

*Testimony of*

**James Chessen**

*On Behalf of the*

**AMERICAN BANKERS ASSOCIATION**

*Before the*

**Committee on Small Business**

**United States Senate**



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March 19, 2009**

Madam Chairwoman, Ranking Member Snowe, and members of the Committee, my name is James Chessen. I am the chief economist of the American Bankers Association (ABA). I appreciate the opportunity to present the views of the 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 \$13.9 trillion in assets and employ over 2 million men and women.

The topic of Main Street lending for small businesses is extremely important and timely. Our nation is certainly facing difficult economic conditions which are affecting all businesses, including banks. Let me begin with one very basic, but important, point – 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 particularly important, as small businesses consistently are drivers of new ideas, new employment, and new economic growth. While some might think of the banking industry as 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 8,000 banks – 96 percent of the industry – would be classified as small businesses. Even more

telling, over 3,400 banks (41 percent) have fewer than 30 employees. Banks have been an integral part of their communities for decades – sometimes more than a century – and they intend to be there for many more to come.

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

- Banks continue to lend, even in this difficult environment,
- The new Presidential initiative to facilitate SBA and other loans to small businesses is important to facilitating an economic recovery; and
- Care must be taken to guard against additional restrictions that may work to restrict credit to businesses and individuals.

I will address each of these points in turn.

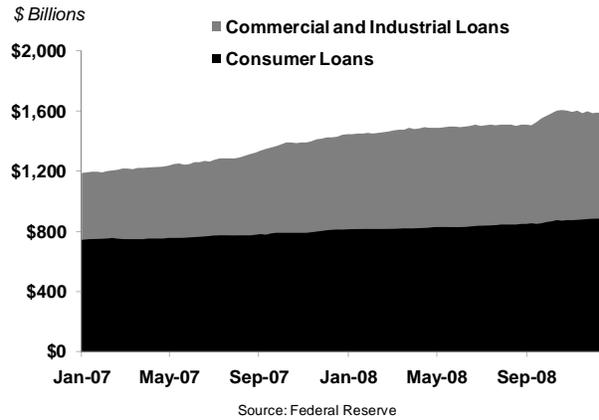
#### **I. Banks continue to lend, even in this difficult economic environment**

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 reasons for not receiving funding was either that the borrower’s financial condition is vulnerable (perhaps weakened by local economic conditions), or the borrower expects 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.

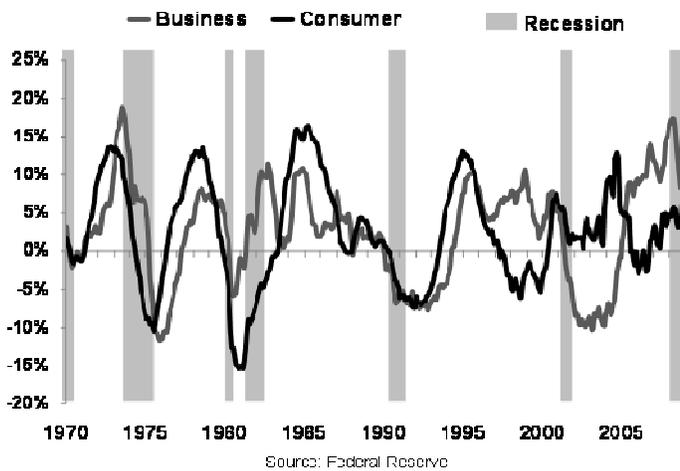
### Bank Lending Continues to Grow



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.

### Commercial Bank Loan Growth

*Inflation-Adjusted Year-Over-Year Percentage Growth*



### Change in Bank Lending During Recessions<sup>1</sup>

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
<b>Median of Past Recessions</b>	<b>-0.7 %</b>	<b>-5.1 %</b>
<b>Dec 2007 - ?</b>	<b>12.2 %</b>	<b>9.0 %</b>

1. Twelve-month change from the month prior to the official start of the recession. Source: Federal Reserve, H.8, Assets and Liabilities of U.S. Commercial Banks

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 will provide capital to support lending and also make it easier for banks to raise capital directly as investors will have more confidence in the overall financial underpinning of the bank.

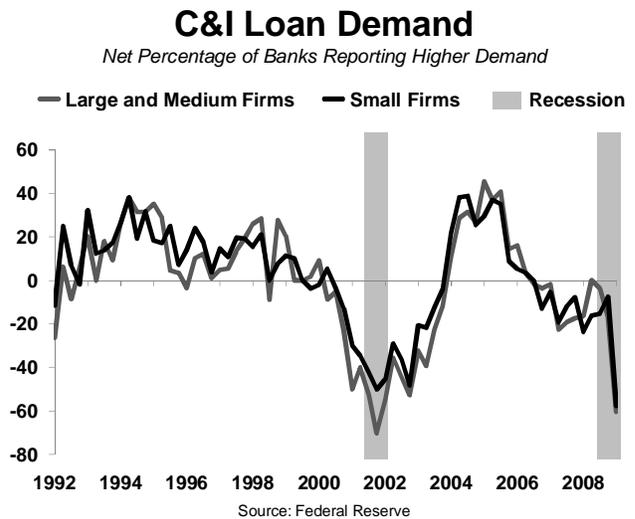
Naturally, banks are following prudent underwriting standards to avoid losses in the future, and bank regulators demand that they do so. One-quarter of the banks surveyed by the Federal Reserve in its January 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices noted a decrease in the size of business lines of credit. Less than one-third of banks have decreased credit limits on business credit card accounts. Of those banks surveyed, 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”). “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”).

Change in Bank Capital During Recessions <sup>1</sup>		
Recession	Average Capital-To-Asset Ratio (%)	Change in Capital-to-Asset Ratio (Basis Points) <sup>2</sup>
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
<b>Median of Past Recessions</b>	<b>5.4 %</b>	<b>70 bp</b>
<b>Dec 2007 - ?</b>	<b>10.5 %</b>	<b>-104 bp</b>

1. Twelve-month change from the month prior to the official start of the recession.  
 2. One basis point equals 1/100<sup>th</sup> 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 March 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 “36 percent [of businesses] reported regular borrowing, up one point from January – 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.

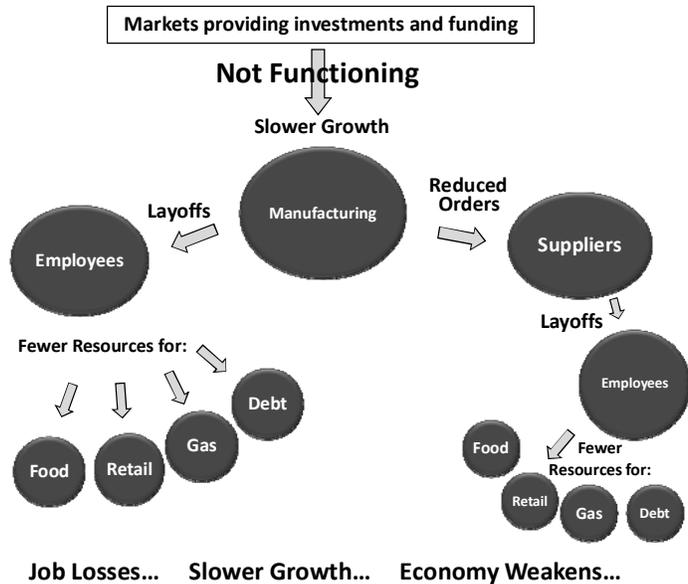


It is almost certain that loan demand in this economy will continue to decline, and there is evidence that traditional bank credit is now marginally declining. With fewer customers, businesses experience a reduction in the need to finance inventory, buy equipment or expand operations. However, as the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

Finally, while banks have been lending, they cannot offset the dramatic fall off of credit *outside* the banking industry. Thirty years ago, banks provided about 60 percent of all credit – today *traditional bank lending provides less than 30 percent*. The collapse this past year of the secondary markets for mortgages and other consumer credit products, such as credit cards and auto lending, has taken out an important pipeline of credit. Thus, many of the stories about the lack of credit are due to the weakness of *non-bank* lenders and the weakness of the securitization markets.

It is critical to free up the global markets for liquidity as it has important implications for small business lending. The flow-chart on the following page shows how difficulties in funding for large businesses – which go directly to the markets for funding rather than through banks – *ends up*

*affecting small businesses.* Most community banks are not involved in lending to large manufacturers or other large business. However, community banks do lend to the employees of these companies and to the small businesses that sell supplies and services to the large companies – tools, office supplies, carpet installers, to name just a few. Each of these smaller suppliers of important every-day needs for larger businesses will



find themselves short on cash because the larger businesses do not have the short-term liquidity to meet their obligations. This disrupts the flow of business to smaller businesses, which in turn will reduce costs in many areas, cutting back on staff and services used to make the business run. Thus, improving liquidity and funding for large corporations is critical to the economic health of many smaller businesses.

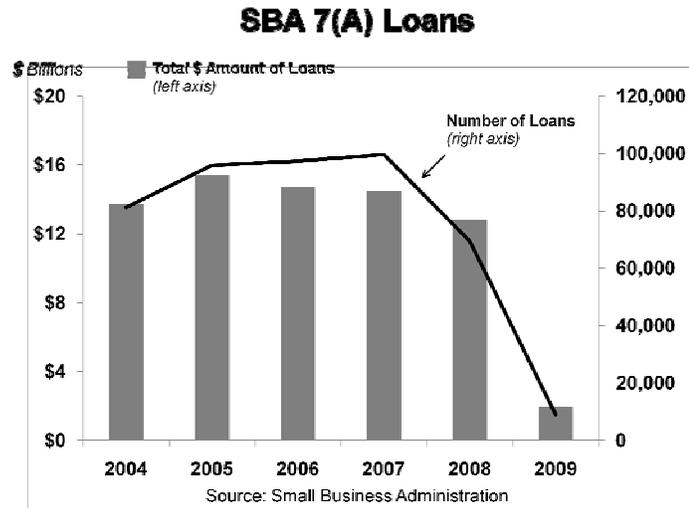
## II. The New Presidential Initiative to Facilitate SBA and Other Loans to Small Businesses is Important to Facilitating an Economic Recovery

SBA fiscal 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 put the 7(a) program on pace to have a 50 percent 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 you for your efforts. Over the years, ABA has worked closely with the Committee to ensure continued availability of the 7(a) program, while also advocating for reduced fees to make the programs more affordable to borrowers.

We were pleased with Congress’ efforts to address many of our concerns regarding SBA in the recently passed Stimulus package. We believe Congress’ recognition of the role SBA can play in

helping to revive small business lending served as a great launch pad for the announcement made this past Monday by President Obama.

Temporarily raising the guarantees to up to 90 percent on 7(a) loans will not only provide an incentive for banks to lend, but also provide lenders with greater confidence to extend credit during these difficult economic times. More importantly, it will provide start-up and existing business owners another avenue to access capital. As this is only a temporary program through 2009, we



hope Congress will look at extending the program through 2010 as the economy continues to recover.

In addition, we support wholeheartedly the temporary elimination of fees on the 7(a) and 504 programs. ABA and our members have long sought the reduction of fees in this program. For nearly eight years, ABA has advocated for fee relief to both borrowers and lenders as a way to resuscitate the 7(a) program. As with the temporary guarantee increase, we hope Congress and the Administration will make low fees in these programs a priority going forward.

We are also pleased that the Administration has announced its commitment to use up to \$15 billion to unlock the stifled credit markets used to purchase small business loan securities currently frozen on the secondary market. Simply put, if the secondary markets for small business loans are frozen, lenders cannot free up capital to reignite lending for small business owners. This is no different than the situation we face in the housing market. This effort by the Administration to address this critical concern of the banking community will go a long way to ensuring that SBA loans can start flowing through our communities once again.

### III. Care must be taken to guard against additional restrictions that may work to restrict credit to businesses and individuals.

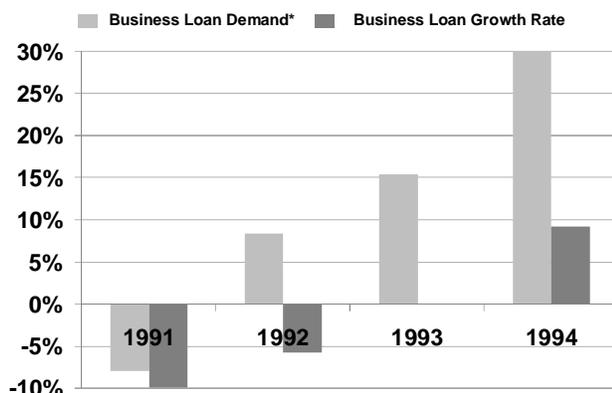
There are several mixed messages that confront banks, encouraging lending on one hand, yet discouraging it on the other. Let me touch on just two of these: the harm to the economic recovery from overly conservative regulatory standards; and the negative impact on lending that is likely if the FDIC imposes a very large special assessment on the banking industry.

#### *Overly conservative regulatory standards pose a threat to continued economic improvement.*

The current regulatory environment is unquestionably impacted by the regulatory concerns flowing from the economic crisis. A natural reaction is to intensify the scrutiny of commercial banks' lending practices. However, we are very concerned that a regulatory over-reaction can exacerbate the problems.

One needs only to look back at the early 1990s to see what can happen when there is a regulatory overreaction to an economic recession with roots in residential and commercial real estate problems. At that time, whether intended or not, the loud and clear message that bankers received from the regulators was that only minimal levels of lending risk would be tolerated. On the surface, this might have seemed reasonable – there is

**Regulatory-Induced Credit Crunch  
Decreased Bank Business Lending**



\* Net Percent of Respondents Reporting Stronger Demand for bank C&I Loans  
Sources: Federal Reserve Senior Loan Officer Opinion Survey and FDIC Quarterly Banking Profile

little doubt that economic consequences of a banking system with too much risk are not acceptable. 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.

In spite of rising demand for bank loans following the recession of 1991, regulatory pressures restrained bank lending. In fact, total bank loans actually declined throughout this period and the

recovery was slower than it might have been. A comparable scenario may be developing in today's regulatory environment. Accounting rules and excessive regulatory demands are acting together to limit the ability of banks to make loans and in some cases to continue existing funding arrangements.

**The FDIC special assessment threatens to devastate bank earnings – and severely curtail lending.**

The FDIC has recently proposed a special assessment (in addition to the regular quarter risk-based premiums) that is a significant and unexpected cost – over \$15 billion in the second quarter of 2009. This will affect all banks and has the potential to devastate earnings. Let me be very clear that the banking industry fully supports having a strong FDIC fund and stands behind the efforts to ensure FDIC's financial health. The industry has always taken our obligation to the FDIC seriously, and banks will honor the obligation to support the FDIC. ***How this is accomplished is the critical question.*** The money to pay such high expenses cannot be created out of thin air. It is very important, therefore, to lower the upfront costs and spread the obligation to FDIC over time.

The banking industry is already dealing with a deepening recession, accounting rules that overstate economic losses and unfairly reduce capital, regulatory pressure to classify assets that continue to perform, and a significant increase in regular quarterly FDIC premiums. Each of these is a big challenge on its own – but collectively, they are a nightmare. Adding another huge one-time cost compounds this burden dramatically.

Moreover, the special assessment is completely at odds with banks' efforts to help communities rebuild from this economic downturn. This assessment makes the cost of raising deposits much higher, and therefore acts as a disincentive to raising new deposits. Fewer deposits will hinder banks' ability to lend. The reduction in earnings will make it harder to build capital when it is needed the most. Banks will also be forced to look at ways to lower the cost of other expenses, which may limit their ability to sponsor community activities or make charitable donations – something most banks have done year after year. Some banks have told us that they may even be forced to reduce bank staff in order to pay for this high cost. In fact, a small community bank in Wisconsin, with 11 employees, commented that: "The proposed assessment to us is equivalent to the cost of one full-time employee. We may not be able to afford to keep existing staff. I'm concerned that we will be forced to reduce our head count or certainly not be able to add staff as planned."

The implications for this significant FDIC charge will impact every corner of every community the banking industry serves. It is patently unfair and harmful to burden healthy banks that are best positioned to help the economy recover. Given the impact that the proposed assessment will have on banks and their communities, it is critical to consider alternatives that would reduce the burden and provide the FDIC the funding its needs in the short term. ***The ABA strongly supports The Depositor Protection Act of 2009, S. 541, introduced by Senator Dodd.*** We believe enacting this bill will enable the FDIC to eliminate or significantly reduce the special assessment.

## **Conclusion**

In this environment, banks are being naturally more conservative. More questions are being asked of borrowers as the risk of lending today is considerably greater than several years ago. Borrowers are also being more careful, and the demand for loans is declining. With all of this disruption, let me assure this Committee that creditworthy borrowers will always have access to credit. Banks are anxious to meet the credit needs of small business and we know that such capital is vital to an economic recovery.