



INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

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
and
Committee on Small Business

Hearing on
**“Condition of Small Business and Commercial Real Estate
Lending in Local Markets”**

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Chairman Frank, Chairwoman Velazquez, Ranking Member Bachus, Ranking Member Graves and Members of the Committees, I am Stephen Andrews, President and CEO of the Bank of Alameda, Alameda, California. The Bank of Alameda is a state chartered bank operating in California with approximately \$248 million in assets. I am pleased to address the Committees on the “State of Small Business and Commercial Real Estate Lending in Local Markets.” I am also privileged to represent the Independent Community Bankers of America and its 5,000 community bank members at this important hearing.

The Bank of Alameda, like almost all community banks, specializes in small business, relationship lending. Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. Even during these challenging times, our nation's nearly 8,000 community banks remain committed to serving their local small business and commercial real estate customers, who are pivotal to our country's economic recovery.

But, my bank and all community banks face serious challenges that can hinder our ability to make new small business and commercial real estate (CRE) loans and to refinance existing loans. First, community banks confront the toughest regulatory environment in more than two decades. While Washington policymakers exhort community banks to lend to businesses and consumers, banking regulators, particularly field examiners, place restrictions on banks well beyond what is required to protect bank safety and soundness. The banking agencies have moved the regulatory pendulum too far in the direction of overregulation at the expense of lending. We need to return to a more balanced approach that promotes lending and economic recovery in addition to bank safety and soundness.

While the tough regulatory environment is inhibiting new loans in many instances, community banks have also witnessed a decrease in demand for loans from qualified borrowers. Many of our best small business and real estate customers cite their uncertainty about the recovery as their key reason for not seeking additional credit.

Commercial real estate lending presents special challenges for the community banking sector. Many community banks rely on CRE loans as the “bread and butter” of their local banking market. Community bank CRE portfolios are under stress. The downturn in the economy affects the ability of CRE borrowers to service their loans. Regulatory overreaction adds further stress to community bank CRE portfolios. For example, field examiners continue to require community banks to classify and reserve for performing CRE loans solely because collateral is impaired, despite guidance from Washington to look beyond collateral values. Community banks all over the country, even those located in areas that have relatively healthy economies, are under regulatory pressure to decrease CRE concentrations.

Community banks are the key to economic recovery. It is vitally important that policymakers create an environment that promotes community bank lending to small businesses, rather than inhibiting lending. We have several recommendations to improve the commercial lending environment and address problems related to CRE.

- Our country needs a balanced regulatory environment that encourages lending. In a balanced environment, regulators do not exacerbate credit availability through pro-cyclical increases in bank capital requirements. And, bank examiners consider the total circumstances of loans and borrowers, and not just collateral values, when determining the value of loans in banks.
- The Term Asset Liquidity Facility (TALF) should be expanded to cover purchases of a wider range of Commercial Mortgage Backed Securities (CMBS). Extending TALF for a five-year period would help the debt refinancing of CRE, and help stabilize the CRE market;
- The American Recovery and Reinvestment Act (ARRA) contained several tax relief and SBA reform measures to help boost small businesses. Congress should adopt the Small Business Committee legislation to extend these beneficial measures.
- The entire amount of the allowance for loan and lease losses (ALLL) should be included as part of risk-based capital. The risk-based capital rules should take into consideration the entire amount of ALLL and not just the amount up to 1.25% of a bank's risk-weighted assets. This would encourage banks to reserve more and recognize the loss-absorbing abilities of the entire amount of the ALLL.
- The FDIC Transaction Account Guaranty (TAG) Program 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. It should be extended another 12 months beyond its June 30th termination date.
- SBA reforms should be enacted to meet the needs of community bank SBA lenders. For example, the SBA "low-doc" program should be revived to help smaller banks that do not have a dedicated SBA lending staff.
- As policymakers decide the status of Fannie Mae and Freddie Mac going forward, a reasonable value should be given to community banks for the preferred shares, which were rendered worthless by the government's takeover of the GSEs. Additionally, dividend payments should be resumed for preferred shares.
- ICBA applauds the recent expansion of the net operating loss (NOL) five-year carryback for 2008 or 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.
- The law governing Subchapter S banks should be amended to permit IRA investments in Subchapter S banks without regard to timing and to permit Subchapter S banks to issue preferred shares. These reforms would give Subchapter S banks new sources of capital at this critical time.
- Congress should preserve the top marginal tax rate for Subchapter S income at 35 percent and maintain parity between corporate and individual tax rates to prevent costly shifts in business forms for Subchapter S businesses, including Subchapter S banks.

Administration's Small Business Lending Fund

In addition to these ideas, ICBA is strongly supportive of the proposal announced by the President and Treasury to further stimulate lending to the small business sector through community banks. ICBA believes the program could be successful, if structured properly. ICBA has made several recommendations for a successful program, including allowing community banks to participate in the new program without the restrictions associated with the TARP Capital Purchase Program (CPP). This would encourage broad participation. All of ICBA's recommendations for the new small business program are discussed more fully below.

Small Business and Community Banks Key to Recovery

America's small businesses are the key to supporting our economic recovery. Small businesses represent 99% of all employer firms and employ half of the private sector workers. The more than 26 million small businesses in the U.S. have created the bulk of new jobs over the past decade. With many of the largest firms stumbling and the U.S. unemployment rate at nearly 10 percent, the viability of the small business sector is more important than ever.

Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. For their size, community banks are prolific small business lenders. While community banks represent about 12 percent of all bank assets, they make 40 percent of the dollar amount of all small business loans less than \$1 million made by banks. Notably, nearly half of all small business loans under \$100,000 are made by community banks. In contrast, banks with more than \$100 billion in assets -- the nation's largest financial firms -- make only 22 percent of small business loans.

Community-based banks have played a vital role in the stability and growth of each of the fifty states by providing a decentralized source of capital and lending. This wide dispersion of our nation's assets and investments helps preserve the safety, soundness, fairness, and stability of our entire financial system.

With that said, the positive attributes of our nation's community banking sector are currently at risk. While the overwhelming majority of community banks are well capitalized, well managed and well positioned to lead our nation's economic recovery, there are certain hurdles in place that are hindering our efforts.

Examination Environment Hinders Lending

Indeed, the mixed signals that appear to be coming out of the banking agencies have dampened the lending environment in many communities. On the one hand, a November 12, 2008, Interagency Statement on Meeting the Needs of Creditworthy Borrowers established a national policy for banks to extend credit to creditworthy borrowers as a means to help our nation get back on its economic feet. It stated that, "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." Again, in November 2009, the banking agencies issued the Guidance on Prudent

Commercial Real Estate Loan Workouts, which was intended to ensure that examiners look at factors other than just collateral values when evaluating commercial credits and to ensure that supervisory policies do not inadvertently curtail credit to sound borrowers. Two weeks ago the regulators repeated some of these same messages in the context of small business lending generally in another interagency statement.

Field Examiners Second Guessing Washington

However, these messages seem to be lost on examiners, particularly in parts of the nation most severely affected by the recession. In California, the tough regulatory environment is forcing my bank and most other banks to avoid making good loans that we would have made in the past. As a result of capital standards above those required by regulations, questionable loan valuation and loan loss reserve policies, and overly strict implementation of CRE concentration guidance, my bank has reduced the amount of its loans from \$248 million at the end of 2007 to about \$200 million today.

But California banks are not the only banks to feel these regulatory pressures. In a recent informal survey conducted by ICBA, 52 percent of respondents said they have curtailed commercial and small business lending as a result of their recent safety and soundness examinations. Also, 82.5 percent of respondents answered that the Federal banking agencies' guidance on CRE loan workouts has not improved the examination environment for CRE loans.

Higher Regulatory Capital Standards

Bank examiners are raising required capital levels well above the capital standards established by statutes and regulations. As a result, community banks with sufficient capital to be considered "well-capitalized" are being classified as only "adequately capitalized." Examiners have increased the leverage ratio requirement that my bank must meet in order to be considered "well-capitalized." Instead of the five percent leverage ratio called for by statute, the bank examiners have increased our leverage benchmark to ten percent. Although my bank meets the higher ten percent standard imposed by the examiners, it has done so at the cost of reducing lending.

Being downgraded to "adequately-capitalized" impacts a bank's liquidity, and its ability to make loans and raise new capital from investors. "Adequately capitalized" institutions may not accept brokered deposits or pay above market interest rates on deposits without a waiver from the FDIC. The FDIC is being very tough on granting brokered deposit waivers causing further liquidity problems for banks. The interest rate restrictions limit many banks' ability to attract good local deposits. These deposits will likely migrate out of the community to other financial firms not subject to this restriction. In addition, to meet the higher capital standards, banks decrease the number of loans on their books and are forced to turn away quality borrowers. As noted above, lending at our bank has

decreased by 20 percent over two years. The higher examiner-imposed capital standard is a major reason for the decrease.

The examiner-imposed capital standards may force my bank to seek additional outside capital. Raising unnecessary capital dilutes the interest of existing shareholders, which erodes wealth that could be deployed by the shareholders to support other economic activities in the local economy. Furthermore, the prospect that regulators might increase capital requirements in the future makes raising capital difficult as potential new investors consider whether their investment in the bank might be diluted in the future.

Aggressive Writedowns of Loans; High Loan Loss Reserves

While the banking regulators in Washington have been very willing to discuss their safety and soundness examination policies with the ICBA and have reassured us that they are taking measures to ensure their examiners are being reasonable and consistent with recent guidance, ICBA continues to hear from community bankers that their examinations are unreasonably tough.

For example, despite the guidance on CRE loan workouts, community banks continue to report that they are forced to write down performing CRE loans based solely on appraisals and absorption rates (lots sold). In those cases, examiners are ignoring the borrower's ability to repay its loan, the borrower's history of repaying other loans with the lender, favorable loan-to-value ratios and guarantors. When a recent appraisal is unavailable, examiners often substitute their own judgment to determine collateral value.

Further, commercial credits that show adequate cash flow to support loan payments are being downgraded because of collateral values, or because the examiner believes the cash flow will diminish in the future. Other bankers complain that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that ignores any differences among markets within a state.

Many community banks report that examiners are not only requiring an aggressive write down of commercial assets, they are also requiring banks to establish reserves at historically high levels. Banks, which were rated CAMELS 1 or 2 on prior examinations and had loan loss reserves of 1 to 1.5 percent of total loans, report that they are being required to more than double their loan loss reserves. Aggressive write-downs of commercial assets and large loan loss reserves have a serious negative impact on bank earnings and capital and the ability of community banks to meet the credit needs of small businesses.

Banks May Avoid Good Loans to Satisfy Regulators

Examiner practices not only undermine the fundamental goal of the interagency policies, they are costing community banks money, leading to a contraction of credit, and forcing many of them to rethink their credit policies. Under this climate, community bankers

may avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital. In my bank's case, we have been forced to turn away developers, to whom we would have provided financing in the past, for both new projects and refinancing of existing projects.

Moreover, the examination environment is driving down the amount banks are willing to lend on a project, when they do decide to provide financing. Two years ago, a bank such as mine would have been willing to finance 75 to 80 percent of the cost of a project, but under today's circumstances, my bank could only finance 65 percent of a project, at most, out of concern about future downgrades of the loan.

Demand for Credit Down

Community banks are willing to lend, that's how banks generate a return and survive. The tough regulatory environment is inhibiting community banks from making new small business loans in many instances. But, community banks have also witnessed a decrease in demand for loans from qualified borrowers. It is a fact that the demand for credit overall is down as businesses suffered lower sales, reduced their inventories, cut capital spending, shed workers and cut debt. Small business loan demand is down as well. In a recent National Federation of Independent Business (NFIB) survey, respondents identified weak sales as the biggest problem they face. Only eight percent of respondents said access to credit was a hurdle. In a recent ICBA survey, 37 percent of banks responding said lack of loan demand was constraining small business lending. The FDIC Quarterly Banking Profile showed a \$129 billion decline in outstanding loan balances in the fourth quarter 2009 after a record \$210.4 billion quarterly decline the previous quarter. Net loans and leases declined across all asset size groups on a quarterly basis in the second half of 2009.

All community banks want to lend more. Less lending hurts profits and income. Many community bank business customers cite the key reason for not seeking credit is their uncertainty about the economic climate and cost of doing business going forward. Until their confidence in the economic outlook improves, businesses will be unlikely to seek more loans.

Commercial Real Estate

One issue of increasing concern in the community banking sector is that of commercial real estate and the potential for overexposure. Many community banks rely on commercial real estate (CRE) as the "bread and butter" of their local markets. The degree of borrowers' ability to service their CRE loans is closely tied to the performance of the overall economy, employment and income. Notably, retail sales declined 0.3% in the important December 2009 figure and unemployment remains near a 26-year high. So the sales at stores and businesses occupying commercial space is under stress and rents are suffering, putting increased pressure on paying loan and lease commitments. Until individual spending (which makes up 70% of GDP) and employment numbers improve, CRE loans set for renewal are likely to see continuing rising defaults.

This adds stress to the community banking sector as they rely on commercial real estate as a significant portion of their overall portfolio. However, bank regulators have much more aggressively examined community banks for CRE concentration dating back to 2006. For example, an institution whose total amount of reported construction, land development, and other land loans represents, approaches, or exceeds 100% or more of the institution's total capital will be subject to greater regulatory pressure and oversight. An institution whose total CRE loans represent, approach, or exceed 300% or more of the institution's total capital and whose outstanding balance of CRE loans has increased by 50% or more during the prior 36 months will also come under even greater regulatory scrutiny.

It is not uncommon to have community banks exceed the 100% of regulatory capital threshold, but few have seen very rapid growth in CRE exceeding 50% in the past 3 years. Many community banks survived the CRE stress in the 1980s and 1990s, and have much better controls over their CRE concentration. Community bankers report today's CRE troubles are nowhere near the magnitude of the late 1980s and 1990s.

CRE credit in the economy has already shrunk by about \$45 billion from its 2007 peak. However, CRE exposure will be a significant reason banks will remain under stress in 2010 and is a key reason 702 banks are on the FDIC problem bank list.

That said, community banks report they underwrite and manage these commercial real estate loans in a conservative manner, requiring higher down payments or other steps that offset credit risks and concentrations. Community banks believe they do a better job monitoring CRE loans than do large nationwide lenders because they are more likely to work one-on-one with the customer, and they have a better understanding of the economic conditions in their communities. The vast majority of community banks have the capital to ride out the depressed CRE market. However, community banks all over the country, even those located in areas with relatively healthy economies, are under regulatory pressure to decrease CRE concentrations.

Should real estate prices stabilize with economic growth, the CRE concerns will abate. Many community banks report that CRE loan payments are regularly being made (so the loans are performing) but their underlying collateral value has declined. Therefore, as CRE loans are due for renewal, borrowers as well as banks are often forced to put up increased capital to be able to refinance and prevent default.

ICBA's Recommendations

Community banks are the key to economic recovery. Despite a 4th Quarter 2009 decline of net loans and leases at an 8.2% compared to the previous year among all banks, community banks with less than \$1 billion in assets showed only a narrow year-over-year decline in net loans and leases of 1.4% after being the only group to post increases in each of the previous three quarters. Our nation's biggest banks cut back on lending the most. Institutions with more than \$100 billion in assets showed an 8.3% decrease while \$10-100 billion-asset-banks had net loans and leases decline at 11.4% compared to the

previous year. Policymakers need to create an environment that promotes community bank lending to small businesses, rather than inhibiting lending. We have several recommendations to improve the commercial lending environment and address problems related to CRE.

Regulatory Relief is Top Priority

Community bankers' top concern is that bank regulators have swung the pendulum too far toward regulatory overkill, inhibiting new small business lending and making the small business and CRE problems worse rather than helping resolve the problem. The bank regulators are forcing write-downs on performing commercial loans and treating all loans in many hard hit states the same regardless of a loan's performance. Also the FDIC practice of dumping properties at "fire sale" prices onto a market can trigger a counterproductive downward spiral in real estate values and further bank write-downs. Banking regulatory staff in the field are ignoring the policies established in Washington put in place to promote lending. Field examiners are imposing arbitrary capital standards on community banks, requiring those banks to shrink their assets rather than increase lending.

If community banks are to increase small business lending, the regulatory environment needs to change. Our country needs a balanced regulatory environment that encourages lending and economic recovery, in addition to bank safety and soundness. In a balanced environment, regulators do not exacerbate credit availability through pro-cyclical increases in bank capital requirements. And, bank examiners consider the total circumstances of loans and borrowers, and not just collateral values, when determining the value of loans in banks.

Extend and Expand TALF Program

The TALF program was designed to keep the secondary markets open and vibrant for a variety of loan and investment products. Secondary markets for commercial debt must be robust so CRE debt refinancing can take place at reasonable borrowing rates. Like residential real estate, commercial real estate loans were bundled into securities, pooled and sold. Specifically, the market for CMBS has not fully recovered. Expanding the TALF to cover purchase of a wider range of CMBS and extending TALF for a five-year period would help the debt refinancing of CRE, and help stabilize the CRE market. Notably, community banks can sell very few of their whole CRE loans; more likely they are engaged in loan participations, so policies should focus on stabilization of CRE valuations.

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 last February 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. We also support the extension of the key incentives for SBA 7(a) and 504 lending programs.

ICBA also applauds the Small Business Committee's legislation to extend 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;
- 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.

SBA Reforms

ICBA supports additional measures to enhance SBA lending. The key to meeting small business capital needs is to have diversity in SBA lending options. The SBA should be able to meet the needs of both large and small SBA loan program users. This was our objection to the SBA's elimination of the successful "LowDoc" program. It was used most often by banks that did a small number of loans and did not have the dedicated SBA loan staff.

Because there are more than 8,000 community banks nationwide they can support a large number of SBA loans if community banks are more easily able to use the SBA. In other words, we do not want an SBA with a one-size-fits all cookie cutter approach that only the biggest-volume SBA lenders can fully use. Before this financial crisis hit, nearly 60% of all SBA loans were concentrated in just ten banks. If we are concerned with supplying small businesses with a steady source of capital, the SBA needs to do a better job of embracing the more than 8,000 community banks nationwide so all lenders can easily participate.

Enhancements to Community Bank Capital

Of course community banks and small businesses rely on raising capital in this difficult capital market. Therefore, we would like to recommend several reforms that can help community banks and small businesses preserve and raise capital.

Restore Reasonable Value to Fannie Mae and Freddie Mac Preferred Stock

Community banks were encouraged by their bank regulators to hold Fannie Mae and Freddie Mac preferred stock as part of their Tier 1 capital and were severely injured when the U.S. Treasury placed these entities into conservatorship in September 2008. Some \$36 billion in Fannie Mae and Freddie Mac capital held in banks, including many community banks, was largely destroyed by Treasury's action. As policymakers decide the status of Fannie Mae and

Freddie Mac going forward, at a minimum, a reasonable value should be given to the preferred shares. Dividend payments should be resumed for these preferred shares. Importantly, this will help restore capital needed for additional small business lending. For each dollar of value restored some eight to ten dollars in new lending can occur.

Extend the 5-Year NOL Carryback Through 2010

ICBA applauds the recent expansion of the NOL five-year carryback for 2008 or 2009 that President Obama signed into law on November 6th. 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, including TARP- CPP programs participants to increase small business lending. 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 tax reform. Allowing all interested small businesses with \$10 billion or less in assets to use an expanded NOL through 2010 will help free up small business resources now to help support investment and employment at a time when capital is needed most. Expanding the NOL five-year carryback to include tax year 2010 and allowing TARP participant banks with \$10 billion in assets or less simply allows these businesses to accelerate the use of allowable NOL deductions that can be claimed in future years under current law. However, by accelerating the use of NOLs it will free up much needed cash flow now when businesses need it most.

A recent report by the Congressional Research Service helps support the net operating loss tax relief. The May 27 CRS report notes most economists agree that U.S. companies would benefit from a longer net operating loss carryback than the current two years 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.

The Entire Amount of the ALLL Should be Included as Part of Risk-Based Capital

Under the current risk-based capital rules, a bank is allowed to include in Tier 2 capital its allowance for loan and lease losses (ALLL) up to 1.25% of risk-weighted assets (net of certain deductions). Consequently, some community banks are now being downgraded based on capital inadequacy even though they have excess amounts of ALLL. The risk-based capital rules should take into consideration the entire amount of ALLL and not just the amount up to 1.25% of a bank's risk-weighted assets. This would encourage banks to reserve more and recognize the loss-absorbing abilities of the entire amount of the ALLL.

Extending the FDIC TAG Program One Additional Year

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 concerned that an expiration date of June 30, 2010, would not provide enough time to restore and maintain liquidity and customer confidence in the banking system. Particularly in those areas of the country like Georgia, Florida, California and the Southwest, it is very important that this program continue an additional 12 months to allow additional time for those areas to stabilize. The TAG program ensures that community banks are not at a competitive disadvantage in this fragile economy. The safety of transaction accounts continues to be one of the most important concerns for customers. The public perceives that too-big-to-fail institutions can provide unlimited protection because these banks will ultimately be bailed out if they become financially unstable. Community banks should be afforded the same opportunity to guarantee their customers' transaction accounts.

Allow New IRAs as Eligible S Corporation Shareholders

The challenging economic and credit markets make it difficult for many community banks to raise additional capital to support small business lending. Unfortunately, Subchapter S community banks are disadvantaged in raising additional capital by onerous shareholder restrictions. Current law restricts the types of individuals or entities that may own S corporation stock.ⁱ S corporation community banks seeking to raise capital may not allow new IRA shareholders. Traditional and Roth IRA stockholders are permitted only to the extent that that IRA stock was held on or before October 22, 2004. Therefore, Subchapter S community banks are put at a disadvantage relative to other less restrictive business forms in their ability to attract capital due to the rigid IRA shareholder restriction.

ICBA recommends that new IRA investments in a Subchapter S bank be allowed regardless of timing. We believe this reform will grant more community banks the needed flexibility in attracting IRA shareholder capital, especially from existing shareholders.

Allow Community Bank S Corporations to Issue Certain Preferred Stock

Another obstacle preventing S Corp. banks from raising capital is the restriction on the type of stock they can offer. Current law only allows S corporations to have one class of stock outstanding.ⁱⁱ C corporations that want to make the S corporation election must eliminate any second class of stock prior to the effective date of the S corporation

election. Likewise, issuing a second stock class by an S corporation terminates its S corporation status. Community banks must maintain certain minimum capital ratios to be considered a well-capitalized institution for regulatory purposes. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth. Banks needing more capital can raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so that they can protect their status as an independent community bank and serve their local community lending needs. Instead, they frequently use preferred stock to fund growth and retain control. However, S corporation banks are not allowed to issue commonly used preferred stock because preferred stock is considered a second class of stock. This prevents small community banks from having access to an important source of capital vital to the economic health and stability of the bank and the community it serves.

ICBA recommends exempting convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S corporation purposes. This would help more community banks become eligible to make the S corporation election as well as help those that currently are S corporations seeking to raise additional capital. Allowing community bank S corporations to issue preferred stock would allow them to reduce the burden of double taxation like other pass-through entities and, at the same time, fund future growth.

Preserve 35% Top Marginal Tax Rate on Subchapter S Income

Small businesses are facing difficult economic times. A troubled credit market combined with a slowdown in U.S. economic growth, high energy prices, and sharp inflationary costs across-the-board for inputs are crimping small business profits and viability. Maintaining cash flow is vital to the ongoing survival of any small business and taxes are typically the second highest expense for a business after labor costs. As pass-through tax entities, Subchapter S taxes are paid at the individual income tax level. Marginal income tax rates do play a critical role in a small business' viability, entrepreneurial activity, and choice of business form. Today more than half of all business income earned in the United States is earned by pass-through entities such as S corporations and limited liability corporations.

The top corporate income tax rate and individual income tax rate are currently set at 35%. Much discussion has been given to addressing the corporate tax rate for international competitiveness concerns and raising the individual income tax rate. Significant shifts in the existing marginal tax rates and parity between corporate and individual tax rate can trigger unwanted and costly shifts in business forms. It is important to consider maintaining parity between the top corporate and individual income tax rates in the Code. Additionally, during this difficult economic period, at a minimum, the current top tax rate of 35% should be preserved on both small business Subchapter S income and C corporation income, not increased.

Administration's Small Business Lending Fund

ICBA is strongly supportive of the proposal announced by the President and Treasury to further stimulate lending to the small business sector through community banks. ICBA believes the program could be successful, if structured properly. ICBA has made several recommendations to the Administration for a successful program:

- The new program should impose no TARP-like restrictions on community banks that participate in the program. For example, the program should not require stock warrants, restrict compensation or bank dividends, or limit access to tax benefits like the NOL carryback.
- The government should not have the right to change the contract to impose unilaterally new conditions and requirements.
- Bank dividend payments to the government should be suspended for one year until the small business loans can be underwritten and put in place.
- Community banks should be able to repay the government's investment without penalty and should be able to retain the government's investment for at least five years or more to support long term small business loans.
- The broadest number of community banks should be eligible to participate. We recommend that CAMELS-rated 3 banks be automatically eligible and that 4-rated banks be allowed to participate on a case-by-case basis. When considering applications to participate in the program, a bank's post investment capital position should be used to determine eligibility.
- Special consideration should be given to minority banks given their role promoting the economic viability of minority communities.
- Treasury should have the ability to make the final capital injection decision after consultation with the banking regulators.
- The eligibility criteria and approval process must be well defined and transparent so bank access to the program will be fair and transparent.
- All forms of banks, including Subchapter S and mutual banks and mutual bank holding companies, should be included in the program.
- Existing TARP CPP participants should be able to transfer to the new program and be relieved of the TARP restrictions.
- All participants should be allowed to treat the investment as Tier 1 capital.
- Agricultural loans should be included within the program.
- Reporting of small business lending should be made simple.
- Finally, credit unions should not be allowed to participate in the programs because credit unions commercial lending is restricted, in the first place, and secondly, because credit union lending is already subsidized through a broad tax exemption.

Conclusion

Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. Community banks form the building blocks of our communities and support small businesses around the country. The community banking industry is poised to serve as an economic catalyst to lead our nation's economic recovery. They are ready, willing and

able to meet the credit needs of small businesses and the communities that they represent. But, we need to move away from an overly restrictive, pro-cyclical regulatory environment to one that actually promotes small business and CRE lending in community banks. In addition, we believe that our other recommendations, if adopted, would go a long way to strengthen the community banking sector and increase small business lending. We look forward to working with Congress and the Administration on these and other initiatives to support small business and CRE lending by community banks.

ⁱ Internal Revenue Code §1361(b)(1).

ⁱⁱ Internal Revenue Code §1361(b)(1)(D).