TESTIMONY OF

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On

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INTRODUCTION

Good afternoon, Mr. Chairman and distinguished members of Congress. My name is Ken Ross. I am the Commissioner of the Michigan Office of Financial and Insurance Regulation. Thank you for the opportunity to testify today on the condition of the banking industry in Michigan and the impact federal policies and initiatives are having upon Michigan financial institutions.

My agency supervises 118 of Michigan's 147 FDIC-insured commercial and savings institutions; they hold over $50 billion in combined assets. In addition, it supervises six trust banks, approximately 200 state-chartered credit unions, over 2,700 mortgage brokers, lenders and servicers, and well over 200,000 insurance agents and companies.

I do want to note at the outset that while Michigan's credit unions play an integral part in Michigan's diversified financial services landscape, my primary focus will be on the community banking sector.

In my testimony today, I will discuss the overall condition of Michigan's banking industry and actions taken by my agency to effectively supervise our regulated entities and protect consumers in this challenging economic environment. Finally, I will discuss some recommendations for Congress and my federal counterparts as we coordinate our efforts to improve supervision and the health of the banking industry.

STATUS OF MICHIGAN'S BANKING INDUSTRY

Because of Michigan's historically cyclical economy, its bankers are by and large very conservative, even in comparison with their counterparts elsewhere in the nation. They've traditionally held capital in amounts in excess of the national average in order to provide the strength to weather typical economic downturns. But as we all know, the current downturn has been far from typical. Michigan did not experience a recovery following the 2001 recession, and its banks have been dealing with a sluggish economy since then. Until the real estate crisis struck a couple years ago, they'd been holding their own. At the end of 2006, around the beginning of the real estate crisis, the average leverage capital ratio for Michigan's banks was 9.5%. At mid-2009, that average ratio was 8.8%.

As this economy has worsened, more and more borrowers, both individual and corporate, have lost the capacity to repay. Unemployment across the state has risen from 7.1% in 2006 to over 15% today.[1] Auto sector-related employment has plummeted by more than 40% since 2006.[2] Corporate reserves set aside to weather a normal downturn gradually have been exhausted. This is showing up as rising loan delinquency and foreclosures in bank loan portfolios across the state. At the end of 2006, non-performing and delinquent loans at Michigan banks amounted to 1.9% of total loans. At mid-year

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[1] U.S. Bureau of Labor Statistics

[2] Michigan Office of Labor Market Information & Strategic Initiatives

2009, 5% of loans were non-performing and another 2.7% were delinquent. Almost 20% of construction and development loans were not current on their payments, along with almost 10% of multi-family residential loans, over 5.5% of commercial real estate loans, and 6% of individual credit cards. [3]

Increasing levels of non-performing and delinquent loans affect bank earnings in a couple ways. First, credit-related revenues are declining. Second, banks' costs of managing collection, workout/modification, and foreclosure activities and then managing and selling foreclosed properties have skyrocketed.

Rising delinquency and plummeting collateral values (median home prices in Michigan have fallen by over one-third since 2006[4]) also mean that banks must set aside increasing amounts for reserves against potential loss. With earnings at some institutions insufficient to fund loan loss reserves, capital accounts are being eroded. As capital falls below adequate levels, struggling institutions are losing access to lines of credit and other liquidity sources.

In 2006, only about 7% of Michigan's banks were unprofitable. At June 30 this year, nearly 40% of the state's banks reported that they did not make a profit in the quarter. Some institutions have merged to reduce costs and strengthen their ability to survive this business cycle. We've seen the number of banks in Michigan decline from 171 at the end of 2006 to 147 today.

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[3] FDIC.gov, Statistics on Depository Institutions

[4] Michigan Association of Realtors

In a state that averaged one bank closure roughly every five years for the past several decades, four Michigan banks and one credit union have been closed in the past 13 months. The number of Michigan banking institutions facing significant challenges is higher than at any time since the Great Depression.

Michigan banks have been able to weather the economic malaise and over time they might have been able to work their way through the challenges associated with the historic job losses in the auto industry, but some will not be able to weather the additional stress associated with the huge devaluation of real property seen across the state.

The current crisis was in many ways fueled by various arms of the nation’s largest commercial and investment banks, a number of which were saved by aggressive capital bolstering at the federal level. For systemically important big banks, the rules have been bent and broken, but community banks have been given little flexibility and are paying the price for the economic problems created by their larger counterparts.

In my view, it is unreasonable to force community bankers, who weren't, by and large, in subprime lending and who weren't reaping fortunes from the national securitization machine, to pay the ultimate price for those who benefited from the fundamental underlying causes of the financial crisis.

STATE ACTIONS TO IMPROVE SUPERVISION AND PERFORMANCE OF THE INDUSTRY

My staff is working hard, in coordination with FDIC and Federal Reserve examiners, to monitor the condition of Michigan's state-chartered banks. We have accelerated examination starts for institutions showing signs of trouble in interim monitoring reports. Troubled institutions are examined more frequently, generally jointly by my staff and federal examiners, and are subject to interim on-site visits to review progress in addressing problems.

The most seriously troubled institutions are:

- placed under formal enforcement actions that clearly identify issues that need to be addressed and have to report to us regularly on their progress.
- instructed, to stop taking deposits that would not be FDIC-insured, to eliminate expeditiously, by restructuring or otherwise, uninsured amounts in existing deposit accounts, and to report weekly on their uninsured deposits. We do this because we have very real concerns about the impact of bank failures on Michigan citizens, already financially stressed, local units of government, small businesses and other public funds depositors holding uninsured deposits.

In a time of economic uncertainty, we've stepped up our outreach to financial institutions. Last year, my agency, in partnership with the Michigan Association of Community Bankers, launched a new semi-annual Bank Directors College to help directors stay abreast of emerging issues, regulatory expectations, and changes in laws and rules. This year, my staff worked hand in hand with the banking industry to draft and

pass changes in Michigan's Banking Code that gave bankers more time to work with troubled borrowers before being required to charge off loans that aren't paying and that better recognize the intrinsic value of underlying collateral. Additionally, for the past several years, my senior staff and I have participated in banker and credit union industry forums presented by the state's two banker associations to facilitate frank dialogue between bankers and their regulators about important issues.

For the past several years, I have communicated to bank and credit union executives the vital importance of preparing all staff for media and customer questions. We have emphasized to all institutions the importance of having and regularly testing back-up liquidity plans. Testing liquidity plans has become especially critical as many out-of-state liquidity sources have reduced their exposures in Michigan.

I have reinforced with bankers and with staff the importance of regular and ongoing communication with regulators during and between exams in order to minimize surprises. Because the stakes are high, we are spending more time assuring that our examination findings are accurate, that bankers' views are carefully considered and that our conclusions are correct.

Consumer confidence in the state's financial institutions is critical, and I take every opportunity to reinforce to the public the strength of the deposit insurance guarantee. We have worked closely with the media to contextualize public enforcement actions in order to preserve confidence in the system. My consumer assistance staff are ready and able to assist callers at our toll-free line with their questions about the health of the industry, how

to protect their deposits or resolve complaints. And they're becoming adept at assisting consumers in negotiating mortgage loan modifications.

CAPITAL IS KING

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

Last year, the Federal government took unprecedented steps to protect the financial system by providing capital investments and liquidity facilities to the nation's largest institutions. Financial holding company status was conferred on a number of major investment banks and other financial concerns with an eagerness that was jaw-

dropping. However, federal policy has not treated the rest of the industry with the same expediency, creativity, or fundamental fairness. Over the last year, nearly 300 community banks nationwide have failed or been merged out of existence, while the largest institutions, considered too big to fail, have only gotten bigger. Nationally, there have been over 130 bank failures, four of which have occurred in Michigan, in this economic downturn.[5] Unfortunately, this cycle will continue for the next few years. In addition, my fellow state Commissioners and I expect an estimated 125 additional unassisted, privately negotiated mergers due to poor banking conditions.

Additional capital, both public and private, must be the building block for success for community and regional banks. While TARP has provided a source of capital for some of these institutions, the process has been cumbersome and expensive for the community and regional banks, whether they actually received the investment of funds or not.

Furthermore, if TARP is to be an effective tool to strengthen community and regional banks, the Treasury should change the viability standard, which currently requires successful applicants to be viable prior to TARP assistance. Instead, capital should be provided to institutions which will be viable after the TARP investment. Expanded and appropriate access to TARP capital will go a long way to saving the FDIC and the rest of the banking industry a lot of money. To date, this has been a lost opportunity for the federal government to support community and regional banks and provide economic stimulus.

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[5] FDIC

Last month, the Administration announced plans to develop a program to provide lower-cost capital, under the Financial Stability Plan, to community banks that submit a plan to increase small business lending. This program has great promise but must be expedited. We strongly encourage the Administration to structure this program with minimal burden to the institutions and a very quick application process. This will ensure the funds reach the market quickly providing valuable economic stimulus and jobs for the American people.

While there are positive signs on the national scene that private capital may be flowing into the system, Michigan banks have largely been shut out of the capital markets. For the six months ending June 30, 2009, over 2,200 U.S. banks have injected $96 billion in capital. While capital injections were achieved by all sizes of institutions, the group with assets under $1 billion showed the smallest percentage of banks raising capital, 25%. Here again, the federal support for the largest financial institutions seems to be conferring a benefit not broadly enjoyed by the industry. A recent study found that banks with more than $100 billion in assets paid 1.15% for funds, while the rest of the banking industry paid 1.93% late last year and early this year for funding. This translates into an annual subsidy worth up to $34.1 billion for the eighteen biggest banking companies.[6]

Michigan banks, unfortunately for the most part, are not experiencing an influx of private capital. I hear all too frequently from bankers that Michigan is being "redlined" by the capital markets.

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[6] Dean Baker and Travis McArthur, "The Value of the 'Too Big to Fail' Big Bank Subsidy," Center for Economic and Policy Research Issue Brief (September 2009).

SUPERVISION DURING THE CRISIS

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

As a regulator, I will never be able, nor would I desire, to have a completely risk-free banking industry. While they are highly regulated and hold the public trust, depository institutions are largely private enterprises. As such, they should be allowed to take risks, generate a return for shareholders, and suffer the consequences when they miscalculate. Over the last year, the nation has experienced a steady stream of bank failures. While unfortunate and expensive, this does provide a dose of reality to the market and should increase the industry's self-discipline and regulators' focus on key risk issues. In contrast to institutions deemed too big to fail, market discipline and enhanced supervisory oversight may well result in fewer, but stronger community and regional banks.

AREAS REQUIRING ATTENTION

This is a time for us to be looking forward, not backward. As regulators, we need to be working to proactively resolve the problems in the banking industry. To do this, we

need to ensure our supervisory approach is fair and balanced and gives those banks which deserve it the chance to improve their financial positions. Industry and regulators must work together to fully identify the scope of the problems. Individual bank management and regulators must work together to fully identify the scope of the problems facing each institution. Understandably, some banks will be too damaged to successfully rebound, regardless of the time and effort afforded senior management. Given the pivotal role that community banks play in local economies across Michigan, regulators are well advised, however to not take an overly rigid approach to banks that can rebound, afforded a reasonable amount of time and flexibility. A reasonable approach will take time and effort, but it will likely result in less cost to the Deposit Insurance Fund and will benefit communities and the broader economy.

I would like to highlight a few areas of particular concern. In the course of participating in banker forums and other industry events, Michigan's bankers have repeatedly articulated serious concerns to me about a perceived biased regulatory treatment against banks located in Michigan that manifests itself in a variety of ways, including:

- regulatory pre-conceptions about Michigan have affected the state's banks' ability to qualify for TARP CPP funds;
- examiners arriving at the start of an examination having pre-determined the bank's ratings;
- that those pre-determinations are being driven by those who are not familiar with Michigan;

- that material loss reports by the FDIC's Office of Inspector General that charge laxity in supervision of failed banks have had the effect of driving examiners to become unnecessarily rigid.

I've heard these kinds of comments with enough frequency to ascribe some truth to the notion that Michigan banks, due to the very challenging economic circumstances in the state, have been given little quarter by some examiners. Additionally, the challenges of obtaining reasonably accurate appraisals in a volatile and downward-driven market flush with a constant stream of new foreclosures that have artificially suppressed collateral values have been particularly vexing.

Having said that, we've found some instances where bankers didn't have adequate processes in place to accurately assess the value of the collateral backing loans and this understandably caused friction as examiners were forced to develop alternative valuation models. Additionally, earlier in the cycle, I know that there were many bankers who remained overly optimistic and underestimated the depth of the problems that we are facing.

Those days are gone.

I have been actively encouraging Michigan bankers to more aggressively communicate with examiners pre-exam, during an exam, post-exam, and between exams in order to stay on top of developments in local submarkets, regional and statewide exam trends. I believe that Michigan bankers have got this message loud and clear.

Increase Access to Capital

First, as discussed earlier, capital must be allowed to flow into the system. The regulatory environment should not discourage private capital investments. We need to encourage this inflow through direct investments in existing institutions and the formation of new banks. To the extent that private investors do not themselves have bank operating experience or intend to dismantle institutions without consideration of the social and economic consequences, such shortcomings can and should be addressed by denial of holding company or bank applications or through operating restrictions in charters or regulatory orders. Conversely, where private equity groups have employed seasoned management teams and proposed acceptable business plans, such groups should be granted the necessary regulatory approvals to invest or acquire.

Expedite Mergers

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

Brokered Deposits

Third, over the last several years the industry has explored more diversified funding, including the use of brokered deposits. Following the last banking crisis, restrictions were placed on use of brokered deposits by banks falling below "well

capitalized." I appreciate the efforts of FDIC Chairman Bair in working to provide more consistency and clarity in the application of this rule. However, I am concerned the current approach leads to unnecessary failures. For some institutions with large amounts of brokered deposits, the sudden inability to renew existing brokered deposits may trigger a liquidity event. Many of the recent failures of community and regional banks have been the result of a sudden and precipitous loss of liquidity. Regulators allowed banks to increase their reliance on this funding in the first place, and I believe we have a responsibility to assist them in gradually unwinding their dependency as they work to clean up their balance sheets. My colleagues in other states have numerous institutions that could have benefited from a brokered deposit waiver granted by the FDIC.

Open Bank Assistance

Fourth, open bank assistance has the potential to stem the rising tide of bank failures and reduce the growth rate of troubled asset acquisition by the FDIC; but the FDIC is seriously constrained in providing any institution with open bank assistance. I am concerned that these constraints are being subjected to excessively strict interpretation. There are opportunities to provide this assistance which do not benefit the existing shareholders and allow for the removal of bank management. This is a much less disruptive approach and could prove to be much less costly for the FDIC. This is essentially the approach applied to Citibank and Bank of America, granting loan guarantees without removing management or eliminating the stockholders. The Capital Purchase Program under TARP can be a source of capital for transactions that restructure banks or assist in mergers to the same effect. I am not suggesting that such support be without conditions necessary to cause the banks to return to health. Congress has the

authority to modify the "least cost analysis" requirement, which is today preventing consideration of alternatives to closure before a troubled institution has effectively failed.

Regulatory Guidance

One positive recent development can be found in the recent issuance of the FFIEC policy statement on Prudent Commercial Real Estate Loan Workouts. This policy statement stresses that performing commercial real estate loans, including those that have been renewed or restructured on reasonable modified terms, made to creditworthy borrowers will not be subject to adverse classification solely because the value of the underlying collateral declined. The policy statement recognizes that prudent commercial loan workouts are often in the best interest of financial institutions and creditworthy commercial real estate borrowers.

LOOKING AHEAD

This crisis will produce a host of legacy items, designed to address both real and perceived risks to the financial system. They deserve our considered deliberation to ensure a balanced and reasoned approach which provides a solid foundation for economic growth and stability.

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

The community bank and credit union models embrace community engagement and strive to deliver high-touch lending. However, regulators will continue to focus on appropriate concentrations, better risk diversification, and improved risk management. Ultimately, we need to ensure financial institutions are viable competitors for consumer finance and ensure they are positioned to lead in establishing high standards for consumer protection and financial literacy.

There must be recognition of bankers' need to buttress capital and reserve positions in good times in order to weather protracted downturns. Counter-cyclical reserving patterns have unnecessarily stressed the financial sector in this cycle.

We need to consider how the Deposit Insurance Fund can help to provide a counter-cyclical approach to supervision. Congress should revisit the cap on the Fund and require the FDIC to build the Fund during strong economic times and reduce assessments during periods of economic stress. This type of structure will help the entire industry when it is most needed.

CONCLUSION

Michigan has been among the states hardest hit by the recent recession and bursting of the real-estate bubble, and it likely will be among the last states to recover. I urge you to keep this in mind in considering the future of TARP and stimulus programs now in place and be wary of the premature termination of programs before all boats are again afloat.

Thank you for the opportunity to testify today on the challenges facing the banks in Michigan, and how initiatives undertaken by the federal government can impact these institutions.

I look forward to any questions you may have.