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TESTIMONY OF

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SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

of the

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

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The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Moore, Ranking Member Biggert and members of the subcommittee, my name is Bert Otto and I am the Deputy Comptroller for the Office of the Comptroller of the Currency's Central District. I appreciate the opportunity to appear before the Subcommittee to discuss ways to improve responsible lending to small businesses in Michigan and other parts of the country. In addition to responding to the Committee's inquiry, I am also here to listen and hear other viewpoints on this important topic.

I have been a National Bank Examiner with the OCC for thirty-six years and have served in a variety of positions in the field and in our Washington D.C. Headquarters. For almost my entire career, I have been involved in the direct supervision of community and midsize national banks. In my present capacity, I am responsible for the oversight of nationally chartered community banks in ten states, including Michigan, which comprises a large part of the Midwestern United States.

To put OCC's regulatory role in Michigan in perspective, OCC supervises a relatively small portion of the banks headquartered in the state. There are 18 nationally chartered community banks headquartered in Michigan, holding aggregate assets of roughly $3.4 billion. By comparison, there are a total of 131 thrifts and state banks holding assets of over $70.0 billion. It is also important to note, however, that several large OCC supervised which are headquartered outside of Michigan do a significant volume of business and operate a large number of banking offices in Michigan. These numbers are also reflective of a steady decline in the number of financial institutions, a trend both in Michigan and across the United States.

The OCC recognizes the importance of small and midsize businesses to the overall health and vitality of Michigan and the U.S. economy. As Secretary of the Treasury Geithner stated earlier this month at the Small Business Conference that he co-hosted with SBA Administrator Karen Mills, “America's small businesses are critical engines of job growth and have historically led us out of recessions.” Secretary Geithner further noted that small businesses rely on banks for 90 percent of their financing, in contrast with large businesses that get 30 percent of their financing from banks.

Clearly, the subject of today’s hearing – “Improving Responsible Lending to Small Businesses”, is particularly timely here in Michigan. To put my remarks into context, it is important to point out that, just like much of the United States, Michigan is presently facing serious economic challenges. While the national economy has been in recession since 2008, Michigan has been experiencing a much more protracted contraction.

It is no secret that Michigan’s economy has experienced a material contraction of its most significant industry – automobile manufacturing. The state’s population has been experiencing “out-migration” since 2005, with further declines expected as the state’s manufacturing base continues to downsize.

As in other parts of the country, employment has been declining. However, in Michigan this trend began as early as 2001 and has persisted since. Current unemployment numbers now approximate levels recorded in the early 1990s. At 15 percent, Michigan's unemployment rate is the highest in the nation, up six percentage points from a year ago. Even areas of the service sector that normally hold their own in recessions—including financial activities, professional and business services, and information services—are experiencing declines in revenue and employment.

We are, however, seeing a modest recovery in education and health services and tourism is holding up better than in some other states. Defense, alternative energy, and life sciences appear set to expand. Some auto suppliers are diversifying into products for the new economy, with four lithium battery plants and a wind turbine assembly facility planned for the state.

As might be expected, the economic stress on households is pushing up loan delinquency rates. Twelve percent of all mortgages in Michigan are now past due, an increase of three percentage points over the past year, and two percentage points higher than the national average. Other loan categories show similar deterioration.

The steady erosion of the state's manufacturing base has taken its toll on commercial property markets, and delinquency rates have increased as a result. Vacancy rates in Detroit, for example, exceed 20 percent for both office and retail properties.

Deteriorating economic fundamentals are certainly causing increasing stress on small businesses. However, most small businesses will survive the current storm and continue to produce goods and services. In fact, new firms are opening their doors, and some established firms are retooling for the new economy, moving into such new fields as alternative energy. Whatever their specialty, the small business sector will continue to need credit.

The banking industry remains the most important supplier of credit to small businesses in the United States. For banks with assets of less than $1 billion, 56 percent of their business loans are small business loans, as of June 2009. For banks with assets over $1 billion, 21 percent of their business loans are small business loans, as of June 2009.

National banks continue to be accessible to small businesses. Although the total number of depository institutions has been declining, the number of banking offices, including offices and branches, continues to increase. In June 2008, 7,380 depository institutions (independent institutions and bank and financial services holding companies) operated in the United States.

Against this backdrop, the OCC recognizes the important roles that credit availability and prudent lending play in our nation's economy, and we are particularly aware of the vital function that national banks play in meeting the credit needs of the small businesses in their communities. Our goal is to ensure that national banks meet the credit needs of their communities and customers while remaining safe and sound.

During this stressful economic period we are extremely mindful of the need to maintain a balanced approach in our supervision of national banks. We strive continually to ensure that our examiners are doing just that. Although in today's weaker economic environment, credit demand among businesses and consumers has significantly declined, we are encouraging banks to work constructively with borrowers who may be facing difficulties and to make new loans to creditworthy borrowers. Our message to our bankers has been straightforward:

- Bankers should continue to make loans to creditworthy borrowers;
- But they should not make loans that they believe are unlikely to be repaid in full; and
- They should continue to work constructively with troubled borrowers – but recognize repayment problems in loans when they see them.

Likewise, examiners should not dictate loan terms, but will ensure that bank management realistically recognizes and addresses problems as they emerge, even as they work with struggling borrowers. The OCC strives to get this balance right through strong, thoughtful and consistent supervision and clear two-way communication with the banks we supervise.

Lending to Creditworthy Small Businesses

Although a small business is defined as having fewer than 500 employees, most small businesses are *very* small—the majority of employer firms have fewer than five employees and many are home-based, providing small incomes for mostly part-time owners. These companies provide economic opportunities to diverse groups of people and offer valuable products and services in the market.

As bank regulators, we recognize the important role that credit availability plays in the viability of these small companies. We share the goal of ensuring banks meet the credit needs of their small and midsize business customers, and have taken steps to see that this happens. Through the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* issued in November of 2008, all the federal regulatory agencies reiterated our view that, at this critical time, it is important that all banking organizations meet the needs of creditworthy borrowers. The OCC is reinforcing the message of the interagency statement through our examination process.

In addition, our ability to monitor small business lending will be enhanced by steps we are presently taking to obtain more frequent reporting of small business lending data. Bank regulators are currently in the process of revising the quarterly Report of Condition to provide this information. We are working to gather more data on small business loans by moving from annual to quarterly reporting of information in the March 2010 call report. This will allow us to better understand and track this lending segment, which is much larger than just Small Business Administration (SBA) loans.

Bank Participation in SBA Programs

One way banks can reduce their credit risk in loans to small and midsize businesses in this environment is to utilize federal and state programs that are designed to make credit more accessible and reduce lenders' credit exposure. The SBA loan guarantee program is one of the best known of these programs. In evaluating the underwriting and quality of small business loans, OCC views government guarantees or support provided through other programs positively as effective mitigants of credit risk. In fact, guidance provided to our examiners in the *Comptroller's Handbook for Rating Credit Risk* specifically states that those portions of credits having a government guarantee are usually assigned a "pass" rating. This standard is applied uniformly by our examiners in Michigan and across the country.

National banks actively participate in government guarantee programs for small business lending. Five of the 18 nationally chartered banks in Michigan are SBA Preferred or Express Lenders offering SBA guaranteed loans and 10 large national banks doing business in Michigan are designated as SBA Preferred or Express Lenders.

The American Recovery and Reinvestment Act (ARRA) expanded several existing Small Business Administration (SBA) programs and created new ones to help stimulate small business lending by banks and other financial institutions. Changes to the

SBA's flagship 7(a) loan guarantee program reduced the credit risk exposure that banks have on these loans. Under the 7(a) program, SBA provides a guarantee to banks originating small business loans. In the event that the borrower defaults on the loan, the SBA reimburses lenders for their loss up to the SBA guarantee limit. ARRA increased that limit from 85 percent to 90 percent. ARRA also temporarily eliminated the upfront guarantee fees, which typically range from 2 percent to 3.5 percent of the loan amount, depending on the size and duration of the loan, although the funding for this has now been exhausted. SBA has reported that these two key ARRA provisions have supported more than $14 billion in lending to small businesses.

The SBA also permanently expanded the SBA 504 certified development company program, in which banks and the SBA co-lend to finance small business plant and equipment. This expanded authority will allow businesses to restructure eligible debt to improve cash flow and enhance capacity for growth and job creation or retention.

We believe these initiatives are having a positive impact on banks' ability and willingness to lend and have sparked a resurgence of interest and participation in SBA programs. SBA has seen its average weekly loan volume increase by more than 75 percent. Over 1,250 lenders have returned to making SBA loans since October 2008. SBA 7(a) loan volume from May to September 2009 totaled $5 billion and SBA 504 loan volume in the same period totaled $2.2 billion. The trends in the third quarter are up when compared to the comparable period in 2008 — by $247 million for SBA 7(a) and $305 million for SBA 504. The National Federation of Independent Businesses' Small

Business Optimism Index is also trending up and more small business owners are reporting that the next three months are a "good time to expand."

These changes have been so successful at spurring small business lending that the Administration has indicated its support for legislation that Congress is considering to increase the maximum size of both 7(a) loans and 504 loans from $2 million to $5 million and increasing the maximum 504 loan limits from $4 million to $5.5 million for manufacturers, as well as raising lending limits on the Microloan program from $35,000 to $50,000.

Just recently Treasury announced a "new" program under TARP that will provide lower-cost capital to community banks that submit a plan to increase small business lending. Treasury is working with community banks and small business interests to finalize terms. This new initiative only applies to banks and bank holding companies with less than $1 billion in total assets. It lowers the dividend rate to 3 percent from the 5 percent level under the current CPP program. The standard for viability and for banking agencies' recommendations for approval has not changed—if a bank was not approved under the Capital Purchase Program, then this program will also be unavailable.

At the same time Treasury also announced a program geared to CDFIs, including credit union CDFIs. This program also envisions an approval by the CDFI's federal banking regulator. The rate on these funds is two percent for eight years

In our examination processes we are just starting to see the use of the new SBA programs. We have been active in working with the SBA and Treasury to facilitate small business lending. We need to ensure these programs provide flexibility for bankers to work with sustainable small businesses. Specifically, we facilitated a meeting in August between representatives from the Treasury and national bankers to provide a forum to explore ways to assist small businesses through the SBA. We have also met directly with SBA staff to discuss their programs so we can ensure examiners understand their programs and are consistently analyzing SBA loans in the field.

Community Reinvestment Act

Beyond our safety and soundness examination activities, OCC encourages lending to small and midsize businesses in a variety of other ways. Among these are our evaluations of national banks' performance under the Community Reinvestment Act (CRA), our extensive Community Affairs activities and our formal outreach programs.

The CRA encourages each insured financial institution to help meet the credit needs of the community in which it operates. The number and dollar volume of loans to small businesses, particularly those with annual revenues of less than $1 million, are important considerations in the OCC's evaluation of how well an institution is meeting local credit needs and in the assignment of its public CRA rating. OCC's CRA examination process ensures that a national bank's lending to small and midsize businesses is carefully assessed and subject to public scrutiny, and that these activities have a direct influence on the institution's CRA rating. The bank's knowledge that it will receive positive CRA consideration creates additional incentive to responsibly lend to creditworthy small business borrowers.

Outreach Activities and Community Affairs

OCC management and examiners regularly conduct outreach meetings and participate in industry and interagency forums with bank directors, chief executive officers, and senior credit officers to promote sound lending, including loans to small and midsize businesses.

OCC's Community Affairs Department is instrumental in providing information and resources to our examiners, bankers, industry associations and community groups. This OCC function is comprised of staff located in our Washington, D.C. headquarters, as well as Community Affairs Officers located in ten major metropolitan areas across the country. These individuals play an active role in agency initiatives to promote existing programs and innovative ideas for advancing small business lending.

The OCC's community affairs activities and publications are specifically developed to increase examiner, banker and community group awareness of programs that promote lending to small businesses. Recent newsletters, informational publications, conferences and teleseminars have highlighted various aspects of small bank lending opportunities and incentives:

- OCC and the other bank regulatory agencies regularly convene seminars for financial institutions to promote bank involvement in CRA activities, including small business lending. During 2009, OCC, the other bank regulatory agencies and SBA held eleven seminars focused exclusively on small business issues. The OCC is continuing this outreach.
- A recent edition of the *Community Development Investments* newsletter, which illustrated various ways multi-bank community development corporations have collaborated to provide financing to small businesses. This newsletter highlighted legislative changes in the Housing and Economic Recovery Act to the "Part 24" public welfare investment authority of national banks which will encourage increased bank investment in community development finance activities. We are particularly appreciative of Chairman Frank's strong leadership in connection with the passage of this important legislation.
- Over the past three years, the OCC has developed two *Community Development Insights* reports which serve as primers for banks considering participation in the SBA 7(a) or 504 Certified Development Corporation loan programs. After the release of these reports, OCC held national informational telephone seminars which drew a combined 3,000 listeners. We are updating both of these reports to reflect program changes and we will publicize the SBA program changes through our ongoing CRA outreach to bankers at training seminars and conferences.
- OCC's public Website also houses a wealth of information on small business lending on its Small Business Resource Guide Webpage.

Conclusion

The OCC recognizes the important roles that credit availability and prudent lending to small businesses play in our nation's economy, and we share the Committee's goal of ensuring that banks continue to meet the credit needs of their customers. We recognize that banks are operating in an economic environment that continues to pose significant challenges to them and their customers. However, we have and will continue to support and encourage lending to small and midsize businesses – in Michigan and across the country – through our supervisory activities, the CRA process, guidance to bankers, small business related programs and publications and ongoing outreach efforts.

While many challenges lie ahead, especially with regard to the significant decline in credit quality, OCC believes that the collective measures that government officials, bank regulators, and many bankers have taken in recent months have put our financial system on much more sound footing. The OCC is firmly committed to a balanced approach that encourages bankers to lend and to work with borrowers in a safe and sound manner, while recognizing and addressing problems on a timely basis.

Thank you for this opportunity to testify and present our views.