

## Lenders and Borrowers are Exercising a Prudent Approach to Credit

Even with the general economy starting to improve, there are still many areas of the United States that struggle under the weight of the very severe downturn. 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) 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.

Comparatively small investments from Treasury can help reverse this need to downsize and help to stimulate lending to small businesses. The proposed new Small Business Lending Fund can help these areas recover faster. 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 3,400 banks (41 percent) have fewer than 30 employees. Small steps taken by the government now can make a huge difference to small banks, their customers, and their communities – keeping capital and resources focused where they are needed most.

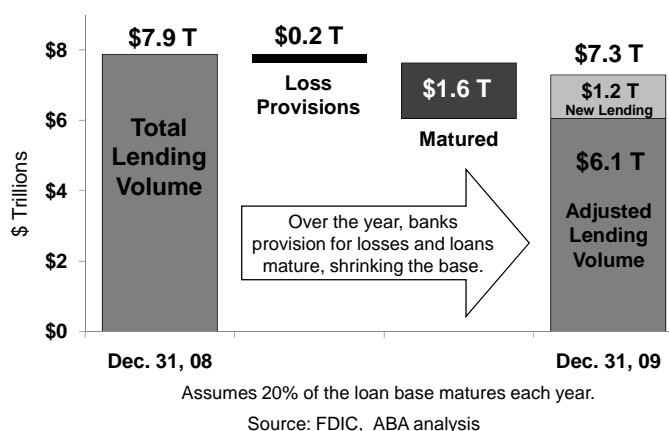
### Banks Are Actively Seeking Borrowers

In every community, banks are actively looking for lending opportunities. Against the backdrop of a very 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 and using less of their credit lines. 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.

Lack of demand by borrowers, regulatory pressure to build capital-to-asset ratios, and loan losses have all combined to lower the total volume of loans outstanding. This is not unusual during recessions. Importantly, while the overall loan volume has declined, 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 \$1.2 trillion in new lending in 2009.***

Just to stay even with last year, banks would have had to originate over \$1.8 trillion of new loans. In normal times of economic growth and low loan losses, this is possible, but it is impossible today with the many economic challenges, such as 61,000 business failures, 4.7 million jobs lost, and 10 percent reduction in business inventories. It is remarkable, in this context, that banks were able to originate about \$1.2 trillion in new loans, for a total of \$7.3 trillion at year-end.

### Banks Lent \$1.2 Trillion in New Loans in 2009



## Business Loan Demand Down, But Positive Signs Are Evident

Business confidence is down. Many businesses either do not want to take on additional debt or are not in a position to do so, given the falloff of their customer base. Thus, loan demand has fallen dramatically since the start of the recession (see the chart at the right). Businesses are actually utilizing less of their credit lines, demonstrating the slowdown in loan demand (see the chart below).

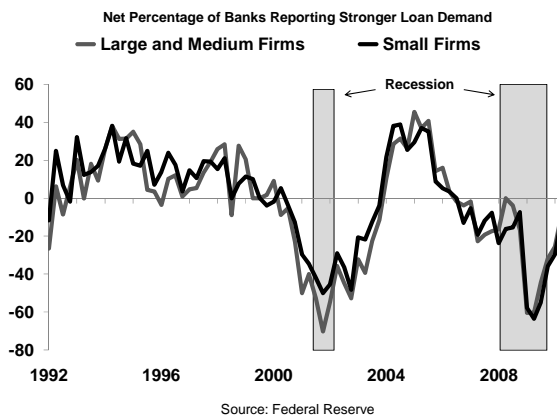
Business groups have also noted this severe falloff in demand for credit. The National Federation of Independent Business (NFIB) explained in its April survey that: “Historically weak plans to make capital expenditures, to add to inventory and expand operations also make it clear that many good borrowers are simply on the sidelines, waiting for a good reason to make capital outlays and order inventory and take out the usual loans used to support these activities.”

Moreover, access to credit is not a driving concern of most businesses. NFIB reports that: “Eighty-nine (89) percent of the owners reported all their credit needs met or they did not want to borrow. Moreover,

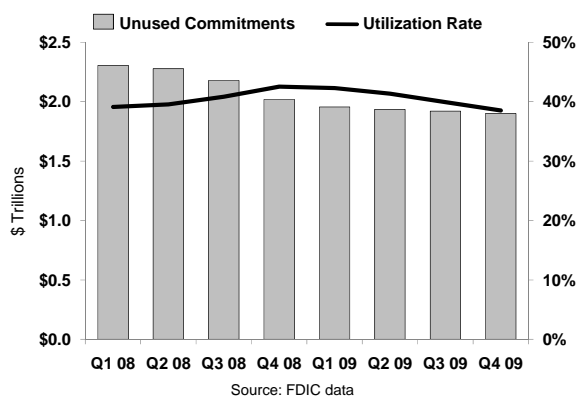
NFIB states that: “Only five percent of the owners reported “finance” as their top business problem (up two points).” This compares to 37 percent during the last big recession of 1981-82.

There are some positive signs beginning to appear as the economy has turned the corner and begun to expand. Bankers report that small businesses are returning to test the market for loans, even though they may not wish to borrow at the moment. It will take time for this renewed interest to be translated into new loans made, however. In previous recessions, it typically took 13 months after the recession for business confidence to return and credit to return to pre-recession levels.

### Business Loan Demand Remains Negative



### 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. The NFIB stated that: “[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).”

Bank regulators are highly sensitive to emerging risks and have cautioned banks to be conservative in underwriting many types of loans. This has been reflected in the tightening of underwriting standards since the onset of the recession. With current economic conditions starting to improve, the majority of banks are beginning to ease those standards a bit. 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 can provide a needed boost to assist viable community banks whether the economic storm and lend to small businesses as the economy gains momentum.

