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RESTORING CREDIT TO MAIN STREET: PROPOSALS TO FIX SMALL BUSINESS BORROWING AND LENDING PROBLEMS

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

ON

EXAMINING RESTORING CREDIT TO MAIN STREET: PROPOSALS TO FIX SMALL BUSINESS BORROWING AND LENDING PROBLEMS

MARCH 2, 2010

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C O N T E N T S

TUESDAY, MARCH 2, 2010

WITNESSES

RESTORING CREDIT TO MAIN STREET: PROPOSALS TO FIX SMALL BUSINESS BORROWING AND LENDING PROBLEMS

TUESDAY, MARCH 2, 2010

U.S. SENATE,
SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:38 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jeff Merkley, presiding.

OPENING STATEMENT OF SENATOR JEFF MERKLEY

Senator MERKLEY. I will call to order the Subcommittee on Economic Policy for this hearing, "Restoring Credit to Main Street: Proposals to Fix Small Business Borrowing and Lending Problems." Senator Sherrod Brown is delayed in transit, but we expect him to be here in a few minutes, however many that might be.

I will give my opening statement, and then Senator Levin will be here to give his testimony—he is here to give his testimony, and we are expected to be joined by Senator Stabenow in due course.

We are in the midst of a crisis for small businesses. Just this past week, the FDIC released its latest quarterly report showing that bank lending has dropped by $578 billion last year, the largest annual decline since the 1940s. This drop in lending has hit the small business community very hard. These companies are the engine of growth in our economy, and we need to enact aggressive policies that ease the credit conditions facing small businesses and get our economy back on track.

I was out this weekend in central Oregon meeting with a group of small business owners—a restaurant owner, the owner of an organic coffee company, the owner of a market, and so forth—and the stories about access to credit just continued one after the other: reduced credit lines, difficulty in getting loans to seize business opportunities, even when there are longstanding relationships with lenders.

The story of one Oregon company tells it all. Kitchen Kaboodle sells cookware and kitchen appliances with five locations around the Portland metro area. They are locally owned. Their flagship store is on one of Portland's most popular shopping streets. They have prudently reacted to the downturn in the economy, making some unpleasant decisions, cutting staff, cutting salaries, cutting back on health insurance. The company is still showing a profit, but banks are cutting their credit lines across the board. This is a healthy company with a long history of success in the Portland area with competent management and a strong credit history, and we have to do more to make sure that companies like Kitchen Kaboodle can gain access to credit.

This hearing will help us examine the proposals my colleagues and I have offered, along with the Administration, providing strategies to support small business lending. As many of you know, Senator Boxer and I introduced the Bank on Our Communities Act which would help recapitalize healthy community banks and incentivize these banks to grow their small business loan portfolios. But solving this credit crisis on Main Street is going to require multiple strategies, and I look forward to hearing from and working with my colleagues, Senator Levin, Senator Stabenow, Senator Warner, and others who have had ideas on how to take this on.

In conclusion, thanks to Senator Brown for holding this hearing, and I look forward to hearing from our panelists this morning.

With that, I would like to invite Senator Carl Levin to speak. He was born in Detroit, Michigan, elected to the Senate in 1978, and has been a tireless voice in the Senate for American manufacturing. Senator Levin has been working closely with colleagues in both chambers to address access to credit issues for small businesses. Welcome, Senator.

STATEMENT OF CARL LEVIN, U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Thank you very much, Chairman Merkley—I thank Senator Brown also—for convening this hearing. I have a rather lengthy statement which I would appreciate being put in the record, and also since Senator Brown is here, I am sure he would want to read every word of my statement as well. But being caught in traffic is nothing new, I am afraid, around Washington.

You have laid out the problem very well. Your bill addresses the problem in a very important way, and I am pleased to cosponsor your bill, which I believe is S. 1822.

Senator MERKLEY. Thank you for your cosponsorship.

Senator LEVIN. It is one way of addressing this issue, which, as you pointed out in your comments, we have got to look at various ways of addressing this decline, this tightening of credit for small businesses. We have done a lot for the big banks, but the lifeblood of our local communities are these small banks, community banks—some of them not so small, but these are our community banks, our local banks.

I want to just address one part of the problem which frequently is not seen. We talk a lot about banks that do not have the capital to loan or the banks which have gotten, in the case of large banks, large capital infusions from the Federal Government sometimes, but that have not lent that money out. There are a lot of efforts going around to see if we cannot, as you point out, Mr. Chairman, incentivize these banks or in some way or other get the banks that have capital, and particularly those that have been helped by the Federal Government, to use that capital to get loans flowing again.

The percentage of the reduction in the number of loans going to small businesses is dramatic. In my State of Michigan, I believe it is down to something like a 74-percent reduction in business loans in the last 2 years. We have got a 15-percent unemployment rate, and there is a connection between those two figures. We all hear about gross domestic product going back up again. This has not affected our job creation yet because, as you point out, Mr. Chairman, the engine of that creation is small business, and we have not seen loans again flowing to small business on Main Street.

One of the reasons for this is what I want to just leave with the Subcommittee this morning. We all know what has happened to home values in America. Most of our homes have gone down in terms of their value. The housing bubble reduced the value of homes typically by 15 or 20 percent or 25 percent in America, and I think most homes, the vast majority, have seen that decline.

Well, the same thing has happened with the assets of businesses. The value of their machinery or the value of their equipment has gone down because of the recession. And so just as you pointed out, business after business after business comes into our offices or meets with us when we get home on weekends and says, "We have a good business going. We have never missed a payment. We have customers. But our lines of credit have been cut."

Now, there are a couple of reasons for that. One could be that the banks do not have capital, and your bill and other efforts are intended to try to get some more capital into those banks. But another reason why banks do not loan is because the collateral value of the borrower has gone down. It is the same collateral. It is the same machinery. It is the same equipment. But the value of that collateral having gone down, the banks are unable because of our regulatory reasons to make the loan. The regulators will say, "Hey, wait a minute. The value of that collateral is down. You are going to have to either not make the loan or use more of your bank's capital in order to make the loan."

So what we need to do is find ways to support the collateral of the borrower as well as to infuse more capital into the banks. And there is a program we have had in Michigan that does exactly that. It is called the Capital Access Program. We have a new version of that program that is now underway where the State is actually depositing funds in reserve accounts, and that is the key to this. It is funds going into reserve accounts to support loans to businesses that need collateral support.

So it is addressing the problem in a way which has not yet been addressed as far as we know, which is to help the borrowers that have decreased collateral values where, again, they have the customers, they have never missed payments, and they have the same collateral. But because of the economy, the value of that collateral has gone down, and so this program, which my brother, Sandy Levin in the House, on the Ways and Means Committee, is working very hard there with colleagues. We are working hard here with colleagues to put the finishing touches on this collateral support program where funds would be actually placed with the bank, put in reserves, either through the State, which is the case with our Michigan Capital Access Program, or where the source could be Federal funds funneled through the State.

We have a small business loan program. It is a loan guarantee program. It is very valuable. This in no way is in conflict with or undermines that. It would be another arrow in the quiver of ways of supporting the small businesses that seek loans and that have had lines of credit that are no longer available.

So I wanted just to highlight that one specific element that has not had enough attention paid to it. Art Johnson, who is a banker from Grand Rapids, is on your second panel, and I am very glad that he has been invited, and he will make a wonderful presentation. And whether he addresses the Capital Access Program or other things, I know he is familiar with that program and could perhaps answer questions about it.

Senator MERKLEY. Thank you very much, Senator, for your testimony, and are you needing to depart?

Senator LEVIN. Yes, and I thank you.

Senator MERKLEY. Could I ask you a question before you go?

Senator LEVIN. Of course.

Senator MERKLEY. Do you envision this collateral support program would help address commercial investors who own buildings, if you will, where the value of the building has gone down and they have 7-year or 10-year balloon loans that are traditionally rolled over, they have made every payment, as you say, like many small businesses have, but the collateral of the building, the value of the building has dropped and is making it very difficult for them to find rollover lending?

Senator LEVIN. I think it can be used for that purpose as well. We are still working out the final language of it, but I see no reason why, where you have that same building, it cannot be the same as the same collateral where it is inventory or other kinds of collateral.

Senator MERKLEY. Thank you very much for bringing this idea forward. I have signed on to the letter in support of your collateral support idea. It certainly helps address a challenge that I am hearing from small businesses throughout Oregon. Thank you for your testimony.

Senator LEVIN. And thank you again for chairing this. I put my entire statement in the record. I want you to know, Senator Brown, because I know how you will want to read every word of it, but thank you, Senator Brown and Senator Merkley both, for hosting this. You have touched on a very, very significant problem in our country where you have got businesses with good credit records who suddenly find their lines of credit cut based on the—in my testimony, I point out that the value of their collateral has gone down because of the economy, just the way the value of our homes has gone down. And so the amount of the loan which can be made to them from the banks is reduced because of the regulatory requirements because the value of the collateral—same assets, same machinery, same equipment, same building. They have the same business and they have customers. They never missed payments, but suddenly their collateral has gone down. So we not only have to—and forgive me for repeating this, Senator Merkley, but I do want to make just this—summarize the point to Senator Brown. Just the way our home values have gone down for the most part, the same home, and we are paying our mortgage payments in most cases where there is no foreclosure, so you have got businesses in business, same customers, they are doing fine, never missed a payment, but the value of their collateral has gone down, and that leads to the lines of credit being cut, and that makes it impossible for them to pay for their payroll, which is usually funded through credit, or their inventory has been supported through lines of credit. And that is what our effort is intended to address, to support that collateral.

I commend you and Senator Merkley for all you are doing here to get these small businesses the kind of support that they need and that is so essential to our country.

Thank you.

Senator MERKLEY. Thank you.

We have the Michigan dream team here this morning, so for the second half, Senator Stabenow, who was born in Michigan, elected to the Senate in 2000 as Michigan's first female Senator. Just last week, she introduced the American Job Creation and Investment Act, a bill to allow companies to utilize existing AMT credits do they can invest in new manufacturing facilities and create jobs. And I know that you have been hearing a lot of stories back home about the challenge of access to credit, and we appreciate your testimony this morning.

STATEMENT OF DEBBIE STABENOW, U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator STABENOW. Well, thank you very much, Senator Merkley and Senator Brown, for convening what is a very important meeting, a very important hearing. And I would first just say that, to follow up on what Senator Levin was saying, I had a conversation yesterday with a banker in Michigan who was right on point with what we are talking about in terms of collateral. This bank CEO said that a business person, a small manufacturing supplier came in to refinance their properties, and they had just 3 years ago received a loan based on $1 million worth of assets, their physical assets of the plant. They had been given about an $800,000 loan, and now when they come in and it is time for them to refinance, that property of $1 million was worth barely $600,000, and they were able to get a loan legally under the rules now of some $400,000, and so it was roughly half of what the loan was, what they owed on the principal.

And so this is a situation that we have happening all across Michigan. I am sure that is happening in Ohio and Oregon and all across the country where we have equipment, facilities, you know, business properties, commercial entities that are operating under one valuation and loans set accordingly who now find themselves underwater even though they own the same property, and nothing has changed other than the economy, and the same this with families and homes. So I appreciate very much that both of you are very open and, I know, supportive of addressing this as part of what we do for small business.

I am pleased that the chairman of the American Bankers Association, Art Johnson, is, in fact, testifying today. As the CEO and Chairman of United Bank of Michigan and United Community Financial Corporation in Grand Rapids, Art understands and is on the front lines of tackling the serious problems facing community banks and small businesses in some of the hardest-hit areas certainly of our State and the country, and I am sure he can speak more specifically to this important issue of collateral.

The fact that we are holding the hearing, we all know why we are here. Small businesses create 64 percent of the jobs in the country. Small businesses tend to get loans from their local community banks, not the big Wall Street banks. According to FDIC call reports, banks with less than $1 billion in assets, making up about 12 percent of the banking assets, make nearly half the small business loans.

So I very much appreciate both of your leadership, and, Senator Merkley, I am very proud to be a cosponsor of your legislation as well.

Federal regulations have, rightly, cracked down on the big banks who caused the financial crisis. According to the FDIC data, the amount of lending by the banking institution rating industry fell, though, by $587 billion, or 7.5 percent, last year, which is the largest decline since the 1940s, which is why we find ourselves here. And, ultimately, it is America's small business and workers who are suffering the most. They cannot get the capital they need up front to make the products that they need.

Another very common story that I hear in Michigan, we have a small supplier making gear boxes, and they get a contract from an auto maker. Normally they get a signed contract, they take it to the bank, they get the capital up front to be able to buy the materials and pay to make the product, and then they get paid and they pay it back. Now those loans are not being made on too many occasions, and it is stopping us from creating jobs. We are actually seeing job loss because of the inability to be able to get the capital that is needed.

It is so important that we separate the large financial institutions that benefited from TARP from the vast majority of banks. And I know that is what you are focused on as well. The smaller banks who did not receive nearly as much support, if any, from TARP as the larger banks originate the vast majority of loans. Thankfully, our community banks are still lending despite dealing with these incredible pressures to increase capital and reduce risk, and they too are suffering from an economic environment that makes it hard to raise capital for them. So I look forward to hearing from the next panel as well.

As Senator Levin emphasized and I would just emphasize again, our small businesses are dealing with reduced cash-flow compounded by collateral whose value has decreased in recent years. And as we move forward on our small business jobs bill, I think it is absolutely critical that we deal with both of those issues if we are actually going to begin to see lending occurring, as we all want to see it.

As I am sure our next panel can attest, even a healthy bank will not make a loan to a borrower who does not have enough collateral value. That is why what we have done in Michigan is so important. We have seen that the new regulations on our big banks make sense, but a one-size-fits-all is hurting the ability of small banks to help small business. And we have been working through our Michigan Economic Development Corporation and the Governor's office to find a way to support and to tackle this issue of collateral.

I would suggest to you the theory of “too big to fail” now means that many of our businesses are too small to grow. That is the reality of what is happening. And it is urgent that we fix that.

Nearly 700,000 Americans work for parts suppliers, more workers than any other types of manufacturing company. And I would just share with you one example of how this credit crunch is affecting our small manufacturers.

Wes Smith, who is the president of E&E Manufacturing, a metal stamping company in Plymouth, Michigan, is looking to expand his business, but might not be able to because his long-term lender recently reduced his line of credit and changed his loan covenants. Although sales picked up at the end of the year—and we are very pleased that we are seeing an uptick in manufacturing for the first time in many, many years, and they are expecting a 20-percent increase in sales projections—he is having trouble getting the capital to rehire about 200 people he was forced to lay off in the worst of the recession. That is 200 people at just one plant who could go back to work right now if this company was able to get the credit that they have received in the past.

Senator Levin mentioned Michigan started a successful program last year that targets businesses that have a good credit risk but have collateral or cash-flow shortfalls. The first $13 million of that fund was fully committed within the first 5 months, and it was oversubscribed by nearly 300 percent. So the need is out there, and that is just in Michigan.

Our program has taken $13.3 million in public funding to leverage $41 million in private loans, which is leverage of about 3:1 and very important for us to look at.

So when we consider the authorization of the President’s small business lending fund, which I strongly support, I would urge that we take some of those dollars and direct them toward programs like the one we have in Michigan to address collateral depreciation issues.

We also need to address the separate problem of small businesses being able to qualify for loans. I hope as we address this issue we also extend the Small Business Administration loan guarantee that expires this month and increase the maximum loan size of SBA 504 and 7(a) programs, which the SBA estimates would create up to $5 billion in growth for small businesses and as many as 160,000 jobs. That is what this debate is really all about, as both of you know so well, and it is about creating jobs, growing the economy. And small businesses and our ability to support small business are really at the heart of our economic engine and the ability to grow.

So I thank you very much for allowing me to testify today, and I would be happy to work with you in any way possible.

Senator MERKLEY. Thank you very much, Senator, for your advocacy for small businesses and for access to credit. Does my colleague have any questions?

Chairman BROWN. No questions, but a special thanks to both of you for your focus especially on manufacturing, what it means to the auto supply chain and helping those companies get credit and transition into other industries when possible and necessary, and how you have really led the charge on that. Thank you, Senator Stabenow.

Senator STABENOW. Thank you.

Senator MERKLEY. I would like to ask just one question before you leave, and that is, given that the program is now oversubscribed, is Michigan planning on expanding that fund? And is the source of the funds coming from general funds, or how is that being established?

Senator STABENOW. Well, at this point, in order for them to expand it, they would need support from the Federal Government to do that given the economic crisis in the State as well. I think they have gone as far as they can. They have put aside some dollars and have approached us, have approached the White House, and would like very much to see a part of what is done in what we do with the President's program redirect some dollars that would allow the Economic Development Corporation to partner and leverage funding, as they have been doing.

Senator MERKLEY. Thank you so much. Thank you for your testimony.

Senator STABENOW. Thank you.

Senator MERKLEY. At this point we will ask the second panel to come forward and take their seats at the table. Thank you.

[Pause.]

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN [presiding]. I thank you all for joining us, and special thanks to Senator Merkley for always doing his job the way he was elected to and beyond. I appreciate that. And I apologize. My flight was a little late. I think I learned a lesson today. Don't fly on the morning of the hearing, with traffic and all that. But I apologize for any delay in the schedule to all three of you. Special thanks to Senator Stabenow and Senator Levin, who, as I had said, have been so tuned in to what we need to do in terms of credit and with a special focus on manufacturing.

I know that Senator Merkley touched a lot of these, as did our two Senate colleagues, but we know the problem. Bank loans and leases have declined for six straight quarters. We know what that means to banks. We know what that means particularly to community banks in small-town Ohio and in Michigan and in Oregon. We know what it means for businesses that are looking for credit. The NFIB Research Foundation found that 60 percent of businesses last year did not have all their credit needs met, and we know what that means.

A brief story and then we will begin the testimony. The *Wall Street Journal* ran an above-the-fold front page article featuring the story of a Cincinnatian named Nick Sachs, who is the owner of a health-care franchise in southwest Ohio. He opened his business in 2008 with the help of a loan from a small bank. He now has 25 employees. He is in a position to add to pretty much double that number. Unfortunately, his original lender isn't big enough to support a second loan. He hasn't been able to find another bank willing to make that loan. I mean, that clearly is a real obstacle to our recovery, obviously, in States like ours, but States across the country.

Again, thanks for all of those and apologies for starting a bit late. I would like to introduce each of the panel members. Each of you take roughly 5 minutes for your testimony and then we will begin the questions.

Arthur Johnson, whom Senator Stabenow mentioned already, is Chairman and CEO of United Bank of Michigan in Grand Rapids. His testimony is on behalf of the American Bankers Association. He is Chair of the American Bankers Association, Chair and CEO of United Bank of Michigan, and President and CEO of United Community Financial Corporation in Grand Rapids. He has previously served in the ABA Community Bankers Council and its administrative committee, is the past Chair of both the ABA Government Relations Council and the Bank PAC Committee. He volunteers his time to benefit several organizations, including Habitat for Humanity and Public Radio. He is the Director of the Employers Association, both the Michigan District of the SBA, he has had special attention there, and the Grand Rapids Area Chamber of Commerce named Mr. Johnson the Financial Services Advocate of the Year in 1988. He holds a BA in Finance from Michigan State in East Lansing and an MBA from Western Michigan in Kalamazoo.

Eric Gillett is Vice Chairman and Chief Executive Officer of the Sutton Bank, which, I would add, has offices, as he said, in my hometown of Mansfield. He is Vice Chair and CEO. He is located in Attica, Ohio. He has 35 years of banking experience, currently serves on the ICBA Payments and Technology Committee and on the Board of Directors of EPCOR, the regional payments association. He served on the Board of Trustees as Chairman of the Investment Committee for the East Ohio United Methodist Foundation, the Board of Directors of NACHA, and on the Fannie Mae National Housing Advisory Council. He has risen through the ranks of Sutton Bank to become an industry leader. He holds a Bachelor of Science degree from the Ohio State University.

Raj Date is Chairman and Executive Director of the Cambridge Winter Center. He was Managing Director in the Financial Institutions Group at Deutsche Bank Securities, where he led the firm's investment banking coverage for the largest U.S.-based banks and thrifts. Prior to joining Deutsche Bank, Mr. Date was a Senior Vice President for Corporate Strategy and Development at Capital One Financial, where he led merger and acquisition development efforts across the U.S. banking and specialty finance markets. He began his business career in the financial institutions practice of the consulting firm McKinsey and Company. He is a graduate of the College of Engineering at Berkeley with highest honors, and the Harvard Law School, where he graduated Magna Cum Laude. He lives in New York with his wife, an Assistant U.S. Attorney, and their twin son and daughter.

So welcome to all three of you. Mr. Johnson, you begin, please.

STATEMENT OF ARTHUR C. JOHNSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, UNITED BANK OF MICHIGAN, GRAND RAPIDS, MICHIGAN, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. JOHNSON. Good morning. Chairman Brown, Members of the Subcommittee, my name is Art Johnson. I am the Chairman and CEO of United Bank of Michigan and Chairman of the American Bankers Association.

This recession is one of the worst we have ever faced. While the statisticians will say that the recession has ended, that is little comfort to Michigan, where we are at a 14.6 percent unemployment rate, and we are not alone. Across the United States, people are still suffering from high levels of unemployment and business failures. The impact of the downturn is being felt by all businesses, banks included.

The cumulative impact of eight straight quarters of job losses, over eight million nationwide since the recession began, is placing enormous financial stress on many individuals and businesses. This has caused business confidence to drop and loan demand to fall. Many businesses either do not want to take on additional debt or are not in a position to do so, given the falloff of their customer base.

There are, however, some positive signs. We have heard from bankers that small businesses are returning to test the market for loans. It will take time for this interest to be translated into new loans. In previous recessions, it took 13 months for credit to return to prerecession levels.

Banks have many pressures to face in the meantime. The commercial real estate market will pose a particularly difficult problem for the banking industry this year. The CRE market has suffered after the collapse of the secondary market for commercial mortgage-backed securities, and because of the economic slowdown, that has caused office and retail vacancies to rise dramatically.

We have heard anecdotes from our members of examiners, bank examiners, who take an inappropriately conservative approach to their analysis of asset quality and who are consistently requiring downgrades of loans whenever there is any doubt about the loan's condition. This is especially true for CRE loans. Examiners need to understand that not all concentrations in CRE loans are equal and that setting arbitrary limits on CRE concentration has the effect of cutting off credit to creditworthy borrowers, exactly at the time when Congress is trying to open up more credit.

ABA appreciates the initiative of President Obama outlined in his State of the Union Address that would provide additional capital to small banks who volunteer to use it to increase small business lending. A key factor to this proposal is removing it from the rules and restrictions of TARP and its related stigma. As this program is developed, ABA recommends that Congress and the Administration create criteria that allow all viable community banks to participate. We also propose that Treasury offer assistance to those banks that did not qualify for Capital Purchase Program funds, but that can demonstrate the ability to operate safely and soundly and survive if given the chance to obtain necessary capital.

Another idea is to use existing State lending programs to target small businesses in local markets, such as has been done in Michigan. One such program, the Capital Asset Program, uses small amounts of public resources to generate private bank financing. This program supported over $628 million in bank lending, a public–private ratio of 27-to-one.

Another Michigan program, the Michigan Collateral Support Program, supplies cash in collateral accounts to lending institutions to enhance the collateral coverage of borrowers. Loan flow in Michigan's pilot program has been high, with close to 300 inquiries and at least $150 million in requests in the first 2 months of the program. These two programs may serve as models for other programs that could be implemented across the United States.

We appreciate the work this Congress has done to increase the guarantees on SBA's 7(a) loan program. Subsequently, the SBA expanded eligibility to small businesses by applying the standard used in the 504 program. These positive changes mean that an additional 70,000 small businesses will be eligible.

The success of small businesses in local economies depends in large part on the success of their community banks. We must all work together to get through these difficult times, and I would be happy to answer any questions that you might have.

Chairman BROWN. Thank you very much, Mr. Johnson.

Mr. Gillett.

STATEMENT OF ERIC A. GILLETT, VICE CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SUTTON BANK, ATTICA, OHIO, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS ASSOCIATION

Mr. GILLETT. Chairman Brown, Senator Merkley, Members of the Subcommittee, thank you for the opportunity to testify on behalf of the 5,000 members of the Independent Community Bankers of America. My name is Eric Gillett and I am the Vice Chairman and CEO of Sutton Bank.

Sutton Bank is a $355 million S Corporation bank established in 1878, focused on small business and agricultural lending. The bank is located in Attica, Ohio, a rural bedroom community of Cleveland with a population of 900. The largest community in our market is Mansfield, whose population is nearly 50,000. Our institution has $215 million in loans, the bulk of which are commercial and farm loans. We use the USDA Business and Industry and SBA loan programs to assist our customers and have consistently been named one of the top small business lenders in Ohio, according to the U.S. Small Business Administration.

Mr. Chairman, community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. While community banks represent about 12 percent of all bank assets, they make 40 percent of the dollar amount of small business loans of less than $1 million made by banks.

Notably, nearly half of all small business loans under $100,000 are made by community banks. In contrast, banks with more than $100 billion in assets, the Nation's largest financial firms, make only 22 percent of small business loans. However, while the overwhelming majority of community banks are well capitalized, well managed, and well positioned to lead our Nation's economic recovery, there are certain hurdles in place that are hindering our efforts.

Many community bankers report the examination environment is hindering lending. In a recent informal survey of bankers conducted by ICBA, 52 percent said they have curtailed commercial and small business lending as a result of their recent safety and soundness examinations. Also, 82 percent answered that the Federal banking agency's guidance on commercial real estate loan workouts has not improved the environment for commercial real estate loans.

Bankers are also impacted by examiners' increasing capital requirements above the statutory and regulatory limits. Therefore, community banks with sufficient capital to be considered well capitalized are being classified as only adequately capitalized. This change in capital status may create higher FDIC premiums, lowering earnings and ultimately the capital of the institution. Examiners who raise leverage capital ratios do so at the expense of lending. More capital required in reserve means less is available to lend to small businesses.

Community bankers also report aggressive write-downs of performing commercial real estate loans based solely on appraisals and absorption rates. Examiners may be ignoring the borrower's ability to repay its loan, the borrower's history of repaying other loans, and favorable loan-to-value ratios. However, community banks believe they do a better job in monitoring and offering loans than do large nationwide lenders because they are more likely to work one-on-one with customers and they have a better understanding of the local economic conditions in their communities.

Small business lending is down because community banks have witnessed a decrease in demand from loans from qualified borrowers. In a recent ICBA survey, 37 percent of banks responding said that lack of loan demand was constraining small business lending. A healthier economic climate and increased confidence in the future will increase loan demand.

In my written statement, I have listed several recommendations for boosting small business lending. ICBA believes the Administration's new small business lending program, if properly structured, can be very successful. ICBA strongly supports the extension of the SBA loan program enhancement included in the American Recovery and Reinvestment Act. My written statement also includes recommendations to help community banks and small business preserve and raise valuable capital.

Mr. Chairman and Members of the Subcommittee, community banks form the building blocks of communities and support small businesses around the country. Community bankers are ready, willing, and able to meet the credit needs of small businesses and the communities they represent. ICBA stands ready to work with you on these important issues and I look forward to your questions.

Chairman BROWN. Thank you, Mr. Gillett. I have never heard Attica referred to as a rural bedroom community of suburban Cleveland, or however you said that.

Mr. GILLETT. It is a geographic reference.

[Laughter.]

Chairman BROWN. Close to Mansfield makes way more sense.

Mr. Date, thank you.

STATEMENT OF RAJ DATE, CHAIRMAN AND EXECUTIVE DIRECTOR, CAMBRIDGE WINTER CENTER FOR FINANCIAL INSTITUTIONS POLICY

Mr. DATE. Thank you, Chairman Brown, Members of the Subcommittee, for inviting me today. My name is Raj Date. I am the Chairman and Executive Director of the Cambridge Winter Center, which is a boutique think tank focused exclusively on U.S. financial institutions policy.

Small business credit is an important issue and this is a critical time. We believe that we are at a crossroads, at the point in the economy where the decline in commercial credit will become less driven by a very rational decline in demand and more driven by a structural deficit in the supply of small business loans.

My written statement provides some tedious detail on both the supply and demand issues, but the core problem we face is easy to summarize. A large fraction of small business finance provided over the last decade was supplied by both products and firms that are shrinking fast or no longer exist. The products that are shrinking are consumer products, for the most part, that bleed over into small business finance: two in particular, the high-line credit card business and the cash-out home equity business.

Aside from those products, there are categories of nonbank lenders that specialize in commercial finance that are shrinking, as well. GE Capital and CIT are the biggest examples, but you may recall that a number of Wall Street firms had big commercial finance businesses, too. AIG and Merrill Lynch both had very large commercial finance outfits. These all seemed like terrific products and terrific business models—during the bubble. They are decidedly less competitive in normalized times, and they don't particularly work well at all now.

The retreat of those products and those firms from the marketplace should create an opportunity for regional and community banks to step in and fill the void. In my written statement, I call that phenomenon the relocalization of small business lending. Over the long term, relocalization of small business lending is a great thing. The financial system and all of us would be better off if it were less reliant on very large finance companies and broker dealers that fund themselves in confidence-sensitive wholesale markets. Plus, regional and community banks are better underwriters of small business risk because of their in-market presence and their in-market focus.

But that is the long term. Over the near term, we have a problem. The most serious is capital. Small banks' capital is pressured in a number of ways and those pressures are not going to resolve themselves soon. The bank market will eventually clean up its collective balance sheet and recapitalize on its own, but that is going to take years and not months. So the question for us is what we had ought to do in the interim.

With that context in mind, and mindful of the track record of past policy efforts, I would like to suggest three criteria to evaluate alternative solutions to the small business credit crunch.

First, we should recognize the limits on the Government's ability to quickly and competently direct the flow of commercial credit on its own. Unlike in education finance, say, there is no existing Government apparatus by which to generate and evaluate and negotiate and close small business loans. Even for the SBA, which would be the most relevant existing agency, building and scaling up an effort like that would take time and it would be a very complicated and massive undertaking. Given the severity and urgency of this issue, working through bank intermediation would seem the more logical course.

The second principle: not all banks are the same and we should not treat them as though they were. I would argue that the central conceptual failing of the original TARP capital infusion plan had nothing to do with executive compensation or anything else. It had to do with creating an investment structure that was deliberately a one-size-fits-all model that became, as a result, disproportionately valuable to exactly the worst banks. As a result, the TARP investments managed to create neither a credible endorsement that could entice private capital back into the market, nor did they provide any competitive benefit to the banks that had actually demonstrated that they knew what they were doing in the first place.

Third principle: we should be careful about and explicit with incentives. Many people who supported the original TARP capital infusions believed, or were led to believe, that credit would thereby be restored. They are irritated by continued declines in bank lending. The lesson is straightforward. If taxpayers are asked to subsidize any particular activity, well, then that subsidy should be narrowly tailored to that objective. Of course, when the desired activity is lending, we need to be especially careful because we don't want to create such artificially strong incentives that it goads banks into making otherwise irresponsible decisions, which, of course, creates more harm than good in the long run.

Let me then turn quickly to the Administration's proposal for a small business lending fund with those principles in mind. I think it is a logical proposal. It is an internally consistent proposal. But it does not in its current form meet either the second or the third principles that I just mentioned. As described in my written statement, the capital provided to banks under the proposal is so large and the amount of required lending so small that it is likely that most of the Government-supplied capital would be used to bolster preexisting weakness in a firm's capital position rather than to support incremental credit. Because of that, the program would disproportionately be valuable to precisely the banks that have proven themselves the worst at making credit decisions. I fear that it would, therefore, quickly devolve into a back-door bailout for the most dubious balance sheets and the most dubious management teams in what is actually a very large industry with plenty of good ones, and I think that that result, obviously, would be unfortunate.

The Administration proposal, then, is going to require some refinement before it is ready to implement and that implementation is going to take some time to do right. Given the urgency of this issue, though, the committee may want to consider in parallel an interim measure that might be rather more simple to implement. My written statement describes one such interim solution. It isn't without risk, but I think that it might be specifically tied to the outcome we desire, incremental small business credit.

I will end my remarks there and obviously I look forward to your questions.

Chairman BROWN. Good. Thank you, and thank you all for staying very close to the 5 minutes in your testimony. We will do a pretty wide-open question period.

I will start with Mr. Johnson. Again, thank you for joining us. You heard Senator Levin in his sort of synopsis of his remarks, and I know in the central thesis of his remarks, talk about the value of collateral declining. Give me a reaction to that in what you think—what kinds of solutions do you see to that?

Mr. JOHNSON. Well, I think he hit the nail on the head. As has been mentioned in one form or another by both our Senators from Michigan, it really strikes a point. There are many instances where borrowers, as Mr. Merkley described earlier, that have performed and yet they are having trouble obtaining a loan now because of the fall-off of their collateral value.

A program like the pilot program in Michigan, where funds are deposited into the bank in an interest bearing account that is, in turn, pledged to be additional collateral for the business loan, fills that collateral gap that is a problem with many of the anecdotal businesses that we are hearing about now that have the opportunity to expand, have the business acumen to be able to do that, and yet they don't have sufficient collateral for the bank to be able to make the loan, because very often, if we were to be able to make that loan, and believe me, we know these businesses. The community banker knows their business. They have been out there. They understand what is going on.

But we can't make a loan that would be classified substandard based on collateral values by our regulators the day we make it. And so filling that collateral gap is certainly one of the things that needs to be done in order for us to be able to fill the supply gap that may very well be upcoming, as has been mentioned by one of the other panelists.

Chairman BROWN. And the situation that both Senator Stabenow—all three, Senator Merkley, Senator Stabenow, and Senator Levin mentioned—is pretty common in the area you serve in Grand Rapids and the auto supply industry, I assume, where you are.

Mr. JOHNSON. I wouldn't say it is real common, but it does occur. There is no question. And it is not just isolated to the auto industry. I mean, it is other small businesses, as well.

Chairman BROWN. One other question for you. I was speaking yesterday with someone from the old National City in Cleveland, a banker, an executive at National City, now PNC in Cleveland, about SBA and lifting the caps on loans, especially for manufacturing, and taking it to the next step. There is discussion of SBA, one, lifting the cap, which I think is likely, but a discussion also of SBA doing direct lending. Give me your thoughts on that. Is it prudent to do that? Is it going to lead to higher default rates? What are your thoughts on more direct lending from SBA?

Mr. JOHNSON. Well, our bank is a preferred SBA lender and we have been for quite some time, and I have the benefit of being around and being engaged in SBA lending nearly 30 years ago when the SBA did, in fact, do some direct lending. And I, frankly, think it is a mistake to go back in that direction, particularly from the perspective of needing to do something that has immediate impact.

The delivery channel, the banking sector, is already in place. I do think that it would be a more prudent path and a more effective path would be to gear up the SBA's resources in terms of supporting the banking delivery channel. You know, there have been huge cutbacks in the staff of the SBA over the last several years, and to ramp that back up to where they can support the existing channel, where the expertise already resides, would, it seems to me, have the greater impact, probably the more prudent impact, because even on a 90 percent guaranteed loan, we still have 10 percent of our money at risk and that makes us want to underwrite, as well.

Chairman BROWN. OK. Thank you.

Mr. Gillett, you mentioned the examination environment, is the term you used, that roughly in the survey, you cited some 50 percent of bankers, of responding bankers said that was a problem. Give me a couple of examples where that may have been a barrier to lending.

Mr. GILLETT. I think it is a matter of interpretation and classification of credits. Just as Mr. Johnson mentioned, you don't want to book a loan on day one and have it classified substandard and it works against your capital ratios at a time when capital is king, and in the community bank sector, capital is very hard to generate.

In our own shop, you know, I can say that we have a very good working relationship with the regulators. We don't always agree, but at the end of the day, we seem to be on the same page. I have read the commercial real estate guidance that was issued last September, I believe, and believe it to be very straightforward.

So from the other 52 percent, Senator, I don't know that I can necessarily speak for them in their particular instances. I can only refer to the experiences that we have had internally in Sutton Bank.

Chairman BROWN. OK. The Associated Builders and Contractors cite access to capital as a major factor contributing to the decrease in lending for private sector construction projects. Many of these projects obviously rely on community banks for access to credit. What do we do about that?

Mr. GILLETT. As I mentioned in my opening remarks, we utilize the USDA Business and Industry and SBA programs to the extent that we can. It helps the customers, favorable terms, if you will, and it also allows the banks to manage their balance sheets. We have utilized that extensively in my career, and when programs fit, we will obviously use them. I will leave it at that.

Chairman BROWN. OK. Mr. Date, and then I will yield to Senator Merkley for his questions. One question. I want to hear your perspective on those manufacturers who are facing this credit environment who have plans to diversify and transition from, say—and I don't mean to make this all about autos, as it is a matter in our States but aren't everything in our States, obviously—but they want to transition to clean energy supply chain manufacturing or assembly, either, for that matter.

There is legislation I introduced called the IMPACT Act, which would set up a Federal revolving loan fund that would pay its— it would be paid back, obviously, to help companies go into clean energy manufacturing. If they are glassmakers in Toledo for trucks, they could be solar panel manufacturers in Toledo, as there is much of already.

How can we help these manufacturers make that transition, short of legislation like that, but even as a companion, if you will, with legislation like that? How do we help manufacturers who want to do that in these more difficult credit times?

Mr. DATE. It is a twofold answer. The first thing to recognize is that the bank system and traditional bank lending has very little to do with business model shifts like the one that you are describing, and the reason for that is, in general, the risk profile. That kind of borrower is going to be something that is a lot more appropriate for something that looks like venture capital or a mezzanine-type investor as opposed to the traditional debt that is available through the banking system. So I think you are right to think about addressing it through a means that is separate from and apart from the ongoing effort to recapitalize and reorient the banking system.

One of the things that will allow the, what I will call broadly sort of the small business venture capital supply to increase—I mean, there really has been a fall-off in the amount of investing in that piece of the capital structure among small businesses—one of the things that will enable it to come back is a stabilization in the financial markets more broadly. If you are a venture investor, at some level, you want your money back, and part of the way you get your money back is, as the business model shift that you are describing takes place, well, then you should be able to access and refinance higher cost debt into lower cost debt. And so a lot of the efforts that you have talked about in terms of making the bank market more stable and productive would have an indirect effect on the kind of needs that you are talking about.

Chairman BROWN. Good. Thank you.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman. Thank you all for your testimony.

Mr. Johnson, in your testimony you lay out the very dramatic decline in SBA's flagship 7(a) loan guarantee program. I had assumed that under the stress of the economy there would have a shift into that guaranteed program. Obviously, that is not the case. Does this decline pretty much match the overall declines in lending, or is it a different pattern? And what can we learn from that?

Mr. JOHNSON. Well, I can speak most authoritatively, I guess, about what has happened in my own bank. Frankly, over the past 5 years or so, we were not as actively engaged in SBA lending because of a variety of factors, but most of them were competitive within our local marketplace. But since the economic downturn, since the initial change in SBA 7(a) programs where the guarantee was raised to 90 percent and where the fee to the borrower was dropped to zero, we held a series of three seminars around our marketplace, which are all within about 30 miles of each other, to give you some perspective of what our footprint is. And we had 60 to 80 people at each one of these to talk about what the new programs from the 7(a) program looked like and to generate some interest and discussion.

Frankly, these were much, much more heavily attended than we anticipated, which we thought was wonderful, and I believe we have made at least one loan from each one of those groups or we are at least talking to people about something.

A good number of them I think were not looking for credit right at the moment, but were looking down the road a little ways, as small business people do, to when things got a little bit better, they would be ready to go.

Senator MERKLEY. Thank you very much. And you also pointed out in your written testimony that you had some comments regarding SBA's no refinancing rule and that that was a challenge: "The SBA allows no refinancing of existing debt by the bank that currently holds the debt. This restriction . . . prohibits the borrower from obtaining new financing critical to continued success." Can you expand a little bit on that?

Mr. JOHNSON. Well, yes, there is—you can do in certain circumstances—and I do not want to get too far down in the weeds here because, believe me, we really could. But, in general, there are some limitations on refinancing. There are sometimes some ways around that if you really know your way through the rules. But, frankly, any restriction in that regard is probably one restriction too many right now.

Senator MERKLEY. What is the underlying theory behind those restrictions on refinancing?

Mr. JOHNSON. I am not sure that I understand that.

Senator MERKLEY. OK. I will flag that for something, and we will try to get some more—anything that somebody has raised as an obstruction at this point, I think we need to pursue it and understand it and see if it needs to be changed.

Mr. JOHNSON. We would be happy to work with you on that.

Senator MERKLEY. Now, Mr. Gillett, you referred to commercial real estate loans as often being the bread and butter of community banks. We had testimony from the two Senators from Michigan about collateral support programs as one way to help address the drop in collateral that has been plaguing commercial real estate. Can you give your insights on whether that strategy would be effective?

Mr. GILLETT. Senator, I believe in one of their testimonies they discussed the fact that the program was oversubscribed, and I think that statement alone speaks to the value of the program. That is something that we would utilize if made available.

Senator MERKLEY. And, Mr. Johnson, a similar experience from your feet on the ground?

Mr. JOHNSON. Yes.

Senator MERKLEY. OK. Thank you. Mr. Date, you noted we have to be careful about subsidies. Is it your concern that the 90-percent guarantee leaves too little exposure and might lead to loans that are not wise investments? Is that the point you are trying to drive home?

Mr. DATE. It is two concerns. With respect to the 90-percent guarantee or any of the SBA programs as enhanced at this point, I think my principal concern is that, you know, $5 billion in a quarter for the SBA is probably a pretty good number. Compare that to Fannie and Freddie together, which are producing some $5 billion a day in the residential mortgage markets. Small business credit is very big business. I mean, depending on how you think about this, it is somewhere between $2 and $3 trillion, and I think that realistically there is no way to really imagine the SBA expanding to something that fills the gap anytime soon.

With respect to direct lending programs, that concern just becomes more enhanced for me. I do not think that we are going to be particularly good arbiters of credit, and I am concerned that even if we were, it would take a long time to build that infrastructure.

Senator MERKLEY. One of the reasons that I have been advocating for the Bank on Our Communities Act, which is similar to the President's proposal, is that we needed the experience and the relationships of the community banks in order to evaluate lending, so helping to recapitalize community banks and using community banks as the—employing their wisdom, and I think that goes to the point you are making about not doing direct lending in the small business arena.

But you also raised some concerns about that model of recapitalizing banks and concern that that would help the banks that need it the least or are unprepared to make the best decisions. Can you kind of elaborate on that a little bit more?

Mr. DATE. Sure. In general, anytime we choose to infuse capital into an institution and, in general, if we have the same set of conditions and pricing applied to everyone, that capital is going to be the most valuable to exactly those institutions who have the biggest capital deficits today. And this is not a credit crisis that has kind of come in out of the blue and impacted us. We—and I say "we" because I was in this industry for most of my career—We kind of created this credit crisis. And if you are the kind of person and the kind of bank that was lending more even as asset prices on real estate got increasingly comically detached from fundamentals, chances are you are still a bad credit underwriter and we, the taxpayers, should not be supporting you. So, hence, I like the idea of more finely tuning capital infusions.

Senator MERKLEY. Well, you might be familiar with—we have a stress test in the Bank on Our Communities Act to avoid putting funds into banks that are failing, and perhaps failing because they have made unwise decisions or have made decisions that were wise at the time but the market changed in unanticipated ways and put them in a very difficult spot. But to protect against the taxpayer—the wisdom of the taxpayers' investment, is that type of a stress test something along the lines that you think would be wise?

Mr. DATE. I think that that, frankly, is a very good idea. I think that one of the singular successes of the Government's response to the crisis, though it was derided at the time, was the stress tests applied to the largest institutions. And although there are—I think there are people—I will not put words in their mouth—I think there are people at the Fed who would view that the idea of a more broad stress test methodology being applied to smaller firms would be too difficult to carry out. I just do not see why that would be.

Senator MERKLEY. Thank you very much. Thank you all.

Chairman BROWN. Thanks, Senator Merkley.

Let me ask a general question of all three of you, and then if Senator Merkley has some more questions, we can end with that.

I spoke yesterday with the top executive at a large national company, head of its Ohio operations, a major manufacturing company, and he was talking about his concern about the supply base for his company once the economy gets better again. He has seen several of his suppliers go out of business—not most of them, but a significant number of them—that he is concerned they are able to keep it together once the economy gets better. His interest partly is, you know—I mean, they are paying special attention to these companies, extending perhaps equity arrangements, perhaps other kinds of arrangements with them.

Putting that aside for a moment, talk, each of you—and I will start with you, Mr. Date, and work this way this time, but ask each of you to sort of address the issue of what we do about those small businesses that are in the supply base for any number of large assembly, large manufacturers, and bringing in to the answer do we utilize TARP funds to get them credit. Some, like the National Federation of Independent Business, will argue that it is not a question of encouraging lending to these small businesses. They do not have the customers, and they do not have the sales. That is beginning to change. They are partly right, to be sure, but there is more to it than that, of course. So talk about what we do with TARP funds, perhaps extending credit, working with community banks, with all the reputation that TARP might have to a community banker, and just to the ultimate user of the TARP funds. Talk about what that might mean for expanding eligibility on loan limits for SBA. Work any of that into your answer and kind of give this Subcommittee some advice on what we might do to partner with some of these companies so that when the economy does begin to grow in earnest, we are more ready than we might be today. Mr. Date.

Mr. DATE. Let me just suggest two things. One is that we need to put some real effort into understanding a number of these non-real estate lending categories, which really impacts manufacturing, I would argue, a little bit more than most. Early on in the crisis, you had this phenomenon where every business in the supply chain was just trying to extend its payable cycle. That does not really work forever, so sooner or later somebody is going to have to re-learn how to lend against receivables and against inventory, frankly, in a market that had been eaten up by the finance companies over the last decade because they were playing by a different set of capital rules than the banks. So now, unfortunately, we are in a situation where the banks have to get back into these businesses, but it is hard. And I think that to the extent that I was going to create a Government guarantee program or some loss sharing, it is really in those non- real estate lending categories that I would focus.

As it relates to TARP's stigma, I have never been especially a believer in that. If a firm needs the capital to grow, at some level the bottom-line interest of shareholders predominates. Of course, bank executives sometimes have a different perspective than shareholders.

Chairman BROWN. Well, thank you, Mr. Date.

Mr. Gillett, your thoughts generally?

Mr. GILLETT. I think there is a possibility that we could utilize the financial institutions as maybe the collection points, if you will, or the distribution network for access to TARP monies to be approved at some level, whether that would be through SBA or whatever office. It might be a way to get capital into the small business, the manufacturing companies that you are alluding to.

As it relates to financial institutions, however, you know, our bank—and I will go back to what Raj just mentioned, you know, the stigma of TARP. Our bank chose not to participate in TARP because of more so the nonmonetary costs. So I think we need to address that somehow in addition or as part of this process.

Chairman BROWN. You were concerned about the stigma attached to Sutton or the stigma attached to people who you lend to?

Mr. GILLETT. To Sutton.

Chairman BROWN. OK. Fair enough.

Mr. Johnson.

Mr. JOHNSON. There will be a lot of community banks that will think long and hard about participating in any program that has any connection to TARP funds. The stigma that was attached, the demonization that many banks went through following that program's initiation, the changing of the rules, is not something that will be looked upon kindly. So anything that can distance any program from TARP I think would have a much higher degree of potential success.

One of the points that I would like to make is just to reiterate a phrase that Senator Levin used, and that phrase was to have as many possible arrows in our quiver as we can. I do not think that one-size-fits-all solutions are likely to be found here because there are a number of different problems. We have talked about the collateral problem. We have talked about the capital problem. There is also at some point—when we get further into the recovery, there may very well be a funding problem in some community banks. We do not know what is going to happen to the rates on deposits. So our ability to be able to raise, actually have the funds to be able to lend, may—it is not a question now, but it may come into question at some point.

So there is a number of different problems that may arise in terms of filling the supply gap that may very well develop, as Raj has, I think very artfully, laid out in his written testimony.

The other thing is that in terms of a small business, not all credit is exactly the same. There is long-term credit for the building. There is intermediate-term credit for the equipment that may be in that building. And then there is short-term credit that is rolling over based upon a particular job that they may have. So we have to have programs and answers that fit all of those needs.

Chairman BROWN. Thank you, Mr. Johnson.

Senator Merkley, any more questions?

Senator MERKLEY. No.

Chairman BROWN. OK. Well, thank you all for joining us. I want to note that statements for the record have been submitted from the independent sector, the Associated Builders and Contractors, the National Association of Home Builders, the Credit Union National Association, and the National Association of Realtors.

Chairman BROWN. The hearing record will remain open for 7 days, so if any of you want to expand on any of your answers or on your opening statements or submit any other information or statement for the record, you are welcome to do that for the next 7 days.

I thank Senator Merkley, again, thank the three of you very much for your contribution. Thanks very much. The hearing is adjourned.

[Whereupon, at 10:50 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CARL LEVIN

Chairman Brown, Ranking Member DeMint, Members of the Subcommittee, thank you for inviting me to speak to you this morning about the important issue of ensuring that small businesses have access to the credit they need. On behalf of the Michiganders and Americans whose livelihoods are at stake, thank you for taking up this enormously important issue.

I'd like to tell you a little bit this morning about the truth on the ground in my State, the word we're getting from small business owners and from community banks who are, even as macroeconomic indicators show our economy is recovering, struggling with the effects of the worst economic crisis in decades. And I'd like to suggest some strategies that I believe, after a great deal of research and discussion, can help relieve those struggles and get our economy, and our constituents, working again.

But first, I want to try to impress upon each of you just how important I believe this issue to be. Recent economic data suggests that, from a technical standpoint, our economy is rebounding. Gross domestic product is starting to grow, and the flood of layoffs and business closings that hammered us for so many months has slowed to a trickle. But for many Americans, things haven't gotten any better, and for far too many, the situation is worse. Unemployment in my State is almost 15 percent, and it is unacceptably high in most States. So far, despite the fact that our economy is becoming productive again, it is not providing the job growth necessary to restore hope and opportunity for the millions of Americans who were caught up in the economic hurricane of financial collapse.

If we do not act, and quickly, to help restore employment, the "green shoots" for which we have so much hope will not blossom. They will wither.

What stands in the way of job growth? When I talk to employers in Michigan, often the first problem they discuss with me is the difficulty in obtaining the capital they have traditionally relied on to finance their operations: capital to meet payroll, to finance inventory, to update their equipment or to expand their business. Dozens upon dozens of businesses have come to us, worried about their inability to keep their lines of credit or get new ones. Even those with good credit and paying customers often cannot get the financing they traditionally have obtained, or sometimes can get it only by agreeing to unaffordable terms. Let me mention just one typical Michigan example of the problem: a small manufacturer based in the Thumb region of our State. The company's longtime bank lender told the company it could not renew the firm's 5-year loan, instead offering 90-day renewals at a much higher interest rate, even though the company had never missed a payment and had adequate business revenue. The company, with 77 workers and 150 customers, sought a loan elsewhere, but other banks—28 of them—rejected its application. That story can be repeated 100 times throughout the State.

At times my staff has worked on a one-on-one basis with individual businesses and local banks, trying to find solutions that can keep business humming. We have had discussions with the Michigan Bankers Association and with State officials to try to match worthy businesses with banks willing and able to lend. But the problem persists. And it is especially damaging in Michigan, where so much of our job base consists of small and midsized manufacturers. These companies form the economic backbone of communities across the State, and they are in capital-intensive industries that make access to capital absolutely vital.

This is frustrating on many levels, but perhaps most frustrating for me, not to mention the businesses involved, is that the local banks they have done business with for years want to continue to lend, but in many cases cannot. For much of this crisis, our attention has been focused on the largest financial institutions in our country. Programs like TARP provided large sums of capital to these institutions because their failure would endanger the entire economy. We've also focused on them because, in many cases, it was their actions that precipitated the crisis.

But now, while giant firms such as Citi and Goldman Sachs report massive profits, the real lifeblood of many local economies—local banks—don't have it nearly so good. Recently, the FDIC released a report that demonstrates the scope of the problem. At the end of 2009, the report said, 702 banks across the United States were in at least some danger of failure. That was up from 252 banks at the beginning of the year, and up 27 percent from just 3 months before. The FDIC warned that this jump is largely the result of a crisis that began on Wall Street spreading throughout the country. And as a result of that spread, bank lending has plummeted, down 7.5 percent from 2008 to 2009. Nationally, business loans—again, the lifeblood of business and employment—declined 18.3 percent.

And in Michigan, the situation is worse. One estimate is that overall bank loan volume in Michigan declined by 74 percent from 2007 to 2009!

The first point I would make is that while those large banks have gotten most of the help so far, they are also the ones pulling back the most on lending. I agree strongly with FDIC Chairman Sheila Bair, who said, "Large banks do need to do a better job of stepping up to the plate here." But that is not all of the problem. I agree with Senator Merkley and with the Administration that we must to something to support community banks so that they can lend to the small businesses that are key to creating jobs in our communities.

We can help businesses that are being turned down for credit despite having excellent credit histories and adequate orders and revenues or viable plans to diversify into emerging growth industries. In many cases, the banks that have long serviced these companies are simply unwilling or unable to lend, not because they fear an increased risk of default, but because the business's collateral has fallen in value. Just as the value of our homes has fallen in this recession, so has the value of the inventory, equipment and buildings held by businesses. Because those assets are worth less, banks are less willing to provide loans that use them as collateral. Even if a bank has enough capital to lend to small businesses, they are unlikely to do so for businesses—like so many in my State—whose assets have fallen so rapidly in value.

In Michigan, our Michigan Economic Development Corporation has a program that is designed to help support the collateral values of borrowers in this situation. And for years, the State has operated a Capital Access Program, which also helps borrowers with decreased collateral values. That program funds reserve accounts to support loans to businesses that need collateral support. I think we can learn from these programs, and those in other States, and work together to craft legislation that will directly help businesses whose depleted collateral values are inhibiting not only their abilities to survive and grow, but also our economy's.

There are other policy details that I have strong feelings about, but again, my strongest feeling is that this is a problem requiring urgent attention. I congratulate the Subcommittee on holding this important hearing, and encourage you all to push hard for a solution that will get capital to struggling businesses so that they can do what we need them to do: put more people to work. Thank you.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman, for your leadership on this issue and for holding this important hearing. And thank you, Senator DeMint (ranking member), for being here today as well. I appreciated hearing from my colleague from Michigan, Senator Levin, and I also want to thank Senator Warner and Senator Merkley, who have also been working so hard to fix this problem.

I'm also pleased that the Chairman of American Bankers Association, Art Johnson, is testifying today. As the CEO and Chairman of the United Bank of Michigan and United Community Financial Corporation in Grand Rapids, Art understands the serious problems facing community banks and small businesses in some of the hardest-hit areas of the country.

The subject of today's hearing is so important to our efforts to rebuild our economy. We know that small business create 64 percent of jobs in this country. We also know that small businesses tend to get loans from their local community bank, not big Wall Street firms. According to FDIC call reports, banks with less than $1 billion in assets—making up only 12 percent of all bank assets nationwide—made nearly half of the small business loans.

Federal regulations have—rightly—cracked down on the big banks who caused this financial crisis. According to the FDIC data the amount of lending by the banking industry fell by about $587 billion or 7.5 percent in 2009, which is the largest annual decline since the 1940s.

Ultimately, it is America's small businesses, and American workers, who suffer the most. I continue to hear from small businesses in my State who can't access credit to grow their company. Some of them have orders in—they have customers ready to buy their products—but they can't get the capital they need up front to make the products.

However, it's important to separate the large financial institutions that benefited from TARP from the vast majority of banks. As I mentioned, the smaller banks, who did not receive nearly as much support from TARP as the larger banks, originate the vast majority of small business loans.

Thankfully, our community banks are still lending, despite dealing with increased pressures to increase capital and reduce risk. They, too, are suffering from an economic environment that makes it hard to raise capital. I look forward to hearing more about this from the witnesses on the next panel.

I am also looking forward to hearing follow-up about the issues raised by Senator Levin—especially how small businesses are dealing with reduced cash flow and collateral whose value has decreased in recent years. Many small business owners have used their homes as collateral for loans to keep their business opened, and as home prices decline, so too does their ability to keep credit flowing.

But, as we know, the housing market isn't the only place where values are declining. The commercial real estate market has also been hard-hit, which hurts manufacturers particularly hard. The value of manufacturers' property, factories, and equipment has dropped as much as 80 percent in the last 18 months.

As I'm sure our next panel can attest, even a healthy bank will not make a loan to a borrower who does not have enough collateral value.

In Michigan, our manufacturers are trying to retool and diversify. They are moving into high growth industries like health care, defense, and clean energy. But they are having trouble growing because they are having trouble getting credit. New regulations imposed on big banks make sense, but a one-size-fits-all approach is hurting the ability of small banks to help our small businesses. The theory of "too big to fail" now means that many of our businesses today are "too small to grow."

These are the companies who create jobs in America. If we are going to create jobs, we need to let those small businesses grow.

Nearly 700,000 Americans work for parts suppliers, more workers than in any other type of manufacturing company. Let me give you just one example of how this credit crunch is affecting these small manufacturers.

Wes Smith, who is the President of E&E Manufacturing, a metal stamping company in Plymouth, Michigan, is looking to expand his business, but might not be able to because his long-time lender recently reduced his line of credit and changed his loan covenants. Although sales picked up at the end of last year, and they are expecting a 20 percent increase in sales projections, he is having trouble getting the capital he needs to rehire about 200 people he was forced to lay off during the worst of the recession.

That's 200 people at just one plant who could come back to work today if their company had better access to credit. As Senator Levin mentioned, Michigan started a successful program in 2009 that targets businesses that may be good credit risks, but have collateral or cash flow shortfalls.

The first $13 million of that fund was fully committed within the first 5 months, and was oversubscribed by nearly 300 percent. Michigan's program has taken $13.3 million in public funding to leverage $41 million in private loans, which is a leverage ratio of about 3 to 1.

When the Senate considers authorization of President Obama's Small Business Lending Fund, I hope we can take some of these funds and direct them toward programs, like the one we have in Michigan that would address these collateral depreciation issues.

We also must address the separate problem of small businesses being able to qualify for a loan. I hope that as we address this issue, we also extend the Small Business Administration loan guarantee that expires this month and increase the maximum loan size of SBA 504 and 7(a) programs, which the SBA estimates would create up to $5 billion in growth for small businesses and as many as 160,000 jobs.

That's what this debate is really about—creating jobs and growing our economy. I hope this hearing can uncover ways that we can help small banks and small businesses create jobs and opportunity throughout America.

PREPARED STATEMENT OF ARTHUR C. JOHNSON

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, UNITED BANK OF MICHIGAN, GRAND RAPIDS, MICHIGAN, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

MARCH 2, 2010

Chairman Brown, Ranking Member DeMint, and Members of the Subcommittee, my name is Arthur C. Johnson. I am Chairman and Chief Executive Officer of United Bank of Michigan, headquartered in Grand Rapids, Michigan. I serve as Chairman of the American Bankers Association (ABA), and I chair the ABA Community Bank Solutions Task Force, a committee dedicated to finding ways to address problems most acutely affecting community banking during this economic downturn. I am pleased to be here today representing ABA. ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the Nation's banking industry and strengthen America's economy and communities. Its members—the majority of which are banks with less than $125 million in assets—represent over 95 percent of the industry's $13.3 trillion in assets and employ over two million men and women.

We are pleased to share the banking industry's perspective on the condition of small business and commercial real estate lending in local markets. As President Obama recognized in his recent State of the Union address, it is imperative to find ways to ensure that small businesses get the credit they need. Small businesses of all kinds—including banks—are suffering from the severe economic recession. While some might think the banking industry is composed of only large global banks, the vast majority of banks in our country are community banks—small businesses in their own right. In fact, over 3,000 banks (41 percent) have fewer than 30 employees.

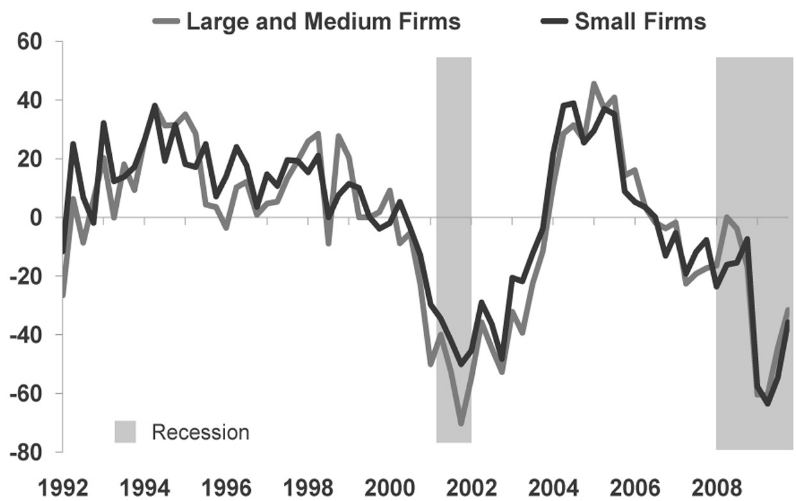
This is not the first recession faced by banks. Most banks have been in their communities for decades and intend to be there for many decades to come. United Bank of Michigan has survived many economic ups and downs for more than a century. We are not alone; there are 62 banks in Michigan that have been in business for more than 50 years, 20 of which have been in business for more than a century. Nationwide, there are 2,556 banks—31 percent of the banking industry—that have been in business for more than a century; 62 percent (5,090) of banks have been in existence for more than half a century. These numbers tell a dramatic story about the staying power of banks and their commitment to the communities they serve. My bank's focus, and those of my fellow bankers throughout the country, is on developing and maintaining long-term relationships with customers, many of which are small businesses. We cannot be successful without such a long-term philosophy and without treating our customers fairly.

This recession is certainly one of the worst we have ever faced. While the statisticians will say the recession has ended, that is little comfort to areas in our country that suffer from very high levels of unemployment and business failures. As the economy has deteriorated, it has become increasingly difficult for consumers and businesses to meet their financial obligations. The cumulative impact of eight straight quarters of job losses—more than 8 million since the recession began—is placing enormous financial stress on some individuals. With jobs lost and work hours cut, it does not take long for the financial pressure to become overwhelming. This, in turn, has increased delinquencies at banks and resulted in losses and reduced capital at banks.

In this severe economic environment, it is only natural for businesses and individuals to be more cautious. Businesses are reevaluating their credit needs and, as a result, loan demand has fallen dramatically since the recession began. Banks, too, are being prudent in underwriting, and our regulators demand it. With the economic downturn, credit quality has suffered, and losses have increased for banks. Fortunately, community banks like mine entered this recession with strong capital levels. As the Subcommittee is aware, however, it is extremely difficult to raise new capital in this financial climate.

Business Loan Demand Down

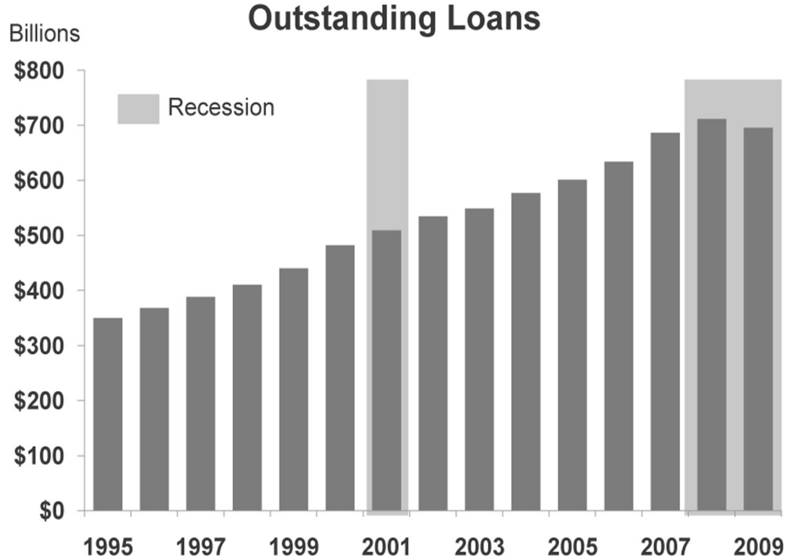
Net Percentage of Banks Reporting Higher Demand



Source: Federal Reserve

Lending to Small Businesses

Outstanding Loans



Source: FDIC – Date as of June of Given Year

The difficult recession, falling loan demand, and loan losses have meant that loan volumes for small businesses have declined somewhat this year. Let me be very clear here: even in a weak economy there are very strong borrowers. Every bank in this country is working hard to ensure that our customers—particularly the small businesses that are our neighbors and the life blood of our communities—get the credit they deserve. The Small Business Administration (SBA), in partnership with America's banks, can play an even larger role in helping small businesses meet the challenges of this economic downturn by expanding their guarantee program and by reducing some of the restrictions currently built into the system.

The success of many local economies—and, by extension, the success of the broader national economy—depends in large part on the success of community banks. We believe there are actions the Government can take to assist viable community banks to weather the current downturn. Comparatively small steps taken by the Government now can make a huge difference to banks, their customers, and their communities—keeping capital and resources focused where they are needed most.

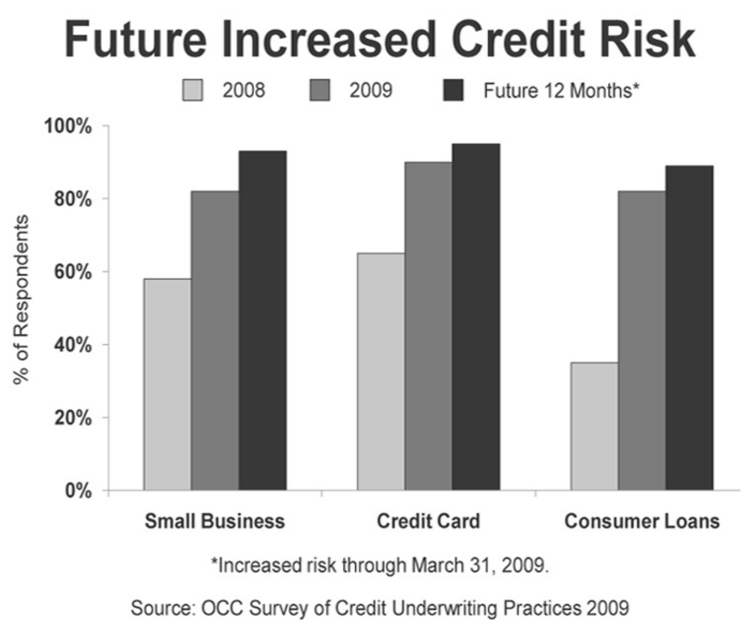
In my statement, I would like to focus on the following points:

- Lenders and borrowers are exercising a prudent approach to credit.
- Recent proposals can help to stimulate lending to small businesses.
- Changes that enhance bank participation in SBA programs have made strides in creating opportunities for small businesses, yet more needs to be done.
- Changes in the regulatory environment will improve the situation for small business lending.

I will address each of these points in turn.

I. Lenders and Borrowers Are Exercising a Prudent Approach to Credit

In every community, banks are actively looking for lending opportunities. Business confidence is down, of course, and many businesses either do not want to take on additional debt or are not in a position to do so given the falloff of their customer base. Thus, loan demand has fallen dramatically since the start of the recession. There are some positive signs beginning to appear. We have heard from bankers that small businesses are returning to test the market for loans, even though they may not wish to borrow at the moment. It will take time for this renewed interest to be translated into new loans made, however. Previous recessions have shown that it typically takes 13 months after the recession for business confidence to return and credit to return to prerecession levels.



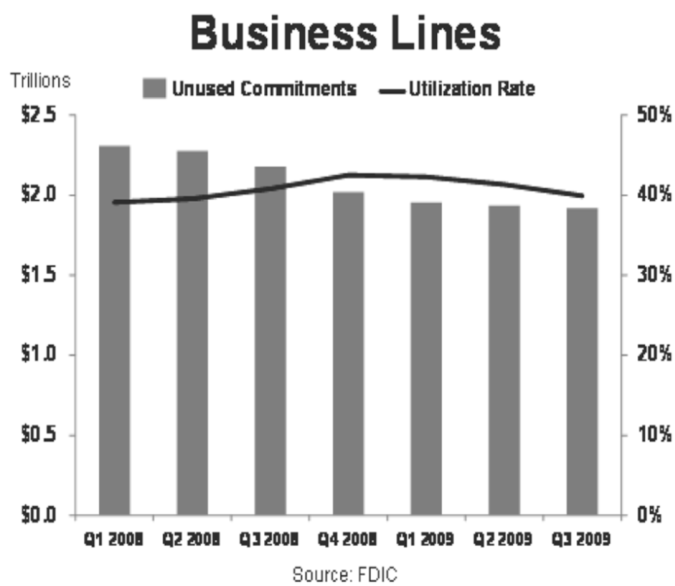
Both banks and their regulators are understandably more cautious in today's environment. Bankers are asking more questions of their borrowers, and regulators are asking more questions of the banks they examine. Given the economic conditions, it is clear that the risk of lending is much greater today than several years ago when the economy was much stronger.

This means that the credit terms are different today, with higher down payments required, and smaller loans consistent with diminished collateral values. Banks are looking at the risk of a loan and reevaluating the proper pricing of that risk. This is a prudent business practice and one expected by our bank regulators. But it means that some projects that might have been funded when the economy was stronger may not find funding today. The NFIB recognized this, stating, "[T]he continued poor earnings and sales performance has weakened the credit worthiness of many potential borrowers. This has resulted in tougher terms and higher loan rejection rates (even with no change in lending standards)" [1]

Moreover, access to credit is not a driving concern of most businesses. In a recent survey of 750 businesses by Discover, only 5 percent said the main issue facing their business was access to capital. [2] NFIB's survey confirmed this finding: "Although credit is harder to get, 'financing' is cited as the 'most important problem' by only 4 percent of NFIB's hundreds of thousands of member firms." NFIB notes that this is extremely low compared to other recessions. For example, in 1983—just after the last big recession—37 percent of business owners said that financing and interest rates were their top problem.

We recognize that there are some consumers and businesses in the current situation that believe they deserve credit that is not being made available. We do not turn down loan applications because we do not want to lend—lending is what banks do. In some cases, however, it makes no sense for the borrower to take on more debt. Sometimes, the best answer is to tell the customer no, so that the borrower does not end up assuming an additional obligation that would be difficult if not impossible to repay.

To help manage the risk of loss, lenders have lowered credit lines for businesses and individuals. However, even with the cutbacks in lines of credit, there is still $6 trillion in unused commitments made available by FDIC-insured banks to businesses and consumers. The utilization rates have declined for business lending, particularly, reflecting the decreased demand.

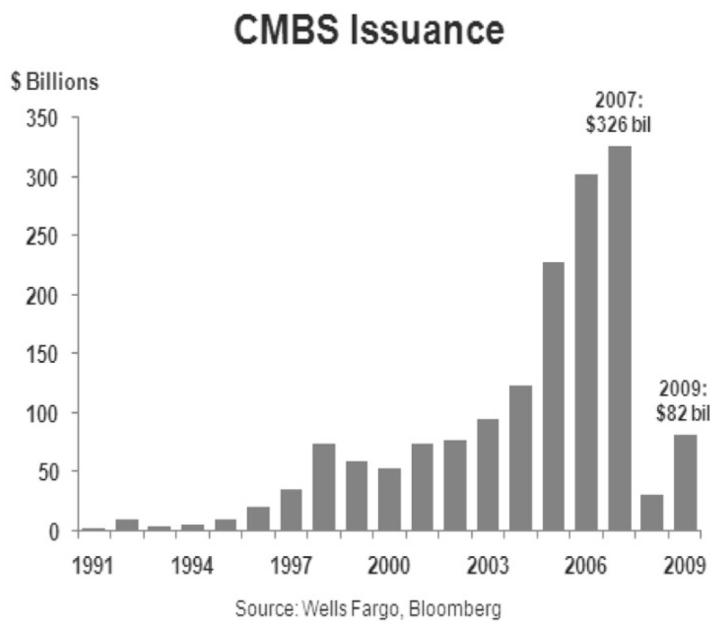


[1] NFIB Small Business Economic Trends, November 2009. National Federation of Independent Business.

[2] Discover Small Business Watch, October 2009. Discover Financial Services.

The commercial real estate (CRE) market will pose a particularly difficult problem for the banking industry this year. The CRE market has been the victim of a near total collapse of the secondary market for commercial mortgage backed securities and of the economic slowdown that has caused office and retail vacancies to rise dramatically. These stresses will affect many small banks, as CRE lending has been an important part of the portfolio for community banks for many years.

Typically, a commercial real estate project in the construction and land development phase receives bank financing with an loan maturity between 3 to 7 years. After the project is completed, it is common for take-out financing to come from insurance companies or through the Commercial Mortgage Backed Securities (CMBS) market. This take-out financing focuses on income-producing properties and, thus, usually occurs once there are stable and sufficient cash flows for full debt servicing. The CMBS market practically disappeared in 2008 and is now just starting to rebuild slowly.



This highlights the current dilemma: as market conditions have deteriorated, vacancies have increased, valuations have plummeted, and rent renewals have slowed. This in turn has made take-out financing increasingly scarce, leaving banks with loans that are stressed and facing refinancing. With transaction prices down dramatically, appraisal values have also fallen, making refinancing of loans much more difficult without significant additional equity contributions from borrowers—which, of course, are difficult if not impossible for many borrowers to put forward in this economic climate.

As I will discuss in the last section of this testimony, regulators will continue to be nervous about the trends in CRE lending as the economy struggles to regain its footing and will be critical of banks' CRE portfolios. The 2009 guidance from the regulators signals a prudent but flexible approach. However, we continue to hear that the translation of the guidance to the field examiners has been missing. However, we remain hopeful that this guidance could help banks work with borrowers to find solutions.

As the economy begins to improve, we expect loan demand to increase, and with it, credit volumes as well. ABA's Economic Advisory Committee (EAC) forecasts that nonresidential fixed investment will increase 3.8 percent in 2010, and businesses will begin to expand and grow inventories. The EAC believes this will coincide with an increase in business lending, which it expects to increase modestly this year at a 2.3 percent rate. The group also expects consumer credit to grow at a rate of 3.2 percent. As the economy grows and loan demand increases, the ability of banks to meet these needs will be stunted if adequate capital is not available to back increased lending.

II. Recent Proposals Can Help To Stimulate Lending to Small Businesses

Capital is absolutely critical to any bank, as it is the financial underpinning of any loan that is made. While conditions have improved over the past year in the economy overall, many community banks are seeing elevated levels of loan delinquencies and loan losses as a result of the lagging impacts of job losses, business failures, and declines in property values. The result has been stresses on bank capital. Given the severity of the downturn, particularly in certain parts of this country hardest hit by the recession, it is very difficult if not impossible for community banks to find new sources of capital.

ABA appreciates the initiative President Obama outlined in his State of the Union address that would help to resolve this issue by providing additional capital to small banks who volunteer to use it to increase small business lending. However, using TARP money to fund it raises the very real possibility that the TARP stigma will discourage banks from participating. This is because hundreds of banks that had never made a subprime loan or had anything to do with Wall Street took TARP capital with their regulator's encouragement—even though they did not need it—so they could bolster their lending and financial position. Then within weeks, they were demonized and subject to after-the-fact restrictions. Community banks will be disinclined to participate if there is any possibility of TARP-related stigma being attached to it. We would urge Congress to distinguish any new proposal it considers from TARP in order to avoid creating a program that permits after-the-fact restrictions.

Another idea is to use existing State lending programs to target small businesses in local markets. The State of Michigan has developed a number of programs that could be used as a model for this kind of proposal. Michigan has two programs, the Capital Access Program (CAP) and the Michigan Collateral Support Program (MCSP).

The CAP uses small amounts of public resources to generate private bank financing, providing small Michigan businesses access to capital that might not otherwise be available. Participating banks throughout Michigan offer CAP loans directly to companies that need credit enhancement. Similar to a loan loss reserve fund, the bank, the company and the MEDC pay a small premium into a reserve that makes it possible for the company to receive fixed asset and working capital financing. Under the CAP, more than 11,211 loans have been provided to Michigan businesses over the past 22 years. The $24.3 million in public/state/MEDC/MSF resources committed to the program supported approximately $628.7 million in bank lending—a private/public ratio of 27 to one.

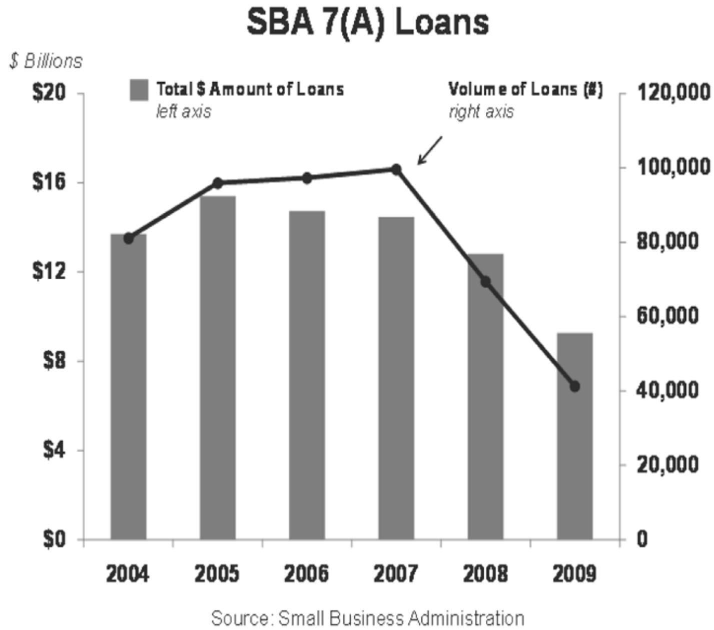
The MCSP supplies cash collateral accounts to lending institutions to enhance the collateral coverage of borrowers. These accounts cover all or a portion of a calculated collateral shortfall as described by the lending institution. Borrowers with a collateral shortfall apply for coverage through the Michigan Economic Development Corporation (MEDC), on behalf of the Michigan Strategic Fund (MSF). If approved, the MSF deposits the cash into an interest bearing account with that lender and this account will then be pledged as collateral on behalf of the borrower. Based on an amortization schedule, the MSF will draw down the account as the loan principal is paid. In the event of full default, the lender will have rights to the account less a liquidation fee. Loan-flow in Michigan's pilot program has been high, with close to 300 inquiries and at least $150 million in requests in the first 2 months of the program. The loans in which Michigan banks have participated have created or saved jobs at a "cost" of approximately $6,000 per job. That is particularly exciting when you consider that the $6,000 is in the form of a loan/deposit which we are confident will be repaid with interest. This creates a real negative cost per job.

As these and other future programs are developed, ABA recommends that Congress and the Administration create criteria that allow all viable community banks to participate. We propose that Treasury offer assistance to those banks that did not qualify for Capital Purchase Program (CPP) funds but that nevertheless can demonstrate the ability to operate safely and soundly and survive if given the chance to obtain necessary capital. The focus should be on whether a bank is viable on a postinvestment basis. Otherwise, Congress will miss an opportunity to help the customers and communities of many banks across the country.

Community banks, like mine, are the backbone of our economy and are critical to the overall improvement of our economy. For a nominal investment by Treasury, viable community banks can be preserved, which in turn would provide more resources for lending and would help create jobs in our communities.

III. Changes That Enhance Bank Participation in SBA Programs Have Created Opportunities for Small businesses, Yet More Needs To Be Done

The SBA program has struggled over the last several years. SBA's flagship 7(a) loan guarantee program reported a 41 percent decline in volume from its 2008 to 2009 fiscal year, after reporting a 30 percent decline from 2007 to 2008. The dollar amount outstanding declined 28 percent from its 2008 to 2009 fiscal year, following an 11 percent reduction over the previous year. The changes made have helped to stem the reductions and show promise for more lending should the program be extended, as we recommend. In particular, the changes have helped to facilitate 12,374 loans made totaling $3.8 billion in its first fiscal quarter of 2010.



In order to show further improvements, the SBA needs go beyond an increase in the amount of the guarantee; it needs to offer an improved value proposition. Current restrictions involving cost, collateral, refinancing, and prepayment penalties, among others, should be addressed.

Although many improvements are needed, much has already been done. This Congress has consistently worked to maintain the integrity of the 7(a) program and we applaud your efforts on the Recovery Act to enact the small business provisions.

The act temporarily increased the guarantees to up to 90 percent on SBA's 7(a) loan program, which have been helpful as banks work to extend credit during the recession. It also temporarily cut fees for borrowers on 7(a) loans and reduced fees for both borrowers and lenders on 504 Certified Development Company loans. SBA Administrator Karen Mills noted that average weekly loan volume has increased both in the 7(a) program and the 504 program following passage of the Act, and that participation among banks had likewise increased.

Further, the SBA expanded eligibility to small businesses in the 7(a) program by applying the broader standard used currently in the 504 program. Now, businesses will be able to qualify with a net worth that does not exceed $8.5 million and an average net income under $3 million (after Federal income taxes) for the preceding two fiscal years. These very positive changes mean that an additional 70,000 among the largest of our small businesses will be eligible to participate in the 7(a) program.

Other provisions from the Act include provisions that raised the maximum contract that can qualify for an SBA Surety Bond guarantee from $2 million to $5 million and provided additional funding to microloan intermediaries, as well as funding for the technical assistance needed to accompany these loans.

All of these initiatives help small businesses during this recession, and should be funded and continued past their current authorization periods in order to reach even more small businesses. Moreover, there are a number of improvements that would provide additional incentives to small businesses and banks that would enable even broader participation:

- *Extend the Provisions of the Stimulus Package.* As part of the economic stabilization package, Congress increased the loan guarantee level in the 7(a) program to 90 percent and also decreased the fees for both the borrowers and the lenders. Both actions have provided a much needed boost for lender participation in the program. Funding for the guarantee and fee relief was exhausted on February 28. We thank the Senate for including additional additional funding in the recently passed jobs bill. We believe these provisions that expand both the guarantee and fee relief should be funded and extended for an additional 2 years beyond the 2010 expiration date. While we are all hopeful that the economy will regain its footing over the next 12 months, we are also realistic in understanding that the recovery may be very slow. Additional capital through lending will create an environment where small businesses will begin to rehire or add new jobs.
- *Eliminate or Reduce the Restriction on Refinancing.* The SBA allows no refinancing of existing debt by the bank that currently holds the debt. This restriction often prohibits the borrower from obtaining new financing critical to continued success. In many circumstances banks would like to make new and consolidated advances, but if the bank already has a deal on the books, that loan cannot become part of the new deal. This restriction often causes the bank to write new loans without the help of the SBA, or ask the borrower to seek help from another lender.
- *Enhance the Human Resources Capacity of the SBA.* There is a very practical barrier to the success of these programs: having the staff necessary to implement, promote, market, and manage the many initiatives of the SBA. We request that the Subcommittee investigate the human resource needs of the SBA. Over the last 8 years, the SBA staff has been reduced by nearly 1,000, roughly one-third of its employees. This has been done through consolidation, retirements and attrition. Since January 2009, the SBA has taken on many new loan programs and seen a sizeable increase in their budget allocation to implement and carry out these programs. Yet, the number of staff assigned to carry out the old and new programs has not been increased and, in fact, the program responsibilities of these employees have increased. SBA has thousands of partners and many more that desire to establish or reestablish a relationship with the agency. Without adequate levels of personnel to meet the needs of these partners, the small businesses that they serve will suffer.

The initiatives and new programs launched by the Administration and by Congress have great potential to help thousands of small businesses. These programs should be improved further and given the time to work. In addition, the SBA must be given the human resources to implement these initiatives, many of which are new to the SBA. ABA is prepared to work with Congress to find ways to improve the SBA program, with the goal of enhancing credit availability to small businesses throughout our Nation.

IV. Changes in the Regulatory Environment Will Improve the Situation for Small Business Lending

As I noted above, banks are not immune from the economic downturn; job losses and business failures have resulted in greater problem loans and much higher loan losses. Nonetheless, banks are working every day to make credit available. Those efforts, however, are made more difficult by regulatory pressures and accounting treatments that exacerbate, rather than help to mitigate, the problems. ABA has raised the issue of overzealous regulators in hearings last year and through letters to the agencies. We are pleased that on February 5, 2010, the Federal financial regulatory agencies and the Conference of State Bank Supervisors issued a joint statement emphasizing that financial institutions that engage in prudent small business lending after performing a comprehensive review of a borrower's financial condition will not be subject to supervisory criticism for small business loans made on that basis. This joint statement, along with earlier statements concerning lending and loan workouts, can give bankers a powerful tool to help them in their exams.

ABA will work to make sure that this announcement is meaningful in the field, as we have seen numerous examples of the similar agency policies emanating from Washington not being carried out during field exams. The challenge should not be underestimated, as the reaction of regulators in the current economic environment has been to intensify the scrutiny of community banks' lending practices. For example, we have heard anecdotes from our members of examiners who continue to take an inappropriately conservative approach in their analysis of asset quality and who are consistently requiring downgrades of loans whenever there is any doubt about the loan's condition.

This inappropriately conservative approach is nowhere more visible than in the supervision of commercial real estate (CRE) loans. We are hearing from our bankers that the 100 percent and 300 percent thresholds are being applied by examiners as caps. ABA foresaw this problem when the guidance on CRE concentrations was released in 2006, and we were assured that the thresholds would be applied judiciously. Examiners need to understand that not all concentrations are equal, and that setting arbitrary limits on CRE concentrations has the effect of cutting off credit to creditworthy borrowers, exactly at a time when Congress is trying to open up more credit.

Just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious economic consequences. Wringing out the risk from bank loan portfolios means that fewer loans will be made, and that only the very best credits will be funded.

Worsening conditions in many markets have strained the ability of some borrowers to perform, which often leads examiners to insist that a bank make a capital call on the borrower, impose an onerous amortization schedule, or obtain additional collateral. These steps can set in motion a "death spiral," where the borrower has to sell assets at fire-sale prices to raise cash, which then drops the comparable sales figures the appraisers pick up, which then lowers the "market values" of other assets, which then increases the write-downs the lenders have to take, and so on. Thus, well-intentioned efforts to address problems can have the unintended consequence of making things worse.

What the regulators want for the industry is what the industry wants for itself: a strong and safe banking system. To achieve that goal, we need to remember the vital role played by good lending in restoring economic growth and not allow a credit crunch to stifle economic recovery. We must work together to get through these difficult times. Providing a regulatory environment that renews lines of credit to small businesses is vital to our economic recovery. We are hopeful that the joint statement from the State and Federal bank regulators will establish the framework for a more positive regulatory approach to bank lending in these difficult times.

Conclusion

I want to thank the Subcommittee for the opportunity to present the views of ABA on the challenges ahead for the banks and the communities they serve. These are difficult times and the challenges are significant. We stand ready to work with Congress and the Administration on finding ways to facilitate credit availability in our communities.

I am happy to answer any questions the Subcommittee may have.

PREPARED STATEMENT OF ERIC A. GILLETT

VICE CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SUTTON BANK, ATTICA, OHIO, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS ASSOCIATION

MARCH 2, 2010

Chairman Brown, Ranking Member DeMint, and Members of the Subcommittee, I am Eric Gillett, Vice Chairman and CEO of Sutton Bank, Attica, Ohio. Sutton Bank is an S Corporation bank dating back to 1878 with a focus on small business and agricultural lending. The bank is located in Attica, Ohio a rural bedroom community of Cleveland with a population of 900. Over the years, the bank has expanded full service offices in Ashland, Huron, and Richland Counties. The largest community in our market is Mansfield whose population is nearly 50,000. We also have loan production offices in Tiffin and West Chester, Ohio. Sutton Bank has a total of $355 million in assets comprised of $215 million in loans. Sutton Bank has consistently been named one of the top small business lenders in Ohio according to the U.S. Small Business Administration (SBA). I am pleased to testify on behalf of the Independent Community Bankers of America and its 5,000 community bank members at this important hearing.

Sutton Bank, like almost all community banks, specializes in small business, relationship lending. Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. Even during these challenging times, our Nation's nearly 8,000 community banks remain committed to serving their local small business and commercial real estate customers, who are pivotal to our country's economic recovery.

But, Sutton Bank and all community banks face serious challenges that can hinder the ability to make new small business and commercial real estate (CRE) loans and to refinance existing loans. Community banks confront a very tough regulatory environment. While Washington policymakers exhort community banks to lend to businesses and consumers, banking regulators, particularly field examiners, have placed very strict restrictions on banks. In many instances, the banking agencies have moved the regulatory pendulum too far in the direction of overregulation at the expense of lending. It is important to return to a more balanced approach that promotes lending and economic recovery in addition to bank safety and soundness.

While the tough regulatory environment is inhibiting new loans in many instances, community banks have also witnessed a decreased demand for loans from qualified borrowers. Many of the best small business and real estate customers cite uncertainty about the recovery as the key reason for not seeking additional credit.

Commercial real estate (CRE) lending presents special challenges for the community banking sector. Many community banks rely on CRE loans as the "bread and butter" of the local banking market. Community bank CRE portfolios are under stress. The downturn in the economy affects the ability of CRE borrowers to service their loans. Regulatory overreaction adds further stress to community bank CRE portfolios. For example, field examiners continue to require community banks classify and reserve for performing CRE loans solely because collateral is impaired, despite guidance from Washington to look beyond collateral values. Community banks all over the country, even those located in areas that have relatively healthy economies, are under regulatory pressure to decrease CRE concentrations.

Community banks are the key to economic recovery. It is vitally important policymakers create an environment that promotes community bank lending to small businesses, rather than inhibit lending. ICBA has several recommendations to improve the commercial lending environment and address problems related to CRE.

- The country needs a balanced regulatory environment to encourage lending. In a balanced environment, regulators do not exacerbate credit availability through procyclical increases in bank capital requirements. And, bank examiners consider the total circumstances of loans and borrowers, and not just collateral values, when determining the value of loans in banks.
- The Term Asset Liquidity Facility (TALF) should be expanded to cover purchases of a wider range of Commercial Mortgage Backed Securities (CMBS). Extending TALF for a 5-year period would help the debt refinancing of CRE, and help stabilize the CRE market.
- The American Recovery and Reinvestment Act (ARRA) contained several tax relief and SBA reform measures to help boost small businesses. Congress should adopt legislation to extend these beneficial measures.
- The entire amount of the allowance for loan and lease losses (ALLL) should be included as part of risk-based capital. The risk-based capital rules should take into consideration the entire amount of ALLL and not just the amount up to 1.25 percent of a bank's risk-weighted assets. This would encourage banks to reserve more and recognize the loss-absorbing abilities of the entire amount of the ALLL.
- The FDIC Transaction Account Guaranty (TAG) Program has been an important tool for protecting and promoting the interests of small businesses by guaranteeing payroll accounts and providing community banks additional liquidity to make loans to creditworthy borrowers. It should be extended another 12 months beyond its June 30th termination date.
- SBA reforms should be enacted to meet the needs of community bank SBA lenders. For example, the SBA "low-doc" program should be revived to help smaller banks that do not have a dedicated SBA lending staff.
- As policymakers decide the status of Fannie Mae and Freddie Mac going forward, a reasonable value should be given to community banks for the preferred shares, which were rendered worthless by the Government's takeover of the GSEs. Additionally, dividend payments should be resumed for preferred shares.
- ICBA applauds the recent expansion of the net operating loss (NOL) 5-year carryback for 2008 or 2009. ICBA recommends extending this beneficial NOL reform through 2010. This would allow many more small businesses to preserve their cash flow and ride out this difficult business environment as the economy recovers.
- The law governing Subchapter S banks should be amended to permit IRA investments in Subchapter S banks without regard to timing and to permit Sub-

chapter S banks to issue preferred shares. These reforms would give Subchapter S banks new sources of capital at this critical time.

- Congress should preserve the top marginal tax rate for Subchapter S income at 35 percent and maintain parity between corporate and individual tax rates to prevent costly shifts in business forms for Subchapter S businesses, including Subchapter S banks.

Administration's Small Business Lending Fund

In addition to these ideas, ICBA strongly supports the proposal announced by the President and Treasury to further stimulate lending to the small business sector through community banks. ICBA believes the program could be successful, if structured properly. ICBA has several recommendations for a successful program, including allowing community banks to participate in the new program without the restrictions associated with the Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP). This would encourage broad participation. All of ICBA's recommendations for the new small business program are discussed more fully below.

Small Business and Community Banks Key to Recovery

America's small businesses are the key to supporting the country's economic recovery. Small businesses represent 99 percent of all employer firms and employ half of the private sector workers. The more than 26 million small businesses in the U.S. have created the bulk of new jobs over the past decade. With many of the largest firms stumbling and the U.S. unemployment rate at nearly 10 percent, the viability of the small business sector is more important than ever.

Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. For their size, community banks are prolific small business lenders. While community banks represent about 12 percent of all bank assets, they make 40 percent of the dollar amount of all small business loans less than $1 million made by banks. Notably, nearly half of all small business loans under $100,000 are made by community banks. In contrast, banks with more than $100 billion in assets—the Nation's largest financial firms—make only 22 percent of small business loans.

Community-based banks have played a vital role in the stability and growth of each of the 50 States by providing a decentralized source of capital and lending. This wide dispersion of our Nation's assets and investments helps preserve the safety, soundness, fairness, and stability of our entire financial system.

With that said, the positive attributes of our Nation's community banking sector are currently at risk. While the overwhelming majority of community banks are well capitalized, well managed and well positioned to lead our Nations' economic recovery, there are certain hurdles in place that are hindering our efforts.

Examination Environment Hinders Lending

Mixed signals that appear to be coming from the banking agencies have dampened the lending environment in many communities. A November 12, 2008, Interagency Statement on Meeting the Needs of Creditworthy Borrowers established a national policy for banks to extend credit to creditworthy borrowers as a means to help our Nation get back on its economic feet. It stated, "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." Again, in November 2009, the banking agencies issued the Guidance on Prudent Commercial Real Estate Loan Workouts, which was intended to ensure examiners look at factors other than just collateral values when evaluating commercial credits and to ensure supervisory policies do not inadvertently curtail credit to sound borrowers. Two weeks ago, the regulators repeated some of these same messages in the context of small business lending generally in another interagency statement.

Some Field Examiners Second Guessing Washington

However, these messages seem to be lost on examiners, particularly in parts of the Nation most severely affected by the recession. In a recent informal survey conducted by ICBA, 52 percent of respondents said they have curtailed commercial and small business lending as a result of their recent safety and soundness examinations. Also, 82.5 percent of respondents answered that the Federal banking agencies' guidance on CRE loan workouts has not improved the examination environment for CRE loans.

Higher Regulatory Capital Standards

Bank examiners are raising required capital levels well above the capital standards established by statutes and regulations. As a result, community banks with sufficient capital to be considered "well-capitalized" are being classified as only "adequately capitalized." Some ICBA members report examiners have increased the leverage ratio requirement a bank must meet in order to be considered "well-capitalized." Instead of the five percent leverage ratio called for by statute, some bank examiners have increased the leverage benchmark to ten percent. This is, unfortunately, done so at the cost of reducing lending.

Being downgraded to "adequately capitalized" impacts a bank's liquidity, and its ability to make loans and raise new capital from investors. "Adequately capitalized" institutions may not accept brokered deposits or pay above market interest rates on deposits without a waiver from the FDIC. The FDIC is being very tough on granting brokered deposit waivers causing further liquidity problems for banks. The interest rate restrictions limit many banks' ability to attract good local deposits. These deposits will likely migrate out of the community to other financial firms not subject to this restriction. In addition, to meet the higher capital standards, banks decrease the number of loans on their books and are forced to turn away quality borrowers.

The examiner-imposed capital standards may force banks to seek additional outside capital. Raising unnecessary capital dilutes the interest of existing shareholders, which erodes wealth that could be deployed by the shareholders to support other economic activities in the local economy. Furthermore, the prospect that regulators might increase capital requirements in the future makes raising capital difficult as potential new investors consider whether their investment in the bank might be diluted in the future.

Aggressive Writedowns of Loans; High Loan Loss Reserves

While the banking regulators in Washington have been very willing to discuss safety and soundness examination policies with the ICBA and have reassured they are taking measures to ensure their examiners are being reasonable and consistent with recent guidance, ICBA continues to hear from community bankers that examinations are unreasonably tough.

For example, despite the guidance on CRE loan workouts, community banks continue to report they are forced to write down performing CRE loans based solely on appraisals and absorption rates (lots sold). In those cases, examiners are ignoring the borrower's ability to repay its loan, the borrower's history of repaying other loans with the lender, favorable loan-to-value ratios and guarantors. When a recent appraisal is unavailable, examiners often substitute their own judgment to determine collateral value.

Further, commercial credits that show adequate cash flow to support loan payments are being downgraded because of collateral values, or because the examiner believes the cash flow will diminish in the future. Other bankers complain that otherwise solid loans are being downgraded simply because they are located in a State with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that ignores any differences among markets within a State.

Many community banks report examiners are not only requiring an aggressive write down of commercial assets, they are also requiring banks to establish reserves at historically high levels. Banks, which were rated CAMELS 1 or 2 on prior examinations and had loan loss reserves of 1 to 1.5 percent of total loans, report they are being required to more than double their loan loss reserves. Aggressive write-downs of commercial assets and large loan loss reserves have a serious negative impact on bank earnings and capital and the ability of community banks to meet the credit needs of small businesses.

Banks May Avoid Good Loans To Satisfy Regulators

Examiner practices not only undermine the fundamental goal of the interagency policies, they are costing community banks money, leading to a contraction of credit, and forcing many of them to rethink their credit policies. Under this climate, community bankers may avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital.

Demand for Credit Down

Community banks are willing to lend, that is how banks generate a return and survive. Community banks have witnessed a decrease in demand for loans from qualified borrowers. The demand for credit overall is down as businesses suffered lower sales, reduced their inventories, cut capital spending, shed workers and cut debt. Small business loan demand is down as well. In a recent National Federation of Independent Business (NFIB) survey, respondents identified weak sales as the biggest problem they face. Only eight percent of respondents said access to credit was a hurdle. In a recent ICBA survey, 37 percent of banks responding said lack of loan demand was constraining small business lending. The FDIC Quarterly Banking Profile showed a $129 billion decline in outstanding loan balances in the fourth quarter of 2009 after a record $210.4 billion quarterly decline the previous quarter.

Net loans and leases declined across all asset size groups on a quarterly basis in the second half of 2009.

All community banks want to lend more. Less lending hurts profits and income. Many community bank business customers cite the key reason for not seeking credit is their uncertainty about the economic climate and cost of doing business going forward. Until confidence in the economic outlook improves, businesses will be unlikely to seek more loans.

Commercial Real Estate

One issue of increasing concern in the community banking sector is commercial real estate and the potential for overexposure. Many community banks rely on commercial real estate (CRE) as the "bread and butter" of their local markets. The degree of borrowers' ability to service their CRE loans is closely tied to the performance of the overall economy, employment and income. Notably, retail sales declined 0.3 percent in the important December 2009 figure and unemployment remains near a 26-year high. So the sales at stores and businesses occupying commercial space is under stress and rents are suffering, putting increased pressure on paying loan and lease commitments. Until individual spending (which makes up 70 percent of GDP) and employment numbers improve, CRE loans set for renewal are likely to see continuing rising defaults.

This adds stress to the community banking sector as they rely on commercial real estate as a significant portion of their overall portfolio. However, bank regulators have much more aggressively examined community banks for CRE concentration dating back to 2006. For example, an institution whose total amount of reported construction, land development, and other land loans represents, approaches, or exceeds 100 percent or more of the institution's total capital will be subject to greater regulatory pressure and oversight. An institution whose total CRE loans represent, approach, or exceed 300 percent or more of the institution's total capital and whose outstanding balance of CRE loans has increased by 50 percent or more during the prior 36 months will also come under even greater regulatory scrutiny.

It is not uncommon to have community banks exceed the 100 percent of regulatory capital threshold, but few have seen very rapid growth in CRE exceeding 50 percent in the past 3 years. Many community banks survived the CRE stress in the 1980s and 1990s, and have much better controls over their CRE concentration. Community bankers report today's CRE troubles are nowhere near the magnitude of the late 1980s and 1990s.

CRE credit in the economy has already shrunk by about $45 billion from its 2007 peak. However, CRE exposure will be a significant reason banks will remain under stress in 2010 and is a key reason 702 banks are on the FDIC problem bank list.

Community banks report they underwrite and manage commercial real estate loans in a conservative manner, requiring higher down payments or other steps to offset credit risks and concentrations. Community banks believe they do a better job monitoring CRE loans than do large nationwide lenders because they are more likely to work one-on-one with the customer, and they have a better understanding of the economic conditions in their communities. The vast majority of community banks have the capital to ride out the depressed CRE market. However, community banks all over the country, even those located in areas that relatively healthy economies, are under regulatory pressure to decrease CRE concentrations.

Should real estate prices stabilize with economic growth, the CRE concerns will abate. Many community banks report CRE loan payments are regularly being made (so the loans are performing) but the underlying collateral value has declined. Therefore, as CRE loans are due for renewal, borrowers as well as banks are often forced to put up increased capital to be able to refinance and prevent default.

ICBA's Recommendations

Community banks are the key to economic recovery. Despite a Fourth Quarter 2009 decline of net loans and leases at 8.2 percent compared to the previous year among all banks, community banks with less than $1 billion in assets showed only a narrow year-over-year decline in net loans and leases of 1.4 percent after being the only group to post increases in each of the previous three quarters. The Nation's biggest banks cut back on lending the most. Institutions with more than $100 billion in assets showed 8.3 percent decrease while $10–100 billion-asset-banks had net loans and leases decline at 11.4 percent compared to the previous year. Policymakers need to create an environment to promote community bank lending to small businesses, rather than inhibiting lending. ICBA has several recommendations to improve the commercial lending environment and address problems related to CRE.

Regulatory Relief Is Top Priority

Community bankers' top concern is that bank regulators have swung the pendulum too far toward regulatory excess, inhibiting new small business lending and making the small business and CRE problems worse rather than helping resolve the problem. Community bankers report bank regulators are forcing write-downs on performing commercial loans and treating all loans in many hard hit States the same regardless of a loan's performance. Also the FDIC practice of dumping properties at "fire sale" prices onto a market can trigger a counterproductive downward spiral in real estate values and further bank write-downs. Banking regulatory staff in the field is paying little heed to the policies established in Washington put in place to promote lending. Field examiners are imposing arbitrary capital standards on community banks, requiring those banks to shrink their assets rather than increase lending.

If community banks are to increase small business lending, the regulatory environment needs to change. The country needs a balanced regulatory environment to encourage lending and economic recovery, in addition to bank safety and soundness. In a balanced environment, regulators do not exacerbate credit availability through procyclical increases in bank capital requirements. And, bank examiners consider the total circumstances of loans and borrowers, and not just collateral values, when determining the value of loans in banks.

Extend and Expand TALF Program

The TALF program was designed to keep the secondary markets open and vibrant for a variety of loan and investment products. Secondary markets for commercial debt must be robust so CRE debt refinancing can take place at reasonable borrowing rates. Like residential real estate, commercial real estate loans were bundled into securities, pooled and sold. Specifically, the market for CMBS has not fully recovered. Expanding the TALF to cover purchase of a wider range of CMBS and extending TALF for a 5-year period would help the debt refinancing of CRE, and help stabilize the CRE market. Notably, community banks can sell very few of their whole CRE loans; more likely they are engaged in loan participations, so policies should focus on stabilization of CRE valuations.

Extend Small Business Changes in the ARRA

The severe economic recession justified a sizable economic stimulus, including tax relief measures for individuals and small businesses. ICBA was pleased the American Recovery and Reinvestment Act (ARRA) enacted last February contained several tax relief and SBA reform measures to help boost small businesses. Specifically, the major SBA loan program enhancements enacted are all helping many small businesses ride out this deep recession. ICBA also supports the extension of the key incentives for SBA 7(a) and 504 lending programs.ICBA also applauds the legislation to extend the beneficial SBA enhancements included in ARRA. Specifically:

- Extending the SBA fee reductions through fiscal year 2011;
- Extending the higher guarantee levels through fiscal year 2011;
- Making permanent the SBA secondary market facility authority.

If enacted, these measures would all help community banks expand their SBA lending to small businesses and would stimulate much-needed economic activity and job creation.

SBA Reforms

ICBA supports additional measures to enhance SBA lending. The key to meeting small business capital needs is to have diversity in SBA lending options. The SBA should be able to meet the needs of both large and small SBA loan program users. This was our objection to the SBA's elimination of the successful "LowDoc" program. It was used most often by banks that did a small number of loans and did not have the dedicated SBA loan staff.

If community banks could more easily use SBA programs, since there are more than 8,000 community banks nationwide, a larger number of SBA loans could be made. In other words, we do not want an SBA with a one-size-fits-all cookie cutter approach that only the biggest-volume SBA lenders can fully use. Before this financial crisis hit, nearly 60 percent of all SBA loans were concentrated in just ten banks. If we are concerned with supplying small businesses with a steady source of capital, the SBA needs to do a better job of embracing the more than 8,000 banks nationwide so all lenders can easily participate.

Enhancements to Community Bank Capital

Of course community banks and small businesses rely on raising capital in this difficult capital market. Therefore, we would like to recommend several reforms to help community banks and small businesses preserve and raise capital.

Restore Reasonable Value to Fannie Mae and Freddie Mac Preferred Stock

Community banks were encouraged by bank regulators to hold Fannie Mae and Freddie Mac preferred stock as part of their Tier 1 capital and were severely injured when the U.S. Treasury placed these entities into conservatorship in September 2008. Some $36 billion in Fannie Mae and Freddie Mac capital held in banks, including many community banks, was largely destroyed by Treasury's action. As policymakers decide the status of Fannie Mae and Freddie Mac going forward, at a minimum, a reasonable value should be given to the preferred shares. Dividend payments should be resumed for these preferred shares. Importantly, this will help restore capital needed for additional small business lending. For each dollar of value restored some eight to ten dollars in new lending can occur.

Extend the 5-Year NOL Carryback Through 2010

ICBA applauds the recent expansion of the NOL 5-year carryback for 2008 or 2009 that President Obama signed into law on November 6. The FDIC reports 30 percent of banks had a net loss for 2009. ICBA recommends extending this beneficial NOL reform through 2010. This would allow many more small businesses to preserve their cash flow and ride out this difficult business environment as the economy recovers.

Specifically, ICBA recommends allowing community banks and small businesses with $10 billion in assets or less to spread out their current losses with a 5-year carryback allowed through tax year 2010, including TARP–CPP programs participants to increase small business lending. It makes little sense for Congress to encourage community banks to lend more to small businesses by participating in the TARP program and then to punish them by not allowing the potential use of the NOL 5-year carryback tax reform. Allowing all interested small businesses with $10 billion or less in assets to use an expanded NOL through 2010 will help free up small business resources now to help support investment and employment at a time when capital is needed most. Expanding the NOL 5-year carryback to include tax year 2010 and allowing TARP participant banks with $10 billion in assets or less simply allows these businesses to accelerate the use of allowable NOL deductions that can be claimed in future years under current law. However, by accelerating the use of NOLs it will free up much needed cash flow now when businesses need it most.

A recent report by the Congressional Research Service helps support the net operating loss tax relief. The May 27 CRS report notes most economists agree that U.S. companies would benefit from a longer net operating loss carryback than the current 2-year period. The CRS report says the carryback period should last through the typical business cycle (6 years) to help smooth the peaks and valleys in income.

The Entire Amount of the ALLL Should Be Included as Part of Risk-Based Capital

Under the current risk-based capital rules, a bank is allowed to include in Tier 2 capital its allowance for loan and lease losses (ALLL) up to 1.25 percent of risk-weighted assets (net of certain deductions). Consequently, some community banks are now being downgraded based on capital inadequacy even though they have excess amounts of ALLL. The risk-based capital rules should take into consideration the entire amount of ALLL and not just the amount up to 1.25 percent of a bank's risk-weighted assets. This would encourage banks to reserve more and recognize the loss-absorbing abilities of the entire amount of the ALLL.

Extending the FDIC TAG Program One Additional Year

The FDIC Transaction Account Guaranty (TAG) Program, which guarantees non-interest bearing transaction accounts, certain NOW accounts and IOLTA accounts, has been an important tool for protecting and promoting the interests of small businesses by guaranteeing payroll accounts and providing community banks additional liquidity to make loans to creditworthy borrowers. Banks pay a separate fee to the FDIC for this additional coverage. Accounts guaranteed under the TAG are not considered in determining the deficit in the FDIC's Deposit Insurance Fund, so continuing the TAG would not increase the deficit in the Deposit Insurance Fund (DIF) or affect the FDIC's regular insurance premiums. ICBA is concerned that an expiration date of June 30, 2010, would not provide enough time to restore and maintain liquidity and customer confidence in the banking system. Particularly in those areas of the country like Georgia, Florida, California and the Southwest, it is very important this program continue an additional 12 months to allow additional time for those areas to stabilize. The TAG program ensures community banks are not at a competitive disadvantage in this fragile economy. The safety of transaction accounts continues to be one of the most important concerns for customers. The public perceives too-big-to-fail institutions can provide unlimited protection because these banks will ultimately be bailed out if they become financially unstable. Community banks should be afforded the same opportunity to guarantee their customers' transaction accounts.

Allow New IRAs as Eligible S Corporation Shareholders

The challenging economic and credit markets make it difficult for many community banks to raise additional capital to support small business lending. Unfortunately, Subchapter S community banks are disadvantaged in raising additional capital by onerous shareholder restrictions. Current law restricts the types of individuals or entities that may own S corporation stock. [1] S corporation community banks seeking to raise capital may not allow new IRA shareholders. Traditional and Roth IRA stockholders are permitted only to the extent that IRA stock was held on or before October 22, 2004. Therefore, Subchapter S community banks are put at a disadvantage relative to other less restrictive business forms in their ability to attract capital due to the rigid IRA shareholder restriction.

ICBA recommends new IRA investments in a Subchapter S bank be allowed regardless of timing. ICBA believes this reform will grant more community banks the needed flexibility in attracting IRA shareholder capital, especially from existing shareholders.

Allow Community Bank S Corporations To Issue Certain Preferred Stock

Another obstacle preventing S Corp. banks from raising capital is the restriction on the type of stock they can offer. Current law only allows S corporations to have one class of stock outstanding. [2] C corporations that want to make the S corporation election must eliminate any second class of stock prior to the effective date of the S corporation election. Likewise, issuing a second stock class by an S corporation terminates its S corporation status. Community banks must maintain certain minimum capital ratios to be considered a well-capitalized institution for regulatory purposes. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth. Banks needing more capital can raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so they can protect their status as an independent community bank and serve their local community lending needs. Instead, they frequently use preferred stock to fund growth and retain control. However, S corporation banks are not allowed to issue commonly used preferred stock because preferred stock is considered a second class of stock. This prevents small community banks from having access to an important source of capital vital to the economic health and stability of the bank and the community it serves.

ICBA recommends exempting convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S corporation purposes. This would help more community banks become eligible to make the S corporation election as well as help those current S corporations seeking to raise additional capital. Allowing community bank S corporations to issue preferred stock would allow them to reduce the burden of double taxation like other pass-through entities and, at the same time, fund future growth.

Preserve 35 Percent Top Marginal Tax Rate on Subchapter S Income

Small businesses are facing difficult economic times. A troubled credit market combined with a slowdown in U.S. economic growth, high energy prices, and sharp inflationary costs across-the-board for inputs are crimping small business profits and viability. Maintaining cash flow is vital to the ongoing survival of any small business and taxes are typically the second highest expense for a business after labor costs. As pass-through tax entities, Subchapter S taxes are paid at the individual income tax level. Marginal income tax rates do play a critical role in a small business' viability, entrepreneurial activity, and choice of business form. Today more than half of all business income earned in the United States is earned by pass-through entities such as S corporations and limited liability corporations.

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[1] Internal Revenue Code §1361(b)(1).
[2] Internal Revenue Code §1361(b)(1)(D).

The top corporate income tax rate and individual income tax rate are currently set at thirty-five percent. Much attention has been given to addressing the corporate tax rate for international competitiveness concerns and raising the individual income tax rate. Significant shifts in the existing marginal tax rates and parity between corporate and individual tax rate can trigger unwanted and costly shifts in business forms. It is important to consider maintaining parity between the top corporate and individual income tax rates in the Code. Additionally, during this difficult economic period, at a minimum, the current top tax rate of thirty-five percent should be preserved on both small business Subchapter S income and C corporation income, not increased.

Administration's Small Business Lending Fund

ICBA strongly supports the proposal announced by the President and Treasury to further stimulate lending to the small business sector through community banks. ICBA believes the program, if structured properly, could be successful. ICBA made several recommendations to the Administration for a successful program:

- The new program should impose no TARP-like restrictions on community banks that participate in the program. For example, the program should not require stock warrants, restrict compensation or bank dividends, or limit access to tax benefits like the NOL carryback.
- The Government should not have the right to change the contract to impose unilaterally new conditions and requirements.
- Bank dividend payments to the Government should be suspended for 1 year until the small business loans can be underwritten and put in place.
- Community banks should be able to repay the Government's investment without penalty and should be able to retain the Government's investment for at least 5 years or more to support long term small business loans.
- The broadest number of community banks should be eligible to participate. CAMELS-rated 3 banks should be automatically eligible and 4-rated banks should be allowed to participate on a case-by-case basis. When considering applications to participate in the program, a bank's post investment capital position should be used to determine eligibility.
- Special consideration should be given to minority banks given their role promoting the economic viability of minority communities.
- Treasury should have the ability to make the final capital injection decision after consultation with the banking regulators.
- The eligibility criteria and approval process must be well defined and transparent so bank access to the program will be fair and transparent.
- All forms of banks, including Subchapter S and mutual banks and mutual bank holding companies, should be included in the program.
- Existing TARP CPP participants should be able to transfer to the new program and be relieved of the TARP restrictions.
- All participants should be allowed to treat the investment as Tier 1 capital.
- Agricultural loans should be included within the program.
- Reporting of small business lending should be made simple.
- Finally, credit unions should not be allowed to participate in the programs because credit unions commercial lending is restricted, in the first place, and secondly, because credit union lending is already subsidized through a broad tax exemption.

Conclusion

Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. Community banks form the building blocks of communities and support small businesses around the country. The community banking industry is poised to serve as an economic catalyst to lead our Nation's economic recovery. Community bankers are ready, willing and able to meet the credit needs of small businesses and the communities they represent. But, it is important to move away from a restrictive, procyclical regulatory environment to one that actually promotes small business and CRE lending in community banks. In addition, ICBA believes the recommendations in this testimony, if adopted, would go a long way to strengthen the community banking sector and increase small business lending. ICBA looks forward to working with Congress and the Administration on these and other initiatives to support small business and CRE lending by community banks.

Attachment

COMMUNITY BANK COMMENTS FROM AN ICBA SURVEY ON EXAM ISSUES AND SMALL BUSINESS LENDING: JANUARY 8, 2010

1. A large unsecured loan that was performing as agreed with monthly payments of principal and interest and had never been past due was required to be charged off as a loss.

2. We have had a number of businesses who were long term customers and whose loans performed according to terms. The regulators looked at 1 year's tax return from a particular customer that does not fully support cash flow but is marginally close. The regulators had us move this to substandard when we believed a watch rating would be prudent based only on 1 year's results. We should then monitor the customer next year and it either goes to a substandard or back to a pass. This is way too aggressive an approach.

3. An insurance company. The regulators criticized the credit due to uncertain collateral position. The credit had never been 15 days past due in over 10 years with the bank. The collateral is short, but payment history and cash flow was satisfactory.

4. Our bank had a number of commercial loans that have not missed a payment. However, the examiners have indicated they do not believe the real estate is worth the same value as 1 or 2 years ago and they required us to place the loan in a substandard classification and set aside reserves which reduces our capital. They also want the bank to stress test all commercial loans with suggested limits that would require a 50 percent plus + down payment on any commercial loan. The examiners certainly did not read the press release issue on 10-30-09 by the Federal Reserve on prudent commercial real estate loans; they were negative on every commercial loan they reviewed. Very few commercial loans received a passing grade.

5. Performing (owner-occupied) loans were criticized because the value of collateral had fallen.

6. In our bank, any loan that was speculative construction or development was automatically classified as substandard. A number of loans that have never been delinquent and are not dependent on the subject project to service the debt were classified.

7. Examiners are so focused on capital ratios, earnings liquidity, and reserves for losses that our bank is very unwilling to allow much growth at this time.

PREPARED STATEMENT OF RAJ DATE

CHAIRMAN AND EXECUTIVE DIRECTOR, CAMBRIDGE WINTER CENTER FOR FINANCIAL INSTITUTIONS POLICY

MARCH 2, 2010

Thank you, Chairman Brown and Ranking Member DeMint, for inviting me to speak to you about the causes of, and potential solutions to, small business credit contraction.

My name is Raj Date, and I am the Chairman and Executive Director of the Cambridge Winter Center. Cambridge Winter is a nonpartisan think tank dedicated exclusively to researching U.S. financial institutions policy issues. [1] Before Cambridge Winter, I had spent virtually my entire career in and around financial services—in consumer finance, in commercial banking, and on Wall Street. Based on that experience, and on the work of Cambridge Winter, my hope is to provide you with a few practical observations on the state of the marketplace, and to suggest some principles by which you might measure alternative solutions.

This is, as you know, an important issue. Small business credit is tight. FDIC data shows that banks' commercial loan balances, which include small business loans, have already declined by more than $500 billion since the onset of the crisis. [2] I fear that we are at something of a transition point in the marketplace today: the

[1] The Cambridge Winter Center is a nonprofit, nonpartisan organization with a pending application for tax exempt status under Internal Revenue Code section 501(c)(3). Cambridge Winter does not engage in lobbying activities, it has no clients, and it does not accept fees or other compensation for any of its work.

[2] FDIC-insured banks' and thrifts' on-balance sheet commercial loans declined by a cumulative $504 billion over the past five quarters. FDIC, Quarterly Banking Profile Graph Book, p. 33 ("FDIC GraphBook") (December 2009).

point at which credit contraction becomes less driven by a rational decline in demand for loans, and becomes more driven by a structural shortfall in supply.

Absent structural remedies to that supply problem, the lack of small business credit could become a serious impediment to both the timing and speed of a recovery in the real economy.

1. Demand Issues

Let me begin by discussing the demand for small business lending. Small business people, in general, are a financially conservative lot. As their own revenue prospects become uncertain, as happens in every recession, they quite prudently tend to shy away from debt financing. Given that natural decline in demand, relatively few small business owners today see the lack of small business credit as their most significant or pressing issue. [3]

The typical recession-driven decline in demand has been accentuated in this downturn by a disconnect on pricing. It is probably not surprising that borrowers, in general, believe that they are more credit-worthy than do their lenders. That is human nature, and in small business lending it is especially true. Prudent lenders should, implicitly or explicitly, consider a number of factors in pricing credit: (1) the small business's cash flow trajectory and resilience; (2) performance history; (3) existing debt load; (4) collateral value and stability; (5) credit quality and character of guarantors; (6) cost of funding; (7) structural interest rate risk; and (8) the asset-liquidity of the loan, once originated. But small business borrowers, which almost definitionally lack professional financial management, typically do not appreciate some of those factors (funding costs, rate risk, and asset liquidity chief among them), and as a result are dissatisfied when those factors drive pricing dramatically higher, as they have in the crisis.

Over the last decade, moreover, small business borrowers' most frequent market signal about their own credit-worthiness came from billions of direct marketing messages from prime credit card issuers. The prime credit card business had come to be dominated by teaser-rate pricing practices, coupled with nontransparent risk mitigation features (*e.g.,* universal default repricing, double-cycle billing, unilateral line decreases). One of the many negative features of teaser-rate marketing is that, when small business owners are, today, confronted with more transparent risk-based pricing, the result is sticker shock. Thankfully, given recent legislation that mandates decidedly more transparent card pricing practices, [4] this pronounced disconnect between borrowers and lenders should reduce over time.

Of course, some apparently credit-worthy small businesses have had a difficult time securing financing over the past year. We have all seen considerable anecdotal evidence to that effect. On balance, though, it is quite likely that the decline in commercial credit so far has been more driven by a drop in demand than any other factor.

2. Supply Issues

Over the coming quarters, however, the binding constraint on small business lending will shift from a deficit of demand, to a deficit of supply.As the real economy begins to recover, we should expect demonstrably credit-worthy small business owners to begin to demand credit in greater amounts. As that demand materializes, however, it is quite possible that it will go unmet by the financial system. Indeed, it seems likely that the threat of a shortfall of credit supply will be more pronounced in small business than anywhere else in the credit markets. The reason for this is a structural shift that has been catalyzed by the crisis: the "relocalization" of small business lending.

a. Contraction in national-scale products and firms

Small business finance is, for many firms, tightly intertwined with consumer finance. Because most small businesses are often quite small indeed, their liquidity sources and uses are frequently related to, and even commingled with, the liquidity positions of their owners. [5] As a result, the rapid expansion of consumer financial products in the decade leading up to the crisis—especially revolving prime credit cards, and cash-out home equity loans—satisfied an increasing fraction of small business credit needs. [6]

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[3] *See,* National Federation of Independent Businesses, "Small Business Credit in a Deep Recession", p. 3 ("NFIB Survey") (February 2010).

[4] Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. 111-24, 123 Stat. 1734 (May 22, 2009).

[5] *See,* NFIB Survey, *supra* note 3, at page 17.

[6] For example, nearly half of small businesses use personal credit cards for transactions or credit extension. Federal Reserve Board, "Report to the Congress on the Availability of Credit

Unfortunately, neither the prime credit card business nor the cash-out home equity business appear to have been particularly suited to withstand an economic downturn. Both businesses, which had become marked by high credit line strategies during the bubble, came under major pressure as unemployment rates climbed. For a lender, high open lines of credit are a recipe for disaster during a recession. In essence, high credit lines tend to be drawn down disproportionately by borrowers facing adversity, while borrowers in solid financial shape do not draw their lines, and therefore do not add to lenders' net interest margins. Credit losses increase, but net interest margins do not grow. As a result, when faced with climbing unemployment, prudent lenders cut credit lines dramatically.[7] Industry-wide, available home equity and credit card lines have declined by an astonishing $1.6 trillion, or 30 percent, over the past 2 years.[8] Massively reduced consumer credit availability, of course, also impacts small businesses.

In addition to the rapid diminution of important lending categories, the past 2 years have seen the disruption of a wide swath of small business and middle-market commercial finance firms. For decades, much commercial finance activity—like equipment finance, inventory finance, or receivables finance—migrated from deposit-funded banks to capital market-funded finance companies. With a benign credit environment, accommodating ABS market investors, and a substantial regulatory capital arbitrage *versus* banks, many of these firms grew to extraordinary size. The commercial lender CIT, for example, boasted after its crisis-driven conversion into a bank holding company that it was the seventh largest bank in the Nation, ranked by commercial and industrial loans. By that metric, CIT was a larger commercial lender than such major regional banks like SunTrust or Regions Financial.[9]

Once the capital market bubble collapsed, unfortunately, these large nonbank finance companies were forced to retreat from the market. GE Capital, for example, apparently plans to shrink its portfolio by some $80 billion over the next few years.[10] Although that down-sizing would only represent 15-20 percent of GE Capital's current size, it implies a reduction in GE's aggregate lending that is roughly equivalent to the entire combined commercial and industrial loan books of the large regional banks Fifth Third, Comerica, and KeyCorp.[11]

The credit crisis, then, has simultaneously and dramatically reduced the availability of important nationally marketed lending products, as well as the credit capacity of large national finance companies. Structurally, the market for small business credit would appear to shifting away from national-scale products and firms, and "relocalizing" to regional and community banks.

b. Constraints among regional and community banks

Over the long term, the relocalization of small business lending is good news. The financial system would be more resilient if it relied less on very large nonbanks that fund themselves in confidence-sensitive wholesale markets, and instead relied on deposit-funded banks that are not "too big to fail."[12] Regional and community banks are also the most natural underwriters of small business credit risk, given their in-market presence and focus.

Over the near term, unfortunately, such banks face major challenges. Without intervention, regional and community banks will almost certainly not be able to re-

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to SmallBusinesses, pages 29-31 (October 2007); see also Charles Ou and Victoria Williams, "Lending to SmallBusinesses by Financial Institutions in the United States", SBA Office of Advocacy ("SBA Advocacy Finance Report") (July 2009).

[7] *See,* Ed Gilligan, American Express Financial Community Meeting, slides 15-20 (February 3, 2010) (illustrating importance of credit line decreases to credit risk mitigation among high-line prime accounts). Some academics appear to have linked credit line decreases to the reforms enacted by the Credit CARDAct. *See,* Todd J. Zywicki, "Testimony Before the U.S. House of Representatives Committee on FinancialServices and Committee on Small Business", pages 5-6 (February 26, 2010). In reality, line decreases began well before the legislation was passed, and extended beyond credit card to other asset classes. *See, infra* note 8.

[8] FDIC, "Assets and Liabilities of FDIC-Insured Commercial Banks and Savings Institutions", Quarterly Banking Profile (December 2009).

[9] Jeffrey M. Peek, CIT's Presentation at the Credit Suisse Financial Services Conference, slide 14 (February 2009). Despite the conversion of its Utah ILC into a state-chartered bank, the attendant conversion of the CIT parent company into a bank holding company by the Federal Reserve, and the infusion of $2.3 billion in TARP capital by the Treasury, CIT filed for bankruptcy. Taxpayers lost the entirety of their TARP capital investment. *See, e.g.,* Michael J. de la Merced, "Creditors Back CIT's Bankruptcy, *New York Times* (November 1, 2009).

[10] Jeffrey R. Immelt, "GE Renewal", GE Annual Outlook Investor Meeting, slide 14 (December 15, 2009).

[11] "Bank Holding Companies with the Largest U.S. Business Loan Portfolios", American Banker, (February 19, 2010).

[12] *See,* generally, Raj Date and Michael Konczal, "Out of the Shadows: Renewing Glass-Steagall for the 21st Century", *Make Markets Be Markets,* Roosevelt Institute (March 2010).

place the small business credit capacity that has otherwise disappeared from the market.

There are two problems.

The most serious problem is small banks' capital constraints. Small banks tend to be heavily concentrated in commercial real estate, and those portfolios will continue to be pressured.[13] Notably, small banks tend to lack the capital markets businesses of larger competitors, which have been major project centers lately. Small bank margins have also been compressed, relative to larger firms, by an exceedingly low rate environment, which tends to disproportionately harm banks with high-quality commercial deposit bases.[14] Given this bleak outlook, and the relative difficulty of small banks' accessing new pools of equity capital, it is much more likely that small banks will shrink their lending books over the coming years, not grow them.[15]

There is a second, and less remarked-upon, problem with small banks' small business lending growth: missing capabilities. It is true that the smallest banks (those under $1 billion in assets) are disproportionately concentrated in business lending, as compared to their larger brethren. But most of small banks' concentration in business lending is attributable to their heavy focus on commercial real estate lending.[16] By contrast, the credit capacity that has most dramatically left the market is in non- real estate lending—that is, the lending that had been satisfied, during the bubble, in major part by credit cards, home equity loans, and nonbank finance companies. And it is non- real estate lending that constitutes the majority of small business finance, particularly in certain capital-intensive sectors, like manufacturing.[17]

3. Evaluating Alternatives

With this context in mind, and mindful of the track record of past policy efforts, I would suggest three criteria to evaluate alternative policy solutions to the small business credit crunch.

a. Recognize the limits of direct Government credit-decisioning

First, we should recognize the limits on the Government's ability, on its own, to quickly and competently direct the flow of commercial credit.[18]

Given the generally negative reaction of both banks and the public to the original TARP capital infusions, it is tempting to imagine that small business credit might be extended by the Government directly, without requiring bank intermediation at all. Unlike in education finance, however, there is no existing Government apparatus by which to generate, evaluate, negotiate, and close small business loans in the primary market. Even for the SBA, which would be the most relevant existing agency, building and scaling up such an effort would be a massive and complicated undertaking. Given the growing size and urgency of small business credit contraction, working through bank intermediation would appear far more practical. To its credit, this is the approach adopted by Administration's proposed Small Business Lending Fund (the "SBLF").[19]

b. Do not reward the worst banks

The second principle we should remember is that not all banks are the same; we should not treat them as though they were.

The central conceptual failing of the original TARP capital infusion plan was that it deliberately created a one-size-fits-all investment structure disproportionately valuable to the worst banks. All banks received the same amount of capital; all banks

[13] *See,* FDIC Graph Book, *supra* note 2, at pages 5, 21, and 37; Congressional Oversight Panel,"Commercial Real Estate Losses and the Risk to Financial Stability" (February 10, 2010).

[14] Commercial deposits typically are not interest-bearing, so a low rate environment does not create lower funding costs (because the interest paid does not become negative). A low rate environment can, however, encourage lower asset yields. The result is a net interest margin squeeze.

[15] It is important to note that although bank capital is pressured, bank funding is not, in general, a constraint for banks today. The FDIC-led measures to backstop a wider range of liabilities have had their intended effect. Banks are holding substantial cash positions, and have invested in steadily growing portfolios of low-risk Government and GSE securities, rather than more capital-intensive consumer and commercial loans.

[16] "Commercial real estate constitutes fully 29 percent of the loan portfolios of banks with under $1 billion in assets; larger banks have only 13 percent of their portfolios in commercial real estate." FDIC Graph Book, *supra* note 2, at page 21.

[17] *See,* SBA Advocacy Finance Report, *supra* note 6, at page 28.

[18] The credit-fueled downfall of Fannie Mae and Freddie Mac is a useful case study on this issue. *See,* Raj Date, "The Giants Fall: Eliminating Fannie Mae and Freddie Mac", Make Markets Be Markets, Roosevelt Institute (March 2010).

[19] Fact Sheet titled "Administration Announces New $30 Billion Small Business Lending Fund" ("FactSheet") (February 2, 2010).

paid the same price. As a result, the TARP investments managed to neither create a credible endorsement that could entice private capital, nor did they provide any competitive benefit to firms that actually had demonstrated an ability to make wise credit risk-return decisions.[20] The Administration's SBLF proposal—at least as it has been described so far—risks a similar problem: it would appear the most valuable to those small banks with the most pressing credit-driven capital problems, irrespective of whether those particular banks have any demonstrated capabilities in small business lending. Nor does the proposal calibrate the size of its investments according to any ground-up evaluation of capital needs (through a simplified stress test methodology, for example).

c. Create an explicit link to desired behavior

Third, we should be careful and explicit with incentives.

Many policy-makers and citizens who supported the original TARP capital infusions, and who believed at the time that credit would, as a result, be stabilized, are unsurprisingly irritated by continued declines in bank lending volumes. The lesson is straightforward: if taxpayers are asked to supply subsidies to support any given activity, those subsidies should be narrowly tailored to achieve that end, and, if possible, be made contingent upon it. Of course, when the desired activity is lending, policy-makers should simultaneously be careful not to create such strong incentives that they inadvertently goad banks into irresponsible credit decisions, which ultimately do more harm than good.

On its face, the SBLF proposal tries to strike this balance this by varying a bank's cost of Government-supplied capital according to its percentage increase in small business lending off a 2009 baseline, but to keep the percentage increase modest enough as to not encourage cavalier decision-making. But the percentage amount of increased small business lending appears so modest—at least in the initial proposal—that it appears likely that most of the Government-supplied capital could be used to bolster preexisting weakness in a firm's capital, rather than to support incremental credit.

Indeed, the example provided in the initial description of the SBLF entails a bank with $500 in assets, $250 million of which are small business loans. The bank, after receiving a $25 million capital infusion from the SBLF, manages to increase its small business lending 10 percent, to $275 million, and thereby receives a full 400 basis point annual reduction in the cost of the Government's capital stake.[21] But regulatory capital required to support that incremental $25 million in loans is probably something close to $2.5 million. So the bank has received, net of the $2.5 million capital support required for the $25 million in new lending, an excess $22.5 million in capital from the Government, which presumably is being used, in the Administration's example, to plug holes in the bank's existing capital position.

The SBLF proposal, then, will require some refinement before it is ready to implement. And it will take time to implement well.

4. An Interim Approach

Given the urgency of this issue, though, Congress may want to consider, in parallel, an interim measure that might be rather simpler to implement.

Rather than investing taxpayer capital directly into banks, we could reduce the regulatory risk weighting on some finite quantum of incremental small business lending. For those banks that find regulatory capital their binding constraint,[22] but who do see economically attractive lending opportunities in the marketplace, a temporary reduction in regulatory capital requirements related to that lending would spur counter-cyclical credit extension.[23] In essence, we would enable otherwise economically attractive loans that are today held back by the legacy of poorly per-

[20] Not until the "stress tests" on the largest banks were these fundamental problems addressed. *See,* RajDate, "Stress Relief", Cambridge Winter Center, pages 1-2 (April 20, 2009) ("Although the Administrationdoes not describe the stress tests in this way, the initiative has the potential to help undo the most profoundly damaging strategic errors of the original Paulson capital purchase plan").

[21] Fact Sheet, *supra* note 19, at p. 2.

[22] For some institutions carrying low risk weightings on their existing assets, it is possible that reductions in leverage ratio requirements might be required in addition to a reduction in risk weightings. In other words, incremental credit can only be encouraged if the binding regulatory capital constraint is relaxed.

[23] Static minimum regulatory capital ratios are frequently criticized because they encourage procyclical lending volumes. Providing regulatory capital relief for small business credit at this point in the cycle would help mitigate that problem, albeit in an admittedly *ad hoc* manner.

forming, capital-intensive assets on bank balance sheets.[24] By limiting the percentage increase in small business loans eligible for this risk weight-reduction, we could prevent small banks from abusing this program by taking on outsized small business portfolios.

By reducing regulatory capital requirements on new lending, of course, we would be increasing the "tail risk" of loss borne by the FDIC's Deposit Insurance Fund, and, indirectly, increasing risk to the taxpayer.[25] But that incremental risk would at least be tied specifically to the outcome we desire—incremental small business credit.

I hope this statement helps you as you consider these critical issues. I look forward to your questions.

[24] Changing regulatory capital requirements does not, strictly speaking, itself transform economically unattractive loans into economically attractive ones. It simply relaxes regulatory capital constraints on otherwise attractive loans. Conceivably, an interim reduction in risk weightings could be coupled with an interim Government or public/private guaranty on the credit losses associated with incremental small business lending. That would transform, on the margin, economically unattractive loans into attractive ones; but it would also be every bit as complicated as the Administration's proposal itself.

[25] The Deposit Insurance Fund (the "DIF") is protected, in part, by a bank's capital cushion. So in the event of a bank failure, the DIF would be more exposed to losses by the magnitude of the capital relief provided under this proposal. Of course, Congress could choose to compensate the DIF in that amount.