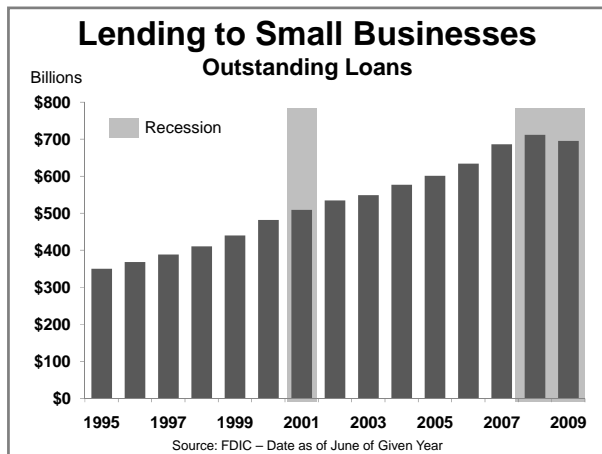
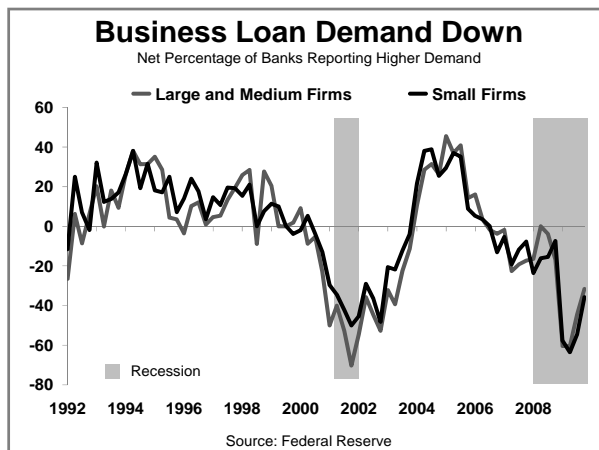


Lenders and Borrowers are Exercising a Prudent Approach to Credit

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. Both banks and their regulators are understandably more cautious in today’s environment. As a consequence, the level of loans outstanding has been falling. This is a result of very weak loan demand, lower utilization of credit lines (due to deleveraging and refinancing from loans into bonds), and higher loan losses.

Loan Demand Down Sharply

According to the Federal Reserve, banks have been experiencing a deep fall off in loan demand. Banks are still reporting declining loan demand, but at a slower rate. Previous recessions have shown that it typically takes 13 months after the recession for business confidence to return and credit to return to pre-recession levels. The National Federation of Independent Business (NFIB) explains in its November survey that: “Overall, loan demand remains weak due to widespread postponement of investment in inventories and record low plans for capital spending.”ⁱⁱ



Moreover, access to credit is not a driving concern of most businesses. In a recent survey of 750 businesses by Discover, only 5 percent said the main issue facing their business was access to capital.ⁱⁱ NFIB survey confirmed this finding: “Although credit is harder to get, ‘financing’ is cited as the ‘most important problem’ by only four percent of NFIB’s hundreds of thousands of member firms.” NFIB notes that this is extremely low compared to other recessions. For example, in 1983 – just after the last big recession – 37 percent of business owners said that financing and interest rates were their top problem.

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 we 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.

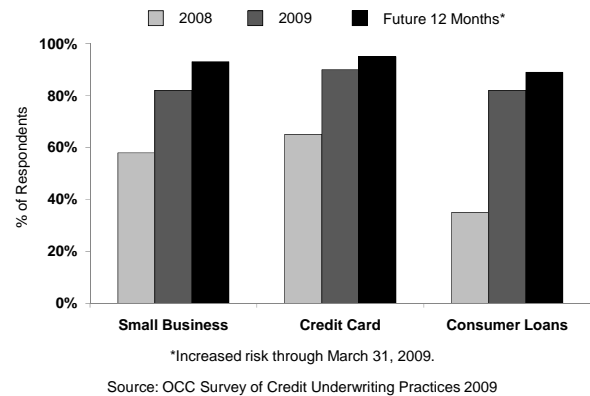
Consumers Repay More and Borrow Less

For consumer lending, the rapid rise in unemployment has led to a rapid rise in delinquencies and loan losses. With jobs lost and work hours cut, it does not take long for the financial pressures to become overwhelming, leading to defaults on loans. Moreover, the loss in wealth – over \$15 trillion peak to trough – has meant that consumers are saving more, spending less, and repaying debt at a faster rate than normal. In spite of recent declines in revolving credit outstanding, consumer lending has held up better in this recession than in most other recessions. Since the start of the recession in December 2007, consumer loans have *increased* by 4.6 percent, whereas in the last six recessions the median change in consumer credit was a *negative* 3.6 percent.

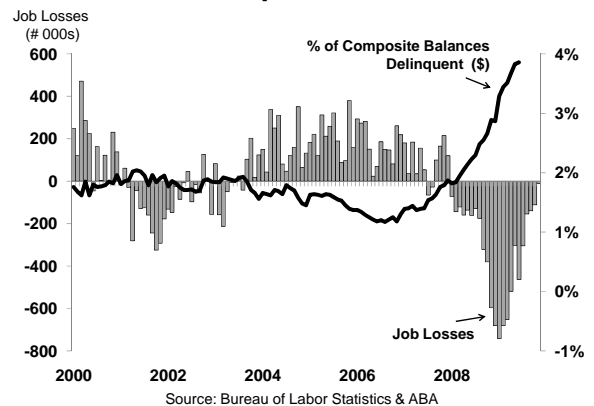
TARP has Directly Supported Lending; Treasury Expects \$19 billion Profit

A common misperception is that banks that accepted capital investments by Treasury have not effectively made use of these funds for loans. According to the Government Accountability Office (GAO), the 21 largest banks in the program extended more than **\$2.2 trillion in new loans** since receiving TARP funds. Moreover, the report of the TARP Special Inspector General noted that over 80 percent of Capital Purchase Program (CPP) participants used their injections to **directly support lending**. Another 43 percent said the CPP funds helped bolster reserves that are required by their regulator to absorb losses, and over 31 percent said they invested portions of the funds in mortgage-backed securities from Fannie Mae and Freddie Mac. These investments provided immediate support to funding markets, which had largely disappeared.

Future Increased Credit Risk



Consumer Delinquencies & Job Losses



Use of CPP Funds

Use	% of Respondents
Lending	83%
Capital Cushion / Reserves	43%
Support Securities Market	31%
Debt Repayments	14%
Acquisitions	4%

Percentages do not total 100, as respondents reported multiple uses of funds.
Source: TARP Special Inspector General

To date, \$247 billion has been invested in over 690 banks of all sizes (60 percent of which are community banks with assets less than \$1 billion). The Treasury recently stated that it expects that “every one of its programs aimed at stabilizing the banking system – the Capital Purchase Program, the Targeted Investment Program, the Asset Guarantee Program, and the Consumer and Business Lending Initiative – will earn a profit thanks to dividends, interest, early repayments, and the sale of warrants.”ⁱⁱⁱ ***Treasury expects to earn \$19 billion in profit for taxpayers.***

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.

Banks Cannot Fill Credit Hole Alone

While banks have been lending, they cannot offset the dramatic fall off of credit *outside* the banking industry. Thirty years ago, banks provided about 60 percent of all credit – today ***traditional bank lending provides less than 30 percent.*** The collapse this past year of the secondary markets for mortgages and other consumer credit products, such as credit cards and auto lending, has taken out an important pipeline of credit. Thus, many of the stories about the lack of credit are due to the weakness of *non-bank* lenders and the weakness of the securitization markets.

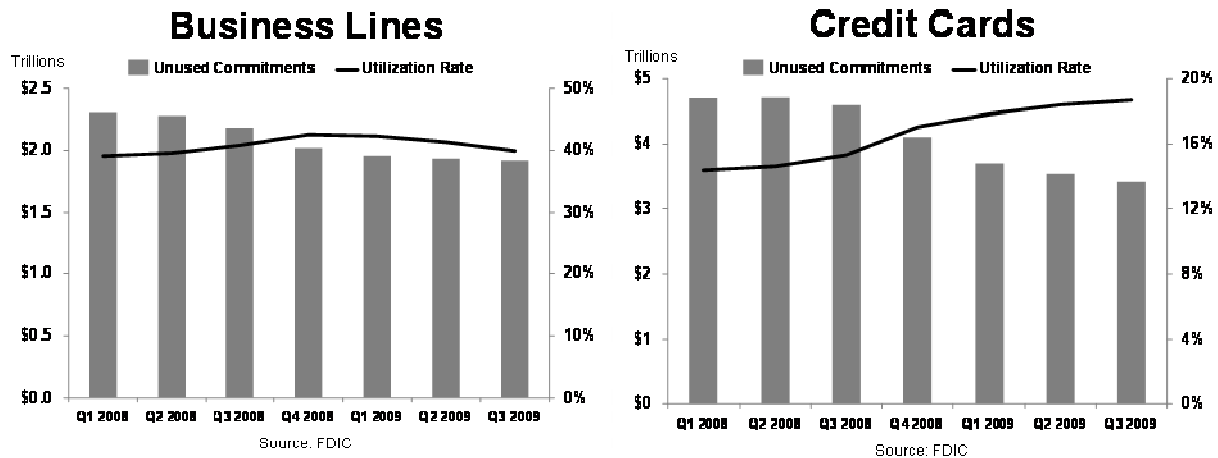
Increases in Expenses for Large Banks Will Cost Jobs in the Banking Industry

The financial reform legislation, currently under consideration, will impose a significant cost on large financial firms, leading to job loss in the financial sector and reduced flow of credit to the economy. Versions of reform would require large financial institutions to hold more capital; pay significantly more in deposit insurance; hold new, potentially expensive convertible debt instruments; and pay assessments to build a new \$150 billion system risk fund. These restrictions, combined with unworkable restrictions on securitizations, will undoubtedly undercut credit availability. The reduction in credit could be severe, as \$1 dollar taken away from capital reduces credit availability by as much as \$10 dollars.

Moreover, as a result of the higher cost, banks will seek to economize on other costs, including closing branches and laying off workers. Currently, banks with \$50 billion or more in assets employ 1,269,000 individuals (61 percent of the industry as of September 2009).

Even with Reductions in Credit Lines, Utilization Still Remains Low

Lenders have managed their risk by re-examining credit lines for both businesses and individuals. However, even with the cutbacks in lines of credit, there is \$6 trillion in unused commitments made available by FDIC-insured banks. The utilization rates have declined for business lending, reflecting the decreased demand. Goldman Sachs, from its U.S. Financial Services Conference, reported that lack of demand for credit has kept utilization rates for business lines 5 percent to 10 percent below normal.^{iv} Credit card utilization rates have risen somewhat, but the rate remains low overall at 18.7 percent, and demonstrates that there is a considerable amount of credit available for card holders overall.



ⁱ *NFIB Small Business Economic Trends*, November 2009. National Federation of Independent Business.

ⁱⁱ *Discover Small Business Watch*, October 2009. Discover Financial Services.

ⁱⁱⁱ Treasury Press Statement, December 9, 2009, TG-436. United States Department of the Treasury.

^{iv} *United States: Financial Services. Key takeaways from the US Financial Services Conference*. Goldman Sachs, December 10, 2009.