only issue TruPS if there were a market for them of willing buyers. This market demanded a pooling of TruPS issued by several banks (into CDOs) for diversification, and relies not just on other small banks as investors—although many stepped up to buy these and help fellow community banks. Rather, the market by necessity needed to be bigger, with banks of all sizes participating. There is no reason to hurt any investor, regardless of size, that had endeavored to help community banks raise capital and serve their communities. It's unfair to punish them now.

Moreover, any asset size cutoff for holders of investments is arbitrary and picks winners and losers. Investments in TruPS CDOs were reasonable investments (at the time they were made) and due to the impairment already suffered, most banks expected to hold these for a long period of time to recover what value they could. It makes no sense for these long-term investments (that have been regaining lost value) to suffer losses regardless of the size of the holder.

Perhaps even more importantly, if banks above $15 billion were required to write down or sell their TruPS CDO investments together and in a relatively short period of time, the entire market suffers a devaluation. If the market is hurt by write downs, it affects ***all*** investors—including smaller community banks.

Besides a devaluation of the entire market, a write down or sell off by the larger institutions could create problems for the issuing banks as it may imply that the pool of bank issuers in any TruPS CDO are weak or troubled. Artificially low prices on existing securities would also make it appreciably more expensive for the issuer to raise additional capital. Why create another potential problem for community banks by forcing a write down by larger bank investors?

As I have mentioned above, TruPS CDOs are ***not*** an investment that raises any concerns related to the kinds of proprietary trading restrictions envisioned under the Volcker Rule. Because community banks can no longer issue TruPS to count as capital, the market will disappear as these securities mature. There can be no systemic issue related to these securities, regardless of the size of the holder. Moreover, the mid-size and regional banks that hold these securities are not systemically important and their investments would not rise to the level to be considered a problem for the financial system. Holdings of TruPS CDOs of large banks are miniscule compared to their balance sheet and pose no systemic issue at all.

III. The Unintended Consequences of the Agencies' Volcker Rule Go Beyond Trust Preferred Securities

The Volcker Rule was designed to promote financial stability by prohibiting banks from future engagement in excessively-risky proprietary trading. Most community, mid-size and regional banks are not and have never been involved in this kind of activity. Although the statutory prohibition on investment in funds focuses on hedge funds and private equity funds—as was the intent behind the Volcker Rule—the final rule opted for an extremely broad definition of "Covered Funds." The definition is so broad because it refers to two exemptions from the Investment Company Act (ICA) of 1940 that are intended to permit pools of securities or other assets to be offered to either a very small number of investors (less than 100), or only to any number of wealthy, sophisticated investors. These two exemptions are used by all kinds of pooled funds that are not hedge funds and private equity funds and that, for banks and the economy as a whole, serve many useful lending and economic development purposes.

As a result of this broad definition, many investments—made by banks of all sizes—in collateralized debt obligations (CDOs), collateralized mortgage obligations (CMOs), collateralized loan obligations (CLOs), and venture capital investments will no longer be allowed. As discussed above, TruPS CDOs are instruments that inappropriately fall under the broad implementing regulation. But the implementing rule also exacerbates the overbroad definition of "covered funds" by unexpectedly making it impermissible for banks to hold debt instruments issued by loan pools. Pooling loans to permit banks to diversify their exposure to borrowers is an important risk-mitigating tool for banks, especially for smaller institutions where one borrower can represent a significant portion of a bank's assets. The ability to invest in debt instruments issued by pools of loans spreads any individual risk across a greater amount of capital, and is not the kind of equity trading investment that the Volcker Rule was intended to capture.

The fact that the Volcker Rule created an exemption for any CLOs and CMOs that hold ***exclusively*** loans shows recognition of the importance of these natural extensions of the business of banking. ***However, very few CLOs or CMOs are currently constructed this way***. This means that banks must evaluate the composition of every CLO and CMO held, and must sell any that do not meet the agencies' punitively strict Volcker standards. As is the case with TruPS, creating a market where sellers outnumber buyers will drive prices sharply lower. Furthermore, in the future a tiered securitization structure is likely to emerge, with both "bank eligible" and "non bank eligible" debt. Banks will surely have to pay a premium for the increased scrutiny on bank eligible CLOs and CMOs.

Although the Volcker Rule provides a time period over which banks can divest any assets that do not comply with the rule, the delay of actually selling will not help save the banks from incurring losses on these investments. The agencies' Volcker Rule allows banks until July 21, 2015 to divest themselves of noncompliant assets. The goal of this was to ensure that all of the assets did not hit markets all at once, limiting losses. However, both the accounting standards and the markets are smarter than that, with the accounting requiring ***immediate losses*** to be recorded (thus reducing capital) and the markets factoring the increased supply and reduced demand into the pricing (thus resulting in market losses upon actual sale).

Simply put, by forcing banks to sell performing assets by 2015, the agencies' Volcker Rule is creating distortions in markets with more sellers than buyers. This depresses prices below what they would be in a fair market, where willing and rational buyers and sellers determine the market prices. As a result of the agencies' actions, the less regulated non-bank investors will be the true winners from the Volcker rule as they pick up performing assets at discount prices at the banks' expense.

I would also note that even if relief can be provided for TruPS, there will remain a significant compliance burden under the rule for community banks, despite agency statements to the contrary. Since a single investment in a covered fund could potentially trigger enforcement actions against the bank, its officers or directors, community banks will put in place compliance monitoring procedures to ensure they do not inadvertently violate the Volcker Rule. This means that every bank, regardless of size must evaluate every investment it holds and determine whether it is covered by the Volcker Rule. This is by no means a straightforward process due to the overbroad definitions used by the final rule for "Covered Funds" and the uncertainty created in the final rule regarding debt interests. Banks must evaluate every single investment they have made in any kind of pooled asset, including the usual and ordinary investments they make in loan pools.

Banks must evaluate every collateralized debt obligation (CDO), collateralized mortgage obligation (CMO), and collateralized loan obligation (CLO). These are assets commonly held by banks of all sizes, that are rarely, if ever traded.

There is another subtle, yet substantive, negative aspect to the events of the past four weeks. At my bank, we spend a considerable amount time and money evaluating and planning to implement regulatory changes. To the extent we devote more resources to compliance management, such as implementing the Volcker Rule, there will most certainly be reduced resources available to serve our customers and help them grow their businesses and plan for their future. For every bank in America, there is always a trade-off between resources devoted to compliance management and customer engagement.

The ABA believes that more can be done beyond the emergency situation related to Trust Preferred Securities to provide clarity in the law to help regulators achieve consistent rules that focus on the original intent of the Volcker Rule without unintentionally sweeping in ordinary, useful, and safe banking activity. We believe that the lack of clarity in the statutory language in some important respects has made it difficult to achieve consistent implementation of the Volcker rule. Legislation to correct these deficiencies could include:

- Focus the prohibition on investment in covered funds to investments in hedge funds and private equity funds (as the statute now reads) without reference to exceptions from the Investment Company Act of 1940;

- Clarify the process for interpretation of implementing regulations as well as requiring agreement and coordination of any enforcement action.

These enhancements to the statute should prevent unintentional impact, including the harmful impact we are seeing on banks holding TruPS CDOs. Further, as the agencies move forward to implement and supervise compliance with the Volcker rule, clarity of interpretive authority will prevent contradictory and duplicative application of the rule. The agencies maintain the broad range of supervisory judgment and actions already available to them.

Conclusion

Despite assertions to the contrary, Dodd-Frank has imposed many new compliance burdens on community institutions. The Volcker rule is just the most immediate concern for community banks. The mission of the Volcker rule was relatively simple—to prevent large systemically important banks from engaging in risky proprietary trading activities that put systemic financial stability at risk. As it is now written, it is an incredibly complex rulemaking that will create tremendous compliance burden for banks of all sizes. Despite the intent to focus this rule on only the largest, systemically important institutions, there will be real tangible compliance costs for community and regional banks that pose no threat to systemic financial stability. All banks, regardless of size will need to fully understand this complex rulemaking and its implications on their operations. Furthermore, many of these will need to implement costly compliance programs, despite the fact that they have never engaged in anything resembling proprietary trading.

The ABA believes that the Volcker Rule should not impair traditional banking services that allow banks to meet the needs of their customers, nor impose costs on banks, particularly regional, mid-size and community banks, where no argument of systemic risk can be justified.

The ABA appreciates and fully supports the bill introduced by the leaders of this important Committee. There is need for urgent action so that banks can avoid write downs they have no reason to make. By taking action now, banks will be better able to serve their communities. We urge this Committee to continue its vigilance in assuring that the agencies' rulemaking does not create unintended consequences that inevitably will lead to fewer resources that can be devoted to all the communities across this nation that banks serve.