Section Two: Additional Views

A. J. Mark McWatters and Paul S. Atkins

We concur with the issuance of the May report and offer the additional observations noted below. We appreciate the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions offered during the drafting process.

In order to suggest a solution to the challenges currently facing the commercial credit and small business lending markets, it is critical that we thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis, it is likely that we may craft an inappropriately targeted remedy with adverse, unintended consequences.

The problems presented by today's commercial credit and small business lending markets would be easier to address if they were solely based upon the undersupply of commercial and small business credit in certain well-defined regions of the country. Unfortunately, the commercial credit and small business lending markets must also assimilate a drop in demand from borrowers who have suffered a reversal in their business operations and prospects over the past two years. In our view, there has been a decrease in demand for commercial and small business credit and many potential borrowers have withdrawn from the credit markets due to, among other reasons:

- their desire to de-leverage;
- the introduction of enhanced underwriting standards by lenders and their regulators;
- the diminishing opportunity for prudent business expansion;
- the crippling effects of the recession; and
- the increasing tax and regulatory burdens facing small and large businesses.[325]

[325] Taxes decrease cash flow that is available for debt service.

Compliance with new regulatory requirements increases the fees and expenses a business must pay to its attorneys, CPAs, consultants, and, quite often, new employees hired to manage the process. Funding these fees and expenses is particularly burdensome for small businesses that do not operate with the economies of scale necessary to spread compliance costs over a significant revenue base.

All other inputs being equal, taxes and compliance costs decrease cash flow available for debt service and thus decrease the level of debt a firm may undertake. In addition, less leverage may decrease a firm's return on equity and market capitalization.

In a recent hearing on commercial credit and small business lending held by the Panel in Phoenix, one of the witnesses, Candace Wiest, the president and CEO of West Valley National Bank (WVNB), remarked in her written testimony:

> The question of demand is difficult. WVNB certainly has room to expand lending, given that we have 39% Tier 1 capital and almost 50% leverage capital. Explained another way, we have originated $25,000,000 in loans and still have $16,000,000 in capital. We could grow the Bank by $100,000,000 in new assets and not need any new capital. … Our lack of loan growth is a reflection of the impact of the recession on the small businesses in this state. While the rest of the country has experienced varying degrees of recession, I believe Arizona has been functioning in a depression … As a result, we have not met our lending projections. Last year we funded approximately $10,000,000 in new credits. We would do more, but it is difficult to find anyone who has not been impacted and remains creditworthy.

While WVNB is apparently ready, willing and able to extend credit, Ms. Wiest is struggling to identify qualified borrowers that are in need of additional debt capital. In other words, WVNB is not suffering from an *undersupply* of capital to lend but from the diminished *demand* for commercial and small business credit.[326]

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[326] Another witness at the hearing, James H. Lundy, President and CEO of Alliance Bank of Arizona, stated in his written testimony:

> While Alliance Bank of Arizona is running against industry norms and adding net loan growth when many banks are not, I don't want to leave the impression that this is not an extremely difficult lending environment. The recession has sharply decreased loan demand from many Arizona businesses. Every bank portfolio experiences normal runoff, and, in this environment, a higher level of charge-offs than normal. Thus, increasing loan outstandings in the current environment is quite challenging. Considered in combination with requests from regulators for more capital and the heavy emphasis on rapidly reducing real estate concentrations it is no surprise that loan totals are shrinking at many banks.

Congressional Oversight Panel, Written Testimony of James H. Lundy, president and chief executive officer, Alliance Bank of Arizona, *Phoenix Field Hearing on Small Business Lending*, at 3 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-lundy.pdf).

The third bank officer to testify at the hearing, Lynne B. Herndon, Phoenix City President of BBVA Compass, stated in her written testimony:

> In the 4th Quarter of 2008, business owners experienced a dramatic halt in revenues. During this quarter and in 2009, business owners struggled to reset the expense structures of their companies in response to the 50-75% reduction in top line revenues. Liquidity and capital were drained as businesses needed excess reserves to fund losses. Companies put expansion plans on hold and tried to curb borrowing where possible. Loan demand dropped dramatically during this period.
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> BBVA Compass continued to make business loans during 2008 and 2009 and is doing so currently. While the bank's structure and terms were similar to previous years, it was and is challenging to underwrite borrowers in the current economic environment. Most companies

Evidence from the borrower side of the lender-borrower equation supports this anecdotal evidence. The Panel's report discusses a survey by the National Federation of Independent Businesses, which concludes that "access to credit is not the primary concern of small businesses at this time. Only eight percent of those surveyed identified access to credit as their most pressing concern, although, of course, these respondents may nonetheless have sought credit during this period."[327]

Conversely, the Administration has focused on the undersupply of commercial and small business credit[328] and, not surprisingly, has proposed a government-sponsored program to remedy the putative problem. If instituted as proposed, the Small Business Lending Fund (SBLF) will permit a subset of commercial and small business lenders to obtain capital from the federal government at very favorable rates, provided the lenders agree to use the proceeds to extend credit to small business borrowers.[329] We are troubled that providing financial institutions with capital at below-market rates may lead to imprudent lending activity[330] and,

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> recorded a loss in 2009 and some in 2008. 2010 looks to be breakeven at best for many companies. These profitability trends are challenging for banks given that we have to maintain higher levels of capital in order to carry watchlist loans. In other words, banks must have higher levels of capital in order to continue to bank existing credits that have had poor performance or in order to entertain new loans to companies coming off of poor performance.
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> In order to compensate for poor performance in previous years, BBVA Compass is placing more emphasis on strong sponsorship, higher levels of equity in real estate or excess availability in borrowing bases. Underwriting the economic risk is more difficult and access to liquidity is important. Companies still in business in 2010 have probably weathered the worst and should be survivors. These borrowers are most likely creditworthy. Banks are now able to obtain appropriate pricing for market risk in deals.

Congressional Oversight Panel, Written Testimony of Lynne B. Herndon, city president - Phoenix, BBVA Compass Bank, *Phoenix Field Hearing on Small Business Lending*, at 2 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-herndon.pdf).

[327] *See* Section E.1(a)(i).

[328] *See* Donna Borak, *Fed Survey: Some Big Banks Loosen Underwriting Criteria*, American Banker (May 4, 2010) (online at www.americanbanker.com/issues/175_84/underwriting-criteria-1018530-1.html); *see* Joshua Zumbrun and Scott Lanman, *Fed Says Most Surveyed Banks Didn't Tighten Lending Standards,* Bloomberg.com, (May 4, 2010) (online at www.bloomberg.com/apps/news?pid=20601068&sid=aVfYj2OMrV7U#).

[329] We note that the Administration has yet to announce the source of any offsets for this program. At first, in announcing the program, the Administration stated that the funds for the program were to be repaid TARP funds transferred from the TARP, but the current draft of the proposed legislation provides instead that the source of the offsets for the program will be negotiated with Congress.

[330] Recipients of SBLF investments may operate with a cost of capital that is lower than non-subsidized financial institutions and, as such, may develop a distinct competitive advantage over their peers. Since borrowers will prefer to obtain credit from the lowest cost provider of financial services, it's quite possible that non-subsidized lenders will be priced out of the market. As the market for subsidized loans increases the government may be tempted to invest additional taxpayer resources in a "successful" program which may drive additional non-subsidized lenders from the market. After a few cycles, private sector lenders may serve as mere originators and servicers of loans with substantially all of the risk of default shifted to the taxpayers. In addition, the guarantee

perhaps, the inflation of a series of government sanctioned and subsidized asset bubbles. If the government convinces – or pressures – financial institutions to accept cheap credit based on financial incentives for the recipients to off-lend the proceeds, then we fully anticipate the government will accomplish just that. Yet, is this not what we recently experienced in the sub-prime and securitized debt lending crisis – too much money chasing transactions of diminishing credit quality?

The Administration's proposal appears to share much of its design and business model with those adopted by Fannie Mae and Freddie Mac. Treasury should have learned from Fannie and Freddie that the combination of easily accessible below-market credit matched with pressure to lend – regardless of credible demand or the employment of prudent underwriting standards – serves as the perfect recipe for the extension of problematic loans and the creation and implosion of asset bubbles. The Administration's program also seems at cross-purposes with the recent actions of federal and state banking regulators who have become increasingly cautious – perhaps overly cautious – regarding extensions and renewals of credit by regulated financial institutions. It is indeed ironic for the Administration to propose a program of cheap credit-driven lending, while at the same time federal and state banking regulators in thousands of individual examinations have become excessively onerous in their second-guessing of banks' lending decisions and determinations of status of loans. It is also counterproductive for any government to subsidize loan originations so as merely to increase the "loan count" that may be reported to the taxpayers.

We also very much doubt that the SBLF program will otherwise attenuate the taint and stigma associated with a dusted-off and repackaged "TARP II" or "Son-of-TARP" program. The taxpayers are far too sophisticated to fall for this trick and financial institutions are far too wary from their experience with TARP not to expect that the government will change the terms of the program mid-stream. The stigma associated with the TARP principally centers on the risk that the government may change the rules mid-stream and subject the recipients to adverse rules and regulations. Candace Wiest noted in her written testimony before the Panel that WVNB withdrew its application for TARP funds because "we saw new conditions being added daily and witnessed the growing stigma being directed at TARP banks. Because we did not want to enter into an agreement with a government who could alter the terms at any time, we chose to withdraw our application."

This photograph taken in Northern Virginia near the Washington, DC area succinctly tells the story.

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programs offered by the Small Business Administration serve as another example of small business lending that is subsidized by the government.

From our perspective, the SBLF is just another government sanctioned subsidy to – and bailout of – the financial community that will create a host of adverse, unintended consequences. In addition to the adverse unintended consequences that may arise from a newly instituted SBLF, similar questions are presented by those programs pursuant to which the Small Business Administration (SBA) is authorized to guarantee a significant percentage of any losses generated from certain eligible loans. In the Panel's recent hearing, an SBA official stated in his written testimony that an SBA guarantee provides "an extra incentive for risk adverse lenders to lend to small businesses."[331] While this is no doubt true, it is critical to recognize that lenders often become risk-averse only after conducting a thorough due diligence and underwriting analysis of their potential borrowers. As a matter of sound public policy, lenders should not commit to extend credit to problematic borrowers solely because the SBA has agreed to absorb a significant percentage of any losses arising from such loans. The subprime lending crisis arose in part because originating lenders neglected to perform a thorough due diligence analysis of their prospective borrowers, confident in the belief that, with Fannie Mae or Freddie Mac credit support, they would be able to off-load their sketchy loans to investment banks for inclusion in residential mortgage-backed securities prior to their default. The SBA should continue to

[331] Congressional Oversight Panel, Written Testimony of Robert J. Blaney, district director for Arizona, Small Business Administration, *Phoenix Field Hearing on Small Business Lending* (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-blaney.pdf).

develop and implement transparent and fully accountable internal control and underwriting procedures to ascertain that it does not accept risky loans into its guarantee programs.

Further, if it develops that there are no restrictions on combining SBLF and SBA programs, that combination may create a particularly toxic mix for the taxpayers. If a financial institution extends credit sourced from SBLF capital and the SBA assumes 90 percent of the risk of loss from such loan, then the taxpayers will suffer the burden of subsidizing a below market capital contribution to the financial institution and also bear the overwhelming bulk of the loss if the borrower defaults under the loan, while the financial institution pockets any profits from the transaction. This result is particularly perverse if the financial institution was well-capitalized and prepared to extend credit without assistance from the SBLF and SBA programs.

In our view, instead of requiring the taxpayers to subsidize another round of imprudent short-term credit expansion, commercial and small business lenders – in consultation with their regulators where appropriate – should adopt long-term business models and strategies that incorporate objective and transparent due diligence standards that permit well-run borrowers to receive credit on reasonable terms and the lenders to earn an appropriate risk-adjusted rate of return. Regrettably, some potential borrowers will fail the heightened underwriting standards and will not receive their requested extensions of credit. This should not necessarily cause angst, but should indicate that the credit markets have moved away from an "anything-goes" mentality where borrowers often over-extended their leverage and some financial institutions survived through the clever interpretation of accounting rules and the implicit guarantee of their obligations by the American taxpayers.

Any suggested solution to the challenges facing commercial credit and small business lenders and borrowers that focuses only on the undersupply of credit to the exclusion of the economic difficulties facing prospective borrowers appears unlikely to succeed. The challenges confronting the commercial credit and small business lending markets are not unique to that industry, but instead are indicative of the systemic uncertainties manifest throughout the larger economy. Until small and large businesses regain the confidence to hire new employees and expand their business operations, it is doubtful that the demand for properly underwritten commercial and small business credit will sustain a meaningful recovery. As long as businesses are faced with the multiple challenges of rising taxes, increasing regulatory burdens, the threat of frivolous lawsuits arising from an erratic litigation system, enhanced political risk associated with unpredictable governmental interventions in the private sector, and uncertain health care and energy costs, it is unlikely that they will enthusiastically assume the entrepreneurial risk necessary for protracted economic expansion and a recovery of the commercial credit and small business lending markets. With the ever-expanding array of less-than-friendly rules, regulations and taxes facing businesses and consumers, we should not be surprised if businesses remain

reluctant to hire new employees, consumers remain cautious about spending, and the commercial credit and small business lending markets continue to struggle.

In our view, the Administration could encourage the robust recovery of the commercial credit and small business lending markets – as well as the overall U.S. economy – by sending an unambiguous message to the private sector that it will not directly or indirectly raise the taxes or increase the regulatory burden of commercial credit and small business market participants and other business enterprises. Without such express action, the recovery of the commercial credit and small business lending markets will most likely proceed at a sluggish and costly pace.

Once the demand for credit from qualified borrowers has rebounded, we think private sector financial institutions will return to the credit markets without hesitation. After all, the principal business of these financial institutions is the extension of thoughtfully underwritten credit to financially-stable and prudently-managed borrowers. Locating these borrowers in the current economic environment with the daunting overhang of tax and regulatory uncertainty will remain a challenge for Candace Wiest of WVNB and her peers.