Testimony of

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On behalf of the

Independent Community Bankers of America

Before the

Congress of the United States

House of Representatives

Committee on Financial Services

Hearing on

"Initiatives to Promote Small Business Lending, Jobs and Economic Growth"

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Washington, D.C.

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I am James MacPhee, CEO of Kalamazoo County State Bank in Schoolcraft Michigan and chairman of the Independent Community Bankers of America. Kalamazoo County State Bank is a state-chartered community bank with $77 million in assets. I am pleased to represent community bankers and ICBA's nearly 5,000 members at this important hearing on "Initiatives to Promote Small Business Lending, Jobs and Economic Growth." My community banker colleagues and I work day-in and day-out to serve our small business customers because our viability is intertwined with theirs in the communities we serve. I am pleased to have the opportunity to offer our perspective.

Small businesses create jobs when they have access to credit, and small businesses will play a leading role in the economic recovery. In my state of Michigan, we face the nation's highest unemployment rate of 14.1 percent. While the country at large added jobs in March**,** Michigan shed another 9,500 payroll jobs. For me, this discussion is not in the least abstract. It is personal and close to home. My customers, friends, and neighbors have felt the full impact of the recession. The need for solutions is urgent. ICBA and its community bank members nationwide will continue to play a constructive role in identifying and implementing solutions.

Small Businesses Continue to Struggle

An economy in which small businesses thrive is a rich, diverse and competitive economy, offering personalized customer service and broad consumer choice. Support for small business is support for the entrepreneurialism and innovation that have always been the strength of the American economy. Small businesses are struggling today and deserve continued attention from policy makers.

The Wall Street meltdown of fall 2008 and the ensuing credit crisis and recession hit small businesses harder than medium and large-size businesses because they have faced greater challenges in obtaining credit. Boosting the flow of credit will help the small business sector to lead the recovery of economic growth and employment. That is why the ICBA strongly supports the proposed Small Business Lending Fund Act (H.R. 5297) among other measures that will bring more credit to small businesses.

Two weeks ago, Treasury Assistant Secretary for Economic Policy Alan Krueger testified that small businesses responded to the recession by laying off more workers than medium and large size businesses. The difference lies in access to credit. Small businesses are more dependent on bank credit than medium and large businesses. Medium and large businesses regained access to credit through the corporate bond market, while small businesses continue to suffer from lack of credit. "The segment of employers that are lagging most behind in hiring are small businesses," said Assistant Secretary Krueger. The greatest potential for job creation is among small business with restored access to credit. ICBA agrees.

Community Banks Stand Ready to Help

Community banks are prolific lenders to small businesses. While community banks represent only about 12 percent of all bank assets, they support nearly 40 percent of small business bank loans under $1 million and nearly half of all small business loans under $100,000. During the economic crisis, small business lending by the mega-banks fell more dramatically than lending by community banks, which held steady or declined only modestly. The community bank business model is built on longstanding relationships with our small business customers and we stand by them in good times and bad. My bank survived the Great Depression and many recessions in its more than 100-year history. We're proud to continue serving our community through this difficult economic climate.

The Small Business Lending Fund

As unemployment has remained high, policy makers have rightly turned their focus to small businesses as the most promising source of job creation. ICBA has endorsed a series of proposals that would spur more small business lending, and I'm pleased to have the opportunity to discuss some of them with you today.

Let me first address the "Small Business Lending Fund Act" (H.R. 5297) (SBLF). We applaud the President and this committee for proposing a fresh, bold program with the incentives needed to get credit flowing to many thousands of businesses, using community banks as conduits. The SBLF would allow banks with less than $1 billion in assets to receive capital investments up to 5 percent of their risk-weighted assets; those with between $1 billion and $10 billion in assets could receive up to 3 percent.

The SBLF is not another TARP program. TARP and other emergency capital programs were enacted in the urgency of the crisis and were used primarily by the mega-banks. Many banks have stabilized and paid the capital back at a profit to the taxpayers. The SBLF would target community banks and – this is a crucial distinction from TARP – it is structured to incentivize increased small business lending. Lenders who increase their small business lending over a baseline will pay discounted dividends to the government, as low as 1 percent. Lenders who decrease their small business lending will pay a dividend premium, as much as 7 percent. This structure could provide a powerful incentive for a bank to increase its small business lending.

ICBA is pleased to see that the proposal has many of the features we have sought and believe will make the program attractive to community banks and successful in increasing lending. In particular:

- It appears, from the legislative detail that we have, to completely avoid the onerous TARP restrictions for SBLF participants. In particular, warrants, compensation restrictions, bank dividend restrictions, or any restrictions on using generally available tax measures such as the net operating loss rules would be avoided. Such punitive conditions would only discourage participation.

- We note that the proposal would allow any participant in the program to repay the investment without impediment following any retroactive change in law that modifies the terms of the program in a materially adverse respect. However, attention should be given to recipient institutions that have already lent their funds. Retroactive changes could have the effect of jeopardizing outstanding small business loans as lenders seek to repay the government in order avoid the change in law. We believe that a participant that has received funds should be able to carry out the program according to the original terms, immune from any harmful change in law.

- We support appropriate Treasury oversight of the SBLF. However, oversight should not be so overbearing that it would discourage participation.

- We support the provision stating that no applicant shall be denied based solely on its composite rating. This will ensure that the broadest possible number of community banks can participate and that the small business customers of these banks will have access to SBLF-financed loans. Participating banks should have the benefit of the capital provided by the program in determining their capitalization at the outset of the program.
- We're pleased that agricultural loans are explicitly eligible. Farms are an important component of the small business sector.

Though we await final legislative language on various aspects of the program, we believe that the SBLF could attract broad participation by banks and result in more lending to small businesses. Notably, $30 billion in SBLF capital can be leveraged by community banks to support $300 billion in new lending. So the SBLF would have tremendous "bang for the buck." ICBA hopes to work with this committee and Congress to refine the proposal and implement it as quickly as possible. ICBA has attached at the end of this statement our letter to the committee highlighting our recommended program structure.

The Administration is also supporting other proposals, such as the State Small Business Credit Initiative, which would provide federal funding for state initiatives. ICBA is pleased to support a broad array of initiatives that have the potential to spur small business lending. Many states have had local success with different approaches, and the federal government should encourage and support successful small business lending efforts using local banks.

Additional Initiatives

GSE preferred share losses continue to pose a challenge to community bank capitalization

Capital levels are critical to support banks lending. As you know, when the government took Fannie Mae and Freddie Mac into conservatorship in September 2008 they destroyed the value of their preferred shares, costing the banking sector, including many community banks, an estimated $15 to $20 billion. This was an unprecedented breach of faith. Community banks were encouraged by their regulators to purchase these shares as a safe investment and with the incentive of special regulatory capital treatment. Nearly two years later, many community banks continue to struggle to cope with this abrupt loss of capital. We urge you to require the Treasury to restore the value of Fannie and Freddie preferred shares to what it was prior to conservatorship both to remedy an injustice and to boost community bank capital and spur lending.

Providing capital through the SBLF is a good idea. Restoring the value of preferred share losses would support the same goal. We urge you to help restore community bank capital and lending by supporting the value of dividend payments of GSE preferred stock.

Improve the exam environment for community banks

While community bankers are coping with the challenges of the economic downturn, an aggressive exam environment is making it harder for us to continue the flow of credit to small businesses. The SBLF program will only work if bank regulators do not choke off lending with overly aggressive bank regulation. Community bankers nationwide continue to report to ICBA about zealous, overreaching examiners second guessing bankers and appraisers and demanding aggressive write-downs and reclassifications of viable and performing commercial real estate loans and other assets. Examiners are focusing on the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have never been questioned before; and substituting their judgment for that of the appraiser. All of this has the effect of smothering small business lending.

Other bankers are concerned that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This is tantamount to statewide redlining, and in today's economic climate it could ultimately lead to capital problems at otherwise healthy banks. *This examination environment is exacerbating the contraction in credit for small businesses*, as community bankers must avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital. While it is expected and understandable that examiners will be more thorough and cautious during a credit downturn, excessively tough exams that result in potentially unnecessary loss of earnings and capital can have a dramatic adverse impact on the ability of community banks to make small business loans and support economic growth.

Extend the FDIC TAG Program to 2013

The FDIC Transaction Account Guaranty (TAG) Program, which guarantees noninterest bearing transaction accounts, certain NOW accounts and IOLTA accounts, has been an important tool for protecting and promoting the interests of small businesses by guaranteeing payroll accounts and providing community banks additional liquidity to make loans to creditworthy borrowers. Banks pay a separate fee to the FDIC for this additional coverage. Accounts guaranteed under the TAG are not considered in determining the deficit in the FDIC's Deposit Insurance Fund, so continuing the TAG would not increase the deficit in the DIF or affect the FDIC's regular insurance premiums.

We are very pleased that the FDIC recently decided to extend TAG, which was scheduled to expire on June 30, till the end of the year, with the option for an additional 12 month extension. In order to provide enough time to restore and maintain liquidity and customer confidence in the banking system, we urge that the program be extended yet further, until 2013. In certain areas of the country, such as Georgia, Florida, California and the Southwest, it is very important that this program continue long enough to bring about stability.

The TAG program ensures that community banks can continue serving their small business customers and are not at a competitive disadvantage in this fragile economy. The safety of transaction accounts continues to be a significant concern for customers. The public perceives that too-big-to-fail institutions can provide unlimited protection because they will ultimately be bailed out if they become financially unstable. Extension of the TAG program would give community bank customers the same assurance.

Extend Small Business Changes in the ARRA

The severe economic recession justified a sizable economic stimulus, including tax relief measures for individuals and small businesses. ICBA was pleased the American Recovery and Reinvestment Act (ARRA) enacted in February 2009 contained several tax relief and SBA reform measures to help boost small businesses. Specifically, the major SBA loan program enhancements enacted are all helping many small businesses ride out this deep recession. These programs have been extremely successful in doubling SBA lending levels in the past year and have been a bright spot in a difficult small business lending environment. We also support the extension of the key incentives for SBA 7(a) and 504 lending programs.

ICBA also supports extension of the beneficial SBA enhancements included in ARRA. Specifically:

• Extending the SBA fee reductions through fiscal year 2011;
• Extending the higher guarantee levels through fiscal year 2011; and
• Making permanent the SBA secondary market facility authority.

If enacted, these measures would all help community banks expand their SBA lending to small businesses and would stimulate much-needed economic activity and job creation.

Extend the 5-Year NOL Carryback Through 2010

ICBA applauds the expansion of the NOL carryback for 2008 or 2009 signed into law by President Obama. The FDIC reports that 30 percent of banks had a net loss for 2009. ICBA recommends extending this beneficial NOL reform through 2010. This would allow many more small businesses to preserve their cash flow and ride out this difficult business environment as the economy recovers.

Specifically, ICBA recommends allowing community banks and small businesses with $10 billion in assets or less to spread out their current losses with a five-year carryback allowed through tax year 2010. This extension would help increase small business lending. TARP-CPP participants should not be excluded. It makes little sense for Congress to encourage community banks to lend more to small businesses by participating in the TARP program and then to punish them by not allowing the potential use of the NOL five-year carryback. Public policies to promote lending should not offset one another.

The expanded NOL carryback simply allows businesses to accelerate allowable NOL deductions that would otherwise be claimed in future years. Businesses should have access to these deductions when they are needed most for capital and lending.

A May 27, 2009 Congressional Research Service report notes that most economists agree that U.S. companies would benefit from a longer net operating loss carryback than the current two-year period. The CRS report says the carryback period should last through the typical business cycle (six years) to help smooth the peaks and valleys in income.

Conclusion

Thank you again for the opportunity to testify today. ICBA strongly supports the new SBLF proposal and we'll do our part to make it a success. Our economy won't truly thrive again until the environment for small businesses improves. Community banks' special relationship with small businesses gives us a special responsibility to pursue practical solutions to the challenges they face. The SBLF holds promise; other initiatives I've discussed warrant your attention as well. We look forward to working with the committee on these issues.

ICBA Letter on SBLF Recommendations:

ICBA
INDEPENDENT COMMUNITY BANKERS of AMERICA®

May 17, 2010

The Honorable Barney Frank	The Honorable Spencer T. Bachus III
Chairman	Ranking Member
Committee on Financial Services	Committee on Financial Services
2129 Rayburn House Office Building	2129 Rayburn House Office Building
Washington, DC 20515	Washington, DC 20515

Dear Chairman Frank and Ranking Member Bachus,

On behalf of the 5,000 members of the Independent Community Bankers of America, we <u>strongly support the proposed Small Business Lending Fund Act of 2010 (H.R. 5297).</u> The Act would offer capital to interested community banks to use to increase small business credit. The Nation's 8,000-strong community banks are well-positioned to leverage this fund and have established relationships with small businesses in their communities to get credit flowing.

Under the proposed $30 billion fund, banks with less than $1 billion in assets could receive capital investments up to 5 percent of their risk-weighted assets, and those with between $1 and $10 billion in assets could receive up to 3 percent.

ICBA firmly supports the central purpose of the program to spur further lending to small businesses by means of community banks. ICBA believes the programs goals will be accomplished with a properly structured plan with incentives to participate and increase lending.

Notably, leveraging the $30 billion fund with community banks would potentially support many times that amount in loan volume to small businesses -- as much as $300 billion in additional lending. By reducing the dividend cost on the capital investment as lending increases, this program helps ensure more community banks have both the incentive and greater capacity to increase total loans to small businesses.

To make sure that the program achieves wide participation and its intended goals as it moves through Congress, ICBA strongly recommends <u>*any final legislation*</u> maintains these recommendations:

- There should be no counterproductive, TARP-like restrictions to receiving the investment, otherwise participation will be minimal and small business lending will suffer. For instance, there should be no warrants, no compensation restrictions, no bank dividend restrictions, and no restriction on generally available tax measures such as the net operation loss (NOL) carryback for tax years 2009 and beyond.

- The government should not have the right to change the contract or add onerous conditions unilaterally. Participants should have certainty that the rules of the contract will not change once they have agreed to participate the program. Therefore, banks should be able to return the investment at any time without penalty and should be able to keep the investment for at least five years or more to better facilitate small business loan durations.

- Dividend payments on the capital should be suspended for one year until the small business loans can be underwritten and put in place.

- The broadest number of community banks possible should be eligible to participate. For instance, banks with composite CAMELS ratings of 3 or higher should be automatically eligible and banks with composite CAMELS ratings of 4 should be eligible to participate after approval. Banks with CAMELS ratings of 1 and 2 generally have enough liquidity and capital to make small business loans without investment from the proposed fund. The fact that a community bank is subject to a supervisory order should not disqualify it from participating.

- If a bank's financial position is to be considered, the status should be based on the bank's post-investment capital position, i.e., include the impact of the capital injection from this proposal.

- In addition, special consideration should be given to minority banks given their roles in promoting the economic viability of minority communities and their financial service in often difficult economic environments.

- Furthermore, all types of banks should be able to participate, including Subchapter S, mutual banks and holding companies on equally fair terms.

- Treasury should have the ability to make the final capital injection decision after consultation with the bank regulators. The application eligibility and approval process must be well-defined and transparent so bank access to the program will be fair and consistent.

- Existing TARP CPP recipients should be able to easily transfer from the CPP program into the new program and be subject to the new program rules and released from their existing TARP restrictions and have their warrants cancelled.

- All community banks that participate should be able to treat the investment as Tier 1 capital.

- The definition of small business loans should be broad enough to include agriculture loans.

- Treasury should implement a relatively easy way to report an institution's small business lending using existing financial reporting banks are already mandated to produce.

- Finally, credit unions should not be eligible to participate in the program since they are subject to statutory restrictions on commercial lending and are tax-exempt. Many federal, state, and local governments are struggling to manage difficult budgets and should not forfeit even more tax revenue by displacing taxpaying activity to the tax-exempt credit union sector.

ICBA believes the proposed Small Business Lending Fund Act supports these recommendations and this fresh program approach will attract a broader spectrum of community banks to boost small business lending and job growth. We applaud the new program focused on getting funds to Main Street small businesses using Main Street community banks.

Thank you again for advancing this positive plan. The ICBA looks forward to working with the House Financial Services Committee and all of Congress to help advance this effort so that community banks can continue to aid in our nations' economic recovery.

Sincerely,
/s/
Camden R. Fine
President and CEO

cc: Members of the House Financial Services Committee