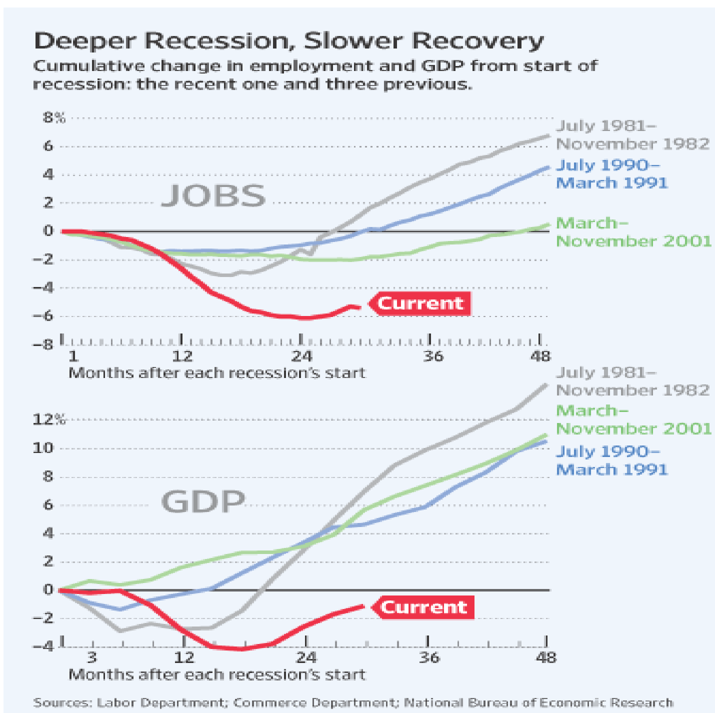
June 29, 2011

Synopsis for US House of Representatives
Small Business subCommittee

Re Testimony: Banking Crisis in Small Business Lending

The Great Recession of 2008 ended two years ago! The national economy should be in recovery mode for two years now. That is obviously not the case: Unemployment remains painfully high, economic activity is declining, uncertainty abounds. By this time in most recessions we would have a fully recovered economy with jobs aplenty. Something is very wrong. I hope to demonstrate that the nation is in a *second Liquidity Crisis* today whose cause is excessive regulation on banks, especially those banks serving Small Businesses.

Comparison of Economic Recoveries: Anemia, Defined
The following chart is one quarter out of date, but shows the difference between three prior recessions and the current one; it compares job creation and GDP growth. The horizontal axis is "number of months after the recession started." The technical definition for a recovery is two quarters of positive GDP growth (bottom half of chart.) The nation has been in recovery mode for two years but failed to reach pre-recession growth rates.



Following is a slightly different view of the same recession(s); this time we focus on the current and the 1982 – 1984 recovery to identify the state of the economy after two years of recovery in both timeframes.

After Deep Recessions

Quarterly GDP growth, seasonally adjusted on an annual basis

1982		2009	
IV	0.3%	III	1.7%
1983		IV	3.8
I	5.1	**2010**	
II	9.3	I	3.9
III	8.1	II	3.8
IV	8.5	III	2.5
1984		IV	2.3
I	8.0	**2011**	
II	7.1	I	0.4
III	3.9	II	1.3

Sources: Commerce Dept., Bureau of Economic Analysis

The chart at left compares the 1982 recession (left column) to the current one by growth rate in Gross Domestic Product (GDP). The chart is normalized to eight quarters <u>after</u> the end of each recession.

Note that after eight quarters of the current 2009 – 2011 recovery (right column) GDP is an anemic 1.3% growth rate; unemployment is still over 9.1%.

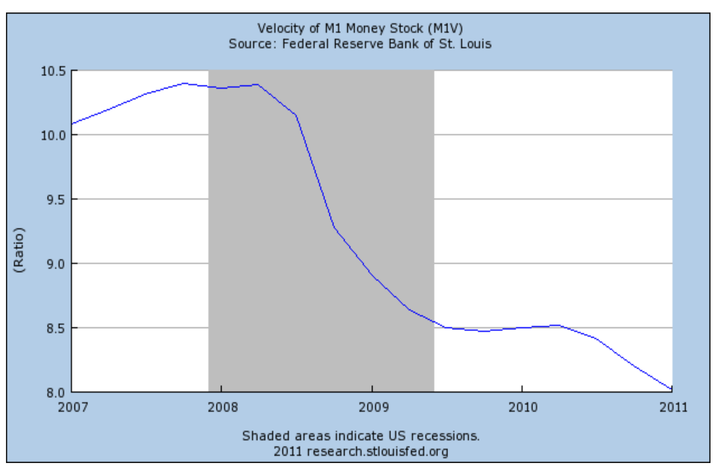
By contrast, the 1982 – 1984 recovery was consistently more robust, reaching GDP growth rate as high as 9.3% and an unemployment rate well below 5%.

By any standard, the current "recovery" is anemic

Federal Reserve Monetary Policy: Velocity Vs Liquidity

How can this be? The Federal Reserve pegged short-term interest rates at effectively zero which is extremely stimulative - one can borrow for almost nothing. The Fed and Treasury completed Quantitative Easing II to provide massive amounts of liquidity to stimulate the economy. This is Keynesian economics on steroids. Classically, vast amounts of cheap money bring strong economic growth and with it, job growth. Yet neither of these truly powerful Monetary Policy tools has worked. Why have these historic, almost infallible tools failed us?

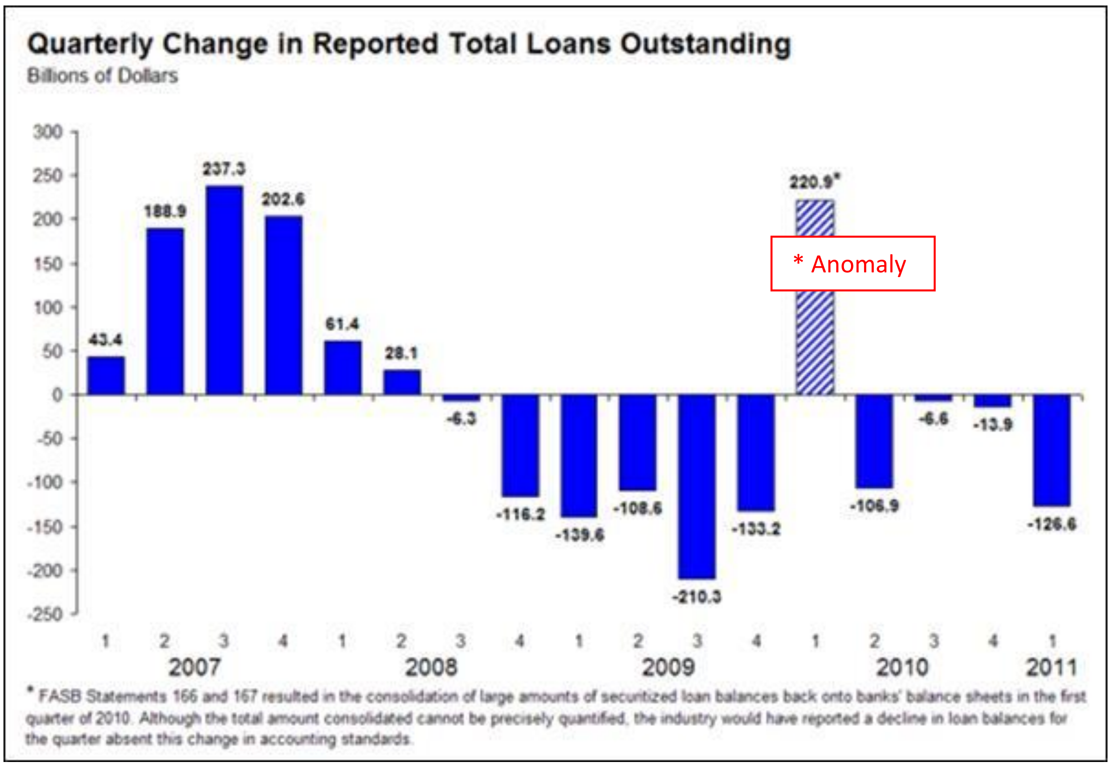
The answer may be in a technical term called Velocity of Money; this term indicates the number of times that money "turns" or is transacted. For instance, money sitting in a bank deposit account, unless the bank lends that money back out, does <u>not</u> improve the economy. Liquidity, as provided by QE II is useless unless that money moves, unless it is transacted. An analogy is that a river can generate electricity because it is moving, a lake cannot.



The chart at right shows Velocity of Money since 2007. The gray area is the 2008-2009 recession. Note the steep decline in Velocity - transactions came to an abrupt halt in early 2008. Note that Velocity has not recovered but is still trending down - two years after the recovery. The number of business transactions continues to decline. In a typical recovery, the chart would demonstrate an increase in Velocity; that is clearly not the case today. The obvious question is why?

Cessation of Bank Lending leads to Economic Malaise

The following graph, assembled by the FDIC (*Quarterly Banking Profile: "Loan Balances Fall by $126.6 Billion")*, proposes the first clue to our nation's economic malaise. Commercial Banking lending is not only declining, loans outstanding are shrinking. This is the underlying reason the Velocity of Money declined so dramatically: Banks are not fulfilling their obligations to assist the economic recovery and therefore small business transactions, expansions and investment are not occurring. No amount of Quantitative Easing will remedy this basic fact. Tools given the Federal Reserve are rendered impotent by this lack of bank lending as demonstrated by the prior two years non-existent recovery.



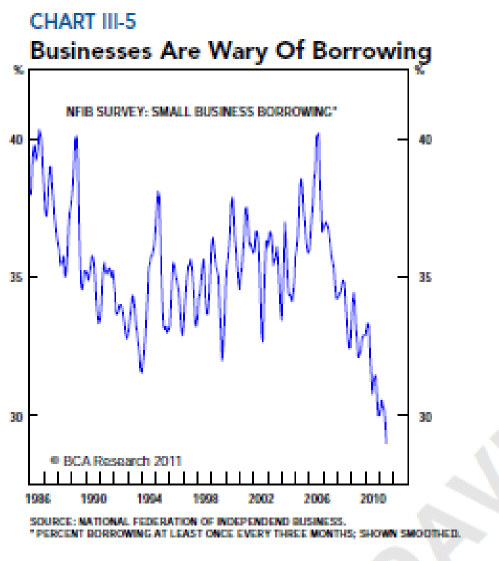
Excerpt: "Total loan and lease balances continued to fall, declining by $126.6 billion. This is the fifth-largest quarterly percentage decline in loan balances in the 28 years for which data are available, and it marks the tenth time in the last eleven quarters that reported loan balances have fallen"

The Second Liquidity Crisis

In spite of massive Federal Reserves Monetary Policy and Liquidity events like TARP, The Stimulus Package, QE I and QE II, the nation fell victim to <u>two</u> *Liquidity Crises* since 2007. The first was caused by Sub-prime home mortgages and the MBS-bonds derived there from.

The second Liquidity Crisis started in mid 2008 when bank regulatory agencies identified those banks that predominantly lend to the Commercial Real Estate (CRE) markets and demanded we <u>immediately</u> increase our "capital ratios." This second liquidity crisis is not recognized by the Federal Reserve, FDIC or OCC; however, as you can see from prior comments and charts, it does exist. Commercial Banks, who serve the Commercial Real Estate market, stopped lending. Our customer and end user is the Small Business person.

The chart at right is a survey of borrowing activity by small businesses prepared by the National Federation of Independent Business (NFIB). Note the peak in 2006 and steady decline in small business loans outstanding.



Further, as evidence of the contagion effect of regulation, even well-performing banks reduced their CRE loans: In Colorado, Commercial Real Estate (CRE) lending declined over $2.7 billion or 27% from March 2008 to March 2011. Of that total reduction in CRE lending, over $1.4 billion or half came from healthy Colorado banks (significantly above 13% Total Risk-Based Capital and within the guidelines for CRE 1 and CRE 2.)

The point is that Federal regulatory actions do impact our state's economy and in a most powerful manner. This effect is magnified because small businesses create over 65% of all new jobs and hold almost half of existing jobs.

The Solution, from a bank at Ground Zero

Bankers and bank regulators all agree that higher levels of capital are safer for the banking system during hard economic times. But there is always a trade-off when regulators enforce new capital rules: Compete cessation of lending to small businesses and the resultant demise of job creation. Instead of creating and sustaining this second Liquidity Crisis, which strikes at the heart of new job creation, regulatory agencies should adhere to Basel rules on bank capital, at least until the current recession is over. **If banks must operate under higher capital levels, then give the banks time to earn our way to higher levels.**

Capital Ratio = Capital **/** Assets

Banks can increase Capital Ratios in two ways: First, raise new capital (numerator) by diluting existing Shareholders through a new stock offering. Second, reduce the denominator, namely Assets and Loans, by selling loans. Commercial Banks cannot raise new capital because the market for bank capital has been non-existent since 2005. So under duress Commercial Banks did the only other thing we could to comply with regulatory demands for immediate and higher capital ratios: Reduced loans outstanding and make no new loans. We caused the second Liquidity Crisis in which the nation still suffers! If you will remember that Commercial Banks in the Colorado lend predominantly on Commercial Real Estate (CRE) and these borrowers are typically "Mom and Pop shops" or Main Street America, the small business person. Consider that in three short years over $2.7 billion in CRE loans evaporated from the state.

Following are three key issues that prevent Commercial Banks from lending into the Small Business and CRE markets:

1. Capital ratios as defined under Basel are NOT being adhered to by the regulators. The calculation of which provides for the possibility that some banks will have higher concentrations in riskier assets, but nonetheless, regulators have arbitrarily decided that a premium to the Basel capital ratios is at their discretion.
    - Capital Levels are the root cause of the problem and the bat with which regulators bludgeon banks. This is a crude, but effective weapon.

2. Enforcing arbitrary CRE limits, with no adjustments for geographic region, or expertise of the lending staff, dissuaded even healthy lenders from making loans on real estate that supports small businesses.
    - See our study of healthy Colorado banks curtailing lending, attached.
    - CRE 2 ratios are uniform across the nation, with no adjustment for region, business climate or demographics. Denver has the same ratio as Detroit, yet these two economies could not be more different.

3. Regulators unilaterally decided to stop all payments of dividends for the purpose of paying down the banks capital loan. These aggressive actions to stop the reduction in bank capital through dividends has cut off the blood supply to the bank holding company, and dramatically decreased its ability to raise new capital.

I suggest the problem has a solution and would deeply appreciate the opportunity, and the honor, to speak before the House Subcommittee on Small Business.

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