

June 10, 2009

Testimony of

Michael McGannon

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business

United States House of Representatives



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Chairwoman Velázquez, Ranking Member Graves and members of the Committee, my name is Michael McGannon, Senior Vice President and Chief Lending Officer of Country Club Bank in Kansas City, Missouri. Country Club Bank is a family owned community bank with over \$650 million in assets. I am pleased to be here today on behalf of the American Bankers Association (ABA), which 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 \$13.5 trillion in assets and employ over 2 million men and women.

The topic of SBA lending for small businesses is important and timely. The efforts that have been made by this Committee, the Congress as a whole, and the Administration to improve the environment and opportunities for small businesses through changes to the SBA program have been needed for many years. These changes are particularly important in the difficult economic conditions which are affecting all businesses, including banks. The core business of banking is lending. That is what banks do. Banks will continue to be the source of financial strength in their communities by meeting the financial needs of businesses and individuals in both good times and bad. Banks in every state in the country are actively looking for good loan opportunities. Even in a weak economy, there are strong borrowers.

The focus of this Committee is especially important. Consistently, small businesses are drivers of new ideas, new employment, and new economic growth. For banks like mine, small businesses are our bread and butter. 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, the Small Business Administration defines a small business as one that has fewer than 500 employees. By this measure, over 8,100 banks – 97 percent of the industry – would be classified as

small businesses. Even more telling, ***over 3,500 banks (41 percent) have fewer than 30 employees.*** Banks like mine have been an integral part of our communities for decades – sometimes more than a century – and we intend to be there for many more to come.

I would like to focus on three points today:

- Banks continue to lend, even in this difficult economic environment.
- Changes in the SBA program have the potential to create opportunities for small businesses.
- Further examination of SBA’s mission and purpose is needed.

I will address each of these points in turn.

I. Banks continue to lend, even in this difficult economic environment

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.

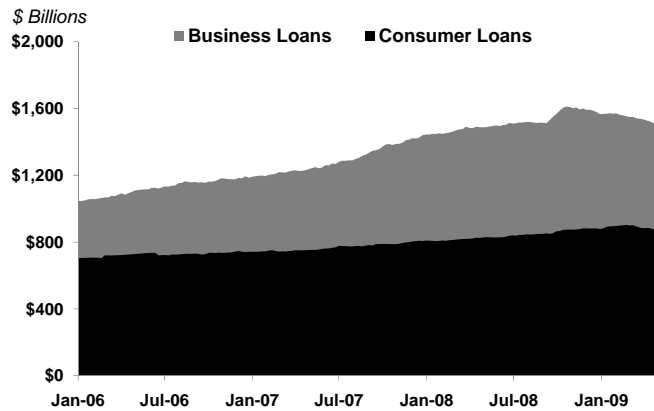
In this environment, we sometimes hear from individual businesses and developers that banks are not lending money. While overall bank lending continues to grow, that does not mean much to an individual borrower having difficulty obtaining financing. In many of these individual cases, however, upon further investigation, it appears that the primary reason for not receiving funding was either that the borrower’s financial condition was vulnerable (perhaps weakened by local economic conditions), or the borrower expected to borrow money at pre-2008 terms when the risk of lending was considerably lower and funds available for lending were more accessible. Of course, every loan application is unique and must be evaluated that way. One thing that has clearly happened is that banks are looking carefully 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.

Even with the economy faltering and individuals and businesses reducing their borrowing, banks continue to lend. This is, in fact, in sharp contrast to the lending trends during other recessions.

History shows that during a recession, several forces typically combine to reduce the volume of loans outstanding: loan demand declines as businesses experience slowdowns, financial shocks make it hard to repay existing loans, and banks tighten lending standards as regulators caution banks about lending in this environment.

As the chart and table below show, loan growth shrinks during a recession as loan demand falls. During the *current* recession, business loans have *expanded* by 12 percent and consumer loans by 9 percent; in contrast, for the previous six recessions, median business loans *declined* by 0.7 percent and consumer loans by 5.1 percent.

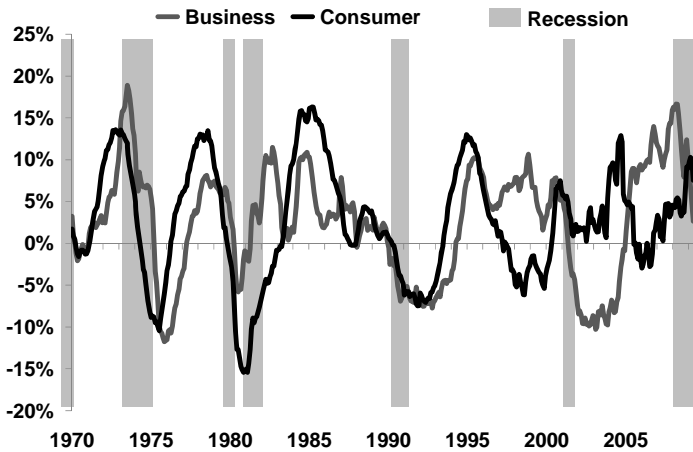
Bank Lending Remains Stable



Source: Federal Reserve

Commercial Bank Loan Growth

Inflation-Adjusted Year-Over-Year Percentage Growth



Source: Federal Reserve

Change in Bank Lending During Recessions¹

Recession	Business Lending (%)	Consumer Lending (%)
Dec 1969 - Nov 1970	-0.9	-1.2
Nov 1973 - Mar 1975	5.7	-6.3
Jan 1980 - Jul 1980	-0.5	-12.8
Jul 1981 - Nov 1982	9.0	-4.4
Jul 1990 - Mar 1991	-6.6	-5.9
Mar 2001 - Nov 2001	-8.0	1.9
Median of Past Recessions	-0.7 %	-5.1 %
Dec 2007 - ?	12.2 %	9.0 %

In the case of Country Club Bank, our bank continues to be an active lender in our community, but we have certainly seen a slowdown in loan requests. Although our loans were up 12 percent in 2008 we have seen year-to-date growth in 2009 of only around 1 percent. We still remain optimistic that our loan demand will pick up as evidenced by the fact that our pipeline for new loan requests is beginning to pick up. We have money to lend and a strong desire to do so but with a watchful eye toward prudent underwriting and proper overall risk management.

Capital is critical to support additional lending. It enables banks to raise deposits to fund loans, and it absorbs unexpected losses when businesses and individuals fail to repay their debt. Currently, \$1 of capital can support up to \$7 in loans. Capital is the money that owners invest in banks to provide the financial security to weather economic downturns.

Banks entered this current recessionary period with much higher capital compared to other recessions (see the table on the right). Loan losses have increased as the economy weakened; as capital absorbed these losses, capital ratios began to fall somewhat.

Under normal circumstances, banks would go to the private capital markets for additional capital. With markets frozen, this has been extremely difficult to do. In fact, banks in the last 12 months have *raised only one-third of capital typically raised during a recession*, according to the Federal Reserve. Without additional capital to back more loans, banks might not be able to grow lending; others might even be forced to shrink lending in order to boost their capital-to-assets ratio. The Capital Purchase Program investments has provided capital to support lending and made it easier for banks to raise capital directly as investors will have more confidence in the overall financial underpinning of the bank. However, the changes made to the program and the constant mixed messages banks have received, have hindered the usefulness of the program and encouraged banks to repay the capital more quickly than the plan envisioned.

Naturally, banks are following prudent underwriting standards to avoid losses in the future, and bank regulators demand that they do so. One-third of the banks surveyed by the Federal Reserve in its April 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices noted a decrease in the size of business lines of credit. About one-third of banks have decreased credit limits on business credit card accounts. Of those banks surveyed, more than 65 percent said that the “less favorable or more uncertain economic outlook” was a “very important” reason for tightening credit standards or loan terms (and 20 percent said it was “somewhat important”). “Worsening of industry-specific problems” was cited by 33 percent as a “very important” driver of these changes (with another 33 percent saying it was “somewhat important”).

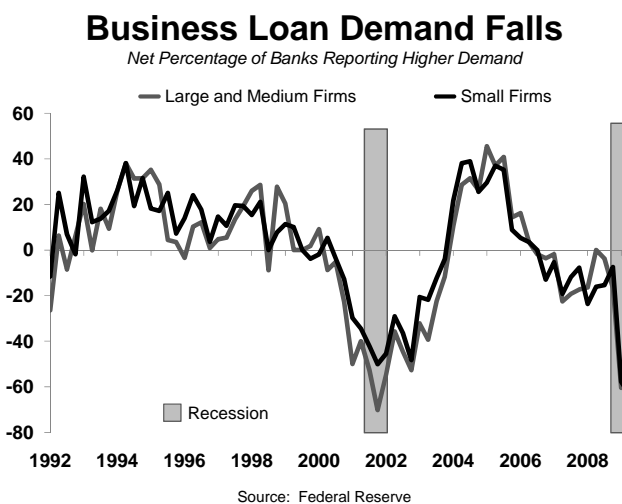
Recession	Average Capital-To-Asset Ratio (%)	Change in Capital-to-Asset Ratio (Basis Points)²
Dec 1969 - Nov 1970	N/A	N/A
Nov 1973 - Mar 1975	4.7	20
Jan 1980 - Jul 1980	5.0	-134
Jul 1981 - Nov 1982	5.4	205
Jul 1990 - Mar 1991	8.2	52
Mar 2001 - Nov 2001	9.6	88
Median of Past Recessions	5.4 %	70 bp
Dec 2007 - ?	10.5 %	-104 bp

1. Twelve-month change from the month prior to the official start of the recession.
 2. One basis point equals 1/100th of a percentage point.
 Source: Federal Reserve, H.8, Assets and Liabilities of U.S. Commercial Banks; capital values based on estimates derived from Federal Reserve's asset and liability survey data.

But in spite of the difficult economic environment, only 8 percent of small businesses (according to a May 2009 survey by the National Federation of Independent Businesses, NFIB) reported problems in obtaining the financing they desired. The report noted that: “The credit worthiness of potential borrowers has also deteriorated over the last year, leading to difficult terms and higher loan rejection rates, even with no change in lending standards.”

Borrowers are also being more careful, and, as would be expected in this economy, the overall demand for loans is declining, although this varies by market. (See the chart on Commercial and Industrial Loan Demand on the right.) The NFIB reports that “33 percent [of businesses] reported regular borrowing, typical of the past 20 years.” This combination of *increased* bank lending in 2008 at the same time that loan demand was *shrinking* underscores the increased prominence of banks in meeting the credit needs of borrowers.

It is almost certain that loan demand – including the demand for SBA loans – will continue to decline in this economy, and there is evidence that the volume of traditional bank credit is now marginally declining. With fewer customers, businesses experience a reduction in the need to finance inventory, buy equipment or expand operations. However, 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.



II. Changes in the SBA program have the potential to create opportunities for small businesses

The SBA program has struggled over the last several years. SBA fiscal year 2008 loan volume figures showed a 30 percent decline year over year in its flagship 7(a) loan guarantee program, and fiscal year 2009 figures would indicate a similar reduction in volume. The economy is certainly playing a significant role in overall loan volume decline. However, many lenders are concerned that this decline is also due to SBA programs becoming too costly and difficult for lenders and small businesses who wish to access the program. This Committee 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. Already, the SBA is making progress to implement these provisions.

First, SBA has made \$375 million available to make access much easier for the two most popular lending programs. The act temporarily increases the guarantees to up to 90 percent on SBA's 7(a) loan program, which will help provide banks with the greater confidence they need to extend credit during the recession. It also temporarily eliminates fees for borrowers on 7(a) loans and eliminated fees for both borrowers and lenders on 504 Certified Development Company loans. According to testimony for the Senate Small Business Committee by SBA Administrator Karen Mills last month, average weekly loan volume was up 28 percent in the 7(a) program and 22 percent in the 504 program immediately following passage of the Act, and that participation among banks had likewise increased. We hope these provisions will be reevaluated as the deadline approaches, to determine whether they should be extended to continue to help with the economic recovery.

Second, 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. This will mean that an additional 70,000 small businesses will be eligible to participate in the 7(a) program.

Third, a whole new category of loan will be available through the America's Recovery Capital (ARC) program. This program provides funding of up to \$35,000 for six months to help small businesses facing immediate financial difficulty. These loans are interest-free to the borrower, and are 100 percent guaranteed by the SBA. In addition, the loans have no fees associated with them and repayment will not begin until 12 months following the final disbursement. Many businesses will be able to get on their feet with this assistance, however the dollar amount allocated for this program is very small and it is anticipated that the ARC program will be fully funded in a matter of months of when banks are able to start using this 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 additional funding to microloan intermediaries and funding for the technical assistance needed to accompany these loans.

III. Further examination of SBA's mission and purpose is needed

The recent legislative changes have the potential to create opportunities for small businesses and lenders. Practically, however, it will be difficult for our bank to take advantage of these opportunities unless SBA makes some changes to address some important challenges we face:

➤ *The challenge to find programs that are right-size for our bank.*

➤ *The challenge of collecting on a loan guarantee.*

➤ *The challenge of finding answers to our questions.*

First, SBA should work with trade associations like the ABA to develop SBA loan programs that are attractive to lenders of all sizes, and especially to community bankers. The United States has over 8,000 banks, but only slightly over 2,500 of these financial institutions participate in SBA's 7(a) loan guaranty program. Most small community banks are intimidated by the amount of paperwork required for a regular SBA 7(a) loan. In the past, the SBA had a product in which there was a two page application for the bank to complete and had an 80 percent guaranty. The SBA has since eliminated their Low-Doc program and has offered their SBA Express product as a substitute. However, the SBA Express guaranty is only 50 percent of the loan amount. Community banks would be more inclined to participate in the SBA program if a regular guaranty was offered for a loan of \$150,000 or less. The ARC loan program may fit this bill; however, as this program was outlined by Congress in February, the implementation of the program is still being drafted by SBA. More importantly, the funds allocated for the program will be expended in a matter months, if not weeks.

Furthermore, the SBA needs to eliminate the financial and human resource burden on community banks created by SBA audits. These audits review loans already on the books that are *already being scrutinized by other federal regulators* such as FDIC or the OCC. Worse, banks are required to pay for their own SBA audit, however it does nothing to correct or stabilize a loan or to assist if there is the need for a liquidation.

Second, SBA should reduce the time it takes for participating banks to collect on loan guarantees. In our own experience, we have been fortunate to collect on all guaranty purchases submitted. However, the time frame for these collections is sporadic. In every case, the items needed were submitted in a complete package, but, as the process continued – far away in Herndon, Virginia – sections of the package were lost. Thus the bank had to resubmit documentation and lost time in the process. There is a near universal agreement in the lending community that efforts to collect on the loan guarantee from SBA can be a time-consuming and costly process.

Third, community banks need personal contacts with knowledgeable people who can answer our questions. Our bank has had the benefit of a very cooperative SBA office in Kansas City. These SBA loan specialists know the area and know the economic environment better than anyone from a 1-800 number. This relationship has been vital in making sure we stay on track of new changes in the SBA regulations and answering questions regarding some of the grey areas of the Standard Operating Procedure. However, banks in outlying areas do not have the benefit of a local SBA office that understands them, their clients, or their town. Instead they have to contact someone at a 1-800 number and get answers to questions. As a community banker from Missouri I take pride in knowing the business and the community that an entrepreneur is trying to serve. A 1-800 number cannot help me through that process. It is critical that SBA returns to a model of helping local small businesses and community banks through off-site training programs that can tend to the needs of the lending partnership.

Conclusion

The initiatives and new programs launched by the Administration and by Congress have great potential to help thousands of small businesses. The SBA, however, must be given the human resources to implement these initiatives, many of which are new to SBA.

Thank you for your time and attention today.