

Lenders and Borrowers are Exercising a Careful Approach to Credit

In every community, banks are actively looking for lending opportunities. Against the backdrop of a still weak economy, it is only reasonable and prudent that all businesses – including banks – exercise caution in taking on new financial obligations. Borrowers are being more cautious in taking on new debt in today's fragile economy. Both banks and their regulators are understandably more cautious in today's environment as the risk of lending is much greater today than before the recession.

Confidence, from both businesses and consumers, has declined recently given uncertainty about the country's fiscal plans and the fragile economic recovery. Many areas of the United States continue to struggle under the weight of poor growth and weak labor market conditions.

Since banks are a reflection of their communities, they are suffering right along with the communities they serve. Business failures and unemployment have impaired credit quality and increased loan losses. As a result, capital – which underpins every loan made by banks – has been stressed.

Yet even in areas beset by poor economic conditions, there are very strong borrowers. Meeting their needs has been made more difficult, however, as regulators pressure banks to maintain (and even increase) their capital-to-asset ratio. Given the severity of the downturn, it is very difficult if not impossible for community banks to find new sources of capital. Thus, for some banks, reducing the size of the bank often becomes the only viable alternative.

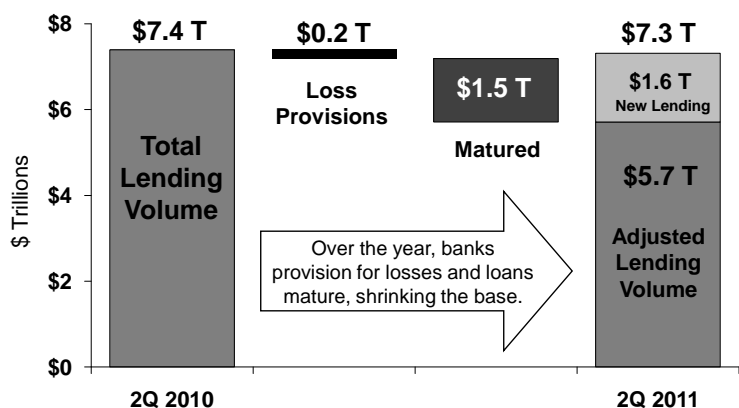
The success of many local economies – and, by extension, the success of the broader national economy – depends in large part on the success of community banks. It is important to keep in mind that most banks are small businesses in their own right. In fact, over 3,100 banks (41 percent) have fewer than 30 employees.

Banks Are Actively Seeking Borrowers

Weak demand from credit-worthy borrowers, regulatory pressure to build capital-to-asset ratios, and loan losses are pressures banks are facing when considering new lending. Importantly, while the overall loan volume has remained mostly level over the past year, it does *not* indicate that banks have stopped lending altogether. In fact, taking into account reserves set aside for losses and the natural repayment of loans each year, *banks initiated roughly \$1.6 trillion in new lending over the past 12 months.*

Despite many headwinds - such as over 100,000 business failures and over eight million jobs losses – banks are prudently seeking borrowers. Given these headwinds, it is remarkable, in this context, that banks were able to originate about \$1.6 trillion in new loans, for a total of \$7.3 trillion at the end of 2Q 2011.

Banks Lent \$1.6 Trillion Over the Past Year



Assumes 20% of the loan base matures each year.

Source: FDIC, ABA analysis

Sales Are Greatest Concern as Loan Demand Shows Early Signs of Recovery

Sales remain the top concern for businesses. Without strong sales prospects, businesses lack the need to hire more workers, grow production, and invest in new products. However, early signs of recovery in business loan demand are present.

According to the NFIB, “[f]or the overwhelming majority, ‘credit supply’ is not a problem.” Ninety-one percent of businesses reported that all of their credit needs were met.

Only three percent of business owners reported obtaining loans as their most important problem, very low compared to over 35 percent that reported this for most of 1982, the year the economy emerged from the last big recession.

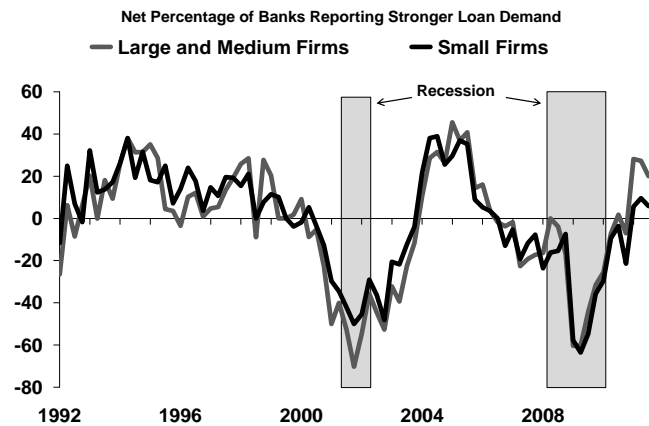
The NFIB’s report stated, “Money is available, but most owners are not interested in a loan to finance the purchase of equipment they don’t need. There was a slight increase in firms planning capital outlays in the next three to six months, although [this indicator remains at] a recession level reading.”

However, the Federal Reserve’s Senior Loan Officer Opinion Survey showed early signs of recovery, particularly from large and medium firms that were seeking funding for mergers and acquisitions. Much of the improvement in demand was the result of a reduction in borrowing from other credit sources.

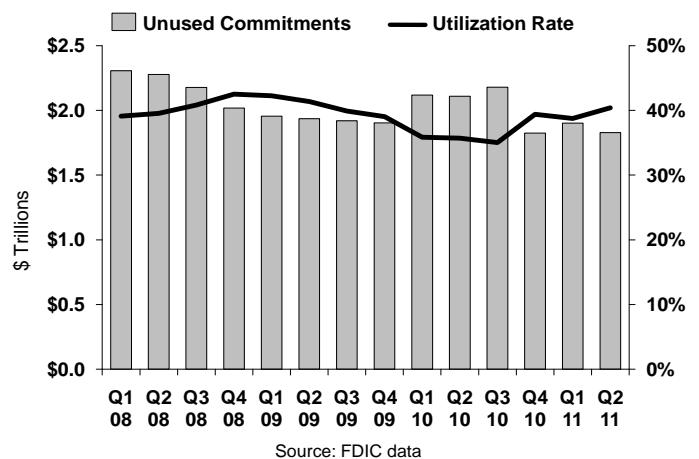
Many small businesses that either did not want to take on additional debt or were not in a position to do so during the recession are showing early signs of an increased appetite for borrowing. During recent quarters, businesses utilized a greater share of their credit lines to fund operations, and according to the Federal Reserve, commercial and industrial loans at banks have risen for nine consecutive months.

Despite signs of improvement, large gains in credit demand and utilization are not expected until businesses see improved sales growth.

Business Loan Demand Rebounds



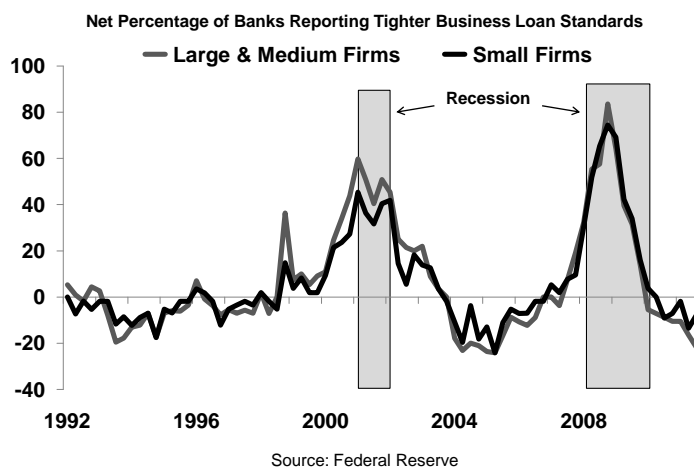
Business Line Utilization



Lending Standards Must Reflect the Risk of Loss in a Weak Economy

Bankers are asking more questions of their borrowers, and regulators are asking more questions of the banks they examine. This means that some projects that might have been funded when the economy was stronger may not find funding today. Banks do not turn down loan applications because they do not want to lend – lending is what banks do. In some cases, however, it makes no sense for the borrower to take on more debt. As the NFIB has reported in previous studies: “[T]he continued poor earnings and sales performance has weakened the credit worthiness of many potential borrowers. This has resulted in tougher terms and higher loan rejection rates (even with no change in lending standards).”

Banks Offering More Favorable Loan Standards



Bank regulators are highly sensitive to emerging risks and have cautioned banks to be conservative in underwriting many types of loans. This was reflected in the tightening of underwriting standards during the recession. With now modest economic growth, the majority of banks are beginning to ease those standards a bit. In fact since 2Q 2010 the majority of banks have reported easing of loan standards. Capital, however, remains the critical concern for lenders, particularly in still weak regions of our country.

Regulatory Overreaction Has Made the Lending Situation Worse

A natural reaction of regulators is to intensify the scrutiny of commercial banks' lending practices. 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. Regulatory over-reaction means that fewer loans will be made, and that only the very best credits will be funded. Worsening conditions in many markets have strained the ability of some borrowers to perform, which often leads examiners to insist that a bank make a capital call on the borrower, impose an onerous amortization schedule, or obtain additional collateral. These steps can set in motion a “death spiral,” where the borrower has to sell assets at fire-sale prices to raise cash, which then drops the comparable sales figures the appraisers pick up, which then lowers the “market values” of other assets, which then increases the write-downs the lenders have to take, and so on. Thus, well-intentioned efforts to address problems can have the unintended consequence of making things worse.

What the regulators want for the industry is what the industry wants for itself: a strong and safe banking system. To achieve that goal, it is important to remember the vital role played by good lending in restoring economic growth and not allow a credit crunch to stifle economic recovery. The Small Business Lending Fund, recently implemented by the Treasury, helps provide a boost to assist viable community banks.