Testimony of

Stephen Wilson

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business

United States House of Representatives

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Madam Chairwoman and members of the Committee, my name is Stephen Wilson, Chairman and CEO, LCNB Corp. and LCNB National Bank, Lebanon, Ohio, and incoming Chairman of the Government Relations Council of the American Bankers Association (ABA). LCNB National Bank is a full-service bank offering trust and brokerage services, along with insurance through a subsidiary. We have over $650 million in assets and our bank has served our community for 133 years. I am pleased to be here today on behalf of ABA. 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 $13.3 trillion in assets and employ over 2.2 million men and women.

This hearing is very timely. Our nation is certainly facing difficult economic conditions. It will clearly take time to work through these problems. We need to collectively look for solutions that will ensure a fast recovery. I have always believed that we must be realistic about the present and hopeful for the future. Hearings like this allow us to discuss these issues and work together to restore confidence in our financial system.

In spite of the difficulties faced by all businesses – including banks – in this weak economy, I want to assure you that the vast majority of banks continue to be well-capitalized and are opening their doors every day to meet the credit and savings needs of their customers. We applaud the efforts of Congress to find solutions, particularly the speed with which you enacted the Emergency Economic Stabilization Act. Although these actions are not ones that the regulated banking industry sought, they should provide the financial backstop needed to unfreeze the financial markets and ensure that credit is available to consumers and businesses on Main Street. This, combined with

the actions taken by the Treasury, Federal Reserve and the FDIC this month, will certainly help free up capital, which has been nervously waiting on the sidelines. That said, we remain concerned that regulatory and accounting policies could exacerbate the situation and make it more difficult for banks like mine to lend.

The focus of the Committee on Small Business is particularly important, as consistently small businesses are drivers of new ideas, new employment, and new economic growth. For banks like mine, small businesses are our bread and butter. While some might think of 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, the Small Business Administration defines a small business as one that has fewer than 500 employees. By this measure, over 8,100 banks – 97 percent of the industry – would be classified as small businesses. Even more telling, over 3,500 banks (41 percent) have ***fewer than 30 employees***. Banks like mine have been an integral part of our communities for decades – sometimes more than a century – and we intend to be there for many more to come.

In my statement today, I'd like to cover three points:

- Ensuring that adequate liquidity and capital are available is critical to maintaining the flow of credit to small businesses.

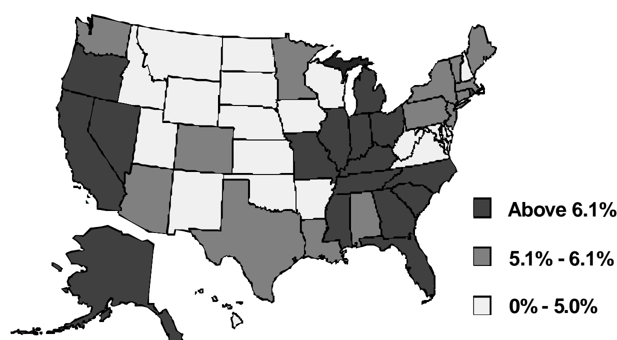
- Banks, large and small, believe that the Troubled Asset Relief Program can be helpful, although the structure and pricing of the program will impact their willingness to participate and the impact of the program.

- Additional measures would help small businesses, but care must be taken not to enact policies or regulations that would further restrict the availability of credit that is so vital to our economic recovery.

I. Ensuring that adequate liquidity and capital are available is critical to maintaining the flow of credit to small businesses.

Our country is in the midst of the most challenging economic period since the recession of 1990-1991. While the dislocations and problems were substantial then as they are today, one

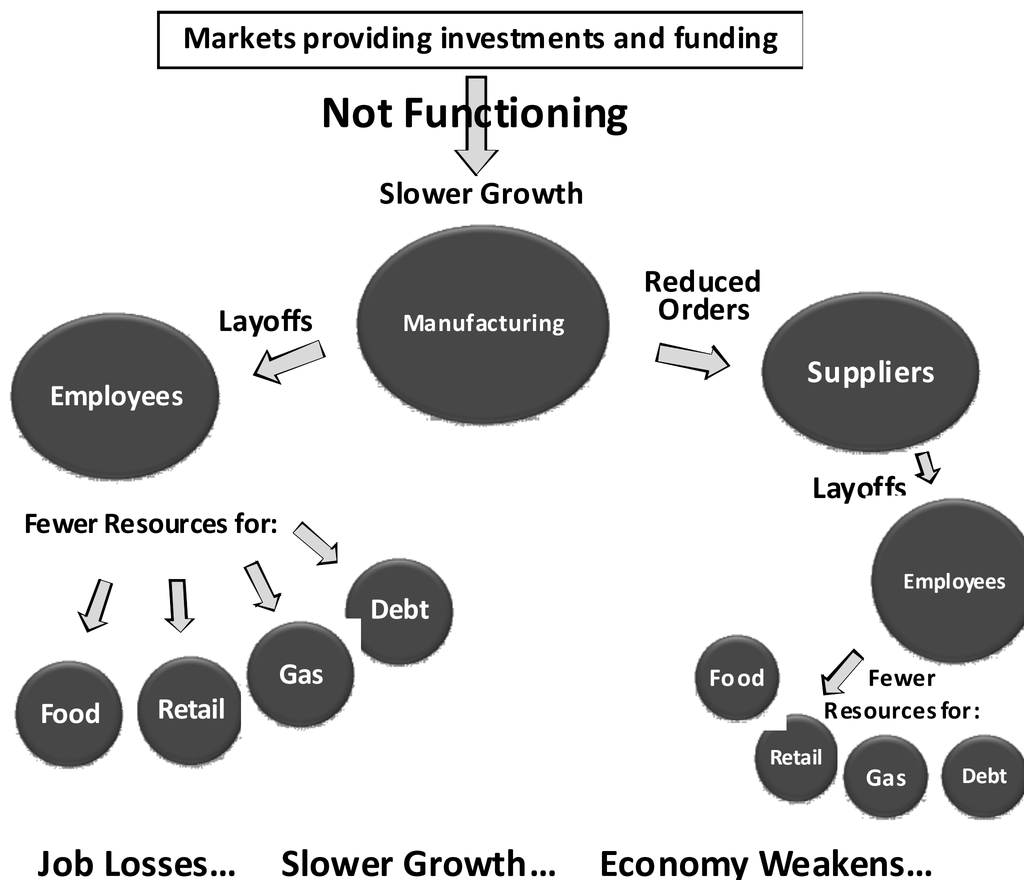
important lesson from the 1990-91 experience is that the economy emerges with a strong base capable of supporting long-term economic growth. Indeed, according to the National Bureau of Economic Research, following March of 1991 there were 120 months of economic expansion, the longest period of prosperity since tracking began in 1854.



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. Many states are either in recession or very close. The causes of these problems are varied. States such as Michigan, Indiana, and Ohio are suffering fundamental economic problems, which are largely tied to the fortunes (or misfortunes) of the auto industry. For example, in southwest Ohio, where our bank operates, the employment picture is expected to deteriorate even further in the short run. Several factors are involved, but most important are three major plant closures. In Batavia, Ohio, Ford is closing a transmission plant, which will eliminate over 1,000 jobs. In Moraine, Ohio, GM is closing an assembly plant, which will eliminate over 2,500 jobs. And in Wilmington, Ohio, DHL is closing a hub, which will eliminate over 10,000 jobs. The effect of these job losses is a major concern not just for our bank, but for the hundreds of small businesses that serve these plants and these employees.

This is a real-world illustration that what happens in global markets for liquidity, and what happens with the funding of very large businesses, has important implications for small business lending. This is why the action taken by Congress was so important – freeing up capital that has been nervously sitting on the sidelines. The chart on the following page shows how difficulties in funding for large businesses – which go directly to the markets for funding rather than through banks – ***ends up affecting small businesses***. Most community banks are not involved in lending to large manufacturers or other large business. However, community banks do lend to the employees of these companies and to the small businesses that sell supplies and services to the large companies – tools, office supplies, carpet installers, to name just a few. Each of these smaller suppliers of important every-day needs for larger businesses will find themselves short on cash because the larger businesses do not have the short-term liquidity to meet their obligations. This

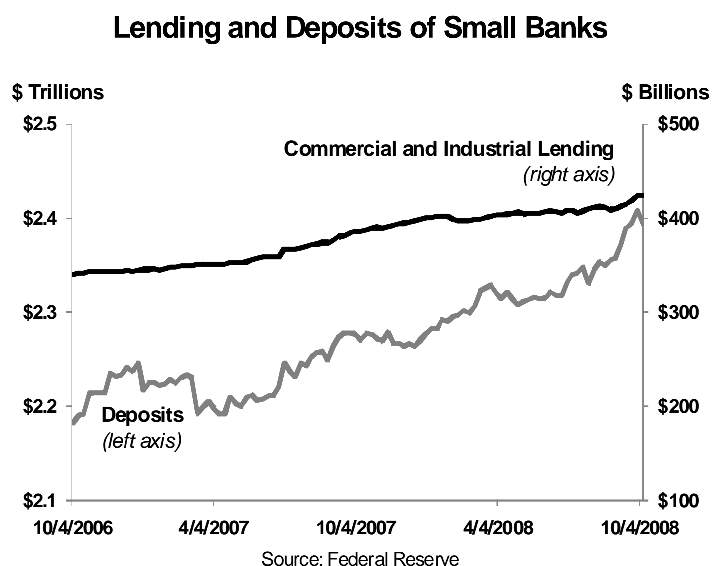
disrupts the flow of business to smaller businesses, which in turn will reduce costs in many areas, cutting back on staff and services used to make the business run. Thus, improving liquidity and funding for large corporations is critical to the economic health of many smaller businesses.



In other areas of the country, the housing downturn has caused or exacerbated problems. For example, communities are struggling in California, Florida, Nevada, and other states, which led the nation in rapidly appreciating home values from 2002 through 2006.

Some geographic regions, including Texas, Utah, Montana and parts of the Northeast and Northwest, continue to show growth. Indeed, many businesses in these areas are involved in exports (including food and energy) which have done quite well over the last year. In fact, the exports sector is largely responsible for keeping the U.S. economy from officially entering a recession. Nevertheless, the global economy is slowing, and the export sector is expected to slow soon. It is likely that this will affect small businesses and, in turn, will affect small banks.

For small businesses, the availability of credit is vital to their continued success in their communities. Banks continue to make loans to small businesses in their communities. However,



the demand for small business lending has fallen in recent months – even recent weeks – and this is most pronounced in areas of the country hardest hit by the housing downturn. However, the perception that there is no lending taking place is simply not true. At our bank, for example, we have the liquidity, capital, growth, earnings and asset quality necessary to meet the credit needs of the communities we serve and the needs of our small business customers. We have the capacity and the desire to make loans. This chart of weekly Federal Reserve data on small bank lending and deposits shows that deposits are ***increasing*** at small depository institutions, and with them, loans. It is vital to keep this economic activity moving as the economic situation moves toward resolution.

Indeed, the October Survey of Small Business Economic Trends, conducted by the National Federation of Independent Businesses (NFIB), confirms this. In the survey, they note that, although credit is generally more difficult to obtain, regular borrowing activity is down, reflecting a decrease in demand, as well. Only 6 percent of those surveyed reported problems in obtaining the financing they desired, while one-third reported that all of their borrowing needs were met. This illustrates that capacity is available from banks, but demand has decreased, indicating that broader economic problems are hitting small businesses.

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

II. Banks have indicated a willingness to participate in the Troubled Asset Relief Program, although the structure and pricing of the program are important considerations for participation and will affect the impact of the program.

The historic legislation that was recently enacted, the Emergency Economic Stabilization Act, contains a number of provisions that will help to assure capital and liquidity is available to facilitate credit availability. The temporary increase in deposit insurance to $250,000, the tax loss treatment of Fannie Mae and Freddie Mac preferred stock, and the Troubled Asset Relief Program (TARP) should help to accomplish this goal. Issues with mark-to-market accounting have not yet fully addressed, and ABA urges Congress to consider creating an accounting standards oversight board to ensure standards reflect the situation of businesses and do not cause unintended consequences.

Community bankers have reservations about whether government cash infusions can help them. These banks have been serving their communities throughout this crisis. They are well-capitalized, and are making solid loans. These banks have already been hurt deeply by this crisis. It is a classic case of how healthy, well-regulated institutions are badly hurt by unscrupulous players and regulatory failures. First, these banks watched as they lost loan business to mortgage brokers and others who made loans to consumers that a good banker just would not make. Second, these banks watched their local economies suffer when the housing bubble burst. Third, these banks watched the reputation of their industry be tarnished as the word "bank" was used to cover all sorts of financial institutions that were not, in fact, banks. They cringed as they heard Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac, and even AIG referred to as "banking failures." These bankers do not want or need any government bailout; they want their insurance fund to handle any problems – as it has – including problems with such large institutions as WAMU and Wachovia. ***It is a solution that these banks did not seek for a problem they did not cause, and yet all of it is often labeled the "bank bailout."***

Community bankers are remain concerned about whether the TARP program can help them – and indeed perceive that it may do them harm. Community banks do not have enough securities to be of interest in large-volume purchases of illiquid financial assets. In addition, community banks worry that arbitrary decisions about the health of their institutions will affect how Treasury chooses to implement capital infusions.

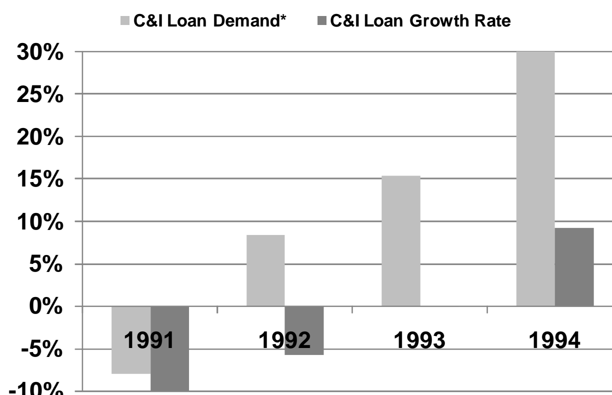
Nevertheless, based on conversations with ABA members, we believe that about half of them may participate in the program, depending on the details of the program and the economic benefit it might provide to individual institutions.

Since most community banks make and hold loans, it is not surprising that having an avenue available to sell whole loans is of particular interest. Many banks believe that using TARP funds to ***guarantee*** loans would be an efficient and effective use of the funds. This would have the advantage of leaving the relationship between the bank and the borrower fully intact, but would put a floor on losses, while freeing up capital to meet new loan demand. Moreover, while the root of the current economic problems has been with residential mortgages, the economic disruptions are spreading into commercial real estate and small business loans. Thus, banks generally believe that TARP funds should be available to purchase or guarantee a broader class of loans.

The first action of the Treasury, of course, with regard to TARP funds has not been with the purchase of troubled assets, but rather a direct capital injection into healthy banks. This action was announced this month, and has only begun to be implemented. Many banks were initially concerned – and still remain concerned – that the market will incorrectly perceive this as a sign of weakness in the industry. In addition, many banks have misgivings about the government taking an ownership position in our banks. As I stated earlier, this solution was not something that banks asked for, as the vast majority of banks remain well-capitalized and have the financial wherewithal to absorb losses in this environment. Banks like mine continue to meet the needs of our customers. Nevertheless, the participation of nine of the largest banks will send a signal that markets should be completely confident in the strength of U.S. banks. Since this announcement, many banks have expressed an interest in participating, although for many banks, this looks to be difficult to accomplish. The universe of institutions that Treasury ***may*** invest in is very large; however, the requirement that Treasury purchase senior preferred shares ***only*** may make it difficult for many institutions to participate. For instance, non-publicly traded institutions, S corporations, and mutuals do not fit the program as outlined. Treasury has expressed the desire to work with institutions that wish to apply, allowing for flexibility of application dates and extra time to obtain documentation. It will also be important for regulators to recognize that many well-capitalized banks have sufficient liquidity and are meeting credit needs in their communities. These banks may not want to participate in the program and no negative consequences should come from that decision. This decision should be respected and allowed.

This brings up a very important point of the involvement of regulators in mitigating – or exacerbating – the credit crunch. The current regulatory environment is unquestionably impacted by the regulatory concerns flowing from the economic downturn. A natural reaction is to intensify the scrutiny of commercial banks' lending practices.

One needs only to look back at the early 1990s to see what can happen when there is a regulatory over-reaction to an economic recession with roots in residential and commercial real estate problems. At that time, whether intended or not, the loud and clear message that bankers received from the regulators and Congress was that only minimal levels of lending risk would be tolerated. On the surface, this might have seemed reasonable – there is little doubt that economic consequences of a banking system with too much risk are not acceptable. But just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious economic consequences. Wringing out the risk from bank loan portfolios means that fewer loans will be made, and that only the very best credits will be funded.



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

A comparable scenario may be developing in today's regulatory environment. A bank can reach the point (as many did in the 1980s and 1990s) where regulatory actions reduce bank resources available to fund new loans. This includes being required to obtain new appraisals on properties for fully performing loans and to mark the value of collateral to current market values even though there is little expectation that the bank will be relying on the collateral for repayment of the loan. Taking a snapshot of a bank's assets during the low point of an economic cycle and forcing the bank to reflect the worst-case scenario on its books runs the risk of bringing about the very consequences that the banks and their examiners are trying to prevent – causing the bank to retrench, reducing banking lending overall. To avoid this outcome, we have been urging the regulators to keep in mind that markets are cyclical and that not every worst-case scenario will occur if the market is left to function without inappropriately restrictive intervention.

The great challenge may be to ensure that regulatory personnel out in the field are applying the measured approach that has been expressed so far by agency leadership. Increasingly, we are hearing troubling reports from our membership that regulatory mistakes of a decade ago are playing out again today. 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.

As the emergency program is implemented, it is very important not to create a conflict in policies – on one hand encouraging lending through new capital released from the TARP program and on the other hand discouraging lending through restrictive examination policies. This would be like spurring a horse to run faster while pulling back on the reins. Such conflicting efforts only waste resources and do not accomplish the goal of expanding lending to small businesses or individuals.

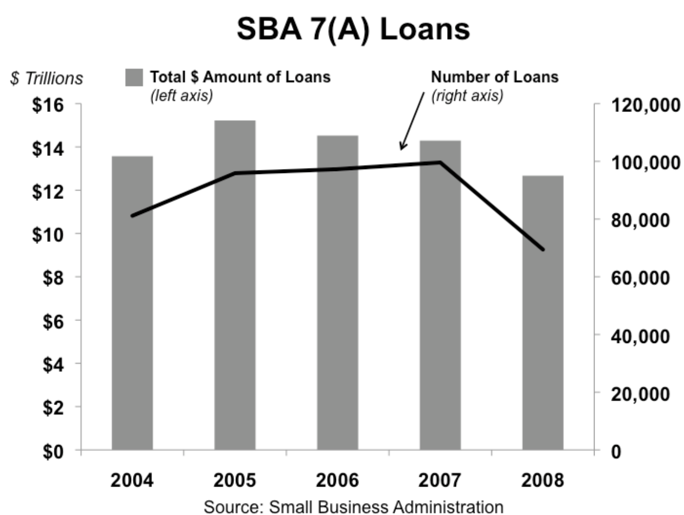
III. Additional measures would help small businesses, but care must be taken not to enact policies or regulations that will create unintended consequences

As I mentioned in the beginning, banks have continued to support the financial needs of our local communities. There are several measures that would help banks to facilitate this support, providing further liquidity and capital investment at a time when it is much needed.

SBA programs should be simplified, fees should be lowered, and guarantees should be increased.

SBA recently revealed that fiscal 2008 loan volume figures show a 30 percent decline year over year in its flagship 7(a) loan guarantee program. The economy is certainly playing a significant role in overall loan volume decline. However, many lenders are concerned that this decline is also due to SBA programs becoming too costly and difficult for lenders and small businesses who wish to access the program. While I believe that the SBA Loan Guarantee Programs should be self-funding to ensure their continued availability, there are times that Congress should provide some funds to reduce fees to make the programs more affordable to borrowers. Current market conditions suggest to me that this is one of those times that Congress should allocate some funds to keep the small business community going.

Another issue is the complicated process that both banks and businesses have to go through to apply for loans. Right now the procedures manual is 400 pages long. Believe it or not, that is less than half its former size; clearly, great strides have been made. However, progress needs to continue in order to attract lenders and bring this program to more small businesses. Now is the time to make this process easier and cheaper for small businesses and the banks who serve them.



Perhaps the most direct way to stimulate more involvement in the program is to provide a temporary increase in the federal guarantee provided on SBA loans. This would extend the program to many more communities across the United States and provide more loans to deserving small businesses.

Fair value measurement rules should reflect true fair value.

Banks of all sizes have cringed as they watched the book value of assets spiraling downward because of the application of accounting rules. The mark-to-market rules required by the Financial Accounting Standards Board (FASB) have certainly exacerbated the situation for many small banks, even putting some at risk of failure. This is due to the downward impact of those valuations and the pro-cyclical nature of valuation and liquidity. This pro-cyclicality is present in both upward and downward moving markets, neither of which is helpful in establishing accurate and appropriate prices.

Accounting standards are not only measurements designed to ensure accurate reporting, but they also have an increasingly profound impact on the financial system – so profound that they must now be part of any systemic risk calculation. Today, as a practical matter, accounting standards are made with little accountability to anyone outside FASB. ABA believes that this is better left in the hands of an accounting oversight board, chaired by the chairman of a new systemic oversight regulator. This type of board could take into account the situation experienced by small banks and recommend a course of action that would not have such dire consequences.

FDIC premium increases should balance the need to rebuild the reserve ratio of the fund with the need to fund local community lending.

Certainly, the banking industry is committed to supporting the deposit insurance fund, and we stand ready to ensure the health of the fund and the strength of the FDIC. We understand how important deposit insurance is for their customers – the fund was built up ***entirely by bank premiums*** over time, and the industry knows that keeping it strong is essential to our nation's banking system. While we understand the need to rebuild the fund, the proposed increase in FDIC premiums will inflict high payment requirements on small, healthy banks that have had nothing to do with the problem. Since the banking industry is obligated to rebuild the fund, the issue is how quickly it should be accomplished. Timing can make a big difference when the economy is in turmoil and our communities can least afford a credit crunch. We want to be sure the FDIC monitors the pace of rebuilding in order to strike the right balance between keeping the fund strong and not taking money out of the system unnecessarily.

Given Congress' recent enactment of the Emergency Economic Stabilization Act and FDIC's long and successful history of nursing troubled institutions back to health, we are optimistic that FDIC's cost projections over the next five years may be too high. Should its projections prove to be too conservative, we hope the FDIC would immediately move to adjust premiums downward so as not to further restrict bank resources that could be used to meet the credit needs of our customers and communities. In addition, we believe that the goal of reaching a reserve ratio of 1.25 in five years – what the FDIC proposed – is aggressive. Congress specifically allowed for a goal of 1.15 in five years in order to avoid taking capital away from banks during difficult times. Moreover, Congress provided for an even longer period under extraordinary circumstances. ABA believes the FDIC should make full use of its authority to minimize the impact on bank lending, particularly to small businesses in our communities.

Banks should be allowed to hold increased quantities of municipal bonds.

In this time of economic difficulty, small and large communities alike are having difficulties placing their municipal bonds. A bill was introduced this year, H.R. 6333, that would help to alleviate this difficulty, increasing capital available to local communities. Clearly, this additional funding source would be welcomed by the residents and leaders of many communities. It works by changing the definition of "small issuer" in the tax code from one that issues no more than $10 million in tax-exempt bonds annually to one that issues no more than $30 million. It also allows the

issuer to elect to apply the $30 million limitation at the "qualified borrower" level, rather than at the issuer level. Additionally, H.R. 6333 will provide a safe harbor for financial firms to hold up to 2 percent of their total assets in tax-exempt municipal bonds without being subject to the interest expense disallowance rules of the IRS Code. ABA supports H.R. 6333.

Subchapter S status should be expanded.

One way to encourage new capital in the banking system to support business lending is to allow banks to have alternative business structures. One of these is Subchapter S, which allows pass-through income tax treatment and limited corporate liability. Congress made Subchapter S available to insured depository institutions for the first time in 1996. However, at that time many existing banking institutions were unable to make the election because a corporation was not eligible if it had more than 75 shareholders. Legislative changes in 2004, 2005, and 2007 made significant improvements to Subchapter S, enhancing the viability of the structure for banking institutions. ABA supports further improvements that will: (1) increase the number of eligible shareholders to at least 150; (2) clarify that a current law reduction in the amount of deductions a regular corporation can claim with respect to tax-exempt obligations will not apply to a bank after it has been a Subchapter S corporation for three years; and (3) permit IRAs to make new investments in Subchapter S Corporations. ABA supports H.R. 4840, which would modernize the Subchapter S structure.

Short selling rules should be modified.

In the last year, there has been a marked increase in short interest in bank stocks and, in July, that interest took a decidedly sharp turn upwards. Banks of all sizes saw precipitous drops in stock prices, extremely high trading volumes, and huge spikes in failures to deliver (FTDs). It is generally recognized that FTDs are indicative of naked short selling, as they represent, in effect, an excess of promises to deliver stock compared with the supply of actual stock when delivery is due, a condition likely caused in large measure by naked short sales. The SEC's recent efforts to ban naked short selling are very much appreciated. However, more can and should be done with respect to short selling generally. Reinstating the uptick rule could help small banks. In addition, it would be very helpful to reinstate the temporary halt on short selling of all bank stocks – not just those listed on an exchange – until the markets become more rational and calm. This would allow small bank stocks who are not traded on exchanges to participate in this ban, and would help to avoid a drastic drop in stock price that comes with short selling. Finally it may make sense for the SEC to consider

whether there is some manner in which short sale information could be made available to the public on a delayed basis. As one banker told me, "I know who is long in my stock, why can't I know who is short in it as well?"

Shareholder thresholds for SEC registration should be increased.

The SEC requires a company with $10 million in assets and 500 shareholders to register its securities with the SEC. This inhibits the capital-raising of small banks, who have to turn away investors in their community for fear that they will trip over the threshold number and increase their regulatory compliance costs overnight. Once labeled as a public company and required to register with the SEC, a company is subject to significant reporting obligations which impose disproportionately high financial and opportunity costs on smaller public companies – costs that are ultimately borne by the company's shareholders and the nation as a whole as the job and economic creativity of small businesses are unnecessarily burdened. While the $10 million dollar asset size measure has twice been increased since Congress enacted Section 12(g) in 1964, the shareholder measure of a public company, has never been updated. Due to the way assets are measured in the bank, ninety-nine percent of banks meet the $10 million asset test and, thus, the only criterion of importance to the banking industry is the shareholder measure of a public company. While the SEC in response to inquiries from this Committee has indicated that they are considering the matter, this issue should be addressed ***during this credit crisis*** – not after it is over. It is high time that the 500-shareholder threshold is increased to be a more accurate indicator of a public company.

Securitization rules should be studied before they are modified.

"Securitization" now carries with it a very negative connotation, given the problems with subprime mortgage backed securities. Nevertheless, securitization is a very important part of funding bank loans, whether it is for mortgages, autos, credit cards, or small business loans. It is an important funding mechanism for our financial systems, bringing outside investment and liquidity to banks of all sizes. The Financial Accounting Standards Board (FASB) is currently working to finalize changes in securitization accounting rules in early 2009. Depending on the outcome, this effort could result in creating more problems than it is attempting to solve, discouraging securitizations. If that market dries up further, banks may find that they do not have the necessary funding to continue to provide affordable credit to consumers. ABA recommends a thorough and complete discussion of any potential changes in securitization accounting rules to ensure that we avoid any unintended consequences to small banks and their small business customers.

Efforts to increase the covered bond market should be encouraged.

Last summer, the FDIC took significant action to promote a market for covered bonds in the United States, a goal shared with the U.S. Treasury Department. A covered bond market could provide a significant long-term funding source (complementing other funding sources, such as short-term Federal Home Loan Bank advances) to help U.S. banks fund consumer mortgages. The FDIC's guidelines for residential covered bonds makes clear that, under certain conditions, the FDIC will grant investors access to the collateral supporting the covered bonds within 10 business days after the bank fails. While the Treasury's release of recommended best practices for a covered bond market is a first and important step in the development of the covered bond market in the U.S., the action taken generally benefits the larger lending institutions. ABA recommends that the Congress and the FDIC take further steps to explore methods for allowing community bank participation in this market.

IV. Conclusion

In conclusion, we are indeed facing a difficult economic cycle, one like we have not seen in many years. However, banks, as always, will provide a helping hand in our communities, utilizing all of the tools we have available to us. The above ideas will help expand our ability to meet the needs of small businesses in our community. As Congress considers these and other changes, we urge caution. Care must be taken not to enact policies or regulations that will create unintended consequences, especially ones that may restrict the availability of credit that is so vital to our economic recovery. The thousands of banks across our great country that never made one toxic subprime loan are scared to death that their already crushing regulatory burden will be increased dramatically by regulations aimed at their less regulated or unregulated competitors. We ask that you continue your efforts to ensure this does not happen. We stand ready to work with the Committee, Madam Chairwoman, to find effective ways to assure lending flows to small businesses.