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INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

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Lafayette, LA

On behalf of the
Independent Community Bankers of America

Before the

Financial Crisis Inquiry Commission

January 13, 2010
Washington, D.C.

Chairman Angelides, Vice Chairman Thomas, members of the Commission, my name is Rusty Cloutier, and I am pleased to testify today on the current state of the financial crisis and in particular the effect it has had on small business lending. I am President and Chief Executive Officer of Midsouth Bank, a $685 million community bank in Lafayette, Louisiana, and I am proud to testify today on behalf if the Independent Community Bankers of America (ICBA) and its 5,000 community bank members nationwide.

Causes and Solutions

Mr. Chairman, it is difficult to talk about the effects of the financial crisis without first looking at its root causes. Too big to fail institutions and the systemic risk they pose were at the heart of our financial and economic meltdown. Equally responsible were those institutions making up the unregulated "shadow" banking industry, operating just outside the legal parameters of the regulatory framework, which made most of the subprime and exotic loans that brought the housing market to its knees. For far too long, these institutions have enjoyed the privileges of favored government treatment, easier access to cheaper funding sources, lower or no compliance costs, and little if any oversight.

A little more than a year ago, key elements of our financial system nearly collapsed due to the failure of these institutions to adequately manage their highly risky activities. These reckless and irresponsible actions by a handful of managers with too much power nearly destroyed our equity, real estate, consumer loan and global finance markets and cost Americans more than $12 trillion in net worth.

This crisis also has pushed our nation to the brink of insolvency by forcing the federal government to pump some $10 trillion in capital and loans and commitments to large complex financial institutions whose balance sheets were over-leveraged and lacked adequate liquidity to offset the risks they had recklessly taken. We are at the point where some world markets are even questioning if the U.S. dollar should be retained as the world's reserve currency. All of this was driven by the ill-conceived logic that some institutions should be allowed to exist even if they are too big to manage, regulate and fail.

By contrast, community banks like mine stuck to their knitting and had no role in the economic crisis. Community banks are engaged in relationship, rather than transaction, banking, which means we know our customers and operate under the quaint but effective practice of only lending money to people who can pay it back. Our conservative principles have served us and our communities well, and have allowed us to meet our customers' needs in good times and in bad.

Even though community banks did not cause the economic crisis, we have been affected by it through a shrinking asset base, heavier FDIC assessments, and a suffocating examination environment. More on that later.

Congressional Response

Congress has been engaged in the monumental task of crafting legislation that will reduce the chances that risky and irresponsible behavior by large or unregulated institutions will again lead us into economic chaos. The House has completed action on its bill, and the Senate is not far behind. ICBA testified before Congress 24 times last year, most of which focused on the financial crisis and public policy initiatives to prevent it from happening again. I would like to submit several of the most recent and relevant statements for the record.

ICBA's goals during this process were to pass meaningful financial reform to rein-in the financial behemoths and the shadow financial industry to ensure that a crisis like this will never happen again, and to level the competitive playing field between Wall Street and Main Street. I am pleased to observe that the legislation adopted by the House, and the bill being considered in the Senate, in large measure does both.

- Both bills create systemic risk regulators to monitor financial stability and supervise institutions that pose risk to our economy.
- Both bills subject systemically dangerous institutions to higher capital and liquidity requirements and more rigorous supervision.
- Both bills give the systemic risk regulator authority to downsize, even shut down, institutions that threaten financial stability.
- Both bills create a systemic risk fund to ensure that taxpayers are protected from the costs of future failures.
- Both bills make the FDIC assessment formula more equitable to free up more money for local investment.
- And both bills go a long way towards ending the doctrine of too big to fail.

Are there things in the bills we don't like? Sure. No legislation is perfect.

- We strongly oppose the single regulator approach in the Senate proposal.
- We want to close the ILC loophole, not study it like the Senate bill does.
- We'd like to see more restrictions on growth and a lower national concentration cap.
- And we have no use for a new national bureaucracy (Consumer Finance Protection Agency) dedicated to protecting consumers from financial abuses when there are already adequate safeguards in place (although we strongly supported changes to this proposal to make it less offensive).

ICBA will continue to work with Congress to address these concerns. But overall, we believe Congress has made a good start in addressing the conditions that led to the economic collapse in order to prevent a future collapse from occurring.

Effects on Lending in Communities

Now, let me highlight how the financial crisis has impacted community banks and lending to small businesses in our communities.

While the financial meltdown and deep global recession may be over, economic growth remains too weak to quickly reverse the massive job losses and asset price damage that resulted. The government has a huge task ahead to unwind the massive fiscal and monetary stimulus that has been undertaken to prop up the U.S. economy. Additionally, the massive financial reform legislation still evolving in Congress creates additional uncertainty, risks, and potential costs for community banks nationwide.

After more than a year and a half of economic decline, the U.S. economy grew by a modest 2.2 percent in the third quarter of 2009. Unemployment is still at a 26-year high and new hiring remains elusive at this modest growth level. The long, deep recession has dramatically increased the lending risk for all banks as individual and business credit risks have increased with their declining balance sheets and reduced sales in most cases. Today, bank regulators are far more highly sensitive to lending risks and force banks to be much more conservative in underwriting all types of loans.

Oppressive Examination Environment

Indeed, the mixed signals that appear to be coming out of Washington 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 borrower."

However, that message seems to be lost on examiners, particularly in parts of the nation most severely affected by the recession. We are hearing from community bankers all across the nation that the way they have conducted business in the past is no longer acceptable. In a recent (if unscientific) survey conducted by ICBA, 61 percent of respondents said that their most recent safety and soundness exam was "significantly tougher" than their last exam. Several bankers commented that they were being treated like they had a portfolio full of sub-prime mortgages, even though they had no sub-prime loans on their books.

Field Examiners Criticize Good Loans

Community bankers are saying that the field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional independent appraisers and demanding overly aggressive write-downs and reclassifications of viable commercial real estate loans and other assets.

While the banking regulators in Washington have been very willing to discuss their safety and soundness examination policies with us and have reassured us that they are taking measures to ensure their examiners are being reasonable, we continue to hear from our members that their examinations are unreasonably tough.

For example, one banker told us he was forced to write down a real estate loan based solely on absorption rates (lots sold) and not on the current market condition or the ability of the borrower to repay the loan. This had an impact of $100,000 on that bank's earnings. Other bankers are complaining 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 is unjustified in today's world and could ultimately lead to capital problems at otherwise healthy banks.

In some cases, banks are suddenly finding themselves classified as "adequately capitalized" rather than "well-capitalized" because of these tough examinations. When a bank becomes "adequately capitalized," it must seek a waiver from the FDIC before it can continue to accept brokered deposits. Yet, the FDIC is being very tough on granting brokered deposit waivers causing further liquidity problems for banks.

These practices not only undermine the fundamental goal of the Interagency Statement, 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.

Community Banks Ready to Lend

Let me assure this commission that our nation's community banks are ready, willing and able to meet the credit needs of our communities and to help in the nation's economic recovery. Even in today's economic climate, the vast majority of community banks remain well-capitalized, because they are common sense lenders that did not engage in the risky practices that led to the current economic crisis. Most community banks stuck to the longstanding fundamentals of responsible banking, and are more risk-averse than big Wall Street or regional banks. In spite of the trouble on Wall Street, community banks remain committed to taking deposits and making loans on Main Street, and are anxious to do our part to aid the economic recovery.

I am submitting for the hearing record testimony delivered before the House Financial Services Committee last year by ICBA Chairman Michael R. Menzies listing recommendations for change in the current regulatory environment in order to meet the objectives of the Interagency Statement.

Demand for Credit, Loan Quality Down

Community banks are willing to lend, that's how banks generate a return and survive. However, quality loan demand is down. 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. In the recent National Federation of Independent Business (NFIB) November survey, respondents identified weak sales as the biggest problem they face; with only 5 percent of

respondents saying access to credit was a hurdle. I can tell you from my own bank's experience customers are scared about the economy climate and are not borrowing. Credit is available but businesses are not demanding it.

For example my bank's line of credit usage is down to the lowest utilization in 25 years. I am pressing my loan officers daily to find loans but the demand is not there. Of course this hurts profits and income. For the first time in my 44 years of in banking I have witnessed a decline in assets due to lower loan demand. My loans were down from $600 million to $585 million this past year. Most businesses I work with are working off of cash-flow only and are not interested in taking on new debt. The key reason they cite for not seeking credit is their uncertainty in 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.

The good news is that my state of Louisiana is fairing better than many other states. While the national unemployment is 10 percent, Louisiana's seasonally adjusted unemployment rate for November was 6.7 percent, the second lowest in the Southern region behind Virginia, which had a rate of 6.6 percent. Louisiana's November unemployment rate tied with Iowa and New Hampshire for the ninth lowest in the United States. A more robust economic growth rate and higher employment levels can only lead to increased lending opportunities in the months ahead. Yes many community banks and small businesses -- the cornerstone of our local economies -- have suffered as a result of the financial crisis and the severe recession caused by mega-banks and unregulated financial players. Yet community banks like mine stick to common-sense lending and serve our customers and communities in good times and in bad. Many of ICBA's community bank members have been around over 100 years and have survived the depression and many recessions. Today they continue to proudly serve their communities through this financial crisis.

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 exceeding 10 percent, the viability of the small business sector is more important than ever.

Community banks like mine specialize in small business relationship lending. Community banks stick with their local communities and small business customers in good times and in bad. We serve a vital role in small business lending and local economic activity not supported by Wall Street. For their size, community banks are enormous small business lenders. While community banks represent about 12% of all bank assets, they make 31% of the dollar amount of all small business loans less than $1 million. Notably, more than 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 form the building blocks of our nation's communities by providing small business capital and credit to all geographic regions of the country. They 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.

A Tale of Two Lenders

Mega-firms have stumbled and have dramatically cut small business lending. The headlines have been full of reports on the giant lenders like Countrywide, Bank of America, GMAC, GE Finance, and CIT that took on huge risks and faltered. Community banks represent the other side of the financial story and credit market. Despite the dominance in the media about a "credit crunch" community banks are very much alive, well and willing to lend. Simply stated, community banks balance sheets are transparent and strong. That said there are genuine credit market difficulties that continue to have real consequences across the entire financial and economic spectrum from Wall Street to Main Street. Extraordinary fiscal and monetary policies have been undertaken to help boost our economy. Credit is the mother's milk of economic activity; unless credit flows more freely, the economic recovery will not be robust or sustained. The nation's 8,000 community banks are positioned to keep credit flowing to small businesses across America but more robust economic growth is needed to spur loan demand.

Real Estate Recovery Critical

The collapse of the real estate market fueled by the subprime meltdown had widespread impact on all banks. In order to address a slowing economy, ICBA recommended a first-time homebuyer tax credit back in early 2008. However, the housing sector remains a troubled spot for the broad economy. ICBA strongly supports additional targeted housing tax incentives to arrest the downward spiral in the housing market. One of the largest underlying problems preventing a more robust economic recovery remains declining home prices. Housing and household related spending typically accounts for 20 percent of the nation's Gross Domestic Product (GDP). Plunging home values are putting record numbers of borrowers' underwater and fueling record foreclosures. Millions of small businesses are suffering the fallout from the dramatic decline in the housing market.

The broad credit markets have been severely damaged by the sharp decline in housing prices and real estate collateral. Some 40% of small business loans outstanding are collateralized by real estate. Small business owners in particular often rely on their homes for collateral and widely use home equity loans and lines of credit. Without a sustained recovery in the housing sector, credit availability for small businesses will jeopardize their ongoing viability.

Financial institutions in general have already experienced more than $600 billion in real estate related asset write downs and credit losses in this recession. Community banks serving their local communities often focused lending in the commercial real estate sector. Bank regulators continue to aggressively demand further write-downs on real estate, forcing banks to raise even more capital or curtail lending. Bankers often are forced to write down real estate loans even if

the borrower is still making payments on the loan. This is making small business lending and the economic recovery more difficult. When lenders are forced to write down assets and raise more capital, they are unable to lend to small business and consumers, exacerbating the economic downturn. Additionally, declining home values and rising foreclosures increase stress in the credit markets by jeopardizing the value of a range of mortgage-backed securities and crimping liquidity.

The regulatory overkill and vicious downward cycle in the housing sector must be stopped if we are to regain our economic and financial footing. The home is still the most important asset on most household balance sheets, and it will remain difficult for lenders to extend loans to consumers and small-business owners as long as they do not know what their homes are worth. Stable real estate prices will better allow small businesses to use their real estate values as collateral for credit. Reducing the overzealous CRE regulatory environment and extending and expanding the homebuyer-tax credit will help.

Community Banks Key to Lending Recovery

The truth is, community banks are open for business. Community banks, in general, rely more on local deposits to fund local lending so they don't rely heavily on Wall Street capital markets for funding. In fact, small banks of $1 billion in asset size or less were the only segment to show any increase in their net loans and leases year-over-year using the latest (third quarter 2009) quarterly FDIC data. Unlike the Wall Street mega-firms, community banks do not have to dramatically readjust our business model or lending practices.

However, small business loan demand is down in general because businesses and individuals are de-leveraging and reducing their reliance on debt. The FDIC Quarterly Banking Profile for third quarter 2009 showed a record $210.4 billion quarterly decline in outstanding loan balances. Net loans and leases declined across all asset size groups on a quarterly basis in the third quarter 2009. Despite a quarterly decline of net loans and leases at a 2.6% annual rate, community banks with less than $1B in assets were the only group to show a year-over-year increase in net loans and leases of 0.5%. While modest, these gains were the best in the financial sector.

Our nation's biggest banks cut back on lending the most. Institutions with more than $100 billion in assets showed a quarterly decline at a 10.9% annual rate and a 10.5% decrease year-over-year. $10-100 billion asset banks had net loans and leases decline at an astounding 17.8% annual rate over the previous quarter.

Economic Recovery Package Important

The severe economic recession justified a sizable economic stimulus, including tax relief measures for individuals and small businesses. The ICBA was pleased the American Recovery and Reinvestment Act (ARRA) enacted in February contained several ICBA-backed 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 and we support the extension of the key incentives for SBA 7(a) and 504 lending programs.

At my bank we have made use of both the first-time homebuyer tax credit and the SBA programs. These incentives have allowed me to best help my individual and small business customers and they are having a positive impact on the community.

ICBA supports the extension of SBA incentives in ARRA. ICBA applauds the Small Business Committee's legislation to extend the beneficial SBA enhancements included in ARRA. Specifically ICBA supports:

- Extending the SBA fee reductions through fiscal year 2011;
- Extending the higher guarantee levels through fiscal year 2011;
- Expanding the "ARC" loans programs to apply to existing SBA loans, increasing the maximum loan amount to $50,000, and streamlining loan paperwork; and,
- Making permanent the SBA secondary market facility authority.

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

ICBA-Backed SBA Reforms

ICBA supports additional measures to enhance SBA lending. ICBA believes the key to best 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 ICBA's main 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 expertise 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 SBA. In other words, we don't 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 banks nationwide so all lenders can easily participate.

Of course community banks and small businesses rely on raising capital in this difficult capital market. Therefore, ICBA recommendations several reforms that can help 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 last September. Some $36 billion in Fannie Mae and Freddie Mac capital held in banks, including many community banks, was largely destroyed by this Treasury 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 based on their par value prior to the Treasury conservatorship action. Importantly, this will help restore capital needed for additional small business lending. For each dollar of value restored some seven to ten dollars in new lending can occur.

Extend the 5-Year NOL Carryback Through 2010

ICBA applauds the recent expansion of the net operation loss (NOL) five-year carryback for 2008 or 2009 that President Obama signed into law on November 6th. 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 ICBA-backed 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.

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 stock 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. ICBA believes 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. ICBA believes 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. ICBA believes 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.

ICBA believes these recommendations would go a long way in helping more small businesses and community banks stay strong and competitive. They would allow small businesses to more fairly and efficiently choose the corporate structure that would best suit the need of their

business. Therefore, ICBA is adamant that any financial regulatory reform not harm community banks' ability to continue supporting small businesses. Small businesses are the engines of our economy and rely on a steady flow of credit. The excesses of giant financial firms were the key cause that destabilized the markets and small business access to credit. Any reforms must target the too-big-to-fail and systemically risky firms, as well as the unregulated non-bank financial firms operating in the shadows, if another financial crisis and economic meltdown is to be averted.

Conclusion

The highly-regulated community banking sector did not trigger the financial crisis.
We must end too-big-to-fail, reduce systemic risk and focus regulation on the unregulated financial entities that caused the economic meltdown. The best financial reforms will protect small businesses from being crushed by the destabilizing effects when a giant financial institution stumbles. Community banks are there to help increase lending and our economic recovery. A diverse and competitive financial system with regulatory checks and balances will best serve the needs of small business. Thank you.

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