

Testimony of

Austin L. Roberts, III

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business

United States House of Representatives

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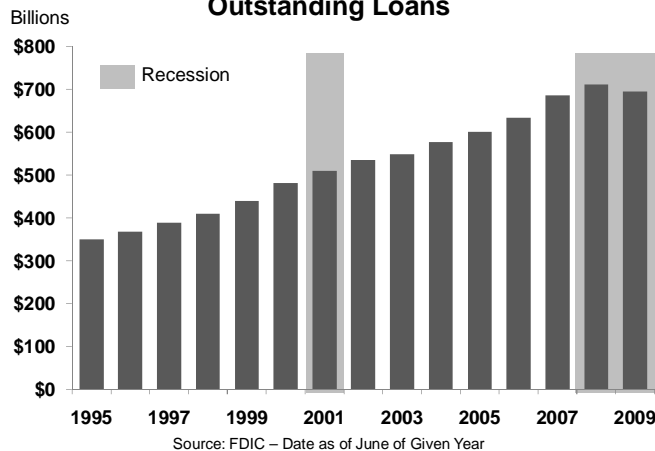
Chairwoman Velázquez, Ranking Member Graves and members of the Committee, my name is Austin Roberts, III. I am Vice Chairman, President and CEO of Bank of Lancaster, headquartered in Kilmarnock, VA. My bank has \$328 million in assets and we have served the northern neck of Virginia since we were founded in 1930. Small entrepreneurial businesses are, by far, the primary sector that meets the needs of the large retiree population in our trading area. The success of these businesses is very important to our communities and our bank. I am pleased to be here today representing the American Bankers Association (ABA), where I have served on the Board of Directors. 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 2 million men and women.

We are pleased to share the banking industry's perspective on the impact of financial restructuring and the current regulatory environment is having on lending to small businesses. Small businesses – 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 3,500 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 Bank of Lancaster has survived many economic ups and downs for almost 80 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 located right down the street from our offices. 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 also declining. 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 committee 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 business has 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 assure that our customers – particularly the small businesses that are our neighbors and the life blood of our communities – get the credit that deserve.

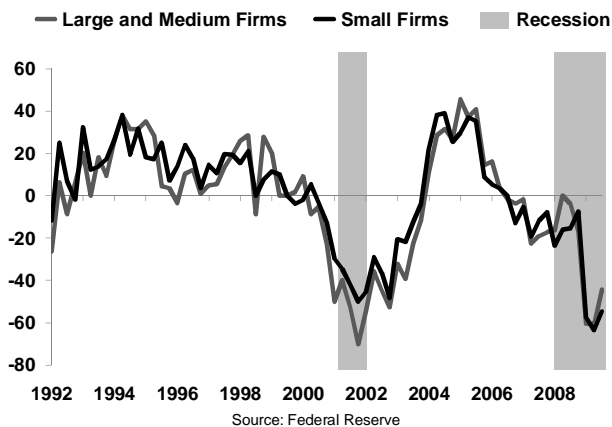
Lending to Small Businesses Outstanding Loans



Hearings like this one, Madam Chairwoman, are extremely important. In order to assess the impact of new regulations and even proposals for a new regulatory body, it is critical for policy makers to understand the regulatory pressures that we face in today’s environment. This is a difficult and critical time for banks, particularly small community banks. They find themselves besieged by deteriorating economies in many parts of the country; by overly restrictive rules and examinations that are making it hard to work through the problems; by government stimulus programs that have focused primarily on the largest and healthiest banks; and now by the government’s proposed changes to the regulatory landscape that would only add to community banks’ burdens.

Business Loan Demand

Net Percentage of Banks Reporting Higher Demand



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.
- The ability to lend is exacerbated by a regulatory environment that has tightened dramatically over the last year.
- Changes in the regulatory environment would improve the situation for small business lending.

I will address each of these points in turn. Before that, however, I did want to comment on a few key proposals for regulatory reform. While we share the same goals as the Administration, we continue to be particularly concerned about impact on small banks from the proposal to create a new Consumer Financial Protection Agency and the impact of eliminating the thrift charter. ABA is on record detailing our position on both of these, and many other key points of the Administration's proposals, so I will not elaborate on our concerns. Certainly, the banking industry fully supports effective consumer protection. But the proposal for a new consumer regulator, rather than rewarding the good banks that had nothing to do with the current problems, will add an extensive layer of new regulation that will take resources that could be devoted to serving consumers and make it more difficult for small community banks to compete. As I will detail below, these community bankers are already overwhelmed with regulatory costs and pressures that are slowly but surely strangling them. As you contemplate major changes in regulation – and change is needed – I urge you to ask this simple question: how will this change impact those thousands of banks like mine that did not create the problem and are making the loans needed to get our economy moving again?

The regulatory restructuring that is being proposed would also eliminate the thrift charter – which are typically small institutions. This proposal would hurt thrift institutions that had nothing to do with the problems, does nothing to address the underlying problems, ignores the significant contributions made over decades to homeownership, and will only serve to confuse customers of thrifts and undermine confidence in banking. The ABA believes strongly that these important charters that have served our country well should be retained.

As mentioned, businesses are being very cautious and 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, 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. This is not because banks do not want to lend – lending is what banks do. The current credit markets have tightened largely because of problems outside the traditional banking sector. In fact, because of these problems, 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.

II. The Ability to Lend is Hurt by a Regulatory Environment That has Tightened Dramatically Over the Last Year

As I noted above, banks are not immune from the economic downturn, with job losses and business failures resulting 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.

Thousands of banks across the country did not make toxic subprime loans, are well-capitalized, and are ready to lend; but they cannot do so if misguided policies increase their regulatory costs and provide disincentives to lend. Banks already face significantly higher costs from increases in deposit insurance premiums. And banks are already receiving contradictory government signals about lending, being told to make new loans and, in some cases, being told by bank examiners not to increase lending because the risk is too great.

As this committee considers changes in the regulatory structure, it is very important not to create a conflict in policies – on one hand encouraging lending to help stimulate the economy and on the other hand discouraging lending through restrictive regulatory policies. This would be like spurring a horse to run faster while pulling back on its reins. Such conflicting efforts only waste resources and do not accomplish the goal of expanding lending to small businesses or individuals.

I'd like to detail some 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. There is no question that the industry fully backs the financial health of the FDIC. All the expenses of the FDIC for the last 75 years have been fully paid for by banks, not taxpayers. It is the healthy banks that are the survivors of any downturn that end up paying for the full cost of those banks that have failed. We do so because we know the importance of FDIC insurance to our customers and are committed to assuring they have that protection long into the future.

This year alone, the banking industry will be paying at least \$17 billion to the FDIC. This includes regular quarterly payments as well as one special assessment of \$5.6 billion paid in the second quarter. The FDIC may decide to impose another special assessment before the end of this year. Such large expenses have a very strong dampening effect on bank lending. Even the FDIC acknowledged in its release of its Quarterly Banking Profile for the second quarter that "earnings were also adversely affected by higher assessments for deposit insurance."

Covering the costs of the FDIC is one of timing. It is far better to pay off the costs of bank failures over time, rather than having huge assessments at the very time banks are struggling to preserve capital and keep costs down. Even if the FDIC were to draw on the Treasury's line of credit – which Congress enacted earlier this year with the full support of the ABA – banks would be fully responsible to repay that loan with interest. By repaying the expenses over a longer period of time, rather than having a huge payment all at once, banks are able to maintain needed resources that support bank lending in local communities.

Pressure on bank capital limit resources available for new loans

Capital is the foundation upon which all lending is built. Thus, having sufficient capital is critical to support lending. In fact, \$1 worth of capital supports about \$10 in bank assets (loans and securities). Fortunately, most banks entered this economic downturn with a great deal of capital. However, the downward spiral of the economy has forced losses on banks. Moreover, banks set aside a substantial amount of reserves for possible future losses.² The ABA continues to hear from bankers that the regulators are demanding increases in capital and that banks improve the “quality” of capital. This puts enormous pressure on banks to increase the relative importance of common stock. Typically, banks are able to raise capital to offset declines, even in a recession.³ Unfortunately, the fragile and sometimes frozen financial markets have made this nearly impossible. Thus, with such pressure, the only course of action is to reduce lending in order to improve the bank’s capital-to-assets ratio.

Some help to bolster capital came from the Capital Purchase Program (CPP), which was designed to provide capital to healthy banks (in contrast to non-CPP TARP money which was used to support troubled institutions, like AIG, General Motors and Chrysler). Unfortunately, the CPP suffered from misperceptions by the public about its purpose, and changes in the rules for participating banks hamstrung the program and discouraged greater participation. Moreover, the program originally focused on the largest banks, and was slow to roll out to others, particularly community banks. The result has been that many communities did not have as much credit available to them.

The changing nature of this program and the restrictive selection process has meant that banks that could have benefited from the program were unable to do so. Moreover, recent loss-share agreements entered into by the FDIC to attract investors in failed banks have the unintended consequence of creating incentives for private equity to wait until a bank fails rather than investing in the bank as a going concern. While these agreements may minimize the losses to the Deposit Insurance Fund, they nevertheless are making it harder for viable banks needing assistance to attract private equity.

As a result, to maintain reasonable capital levels, these banks have been forced to limit, or even reduce, their lending. The problem is even more acute for banks that are located in states with enormous economic problems. Many banks have been discouraged by their regulators to seek CPP or Capital Assistance Program (CAP) funding. This is having an impact on their banks and their customers. The ABA recommends that Treasury modify the criteria for its CAP to assist viable community banks that need help working through their current issues. We propose that Treasury offer assistance to those banks that did not qualify for CPP funds but that nevertheless can demonstrate the ability to operate safely and soundly if given the chance.

² In the second quarter, banks set aside nearly \$67 billion to cover losses expected in the future.

³ In the past 6 recessions banks were able to add enough capital to *raise* the median capital-to-assets ratio by 70 basis points in the first 12 months since the start of the recession. However, in the first 12 months of this recession, banks’ median capital-to-asset ratio *declined* by 104 basis points.

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. Moreover, these actions can be completely counter to the notion of working with customers to make sure they have the credit they need and to work with those borrowers that may even be in distress.

We also have heard complaints from our members 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. In some situations the examiners reportedly are requiring banks to increase reserves notwithstanding that the banks have written down the asset values in accordance with accounting practices (FAS 114). Clearly, economic conditions are worse today than a few years ago, and we understand that the examinations likely will be appropriately harder in many instances. However, the combination of inappropriate downward pressure on loan classifications and required higher reserves can cause a bank’s capital position to worsen and further harm the condition of the bank.

While we appreciate the comments made by the heads of the federal banking agencies about finding the appropriate balance, the great challenge may be to ensure that regulatory personnel out in the field are applying the measured approach that has been expressed by the agency leadership. Increasingly, we are hearing troubling reports from our membership that regulatory mistakes of a decade ago are playing out again today. Such supervisory responses will only compound the problem we have today and make it much more difficult for banks to originate new loans.

Restrictions are acting to limit available funding sources for many banks

Banks cannot make loans if they lack adequate funding. There are several programs that enable banks to attract additional funding from core deposit customers. These programs include reciprocal deposit programs and sweeps from broker-dealers to their affiliated banks, and they enable banks to attract funds from core deposit customers. These deposit programs are designed to provide greater FDIC deposit insurance protection for customers, maintain the relationship between the bank and customer, and keep funds in the local community. The problem is that these deposits are lumped into the category of brokered deposits even though they have characteristics that more closely resemble “core” funding.

The problem arises due to the inability of banks to accept “brokered” deposits if it becomes less than well capitalized. However, the deposits obtained from reciprocal arrangements and sweep programs are volatile primarily because the statute, as implemented by the FDIC, creates the volatility. All banks, but particularly banks that are less than well capitalized, need to be able to attract and retain deposits from their core customer base. A rule that elevates form over substance impedes banks’ ability to do so and, in turn, adversely affects the banks’ ability to make loans.

Recent FASB rules will significantly reduce capital ratios and may devastate new lending

ABA is very concerned about new rules that have recently been promulgated by the Financial Accounting Standards Board.⁴ Essentially, the new rules will require that the assets and liabilities of certain securitizations and variable interest entities be included on the balance sheets of some banks – even though these assets and liabilities do not belong to those banks. This “gross-up” of the balance sheet raises concerns about skewed financial ratios from a public reporting perspective, as well as the potential adverse impact on regulatory capital. If capital ratios are impacted, the ability of banks to make new loans is reduced.

ABA has urged the banking regulators to require that additional capital be held only for any incremental risk related to the assets and liabilities rather than a broad brushed assumption that the assets are available to the bank or its creditors. We also requested a transition period for any additional capital requirements of at least three years, with no capital impact in the first year.

The banking agencies have issued a proposal that would require capital to be held for all assets – including the new assets required to be consolidated under the new FASB rules. This translates into significant increases in capital for a number of banks, tying up dollars that could otherwise be placed in loans.

Proposals to mark-to-market loans will increase capital and reduce credit availability

Another accounting rule being considered would also impact the ability of banks to make new loans. For over 20 years there has been considerable debate about whether the accounting model should be based on market values. It is now being formally discussed as the new model for financial instruments, which is, effectively, banks’ entire balance sheets. ABA agrees that if a bank’s business model is based on buying and selling, then mark-to-market is appropriate. However, traditional banking is as an intermediary, taking in deposits and making loans, with earnings based on cash flows that are unrelated to buying and selling assets.

With mark-to-market, all loans – including healthy loans that have no credit deterioration – will be marked to market. The losses (and then subsequent gains and losses) will be flowing through the banks’ financial statements and result in significant volatility that will not be tolerated by investors, regulators or independent bank directors. Volatile loan values will increase the cost of lending and reduce the availability of credit. The

⁴ SFAS 166 and 167.

need for capital cushions will increase, increasing the cost of capital that will further reduce credit availability; product lives will be shortened; and, banks will begin to operate more like investment banks with a short-term trading mentality, instead of traditional banks governed by longer-term customer relationships.

Other regulatory rules have also limited banks ability to lend

Another issue of concern is the capital disincentives to robust provisioning for possible loan losses. Under the existing U.S. risk-based capital rules, reserves are included in regulatory capital only up to a specified percentage of risk-weighted assets. This fails to adequately recognize the loss-absorbing abilities of the entire allowance for loan losses and creates a disincentive to banks reserving more. Both the allowance for loan losses and “core” capital are available to absorb losses. Thus, these limitations create disincentives for banks to hold higher levels of reserves giving banks less loss-absorbing ability when times get tough.

An additional regulatory problem related to bank capital is that the risk weighting of debt issued by Fannie Mae and Freddie Mac is too high, meaning that banks are required to hold more capital than is necessary for the risk.⁵ This means that capital that could be used to support additional lending is not available.

III. Changes in the Regulatory Environment Would Improve the Situation for Small Business Lending

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.

Given the continued weakness in this economy and the challenges we will face in the next 18 months, it is a critical time to focus on strategies for helping community banks. ABA recommends that existing programs

⁵ Prior to those institutions being placed into conservatorship, the debt was risk-weighted at 20 percent. Given the stated intent of the United States government to support these GSEs, a lower risk weight is appropriate and would help offset to a small degree the adverse impact that the conservatorships had on those banks that invested in Fannie and Freddie stock. The risk weight of GSE debt should be reduced to below 20 percent. The agencies proposed to lower the risk weight of Fannie and Freddie debt to 10 percent, but this rulemaking has been pending since October of last year and appears to be tangled in international discussions of capital weightings. We also support a comparable risk weighting for Federal Home Loan Bank debt and guarantees. This would provide parity of treatment and avoid unintended consequences for the Home Loan Banks and their members. Fannie Mae, Freddie Mac, and the Home Loan Banks engage in related housing finance missions, and the United States government has supported all three with comparable safety nets. To treat them in a dissimilar fashion ignores these fundamental similarities and will lead to the presumably unintended consequence of creating a perception that there is a greater degree of risk inherent in Home Loan Bank debt.

be expanded, particularly designed to help community banks. Several key changes that are needed include broadening capital programs to enable participation by a broader cross-section of banks (particularly community banks that are viable but are struggling in communities most hard hit by the recession) and avoiding appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards.

Broaden capital programs to enable participation by a broader cross section of banks

As I emphasized at the outset, the amount of capital required to provide an additional cushion for all community banks is small. For instance, \$5 billion of TARP money specifically for community banks, when matched by private equity on a dollar-for-dollar basis, would be sufficient to bring all insured depository institutions with assets under \$5 billion to capital levels equal to a Tier 1 risk-based capital ratio of 8 percent and a total risk-based capital ratio of 12 percent assuming the stressed scenarios used by the banking regulators in the stress testing under the Supervisory Capital Assessment Program (SCAP). These capital levels significantly exceed the thresholds established by the banking regulators for a bank to be deemed “well capitalized” under the Prompt Correct Action rules and would provide a cushion that could enable participating banks to continue meeting the credit needs of their communities without having to shrink to comply with minimum regulatory capital requirements.

As noted above, the CPP has been implemented in a way that ignores community banks that are viable but that are experiencing significant – yet temporary – problems. The Capital Assistance Program (CAP) has not yet been implemented for community banks, but reportedly will apply the same eligibility criteria that have been used with the CPP. The Legacy Loans Program has the potential to help, but the FDIC recently announced a delay in implementing the Legacy Loans Program that calls into serious question its viability outside the possible use in failed bank situations. The Legacy Securities Program is still struggling to get off the ground as well. Program after program either has failed to meet the needs of viable community banks or has languished.

ABA believes that this problem can be solved through several modifications of the CAP:

1. Permit banks with up to \$5 billion in total assets to participate in the CAP.
2. Provide funding to viable banks that have significant – yet manageable – issues. Viability could be demonstrated by the ability of a bank to attract private equity that would be willing to match Treasury’s investment and accept an interest that is subordinate to that given to Treasury.
3. Revive the Legacy Loans Program and implement the Legacy Securities Program in a way that expands the universe of eligible assets to include trust preferred securities, “real estate owned,” and other real estate-related loans. The programs also should be implemented in a way that avoids effectively shutting small banks out (for example, by requiring minimum sizes on asset pools that no community bank could meet).

The comparatively small sums of money that would be invested in these struggling but viable banks would pay big returns for the communities they serve.

Avoid appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards

ABA believes there are several steps that the regulators should be taking to remedy this situation and we urge this committee to use its oversight authority to encourage them to issue written guidance affirming that banks should not use distressed sales values when analyzing “comparables” and apply clear and consistent standards for a banks’ loss reserve that reflect a realistic assessment (based on the current accounting standards) of the assets’ likely performance.

These changes are necessary to confront the natural inclination of examiners to be conservative in order to avoid the inevitable second-guessing that would arise if a bank were to fail on their watch. We are not suggesting that examiners use forbearance or otherwise relax their examination standards; rather, we are suggesting that the examiners not be harder on banks than circumstances warrant. The regulators can make things worse in their efforts to make things better. Insisting upon punitive, pro-cyclical steps at a time when a bank is working through issues can push an otherwise viable bank over the edge.

Enact comprehensive regulatory reform

Since last fall, in hearings like this and elsewhere, ABA has called for comprehensive regulatory reform including many issues covered in the Administration’s proposal. We believe regulatory reform is badly needed, and Congress should move to adopt such reforms. ABA has testified in favor of creating a systemic regulator, providing a mechanism for resolving troubled firms deemed “too big to fail,” closing gaps in the regulation of non-banks and improvements in consumer protection. We will continue to strongly advocate for legislation that focuses on these critical issues and are committed to working with the Administration, Congress and our regulators to enact strong – and effective – reform legislation.

While ABA, like key members of Congress and the regulators, has suggestions for improvements, we are in general agreement of the need for comprehensive reform in the broad areas the Administration has targeted. Among the recommendations ABA is making are to avoid an expansive new bureaucracy for consumer issues that would conflict with the prudential regulator, maintaining the thrift charter and strengthening the resolution mechanism.

Conclusion

I want to thank you, Madam Chairwoman, for the opportunity to present the views of the ABA on the challenges ahead for the banks that serve small businesses. 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. As you contemplate major changes in regulation – and change is needed – ABA would urge you to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again? Addressing these issues will provide the most constructive avenue to ensure that communities throughout this nation will continue to have access to credit by local financial institutions.

Thousands of banks of all sizes, in communities across the country, are scared to death that their already-crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to non-banks while they will be rigorously applied – down to the last comma – to banks.

We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our nation's banks.