*Testimony of*

**Stephen Wilson**

*On Behalf of the*

AMERICAN **BANKERS** ASSOCIATION

*Before the*

**Subcommittee on Economic Policy**

**of the**

**Committee on Banking, Housing & Urban Affairs**

**United States Senate**

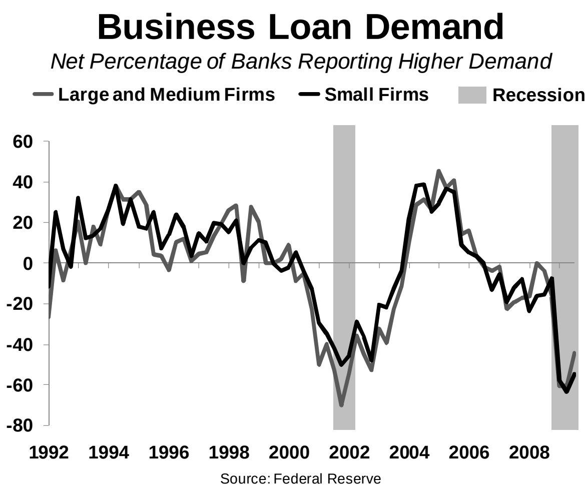
**Testimony of Stephen Wilson**
**on behalf of the**
**American Bankers Association**
**before the**
**Subcommittee on Economic Policy**
**of the**
**Committee on Banking, Housing, & Urban Affairs**
**United States Senate**
**October 9, 2009**

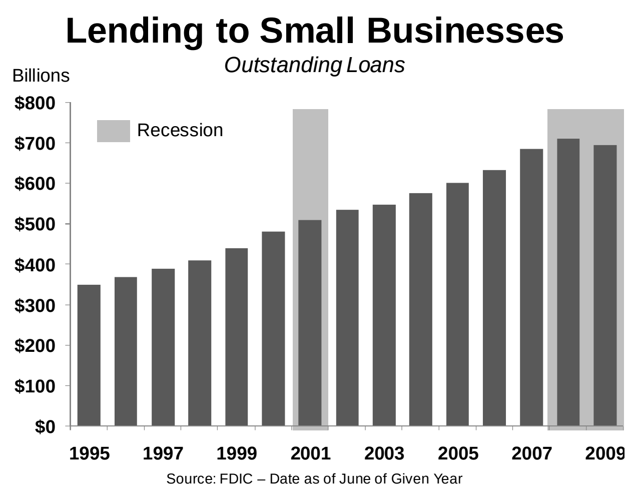
Chairman Brown, Ranking Member DeMint, and members of the Subcommittee, my name is Stephen Wilson, Chairman and CEO, LCNB Corp. and LCNB National Bank, Lebanon, Ohio. I currently serve as the chairman of the Government Relations Council of the American Bankers Association (ABA) and will assume the role of Chairman-Elect of the association at the end of this month. LCNB National Bank is a full-service bank offering trust and brokerage services, along with insurance through a subsidiary. We have over $700 million in assets, and our bank has served our community for 132 years. I am pleased to be here today on behalf of ABA.

The American Bankers Association 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 impact this recession is having on lending to small and medium size manufacturers. Small businesses of all kinds – including banks – are certainly 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. In fact, most banks have been in their communities for decades and intend to be there for many decades to come. The LCNB National Bank has survived many economic ups and downs for 132 years. We are not alone, however. In fact, 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.




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 is declining (see chart on right). 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 this 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 (see chart on right). 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.

We believe there are actions the government can take to assist viable community banks to weather the current downturn. The success of many local economies – and, by extension, the success of the broader national economy – depends in large part on the success of these banks. Comparatively small steps taken by the government now can make a huge difference to these 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:

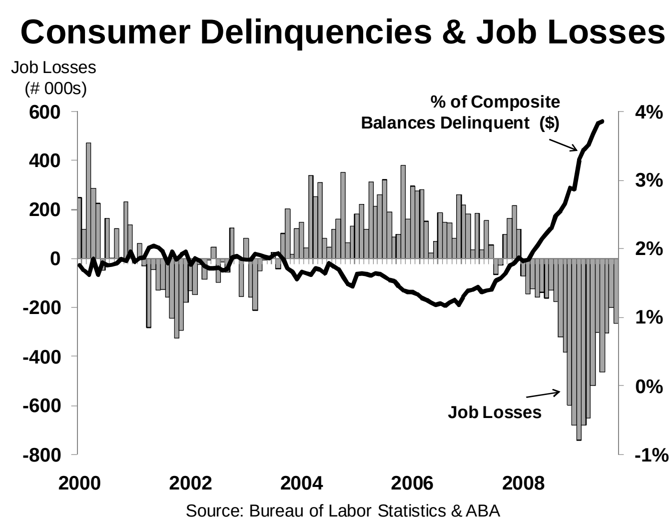
- Banks continue to lend in this difficult economic environment, but the broadening economic problems have already started to impact lending.

- Lenders and borrowers are exercising a prudent approach to credit.

- Changes in the regulatory environment would improve the situation for small business lending.

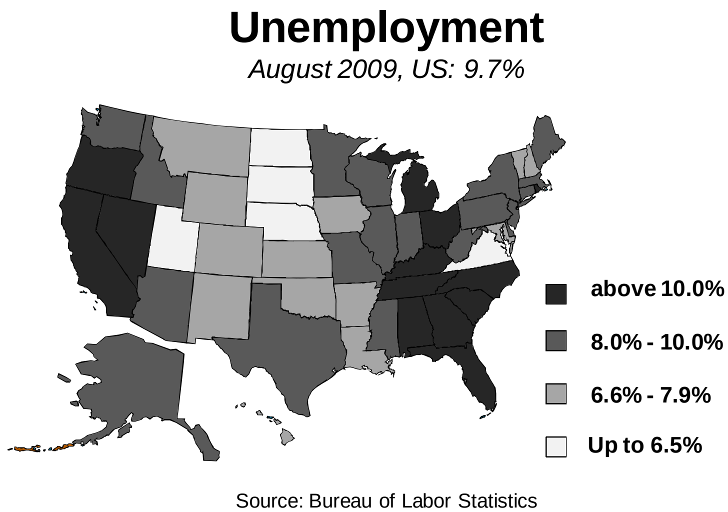
I will address each of these points in turn.

## I. Banks Continue to Lend in this Difficult Economic Environment, but the Broadening Economic Problems have Already Started to Impact Lending




Since the recession began over 21 months ago, banks have continued to provide credit to their customers. The impact of the downturn, however, is being felt by all businesses, banks included. As the economy has deteriorated, it has become increasingly difficult for consumers and businesses to meet their financial obligations. The cumulative impact of six straight quarters of job losses – 7 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. The impact of job losses on delinquencies is illustrated in the chart above. Job loss and other reductions or interruptions of income remain the number one cause of loan delinquencies and losses.

What makes our current national economic circumstances so difficult to discuss is that there are such dramatic regional differences in economic performance. This chart, showing unemployment levels for states across the U.S., makes the variability clear. Most states are either in recession or very close. The causes of these problems are varied.




In the West and Southeast, the housing sector collapse has now broadened to a deep recession. States such as Michigan, Indiana, and Ohio are suffering fundamental economic problems, which are largely tied to the fortunes (or misfortunes) of the auto industry.

For example, in southwest Ohio, where our bank operates, the employment picture is expected to deteriorate even further in the short run. Several factors are involved, but most important are three major plant closures. In Batavia, Ohio, Ford is closing a transmission plant, which will eliminate over 1,000 jobs. In Moraine, Ohio, GM is closing an assembly plant, which will eliminate over 2,500 jobs. And in Wilmington, Ohio, DHL is closing a hub, which will eliminate over 10,000 jobs.

The effect of job losses and closings is a major concern, but these are not the only events impacting small businesses, including small banks. Individuals are saving more and buying less, which reduces foot traffic for retail and other businesses. As a consequence, business bankruptcies have risen from 28,000 in 2007 to more than 43,000 at the end of 2008. Those trends have continued into this year with 30,000 business failures already.[1]

One small business segment that has been particularly hard-hit in my region is the automobile supply chain. Manufacturers that produced for the automobile industry were dealt a hard blow with the economic downturn and the subsequent drop-off in automobile sales. Suppliers' customers went bankrupt, wiping out receivables in the process. Many suppliers lowered

[1] These trends have meant that banks continue to experience losses and are also aggressively setting aside reserves to cover expected losses in the future given the severity of the recession. Setting aside reserves has reduced income and impaired earnings for banks. In fact, two out of every three institutions (64.4 percent) reported lower quarterly earnings than a year ago, and more than one in four (28.3 percent) reported a net loss for the quarter.

production and slimmed down to wait out the storm; others hoped to retool in order to create parts for other industries. The economic downturn had also affected the value of their collateral. This double-whammy of severely decreased cash flows and low collateral values made new borrowing difficult to find, especially without established relationships with lenders.

However, even this segment is seeing some improvements. In the September 2009 Supplier Barometer survey, produced by the Original Equipment Suppliers Association (OESA), automotive suppliers report a growing optimism for the 12-month outlook. In addition, they report they are "generally confident that they will have access over the short-term to capital in the amounts and costs necessary to fund their businesses." This echoes the sentiment reported in PNC's recent Small Business Survey, released this week, which noted small business owners are much less pessimistic about their own company's prospects over the next six months. Last Spring, 36 percent of owners reported pessimism, whereas this autumn, that figure had dropped to 25 percent, comparable with the outlook among small business owners prior to the Lehman collapse. There is still a long way to go, but we remain hopeful that the recovery is underway.

## II. Lenders and Borrowers are Exercising a Prudent Approach to Credit

Against the backdrop of a very weak economy it is only reasonable and prudent that all businesses – including banks – exercise caution in taking on new financial obligations. 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. This means that some higher-risk projects that might have been funded when the economy was stronger may not find funding today.

It comes as no surprise, then, that businesses are being very cautious. As a result, loan demand is down considerably. This is due, according to the National Federation of Independent Businesses (NFIB), to "widespread postponement of investment in inventories and historically low plans for capital spending." The NFIB reports that in spite of the difficult economic environment, 32 percent of businesses reported regular borrowing in August (down one point from July) compared to 7 percent who reported problems in obtaining the financing they desired (down 3 points). The NFIB also noted that only 4 percent of business owners reported "financing" as their number one business problem. This is extremely low compared with 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.

Our expectation is that loan demand in this economy will continue to decline. Loan delinquencies and losses, which often lag the overall economy, will also continue to impact banks. Thus, realistically, the level of lending outstanding to all businesses will continue to decline for the rest of this year. However, we believe that as business confidence continues to improve, inventory and capital investments will increase, and lending volumes will rebound. As the economy starts to grow again 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.

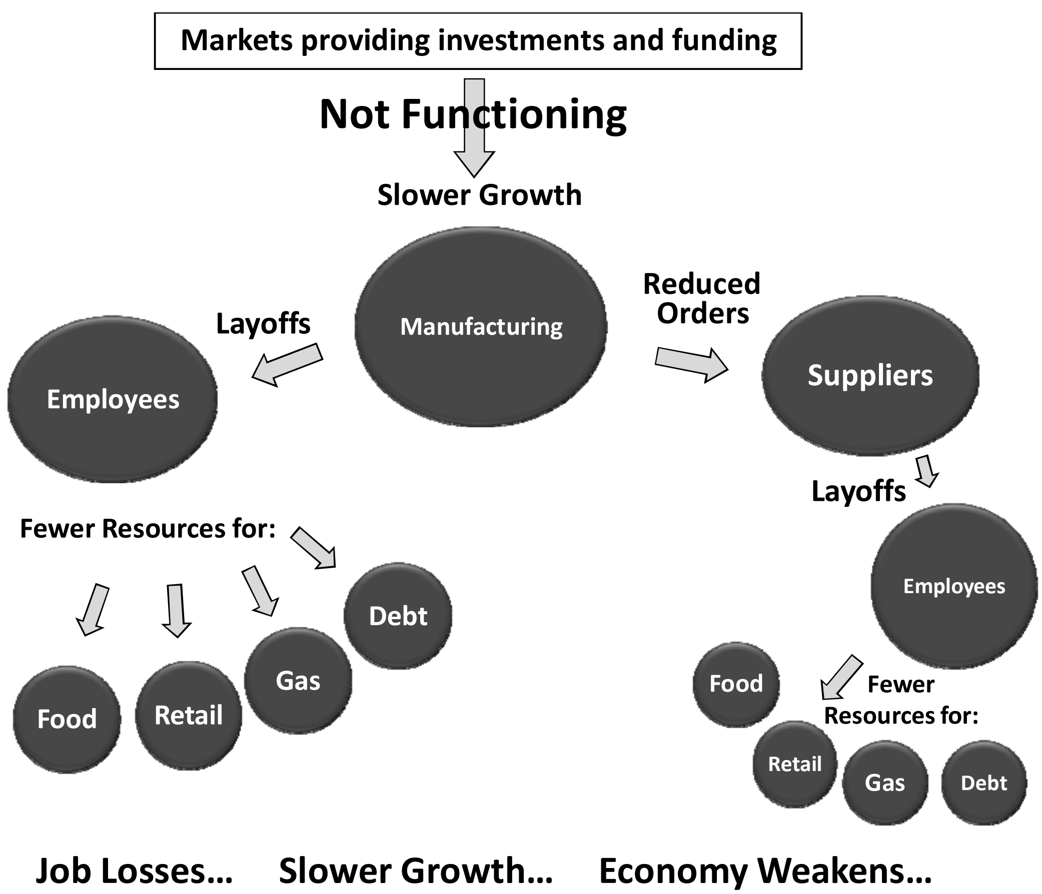
We recognize that there are some consumers and businesses in the current situation that believe they deserve credit that is not being made available. In some cases, it makes no sense for the borrower to take on more debt. Sometimes, the best answer is to tell the customer no, so that the borrower does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

I have an example that illustrates this. We had a customer who we turned down on an application for a loan. The customer was frustrated and angry, and left our bank. Recently, he e-mailed me to say he should not have been granted that loan and that he is coming back to our bank. He said that if he would have accepted our response instead of looking elsewhere, he would have been in better financial stature now. He moved back to our bank, he said, because he appreciates the fact that when we underwrite loans, we are concerned about the success of our customers and whether the loan makes sense for them.

We do not turn down loan applications because we do not want to lend – lending is what banks do. When banks consider an individual loan application, we have to place it in the context of the economic environment. For small local businesses, banks will consider local economic conditions in addition to any specific issues that may affect the business.

The July Senior Loan Officer Opinion Survey by the Federal Reserve bears this out. The survey found that the number one reason for a more conservative approach to underwriting was the poor outlook for the economy. Of that segment of the banks that had tightened lending, more than 70 percent said that the "less favorable or more uncertain economic outlook" was a "very important" reason for tightening credit standards or loan terms (and 30 percent said it was "somewhat important"). Concerns with the outlook in individual business sectors was also noted as a problem. "Worsening of industry-specific problems" was cited by 43 percent as a "very important" driver of these changes (with another 49 percent saying it was "somewhat important"). This is the ***context*** that banks must consider when evaluating a loan application. For example, if a developer came into our office wanting to build spec homes, we would be very hesitant to make this kind of loan in today's housing environment.

The current credit markets have tightened largely because of problems outside the traditional banking sector. Many large manufacturing companies, like the auto companies, relied on funding that came directly from investors, not banks. However, when those funding sources dried up, the impact cascaded down the supply chain.




In fact, because of the funding problems associated with individual investors, the traditional banking sector will have to play an even larger role in providing credit to get the economy growing again. Banks are anxious to meet the credit needs of businesses and consumers, and we know that such lending is vital to an economic recovery in communities large and small across the country.

## III. Changes in the Regulatory Environment Would 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.

Of course, the current regulatory environment is unquestionably impacted by concerns flowing from the economic downturn. A natural reaction of regulators is to intensify the scrutiny of commercial banks' lending practices. But 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. Here are a couple of the factors that are impeding greater bank lending:

- ***FDIC premium payments are impacting banks' ability to make new loans:*** Perhaps the most immediate threat hampering banks' ability to make new loans is the very high premiums being paid by banks to the FDIC. This year alone, the banking industry will be paying at least $17 billion to the FDIC. The recent proposal by the FDIC to pay expenses over a longer period of time, rather than having a huge payment all at once, is promising. Banks have paid the full cost of the FDIC for 75 years now, and banks will assure the financial health of the FDIC during this difficult period. It is absolutely critical how those obligations are repaid so as not to further exacerbate the poor economic conditions.

- ***Supervisory responses to the crisis threaten to stifle new lending:*** 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. We also have heard complaints from other banks about examiners being inappropriately tougher in their analysis of asset quality and consistently requiring downgrades of loans whenever there is any doubt about the loan's condition.

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. Commendably, the bank regulators are publicly encouraging lenders to work with their borrowers who are doing the right thing in good faith during these challenging times. But the current regulatory environment essentially precludes banks from being able to do that. 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.

## Conclusion

I want to thank you, Chairman Brown, for the opportunity to present the views of the ABA on the challenges ahead for the banks that serve small businesses and manufacturers. These are difficult times and the challenges are significant. In the face of a severe recession, however, bankers are working hard every day to ensure that the credit needs of our communities are met.

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