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September 22, 2008

The Honorable Henry M. Paulson, Jr.
Secretary of the Treasury
Office of the Secretary
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Ben S. Bernanke
Chairman
Federal Reserve System
Eccles Board Building
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable John M. Reich
Director
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

The Honorable John C. Dugan
Comptroller of the Currency
250 E Street, SW
Washington, DC 20219-0001

Dear Secretary Paulson, Chairman Bernanke, Chairman Bair, Director Reich and Comptroller Dugan:

As we noted in our letter of September 18, 2008, the American Bankers Association is deeply concerned about the impact of the recent financial events, including aspects of the conservatorship program for Fannie Mae and Freddie Mac (GSEs). In particular, the elimination of all dividends on preferred shares is reducing bank capital and impeding the ability of banks to make new loans and renew existing ones that are so critical to our nation's economic recovery. The negative impact on banks – ***particularly Main Street community banks*** – is far greater than the regulators first thought. This letter provides further details based on an extensive survey of the banking industry. It is imperative that this impact be addressed both quickly and in a comprehensive fashion to mitigate the unintended consequences. Otherwise, banks would be restricted in their ability to provide the credit that is desperately needed at this time.

Banks were encouraged to hold these supposedly low-risk, highly rated instruments of Fannie Mae and Freddie Mac, and the regulatory treatment of GSE

securities, including preferred shares, strongly supported it. Now the unexpected write-downs will clearly impede lending unless action is taken.

When the actions were contemplated to reduce dividends on Fannie Mae and Freddie Mac preferred stock, the bank regulators estimated that only a few dozen banks would be affected by it. Based on our banking industry survey, ***nearly 27 percent of banks hold preferred stock of these GSEs.*** Moreover, 3.4 percent of banks hold auction-rate securities, which were backed by preferred stock of these GSEs. The average exposure relative to core equity capital for banks with GSE preferred and auction-rate preferred securities was 11 percent. Extrapolating the results of our survey together with SEC 8K filings for the largest banks, the total industry exposure is estimated to be between $10 billion and $15 billion. ***Since $1 of bank capital supports $7.6 dollars of lending, the actions contemplated mean that lending could decline by between $76 billion and $114 billion.*** The credit crunch will be immediate: with capital difficult to raise in the market today, banks will have no choice but to shrink in order to restore their capital-to-assets ratio to previous levels.

The magnitude of the exposure among individual banks that hold these securities, of course, varies considerably and ranges from a very small percent of capital to over 90 percent of core equity capital. Most banks – 85 percent – have exposure of less than 20 percent of equity capital (and 94 percent have less than 30 percent). ***Any*** reduction in capital, however, means ***less*** lending. Moreover, the impact is widespread and particularly affects Main Street community banks. In fact, of the banks that reported holding GSE securities, 85 percent were community banks (less than $1 billion in assets) and 65 percent were banks with assets of less than $500 million. Every state in the nation is affected, with the largest number of banks with exposure in Massachusetts, followed by Illinois, Connecticut, South Carolina and Virginia.

Banks are naturally cautious in extending new loans – a prudent approach given the economic circumstances. These unexpected losses, however, are magnifying the impact dramatically. These community banks are the lifeblood of communities across this nation and the reduction in capital will hinder credit availability so vital to economic recovery. The vast majority of banks that are now suffering these losses did not make high-risk subprime loans and have very few losses for any of the loans they have made. However, the impact on capital from the Fannie and Freddie preferred stock write-downs will restrain even the best banks in this country from making new loans.

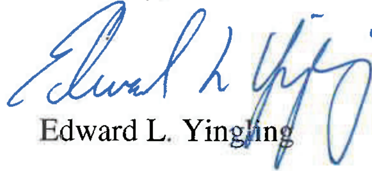
As ABA stated in our previous letter, a comprehensive approach is needed to rectify the situation:

- Dividends on preferred stock should not be reduced until after September 30 quarter end, permitting Congress and the regulators to assess the implications and address solutions;
- A reasonable level of dividends should be paid (which would restore a portion of the share value and reduce impairment charges);

- For tax purposes, losses should be authorized to be treated as ordinary and allowed to be offset against ordinary income (we recommend that this be authorized in the financial rescue legislation to be considered this week);
- Reduce the risk-weightings on GSE debt and GSE-guaranteed mortgage-backed securities from the current 20 percent weight;
- Risk-weight the Auction Rate Preferred Securities (ARPS) backed by Fannie Mae and Freddie Mac at 20 percent; and
- Increase the flexibility of capital restoration plans required by the regulators for banks that fall below minimum standards.

While 98 percent of banks are well-capitalized and have the desire to make credit available in their communities, the capital eliminated by the government's action will immediately – and in some cases severely – limit their ability to do so. ABA is asking for prompt, comprehensive action to address this serious consequence of the GSE bailout on our banking system. We look forward to meeting with you to discuss solutions to these problems.

Sincerely,



Edward L. Yingling