

Testimony of Arthur R. Connelly

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business

United States House of Representatives



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Madame Chairwoman and members of the Committee, my name is Arthur R. Connelly. I am Chairman of South Shore Savings Bank in Weymouth, Massachusetts, and Chairman-Elect of the American Bankers Association (ABA). South Shore Bank is a mutual savings bank with \$950 million in assets and has served our community for 175 years. I am pleased to be here today on behalf of ABA. ABA brings together banks of all sizes and charters into one association, and works to enhance the competitiveness of the nation's banking industry and to 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 million men and women.

This hearing is very timely. Our nation is certainly facing difficult economic conditions. However, I want to say at the outset that I am, and my banking colleagues across this country are, very bullish about our nation's economic future. We have gone through these periods before and have emerged much stronger as a result. This is not to minimize the problems and dislocations that are occurring today, whether they are from job losses, struggles to stay in homes to avoid foreclosure, or simply the endeavor to meet daily needs in the face of high gas and food prices. It will clearly take time to work through these problems, perhaps even several years. We cannot ignore the current struggles and 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, work together to restore consumer confidence, and underscore the fact that the heart of our economy is still strong and the overall health of the country will return and be even stronger.

The banking industry continues to work with our customers and our bank regulators to help resolve financial problems as quickly and judiciously as possible. We applaud the efforts of

Congress to find solutions, particularly the modernization of the Federal Housing Administration (FHA) lending authority, the reform of the regulation of Government Sponsored Enterprises (Fannie Mae and Freddie Mac), and the temporary program to utilize FHA to assist distressed borrowers. The Housing package moving through Congress will be another tool for lenders to help borrowers, which should have a positive impact on the overall economy.

The focus of this committee on small businesses is particularly important, as consistently they are drivers of new ideas, new employment, and new economic growth. While some might think of the banking industry as 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*. Even at nearly \$1 billion in assets, my community bank has only 170 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.

Before turning to my main points, I know that many committee members may be wondering about the health of the banking industry in light of the recent failure of IndyMac. This well-publicized failure – and the subsequent acknowledgment that there will be more bank failures due to bad loans – has focused headlines and lead news stories intensely on the banking industry. Let me assure you that the industry as a whole remains fundamentally strong. Banks entered this current period with a very strong capital position and have continued to build capital over the last several quarters. In fact, the industry added \$13.5 billion to capital in the first quarter – which increased the total capital in the industry to well over \$1.3 trillion – and banks have set aside an additional \$121 billion in reserves as a safeguard against possible losses. Moreover, 99 percent of banks are classified by the regulators as “well-capitalized,” the highest designation given by the banking regulators. Simply put, the industry has the capital and reserves to continue to make the loans that are so vital to our communities. I can tell you that my bank employees are reiterating this fact in all of our communications with customers including our small business customers – as we are making sure that their financial needs are being met.

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

- Current economic weaknesses will take many months to resolve, but our country will emerge even stronger in the future.
- The process of economic adjustment is well underway, helped by Federal Reserve action and the economic stimulus package. Congressional actions – including improvements to the FHA program, the reform of GSEs, and the temporary FHA program to assist distressed borrowers – should also provide helpful tools.
- Several additional measures would help small businesses, but care must be taken not to enact policies or regulations that will create unintended consequences, including further restricting the availability of credit that is so vital to our economic recovery.

I. Current economic weaknesses will take many months to resolve, but our country will emerge even stronger in the future

The U.S. 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 was 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. 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. Stagnant job markets and net population out-migration have increased vacancies and pushed prices down. The housing downturn in the last year has only added to the problems already being felt in those and other surrounding states.

Housing problems have led some states into a broader economic downturn. California, Nevada, Arizona, and Florida led the nation in rapidly appreciating home values from 2002 through 2006. All these states had 10-15 percent increases in home prices from 2002-2006, surpassing the national average of 9 percent, and have now witnessed the most dramatic declines in values since last summer. These states, together with Michigan, Indiana and Ohio, account for about half of the foreclosures nationwide.

Other areas of the country, including Texas, Utah, Montana and parts of the Northeast and Northwest, continue to show growth. Businesses involved in exports and food and energy continue to do quite well, and in fact the exports sector played a major role in preventing the U.S. economy from officially entering a recession. Due to restrictions on development, the Boston market did not experience the speculative frenzy experienced in many others parts of the country. While the region experienced declining home prices, these declines were moderate when compared to certain other parts of the country. Although foreclosures have been at record levels due to subprime and other high risk loan products, most in-state banks in the region have not experienced a large increase in delinquencies; these have been concentrated in the out-of-state companies that were aggressive in subprime lending and alternative loan products.

This seems to be the story nationwide. With adjustable subprime mortgages resetting to higher rates and with falling home values in many states and metropolitan areas, delinquencies and foreclosures have increased dramatically. Delinquencies on home equity loans and lines of credit, as well as for autos and other categories of consumer loans, have also risen over the last six months. With slow income growth, falling home equity and stock values, as well as rising costs of food and gas, it is unlikely that we will see delinquency rates fall this year. The most important determinant of consumer delinquencies is job loss. Thus, anything that will stimulate new jobs is likely to have an important influence on economic conditions.

II. The process of economic adjustment is underway

Fortunately, there are signs that the process of adjustment, while slow and often painful, is already underway. There is no silver bullet that will make this happen faster or avoid the strains that many people may suffer. However, there are several positive actions that are already helping.

The action by the Federal Reserve to lower interest rates in the last year has had profound effects. The low interest rate environment (the target Federal Funds Rate has been at 2 percent

since April 30) has reduced the interest rate shock faced by many subprime borrowers with adjustable rate mortgages. Moreover, the interest rate reduction by the Fed reduces the prime rate, which is the standard benchmark for business loans. This has already had the effect of lowering the cost of servicing existing debt for many businesses and lowering the cost of new loans. Moreover, the Fed's interest rate reductions also have meant that rates have fallen for adjustable rate loans such as home equity line and adjustable rate credit cards. New loan rates have fallen on fixed rate loans as well. For example, the interest rate on auto loans fell from 7.77 percent in 2007 to 6.81 percent in May 2008, and the rate on credit cards fell from 13.38 percent in 2007 to 11.87 percent as of May 2008, according to the Fed's most recent Consumer Credit report.

The economic stimulus checks were well timed, and they provided some relief in the face of rising food and gas prices. Also in the stimulus package, allowing small businesses to expense capital investments will stimulate spending in plant and equipment.

The housing market, which has suffered the most, is showing signs that it is improving. At South Shore Savings Bank, residential loan originations for the first six months of 2008 are over 24 percent higher than for the same period in 2007. Our bank competitors voice similar experience, although across the nation housing starts continue to decline. The decline in starts has reduced inventory, which has consequently become much more affordable. This may help to clear further inventory over the summer.

In spite of the housing market problems, lending for individuals and businesses is expected to continue. The National Federation of Independent Businesses (NFIB) commented that businesses are reporting no sign of credit stress. For South Shore Savings Bank, the volume of closed small business lending for the period January – June is up 40 percent compared to the same time last year. The ABA Economic Advisory Committee forecast consumer lending to increase by 4.5 percent and business loans by 7.8 percent for next year.

Lenders are actively working with borrowers who are having difficulty making their mortgage payments. In the second half of 2007, HOPE NOW reported helping an estimated 869,000 mortgage holders through assisting with a repayment plan (652,000) or a loan modification (217,000). This is a difficult and often slow process, and, while many people are being helped, all options are not available to all homeowners. The expansion of the FHA funding (including the FHA Secure Refinancing program) is also helping to stabilize the housing markets.

ABA's Economic Advisory Committee (EAC) expects housing starts and home sales to reach their low point within six months and then improve next year. While the home price

correction is nearly complete in many markets, further price declines, particularly major metropolitan markets in California, Nevada and Florida, are expected next year.

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 are bullish about our nation's economic future and have continued to invest in local communities. As small businesses themselves, there are several measures that would help banks to carry out this investment, providing further liquidity and capital investment at a time when it is much needed.

Subchapter S status should be expanded

One way to encourage new capital in the banking system 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, and we encourage Congress to enact it.

Banks incorporating as LLCs should be recognized by the IRS

Another corporate structure that can be useful for banks is a Limited Liability Company (LLC). This structure allows partnership pass-through and corporate limited liability, similar to an S corporation, but allows for increased flexibility to allocate income or losses to different investors. Unlike an S corporation, there are no restrictions on the size and classes of members, so an LLC can be formed quite quickly. Since 1995, the IRS has failed to recognize the tax status of bank LLCs on the federal level. The IRS has maintained this stance even as many states passed laws allowing state

chartered banks to be treated as LLCs for state tax purposes. Moreover, the Federal Deposit Insurance Corporation in 2003 issued a rule establishing that banks could qualify for FDIC coverage as LLCs. This month, legislation was introduced in the Senate that would allow state chartered banks to be taxed as Limited Liability Corporations (LLCs) at the federal level. We encourage the introduction of similar legislation in the House of Representatives.

Shareholder thresholds for SEC registration should be increased

Currently, Section 12(g) of the Securities Exchange Act of 1934 requires a company with \$10 million in assets and 500 shareholders to register its securities with the SEC. 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. 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.

On March 31, 2008, the American Bankers Association NASDAQ index (ABAQ), was comprised of 493 banking companies with a combined market capitalization of \$144 billion. Each year as many as 50 banks choose to delist, triggered primarily by efforts to reduce the burden of the reporting requirements. At a time when the outsourcing of jobs overseas is becoming more and more common among large corporations, small companies such as community banks continue to be job incubators on main street America. It is high time that the 500-shareholder threshold is increased to be a more accurate indicator of a public company. Making this change will restore the principals of proportionality and balance to our securities laws so that the benefits to the investing public outweigh the regulatory costs to our nations' small businesses.

Securitization rules should be studied before they are modified

Securitization is an important funding mechanism for our financial systems, bringing outside investment and liquidity to banks of all sizes. It has revolutionized the capacity of lenders to build capital and offer credit, and has significantly lowered the cost of credit for borrowers. The

Financial Accounting Standards Board (FASB) is currently working to finalize changes in securitization accounting rules in 2008. This rush by FASB to finalize rules by year-end could result in creating more problems than the effort is attempting to solve, discouraging securitizations. This would detrimentally impact lenders of all sorts, especially banks, as securitizations provide a significant market for consumer loans and other credits. 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.

Efforts to increase the covered bond market should be encouraged

Just this month, the FDIC took a 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. Covered bonds are general obligation bonds of the issuing bank secured by a pledge of loans. Unlike other securitizations, the loans backing the bonds remain on the bank's balance sheet. While the European markets for covered bonds is well developed, with an estimated \$2.75 trillion of bonds currently outstanding, the U.S. market is significantly less so due to investor uncertainty regarding how these bonds would be treated in the event the issuing bank failed. The FDIC's recent action 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 FDIC's action 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.

Fair value measurement rules should reflect intrinsic value

ABA believes that the accounting model used to value assets should reflect the business model of the reporting entity. FASB believes that full fair value for financial instruments is the most relevant basis; however, recent accounting rules on how to measure fair value may have brought some unintended consequences and contributed to the current credit and liquidity issues in the marketplace. 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. In an up market, the fair value rules, as promulgated by FASB, contribute to over-inflation of prices and underpricing of risk. In a down market, the exact opposite occurs.

As an example, if one institution, due to liquidity issues, is required to dispose of an asset at an unnaturally low price to improve liquidity in the short-term, other institutions are subsequently ***required to mark their own securities*** to reflect the new lower price point set by the distressed institution. As the pricing of assets degrades, yet another institution finds itself in a situation where it needs to quickly sell assets. This then causes prices to erode further, accelerating the decline in liquidity, and around and around we go. This circle of impairment is self-perpetuating, despite the fact that the asset is performing (e.g., payments are current). ABA recommends a correction to the current fair value measurement rules, which currently fail to reflect intrinsic values or provide accurate and useful values to users of financial statements.

SBA programs should be simplified and fees should be lowered

Former SBA Administrator Steven Preston recently noted that volume is decreasing in its flagship 7(a) loan guarantee program. South Shore Savings Bank's experience bears that out. For SBA calendar year 2007, nearly 20 percent of our C&I loans were closed with an SBA guaranty; volume is significantly down this year. No one could argue that the economy is playing a significant role in overall loan volume and dollar decreases, but many lenders and some members of Congress are beginning to wonder whether the SBA programs are becoming too costly and difficult for lenders and the small businesses who wish to access the program. One issue is fees. While no lender would question the need for proper oversight, SBA is now requiring 7(a) lenders to pay SBA fees to cover the costs of conducting an on-site review. The amount of the fee will vary, but as an example of the size of the fee, a \$160 million community bank based in California recently received an examination letter indicating that their fee would be just over \$19,000, plus travel expenses.

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.

In conclusion, we are indeed facing a difficult economic cycle, but it's one from which we believe the U.S. economy will emerge strong. Banks, as always, will provide a helping hand in our communities, utilizing all of the tools we have available to us. The above ideas may help expand our arsenal of tools or the reach that some of our tools have. However, 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.