STATEMENT OF

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on

SMALL BUSINESS CREDIT AND LENDING

before the

CONGRESSIONAL OVERSIGHT PANEL

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Chair Warren and Members of the Congressional Oversight Panel, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the state of lending and credit availability for small business. As the Regional Director for the FDIC's San Francisco region, I am responsible for overseeing bank supervision, regulation, safety and soundness examinations and consumer compliance examinations in 11 western states, including Arizona.

In my testimony, I will briefly describe the quality of loan portfolios at FDIC-insured institutions, nationwide trends in the availability of credit, and conditions currently creating obstacles to credit availability. I also will address the credit conditions in Arizona. Finally, I will discuss concerns that banks are receiving mixed messages from their supervisors and the efforts the FDIC is making to encourage prudent lending by the institutions we supervise.

Credit Quality and Lending Activity

As federal insurer for all banks and thrifts, and primary federal supervisor for just over 5,000 state chartered banks, the FDIC is very aware of the challenges faced by financial institutions and their customers during these difficult economic times. Among the greatest strengths of our economy is the diverse collection of over 8,000 FDIC-insured depository institutions that operate almost 100,000 offices in every corner of our nation. Bankers and examiners know that prudent, responsible lending is good business and benefits everyone.

Adverse credit conditions brought on by an ailing economy and stressed balance sheets, however, have created a difficult environment for both borrowers and lenders. The deterioration in the economy contributed to a decline in both the demand and the supply of credit. Continued resolution of the current economic crisis will depend heavily on creditworthy borrowers, both consumer and business, having access to lending.

Nationwide, expenses for troubled loans continue to weigh heavily on insured depository institutions. The industry earned less than $1 billion in the fourth quarter of 2009, essentially just breaking even. During the quarter, insured institutions added $61.1 billion in provisions for loan and lease losses to their reserves, although this was $10 billion less (-14.1 percent) than they set aside in the fourth quarter of 2008. Net charge-offs of loans and leases totaled $53 billion, an increase of $14.4 billion (37.2 percent) compared to a year earlier. The annualized net charge-off rate in the quarter was 2.89 percent, which is the highest rate in any quarter in the 26 years for which quarterly charge-off data are available. The amount of loans and leases remaining on banks' balance sheets that were noncurrent rose by $24.3 billion (6.6 percent) during the quarter.[1] At the end of December, 5.37 percent of all loans and leases were noncurrent. This also represents a 26-year high. However, fourth quarter 2009 was the third consecutive quarter that the rate of increase in the volume of noncurrent loans slowed.

Major loan categories exhibited high levels of charge-offs and noncurrent loans. The highest net charge-off rates in the fourth quarter were for credit cards (9.16 percent

[1] Noncurrent loans are those that are 90 days or more past due or on nonaccrual status.

annualized) and real estate construction and development loans (7.77 percent). The net charge-off rate for real estate construction and development loans represented a record high and the net charge-off rate for credit card loans is near the record high set last quarter. Construction and development loans also had the highest noncurrent rate at the end of December (15.95 percent), followed by 1-4 family residential mortgage loans (9.31 percent), both record high levels.

Larger institutions had higher charge-off and noncurrent rates than smaller institutions. The average net charge-off rate on all loans and leases for community banks (institutions with less than $1 billion in assets) was 1.70 percent in the quarter, compared to an average of 3.09 percent at larger institutions. The ratio of noncurrent loans and leases to total loans and leases for community banks as of December 31 was 3.43 percent, versus 5.68 percent for larger institutions. Some of the difference in credit quality performance reflects differences in the composition of loan portfolios at large and small banks. Large institutions have higher proportions of retail loans (residential mortgages and consumer loans) while community banks have larger relative shares of loans to commercial borrowers. Consequently, the negative impact of falling housing prices and rising unemployment and bankruptcies has been greater in the loan portfolios of large banks. Further deterioration in commercial real estate (CRE) markets would have a greater proportional impact on the performance of small and medium-sized institutions.

Tighter underwriting standards, deleveraging by institutions seeking to improve their capital ratios, and slack loan demand have all contributed to declines in loan balances at many institutions. Total loan and lease balances at FDIC-insured institutions declined by $128.8 billion (1.7 percent) during the fourth quarter. This is the sixth consecutive quarter that aggregate loan balances have fallen. In 2009, loan balances declined by $587.3 billion, or 7.5 percent, which was the largest percentage decline since 1942.

As shown in Table 1, much of the decline in loan balances occurred at larger institutions. Institutions with total assets greater than $100 billion as of December 31 reported an aggregate net decline in total loans and leases of $116.8 billion in the quarter, or over 90 percent of the total industry decline. On a merger-adjusted basis, at community banks that filed reports as of December 31, total loan and lease balances decreased $4.3 billion during the quarter. A majority of institutions (53.2 percent) reported declines in their total loan balances during the quarter.

Table 1. Loan Growth by Asset Size Groups, Fourth Quarter 2009
(Dollar amounts in billions)

Asset Size	Number of Institutions	Number Not Reporting Increase in Loans	Number Reporting Increase in Loans	Aggregate Net Change in Loans ($ Billions)	Percent Change
> $100 Billion*	48	40	8	(116.8)	-2.82%
$10 - $100 Bill.	77	55	22	9.6	0.74%
$1 - $10 Billion	554	372	182	(16.9)	-1.78%
< $1 Billion	7,333	3,794	3,539	(4.3)	-0.41%
All Insured Institutions	8,012	4,261	3,751	(128.4)	-1.73%

Note: Reflects changes in loan balances for institutions categorized by size group as of December 31, 2009. Changes in these groups are adjusted for mergers and acquisitions. The difference between the net decline on this table ($128.4 billion) and the industry aggregate net decline ($128.8 billion) reflects institutions that closed during the quarter but were not acquired by another institution.
Source: Call and Thrift Financial Reports.
*The > $100 billion asset size category includes insured depository institution affiliates that would otherwise fall in smaller size groups.

Credit Quality and Lending Activity in Arizona

Arizona has been particularly hard-hit by the recent economic downturn. More than 10 percent of the state's jobs have been lost since mid-2007. Average home prices are nearly 40 percent below peak levels and commercial real estate markets have been strained by higher vacancy rates. Nevertheless, Arizona remains poised for recovery as a result of continued population growth and strong high tech and service-sector capacity.

The financial condition of insured depository institutions headquartered in Arizona remains weak, reflecting the severe economic downturn that the state has endured. In 2009, the median pre-tax return on assets for insured depository institutions in Arizona was the second lowest in the nation at negative 2.33 percent. Loan loss provisions reached record levels in 2009 and weighed heavily on earnings. Loan delinquencies for Arizona institutions in fourth quarter 2009 were also among the highest in the nation and the state's institutions reported record-high net charge-off activity during the year. After posting double-digit loan growth rates since the early 1990s, Arizona depository institutions reported a median loan growth rate that was marginally negative in fourth quarter 2009, led by sharp slowdowns in construction and development, commercial and industrial, and consumer lending.

Factors Affecting Small Business Lending

Weak economic conditions have created an extremely challenging business environment throughout the nation, which particularly affects small businesses. After real GDP posted four consecutive quarters of decline during the second half of 2008 and first half of 2009, economic activity is now showing some signs of recovery. Consumer spending rose in both the third and fourth quarters of 2009 after declining in three of the prior four quarters. Even the housing sector showed some signs of stabilization in sales and prices during the second half of 2009. However, the unemployment rate remains high -- 9.7 percent as of March 2010 -- and persistent labor market weakness poses ongoing risks to the business outlook. Small business optimism remained near record low levels in March, according to a survey by the National Federation of Independent Business (NFIB).[2]

This weakness in business conditions has had significant effects on both credit demand and supply. The demand for business credit tends to vary over the business cycle with the level of spending on new capital equipment and inventories. Small businesses reported that capital spending levels remained near record low levels in March 2010, as did the demand for credit to finance such projects.[3] Similarly, in the Federal Reserve's

[2] "NFIB Small Business Economic Trends," April 2010.
[3] "NFIB Small Business Economic Trends," April 2010.

most recent *Senior Loan Officer Opinion Survey*, banks again noted weaker loan demand from business borrowers, especially from small businesses. At the same time, access to credit remains difficult, as lenders raise credit standards in response to higher loan losses. Banks continued to report net tightening of their lending standards on business loans in January 2010, although the pace of that tightening has slowed.[4]

Surveys of small businesses suggest that while small business loans have clearly become harder to obtain, deteriorating business conditions appear to represent an even larger problem. In the NFIB's March 2010 survey, the percent of respondents who said that loans were "harder" to get in the last three months outnumbered those who said loans were "easier" to get by 15 percentage points. In addition, the percent of respondents citing "finance and interest rates" as their single most important business problem stood at 5 percent, compared to 4 percent a year ago. By comparison, a 34 percent plurality of respondents cited "poor sales" as their biggest business problem, up from 31 percent a year ago and 16 percent two years ago. The percentage of respondents who said that sales were "lower" in the last three months outnumbered those who said sales were "higher" by 25 percentage points.[5]

Ensuring that creditworthy small business borrowers have access to credit remains critical to sustaining the economic recovery. FDIC-insured institutions are a major

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[4] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, January 2010, http://www.federalreserve.gov/boarddocs/SnLoanSurvey/

[5] "NFIB Small Business Economic Trends." April 2010.

source of financing for small businesses, supplying over 60 percent of the credit used by small businesses to run and grow their businesses. Community banks have a particularly important role in lending to small businesses. As of June 30, 2009 (the most recent data available), community banks accounted for 38 percent of small business and farm loans, even though these institutions represented only 11 percent of industry assets.

Recent initiatives and proposals to support small business financing will help to sustain local communities and community banks. For example, the American Recovery and Reinvestment Act (ARRA), signed into law in February 2009, temporarily raised the guarantee levels on Small Business Administration (SBA) 7(a) loans and eliminated upfront borrowing fees on SBA loans in the 7(a) and 504 programs. ARRA also provided a range of tax cuts and tax incentives for small businesses, helping them to cope with the unusually harsh economic environment. In addition, the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) was authorized to provide financing for SBA-backed loans. After these measures were implemented in early 2009, both the volume of SBA loan originations and the volume traded in the secondary market have risen above pre-crisis levels.[6] Further efforts to support small business financing will also provide important benefits to the overall economy.

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[6] U.S. Department of Treasury, "Treasury, SBA Host Small Business Financing Forum," November 18, 2009, http://www.treas.gov/press/releases/tg411.htm

The Role of Bank Supervision

As federal supervisor for nearly 5,000 community banks in the U.S., the FDIC and its examiners uniquely understand that bank lending is the lifeblood of our local and national economies. We share the widespread belief in making credit available on Main Street and working with borrowers that are experiencing difficulties.

The FDIC's bank examiners work out of duty stations located in 85 communities across the country, and are both knowledgeable of local conditions and very experienced in their profession. Many have seen more than one previous economic down cycle and recognize the critical role that banks play in credit availability. We believe that our examiners do their jobs with a keen understanding of the economic environment and real estate conditions where banks operate.

Concerns have been expressed by small businesses, trade groups, and members of Congress that the bank supervisors may be contributing to the lack of credit availability, and that examiners are discouraging banks from extending small business and commercial real estate mortgage loans. There are assertions that examiners are instructing banks to curtail loan originations and renewals, and are criticizing sound performing loans where collateral values have declined. We also have heard criticisms that regulators are requiring widespread re-appraisals on performing commercial real estate mortgage loans, which then precipitate write-downs or a curtailment of credit commitments based on a downward revision to collateral values.

FDIC examiners are not directly involved in bank credit decisions. Accordingly, the FDIC provides banks with considerable flexibility in dealing with customer relationships and managing loan portfolios. We do not instruct banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or deny a refinance request solely because of weakened collateral value. In addition, we encourage banks to be knowledgeable of local market conditions and closely review collateral valuations when a borrower's financial condition has materially deteriorated and a sale of the collateral may be necessary. We would not require a re-appraisal for a healthy performing loan. We leave the business of lending to those who know it best -- the community bankers who provide credit to small businesses and consumers on Main Street. The FDIC believes that bank supervision should avoid interfering with banks' day-to-day credit operations.

To reiterate the importance of bank lending at this critical stage in the economic cycle, the FDIC has an on-going dialogue between the Washington Headquarters, Regional Directors and our field examiners about credit availability. We have re-emphasized that examiners should encourage banks to originate and renew prudently underwritten commercial loans and work cooperatively with borrowers facing financial difficulties. Examiners will not criticize financial institutions for making good loans or entering into prudently structured workout arrangements. These expectations are consistent with the FDIC's bank examination process and policy guidance that has been issued to the institutions we supervise.

The crux of many of the complaints about refinancing commercial loans seems to center on what is a performing loan. We hear that loans are considered to be in performing status by many borrowers because they are current on the interest payments. However, in some cases, the interest payments are coming from the loan proceeds -- often because the borrower is in a deteriorating financial condition. It is difficult for the bank, and the examiner, to not consider this situation a potential problem. In other cases, borrowers complain that examiners are telling banks that more equity is needed when the collateral goes down in value. To be clear, FDIC examiners focus on borrower cash flow as the primary source of repayment during our credit reviews -- not on collateral support which serves a secondary or tertiary source of repayment. When reviewing loans during our examinations, we look at collateral documentation, but also closely focus on the borrower's financial strength, as well as other critical elements of credit support such as guarantor support, business cash flow and prospects. The borrower's willingness and ability to keep payments current, especially when economic conditions are stressed, is always the primary evaluative criterion for our loan reviews.

From a banking policy perspective, the FDIC has issued several statements that encourage financial institutions to continue making prudent CRE loans and working with borrowers that are experiencing difficulty. Most recently, on February 12, 2010, the regulators jointly issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* to encourage prudent lending and emphasize that examiners will apply a balanced approach in evaluating small business loans. We believe this statement will help banks become more comfortable extending soundly underwritten and structured small business loans. The Interagency Statement is included an Appendix to this testimony.

Previously, the FDIC issued in March 2008 a Financial Institutions Letter on *Managing CRE Concentrations in a Challenging Environment* which reiterated supervisory guidelines for managing CRE portfolios, while encouraging banks to keep prudent CRE credit available in their markets. At the time, we recognized that credit for small business and commercial real estate had become relatively scarce, and our goal was to support banks' efforts to continue lending despite difficult market conditions.

In November 2008, the FDIC joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* to encourage banks to continue making loans available to creditworthy borrowers and work with mortgage borrowers that are having trouble making payments. The banking agencies remain committed to this Statement as it promotes lending to creditworthy customers, working with mortgage borrowers that need relief, and implementation of appropriately structured compensation programs.

Also, in October 2009, we joined the other financial regulators in issuing the *Policy Statement on Prudent Commercial Real Estate Workout*s. This Policy Statement encourages banks to restructure commercial real estate loans, applying appropriate and long-standing supervisory principles in a manner that recognizes pragmatic actions by lenders and borrowers are necessary to weather this difficult economic period.

Our efforts to communicate supervisory expectations to the industry should help banks become more comfortable extending and restructuring loans, and in turn strengthen business conditions and hasten a much-awaited recovery.

Conclusion

Large dislocations in real estate and credit markets are contributing to an economic recovery that is characterized by weak private demand and persistent high unemployment. While it will clearly take time to fully resolve these credit market dislocations, there is a clear need for policies that promote the prompt and orderly workout of existing problem loans and that enhance the ability of lenders to make new credit available to qualified household and business borrowers.

In concert with other agencies and departments of the federal government, the FDIC continues to employ a range of strategies designed to ensure that credit continues to flow on sound terms to creditworthy borrowers. Banks are being encouraged to work with borrowers that are experiencing difficulties during this difficult period whenever possible. While many challenges remain before us, the FDIC is confident that the banking industry as a whole is moving in the right direction -- toward sounder lending practices, stronger balance sheets, and a greater capacity to meet the credit needs of their communities.

APPENDIX

INTERAGENCY STATEMENT ON MEETING THE CREDIT NEEDS OF CREDITWORTHY SMALL BUSINESS BORROWERS
February 12, 2010

The federal financial institutions regulatory agencies[1] and the state supervisors[2] (collectively, the "regulators") are issuing this *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* (the "Statement") to restate and elaborate their supervisory views on prudent lending to creditworthy small business borrowers.[3] This Statement builds upon principles in existing guidance, including the November 2008 *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* and the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*. The regulators note that while the October 2009 statement focused on commercial real estate, many principles articulated in that guidance are applicable to small business lending.

Some small businesses are experiencing difficulty in obtaining or renewing credit to support their operations.[4] Between June 30, 2008, and June 30, 2009, loans outstanding to small businesses and farms, as defined in the Consolidated Report of Condition (Call Report), declined 1.8 percent, by almost $14 billion.[5] Although this category of lending increased slightly at institutions with total assets of less than $1 billion, it declined over 4 percent at institutions with total assets greater than $100 billion during this timeframe. This decline is attributable to a number of factors, including weakness in the broader economy, decreasing loan demand, and higher levels of credit risk and delinquency. These factors have prompted institutions to review their lending practices, tighten their underwriting standards, and review their capacity to meet current and future credit demands. In addition, some financial institutions may have reduced lending due to a need to strengthen their own capital positions and balance sheets.

Supervisory Expectations

While the regulators believe that many of these responses by financial institutions are prudent in light of current economic conditions and the position of specific financial institutions, experience suggests that financial institutions may at times react to a significant economic downturn by becoming overly cautious with respect to small business lending. Regulators are mindful of the harmful economic effects of an excessive tightening of credit availability in a downturn and are working through outreach and communication with the industry and supervisory staff to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound small business borrowers. Financial institutions that engage in prudent small business lending after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for loans made on that basis.

Underwriting and Risk Management Considerations

An institution should understand the long-term viability of the borrower's business, and focus on the strength of a borrower's business plan, including its plan for the use and repayment of borrowed funds. The institution should have an understanding of the competition and local market conditions affecting the borrower's business and should not base lending decisions solely on national market trends when local conditions may be more favorable. Further, while the regulators expect institutions to effectively monitor and manage credit concentrations, institutions should not automatically refuse credit to sound borrowers because of a borrower's particular industry or geographic location. To the maximum extent possible, loan decisions should be made based on the creditworthiness of the individual borrower, consistent with prudent management of credit concentrations.

For most small business loans, the primary source of repayment is often the cash flow of the business, either through the conversion of current assets or ongoing business operations. An institution's cash flow analysis should cover current and expected cash flows, and reflect expectations for the borrower's performance over a reasonable range of future conditions, rather than overly optimistic or pessimistic cases. Many small business borrowers also rely on their personal wealth and resources to support loan requests. A borrower's credit history and financial strength, including credit score, are components of assessing willingness and ability to repay, and should be considered in conjunction with other judgmental factors, such as the strength of management. The loan structure should be appropriate for meeting the funding needs of the borrower given the type of credit and expected timing of the business' cash flow. Further, an institution should analyze the secondary sources of repayment, such as the strength of any guarantor or collateral support, and the ability of the borrower to provide additional capital. Institutions should not place excessive reliance on cyclical factors, such as appreciating or depreciating collateral values.

An institution should have robust risk management practices to identify, measure, monitor, and control credit risk in its lending activities. Further, institutions should promote a credit culture in which lenders develop and maintain prudent lending relationships and knowledge of borrowers. This culture should encourage lending staff to use sound judgment during the underwriting process. While institutions may use models to identify and manage concentration risk, portfolio management models that rely primarily on general inputs, such as geographic location and industry, should not be used as a substitute for the evaluation of an individual customer's repayment capacity.

Examination Reviews

Examiners will not discourage prudent small business lending by financial institutions, nor will they criticize institutions for working in a prudent and constructive manner with small business borrowers. Examiners will expect institutions to employ sound underwriting and risk management practices, maintain adequate loan loss reserves and capital, and take appropriate charge-offs when warranted. As with all lending, examiners are expected to take a balanced approach in assessing the adequacy of an institution's risk management practices in its small business lending activities. As a general principle, examiners will not adversely classify loans solely due to a decline in the collateral value below the loan balance, provided the borrower has the willingness and ability to repay the loan according to reasonable terms. In addition, examiners will not classify loans due solely to the borrower's association with a particular industry or geographic location that is experiencing financial difficulties.

[1] The federal financial institutions regulatory agencies consist of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the National Credit Union Administration (collectively, the "agencies").

[2] The state supervisors are represented through the Conference of State Bank Supervisors.

[3] Financial institutions should apply the principles of this Statement in accordance with their internal definitions of small business loans or as appropriate in their loan portfolios. Small business lending includes loans to small businesses and farms, such as working capital lines of credit, secured and unsecured term loans, as well as unsecured revolving credit.

[4] Responses to the Federal Reserve Board's Senior Loan Officer Opinion Survey indicate that the net fraction of banks that tightened credit standards and terms on C&I loans to small firms was very high in 2009, and exceeded its previous highs in the past twenty years.

[5] The data is for commercial banks, where small business loans, as reported in the Call Report FFIEC 031 and 041, schedule RC-C, part II are defined as loans with original amounts of $1 million or less that are secured by nonfarm nonresidential properties or commercial and industrial loans plus loans with original balances of $500,000 or less for agricultural production or secured by farmland.