

Testimony of

Arthur C. Johnson

On Behalf of the

AMERICAN BANKERS ASSOCIATION

Before the

Subcommittee on Economic Policy

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate



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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

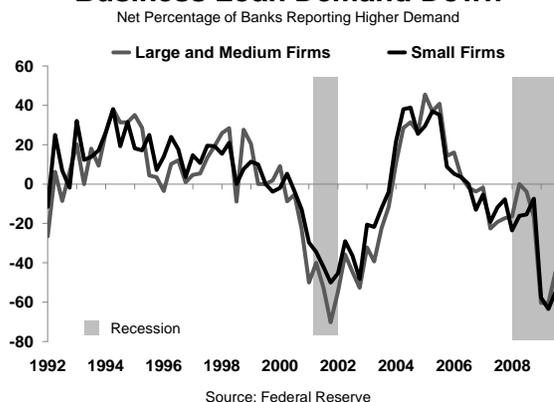
industry – that have been in business for more than a century; 62 percent (5,090) of banks have been in existence for more than half a century. These numbers tell a dramatic story about the staying power of banks and their commitment to the communities they serve. My bank’s focus, and those of my fellow 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.

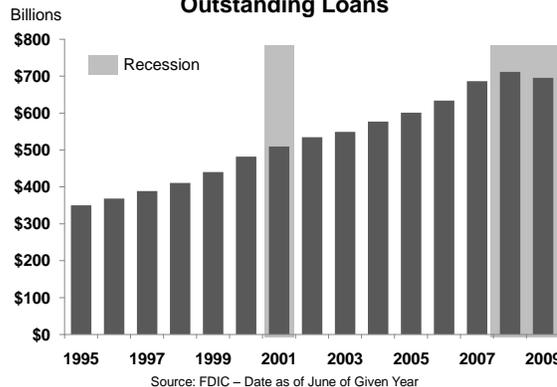
The difficult recession, falling loan demand, and loan losses have meant that loan volumes for small businesses have declined somewhat this year.

Business Loan Demand Down



Lending to Small Businesses

Outstanding Loans



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.

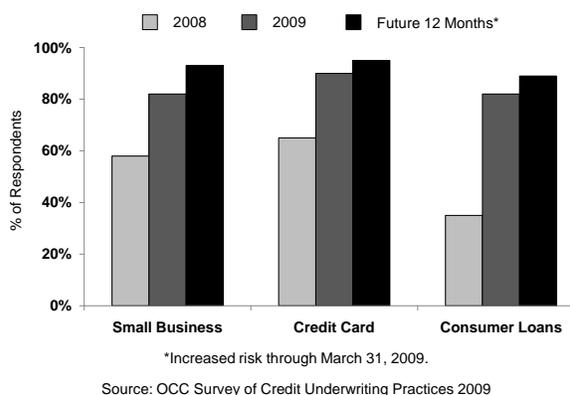
I will address each of these points in turn.

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 pre-recession levels.

Future Increased Credit Risk



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 downpayments required, and smaller loans consistent with diminished collateral values. Banks are looking at the risk of a loan and re-evaluating 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

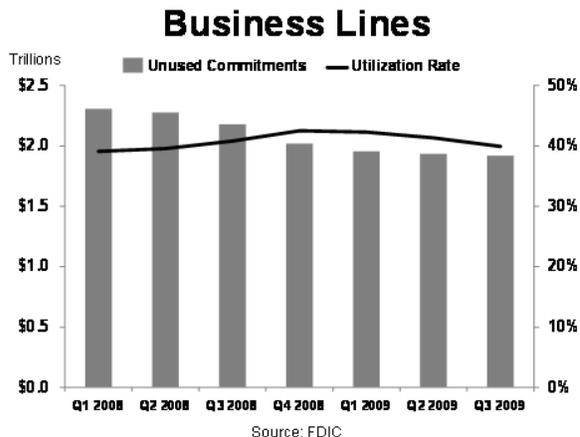
Moreover, access to credit is not a driving concern of most businesses. In a recent survey of 750 businesses by Discover, only 5 percent said the main issue facing their business was access to

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

capital.² NFIB’s survey confirmed this finding: “Although credit is harder to get, ‘financing’ is cited as the ‘most important problem’ by only four 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.



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 three to seven years. After the project is completed, it is common for take-out financing to come from insurance companies or through the

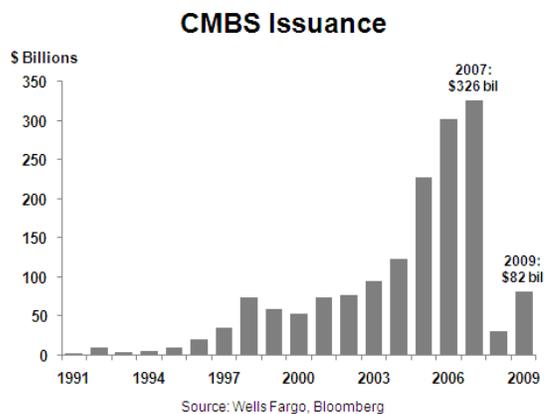
² *Discover Small Business Watch*, October 2009. Discover Financial Services.

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 non-residential 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 two months of the program. The loans in which Michigan banks have participated have created or saved jobs at a "cost" of approximately \$6000 per job. That is particularly exciting when you consider that the \$6000 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.

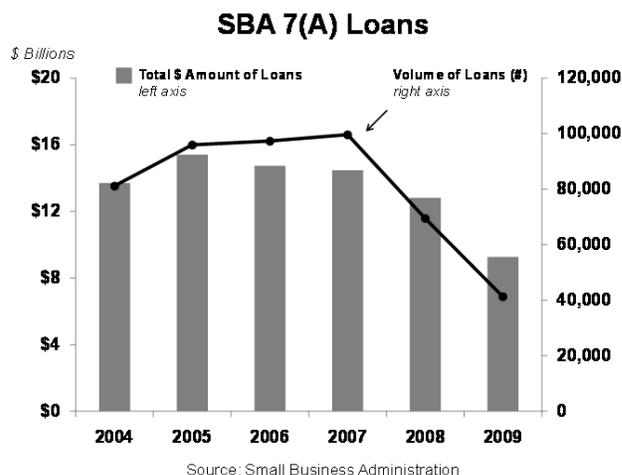
As these and other future programs are developed, ABA recommends that Congress and the Administration create criteria that allow all viable community banks to participate. We propose that Treasury offer assistance to those banks that did not qualify for Capital Purchase Program (CPP) funds but that nevertheless 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 post-investment 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 two 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 eight

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.