Testimony of

Arthur C. Johnson

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Oversight and Investigations

Of the

Committee on Financial Services

United States House of Representatives

Field Hearing, Southfield, Michigan

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Chairman Moore, Ranking Member Biggert, Congressman Peters and members of the Subcommittee, my name is Arthur C. Johnson. I am Chairman and Chief Executive Officer of United Bank of Michigan, headquartered in Grand Rapids, Michigan. I serve as Chairman of the American Bankers Association (ABA), and I chair the ABA Community Bank Solutions Task Force, a committee dedicated to finding ways to address problems most acutely affecting community banking during this economic downturn. I am pleased to be here today representing ABA. ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.5 trillion in assets and employ over 2 million men and women.

We are pleased to share the banking industry's perspective ways to promote capital assistance and improve business lending in this distressed economy. 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, and certainly not the first downturn we have seen in Michigan. In fact, most banks have been in their communities for decades and intend to be there for many decades to come. The United Bank of Michigan has survived many economic ups and downs for 132 years. We are not alone, however. In fact, there are 62 banks in Michigan that have been in business for more than 50 years, 20 of which have been in business for more than a century. Nationwide, more than 5,000 banks – 62 percent of the industry – have been serving their communities for more than 50 years. 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 this great state and across our country, is on developing and maintaining long-term relationships with customers, many of which are small businesses. We cannot be successful without such a long-term philosophy and without treating our customers fairly.

This recession is certainly one of the worst we have ever faced. While the statisticians will say the recession has ended, that is little comfort to areas in Michigan and elsewhere in the United States, that still suffer from very high levels of unemployment and business failures. The impact of the downturn 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 seven straight quarters of job losses – over 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 and reduced the capital of banks.

My bank, as with most community banks, 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. In some areas of this country, it is impossible to raise new capital. Michigan is particularly hard hit, as the long-term outlook remains cloudy; but we are not alone. There are many communities across this country that are suffering, and the need for capital is acute. Capital underpins every loan that is made. Loan losses resulting from the recession have reduced capital and with it, reduced the capacity to make new loans. Without new sources of capital, banks will inevitably end up shrinking in order to keep regulatory capital-to-assets ratios in acceptable ranges. This, of course, makes it increasingly difficult for community banks to continue to meet the credit needs of their communities.

We believe there are actions the government can take to assist viable community banks to weather the current downturn. By providing needed capital – which enhances the lending capacity of banks – the entire community will benefit. In fact, the success of many local economies – and, by extension, the success of the broader national economy – depends in large part on the success of community banks. 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 a letter to Treasury Secretary Geithner on September 21, 2009, I laid out specific recommendations for ways the existing unused Troubled Asset Relief Program (TARP) funds could be

used to assist well-managed, viable community banks and, therefore, be more effective in achieving its objectives. We recommended modification of the existing Capital Assistance Program (CAP), but there are certainly other unused resources available under the TARP program that certainly could – and should – be made available for this purpose. ABA's recommendations may be summarized as follows:

- Invest up to $5 billion of Troubled Asset Relief Program (TARP) funds in community banks that did not receive Capital Purchase Program (CPP) funds;
- Limit the maximum investment by Treasury in any one bank to five percent of the bank's risk-weighted assets;
- Require participating banks to issue Treasury senior preferred securities; require participants to show that they have commitments from private equity to match Treasury's investment dollar for dollar; and
- Allow any bank with total assets of $5 billion or less to apply but condition approval upon the submission of an acceptable capital restoration plan.

The ABA believes that this type of program can provide capital assistance to community banks that they need to work through their current issues. In thinking through the details of a program such as this, it is important to consider areas of this country that are unlikely to draw new sources of capital even with matching support from the Treasury. Even in these "economic disaster zones" there are still viable banks, good borrowers and a desperate need for capital to stimulate economic activity. The market for capital, however, is completely dysfunctional. For these areas, it may well be necessary to have some disaster zone exception that would still provide capital without as severe a matching requirement.

On a related note, we appreciate the recent announcement of the President's New Small Business Lending Initiatives designed to improve access to credit for small businesses by providing lower-cost capital to community banks that submit a plan to increase small business lending. While this program addresses a different issue than the one I have outlined above, we nevertheless think that it is potentially helpful in stimulating additional lending to small businesses. ABA has urged Treasury to increase the cap on the size of participating banks from $1 billion to $5 billion, as doing so would expand the eligible pool of community banks that could participate and thereby increase access to credit for small businesses.

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

- Capital injections for well-managed, viable community banks can be a highly effective method to maintain credit availability and facilitate an economic rebound in distressed areas.

- Banks continue to lend in this difficult economic environment, but both 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. Capital Injections Will Facilitate an Economic Recovery

Strong capital is essential to helping community banks work through the problems caused by declines in asset values. Capital is absolutely critical to any bank, as it is the financial underpinning of any loan that is made. While conditions have improved over the past year in the economy overall, many community banks are finding that the lagging impacts of job losses and declines in property values are negatively affecting their institution, causing declines in their capital at a time when new capital often is hard to find. There are some areas, such as southeast Michigan, where the economic conditions are so severe that new capital is nearly impossible to obtain. There are many other areas in the country that are feeling a similar pain and are finding capital impossible to obtain.

Governmental actions have exacerbated community banks' problems and in so doing have made it harder for them to raise capital. For instance, the banking agencies are requiring many banks to raise capital at a time when sources of capital are scarce and at precisely the time when capital should be available to absorb losses. This can put these banks in an untenable position, precipitating the failure of a viable bank that has a good franchise and could survive if capital was made available. In addition, the FDIC failure resolution policies (such as FDIC-guaranteed financing for winning bidders of failed banks or loss-sharing agreements) are creating incentives for investors to wait until a bank has failed before investing. This has kept capital on the sidelines instead of being injected into existing banks.

The influences come on the heals of government decisions to place Fannie Mae and Freddie Mac into receivership which caused a sudden and unexpected loss of billions of dollars to the banks that held shares of Fannie's and Freddie's stock. Moreover, the serial implementation of the Capital Purchase Program (CPP) meant that the applications of many non-public financial institutions were not considered until further into the recession. As a result, banks that perhaps would have qualified for CPP funds early in the process were denied the opportunity to participate once a deteriorating economy started to adversely affect the banks' condition.

The government's investment of billions of dollars in the largest financial institutions has improved the competitive position of these institutions, making it easier for them to raise capital and issue debt. However, the relative condition of many of the community banks that did not receive CPP funds has looked worse as a result.

The ABA recommends that Treasury modify the criteria for 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 and survive if given the chance to obtain necessary capital. This ability would be demonstrated in three ways:

- First, a bank would have to present evidence that private investors are contractually committed to match Treasury's investment dollar for dollar.
- Second, the private investors would have to agree to receive securities that are subordinate to Treasury's interests.
- Third, the bank would have to submit a capital restoration plan to its primary regulator that, when factoring in the proposed investments by Treasury and private equity, satisfies the requirements of the "Prompt Corrective Action" rules. As part of that plan, the bank also would have to show that it has adequate management to address its problems.

The suggested aggregate investment by Treasury of $5 billion is based on the amount of funds, when matched by private equity on a dollar-for-dollar basis, needed 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 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. A $5 billion commitment by Treasury is well below ***half*** of the dividends and warrant repurchases received by Treasury from CPP participants and ***less than 4 percent of the total of CPP funds invested to date***. Our projections show that an estimated 2,000 community banks would be potentially eligible, although it is highly unlikely that all 2,000 would choose to, or be approved to, participate.

As noted above, this program would involve matching investments by private equity investors. It is important that private equity qualify regardless of whether it comes from existing shareholders or new investors. Either way, the bank is receiving a strong vote of confidence in its viability from stakeholders who stand to lose their investments. Moreover, current investors and management often are in the best position to judge the prospects of a bank and to determine the advisability of investing in that bank.

As I mentioned at the outset, it is important to consider areas of this country that are economic disaster zones and unlikely to draw new sources of capital even with matching support from the Treasury. There are still viable banks, good borrowers and a need for capital to stimulate economic activity. The market for capital, however, is completely dysfunctional and it may well be necessary to have some disaster zone exception that would still provide capital without as severe a matching requirement. These banks would have to demonstrate their ability to operate safely and soundly even though they cannot currently raise private capital in their market area. This capital support may particularly be helpful for the banks that are facing increasing problems with commercial real estate loan problems in these deeply troubled markets.

Moreover, improved access to capital through the President's New Small Business Lending Initiatives should also help improve access to credit for small businesses. This program, in addition to the one I have outlined above, can help stimulate additional lending to small businesses.

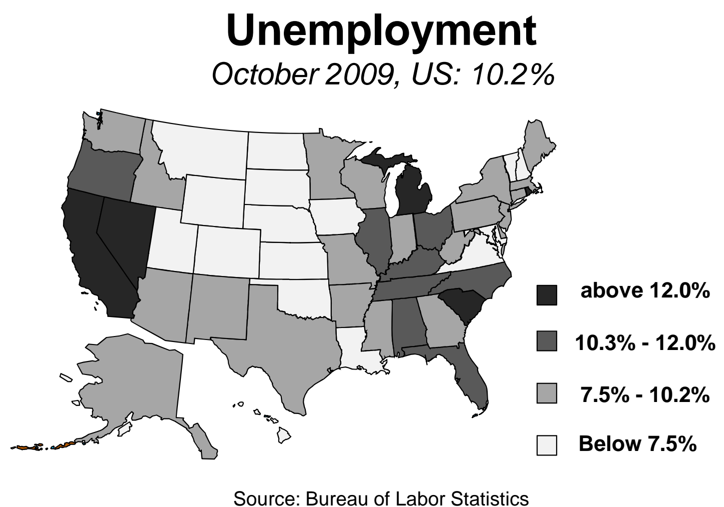
The Fact Sheet describing Treasury's proposed initiative limits the program to community banks with less than $1 billion in assets. Expanding the cap to $5 billion would expand the eligible pool of community banks that could participate in this proposed new program and thereby expand access to credit for small businesses. We urged Treasury, in a letter dated November 19, 2009, to offer this lower cost capital to banks under $5 billion in assets that demonstrate their ability to operate safely and soundly.

Community banks are the backbone of our economy and are critical to the overall improvement of our economy. For a nominal investment, Treasury can preserve viable community banks, which in turn would provide more resources for lending and would help preserve jobs and communities.

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

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.

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 projects that might have been funded when the economy was stronger may not find funding today.

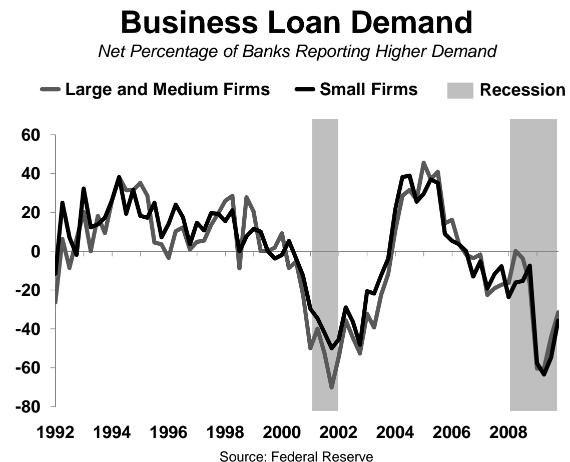


We recognize that there are some consumers and businesses in the current situation that believe they deserve credit that is not being made available. We do not turn down loan applications because we do not want to lend – lending is what banks do. In some cases, however, it makes no sense for the borrower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

Given the economic conditions, it is clear that the risk of lending is much greater today than several years ago when the economy was much stronger. This means that the credit terms are different today, with higher downpayments required, and smaller loans consistent with diminished collateral

values. Banks are looking at the risk of a loan and re-evaluating the proper pricing of that risk. This is a prudent business practice and one expected by our bank regulators.

Not only are banks being prudent in this environment, but it comes as no surprise that businesses are being very cautious in taking on new debt. 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, 33 percent of businesses reported regular borrowing in October (up one point from September) compared to 9 percent who reported problems in obtaining the financing they desired (down 1 point). 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.



The difficult recession, falling loan demand, and loan losses have meant that loan volumes for small businesses have declined somewhat this year. Our expectation is that loan demand in this economy will continue to decline. 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.

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.***

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.

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 appreciate the recently-issued guidance that addresses the need for banks to have the flexibility to work out loans. However, we continue to hear anecdotes from our members of examiners who continue to take an inappropriately conservative approach in their analysis of asset quality and who are consistently requiring downgrades of loans whenever there is any doubt about the loan's condition.

What the regulators want for the industry is what the industry wants for itself: a strong and safe banking system. To achieve that goal, we need to remember the vital role played by good lending in restoring economic growth and not allow a credit crunch to stifle economic recovery. We must work together to get through these difficult times. Providing a regulatory environment that renews lines of credit to small businesses is vital to our economic recovery.

Conclusion

I want to thank you, Chairman Moore, Ranking Member Biggert, and Congressman Peters for the opportunity to present the views of ABA on the challenges ahead for the banks and the communities they serve. These are difficult times and the challenges are significant. In the face of a still weak and troubled economy, 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.