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STATEMENT OF

MARTIN J. GRUENBERG
VICE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

EXPLORING THE BALANCE BETWEEN INCREASED CREDIT AVAILABILITY AND PRUDENT LENDING STANDARDS

before the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

March 25, 2009

2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the balance between increased credit availability and prudent lending standards.

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 in recent months has contributed to a decline in both the demand and the supply of credit. Resolving the current economic crisis will depend heavily on creditworthy borrowers, both consumer and business, having access to lending.

In response to these challenging circumstances, banks are clearly taking more care in evaluating applications for credit. While this more prudent approach to underwriting may mean that some borrowers who received credit in past years will have more difficulty receiving credit going forward, it should not mean that creditworthy borrowers are denied loans. Unfortunately, in such a difficult environment, there is a risk that some lenders will become overly risk averse. As bank supervisors, we have a responsibility to assure our institutions, regularly and clearly, that soundly structured and underwritten loans are encouraged.

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

Use and Availability of Credit Over the Business Cycle

Following the intensification of financial market turmoil in September 2008, the U.S. economy experienced a marked deterioration in performance from what already was a recession level. During the fourth quarter, real gross domestic product (GDP) declined at an annualized rate of 6.2 percent, the largest decline in any single quarter since 1982. Payrolls have declined by just under 3 million jobs since September, bringing total job losses during the recession to 4.4 million. The unemployment rate rose to 8.1 percent in February 2009, compared to just 4.9 percent when the recession started in December 2007.

This rapid deterioration in business conditions has had important effects on both the demand for, and the supply of, credit. The demand for business credit tends to vary over the business cycle with the level of spending on new capital equipment and inventories. During the fourth quarter of last year, business spending on nonresidential equipment and structures declined at an annualized rate of over 21 percent -- the largest quarterly decline since 1975. Private inventories fell by almost $28 billion during the year (adjusted for inflation), the largest annual decline since the 2001 recession.

Amid this downturn, loan performance has deteriorated and lenders have tightened lending standards. According to Standard and Poor's (S&P), the 12-month default rate on U.S. high-risk loans rose to 4.35 percent in December, up from 0.26 percent a year earlier.[1] Meanwhile, the Federal Reserve *Senior Loan Officer Survey* shows that large lenders have progressively tightened standards on loans to both large and small business borrowers since late 2007.[2]

Surveys of small businesses conducted by the National Federation of Independent Business (NFIB) show that while small business loans have clearly become harder to obtain, deteriorating business conditions appear to represent an even larger problem. In an NFIB survey conducted in January, the percent of respondents who said that loans were "harder" to get in the last three months outnumbered those who said loans were

[1] "U.S. Corporate Default Rate Forecasted to Reach All-Time High of 13.9% in 2009," Standard and Poor's *RatingsDirect*, January 23, 2009.
[2] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, http://www.federalreserve.gov/boarddocs/SnLoanSurvey/

"easier" to get by 13 percentage points, the highest margin since 1981.[3] At the same time, however, the percent of respondents who said that sales were "lower" in the last three months outnumbered those who said sales were "higher" by 31 percentage points, the highest margin in the 35-year history of the survey.

Given that the center of the current crisis has been in residential mortgage lending, the effects on loan demand and the availability of credit have been even more pronounced in the case of U.S. households. Net borrowing by U.S. households exceeded $1 trillion annually in 2004, 2005 and 2006, fell to $849 billion in 2007, and declined to $51 billion in 2008.[4] During the peak borrowing years, some 87 percent of household borrowing was comprised of mortgage debt. As in the case of business credit, the shrinking volume of household credit reflects trends on both the demand side and the supply side of the equation.

A significant contributing factor behind the contraction in the volume of credit in recent months has been the virtual shut-down of the private securitization market. Private-label securitization played an increasingly important role in bank funding through 2007, but declined precipitously in 2008. It was the securitization market that fueled much of the growth in residential and commercial real estate lending in the earlier part of this decade, so the impact of this tightening is felt particularly in these sectors.

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[3] *NFIB Small Business Economic Trends*, February 2009, http://www.nfib.com/object/IO_39981.html
[4] Federal Reserve Board, *Flow of Funds*, Table F.2.

As they face a very difficult economic environment, businesses and households are curtailing their spending, which tends to reduce the volume of credit they wish to obtain in the aggregate. Meanwhile, rising unemployment and falling business profits are reducing the creditworthiness of some business and household borrowers at the same time that lenders are raising credit standards in response to higher loan losses. In a normal economic cycle, these trends will tend to self-correct over time; however, the current environment appears particularly challenging.

Bank Credit Quality and Lending Activity

Fourth quarter financial results demonstrated considerable stress for FDIC-insured institutions. The industry posted an aggregate loss of $32 billion over the quarter, as revenues were outpaced by increased expenses of provisions for loan losses, goodwill writedowns, and trading losses. Asset quality also continued to deteriorate. At year-end, the ratio of noncurrent loans to total loans at insured institutions climbed to 2.93 percent, doubling from just one year earlier.[5] This is the highest noncurrent rate for the industry since fourth quarter 1992, when the noncurrent rate was 2.94 percent. Noncurrent rates rose rapidly during 2008, reflecting the slowing economy and growing inability of some businesses and consumers to make loan payments. Net charge-offs also rose steadily in 2008, climbing to an annualized rate of 1.92 percent in the fourth quarter -- the highest level in the 25 years that institutions have reported quarterly net charge-offs.

[5] Noncurrent loans are loans that are past due 90 days or more or that are in nonaccrual status.

These credit problems are most pronounced in construction and development lending, where the percent of noncurrent loans stood at 8.55 percent as of year end 2008 -- a marked increase from 3.22 percent at year end 2007. Steady declines in performance are also evident in other loan types such as residential mortgages, credit cards and commercial real estate. Because of the rapid slowdown in the economy and the protracted distress in the real estate sector, it seems clear that credit quality will continue to be problematic this year.

The fourth quarter bank and thrift financial reports also show that lending activity has slowed. Year-end 2008 Call and Thrift Reports showed aggregate loan balances of $7.9 trillion, reflecting a decline of 1.4 percent during the fourth quarter and a smaller decline of 0.4 percent from year-end 2007. While many factors -- including loan sales, write-downs, payments, and originations -- can affect loan balances, changes in loan balances can also reflect changes in lending patterns over time. Prior to the third quarter of 2008, the industry had reported an increase in total loans outstanding in 25 consecutive quarters dating back to third quarter 2002.

Fourth-quarter loan growth at FDIC-insured institutions tended to vary according to the size of the institution. Table 1 shows that largest institutions, those with assets over $100 billion, reported a decline of 3.4 percent in loan balances while the smallest, those with assets under $1 billion, showed an increase of 1.5 percent. In fact, the fourth-quarter decline in loans outstanding at FDIC-insured institutions was driven mostly by large declines at some of the biggest banks. More than half of the insured institutions with assets greater than $100 billion reported a decline in loan balances during the quarter, and the change in loan levels at the three institutions with the greatest decreases represented more than 100 percent of the total industry decline in loans outstanding.

Table 1. Loan Growth by Asset Size Groups, Fourth Quarter 2008 (Dollar amounts in billions)					
Asset Size	**Number of Institutions**	**Number Reporting Decline in Loans**	**Number Reporting Increase in Loans**	**Aggregate Net Change in Loans ($ Billions)**	**Percent Change**
> $100 Billion	22	13	9	($142.7)	-3.4%
$10 - $100 Bill.	92	43	49	$6.9	0.4%
$1 - $10 Billion	561	179	382	$8.2	0.8%
< $1 Billion	7,630	2,657	4,973	$15.6	1.5%
All Insured Institutions	8,305	2,892	5,413	($112.0)	-1.4%
Source: Call and Thrift Financial Reports					

The data also point to some important differences in portfolio structure between small banks and large banks that may account for the relative stability of loan balances at small banks. On average, community banks at the end of fourth quarter 2008 had a higher ratio of core deposits to assets than did banks with assets over $1 billion. Community banks also reported a higher average ratio of loans to assets than larger banks. These differences suggest that, at least in this stressful period, the business model that relies on funding through core deposits and relationship lending, which has been adhered to by many community banks, has proven to be resilient.

The Role of Bank Supervision

The FDIC is committed to ensuring that examiners carry out their responsibilities in an objective and even handed manner. Examiners are expected to closely review and test bank management's assessment of risk, market conditions, policy parameters, and use of any federal financial assistance. The examination process focuses on assessing banks' own risk management process and identifying any weaknesses for consideration and action by bank management.

In the period leading up to the credit market disruption, regulators should have been more aggressive in their supervisory approach to high risk credit practices that contributed to our current economic problems. While the banking supervisors issued a number of warnings to the industry and provided guidance for enhancing risk management, in hindsight, the agencies should have been more vigilant about some institutions' outsized risk exposures and underwriting practices.

Some have suggested that bank supervisors are now contributing to adverse credit conditions by overreacting to current problems in the economy and discouraging banks from making good loans. Borrowers report that banks are reluctant to lend and some are attributing this to the bank examination process. In particular, concerns have been expressed that bank examiners are discouraging banks from making loans in an effort to preserve capital, or that examiners are requiring banks to engage in aggressive exit strategies with borrowers who are experiencing difficulties in their businesses, particularly those involving real estate.

The FDIC understands the critical role that credit availability plays in the national economy, and we balance those considerations with prudential safety and soundness requirements. Through our formal and on-the-job training process at the FDIC, field examiners are taught how to review banks' policies, lending and investment practices, financial reporting, and management performance. Based on their findings, examiners communicate their observations to superiors and bank management both orally and in writing. The examiners are instructed on how to deliver their observations without infringing on bank management's day-to-day decision-making and relationships with customers.

A number of discussions have taken place with the FDIC's regional management to raise sensitivity to issues of credit availability. FDIC senior management has reiterated that examiners should be encouraging banks to continue making prudent loans and working with customers facing financial difficulties.

Many members of the FDIC's supervisory staff served through the 1980s and 1990s as regulators and have an average tenure of nearly 16 years. Given their seasoning as regulators, our examiners are keenly aware that credit extended by banks is critical to local economies across the country. Most FDIC examiners live in the communities of the banks they examine, and are very familiar with the local markets and economic trends.

We also have heard criticisms that regulators are requiring widespread re-appraisals on performing real estate loans, which then precipitate write-downs or a curtailment of credit commitments based on a downward revision to value. While we encourage banks to review collateral valuations when a borrower's financial condition has materially deteriorated or loan covenants have not been met, periodic credit reviews, including collateral assessments, by bank management are a long-standing credit practice. Bank management has considerable flexibility in making collateral assessments, both for individual loans and portfolio reviews, and we have not revised our supervisory expectations in the current environment. In cases where market values of collateral have significantly deteriorated and the borrower also is seeking a modification of loan terms, we have encouraged banks to work with the borrower during this difficult period. It is our hope that banks can reach mutually-advantageous workout arrangements that take into account the borrower's financial position and the collateral's valuation and result in a re-structured, and stable credit relationship.

In regard to fair value accounting, we are faced with a situation in which an institution confronted with even a single dollar of credit loss on its available for sale and held to maturity securities must write down the security to fair value, which includes not only recognizing the credit loss, but also the liquidity discount. The FDIC has expressed its support for the idea that the Financial Accounting Standards Board (FASB) should consider allowing institutions facing an other-than temporary-impairment (OTTI) loss to recognize the credit loss in earnings but not the liquidity discount. The FASB last week issued a proposal that would move in this direction.

The FDIC understands the tight credit conditions in the market and is contributing to a number of efforts to improve the current situation. Over the past year, we have issued guidance to the institutions we regulate to encourage banks to maintain the availability of credit. Moreover, examination professionals have received specific instruction on properly applying this guidance within the context of FDIC supervised institutions.

On November 12, 2008, we joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* (FDIC FIL-128-2008).[6] This statement reinforces the FDIC's view that the continued origination and refinancing of loans to creditworthy borrowers is essential to the vitality of our domestic economy. The statement encourages banks to continue making loans in their markets, work with borrowers who may be encountering difficulty during this challenging period, and pursue initiatives such as loan modifications to prevent unnecessary foreclosures.

In light of the present challenges facing banks and their customers, the FDIC hosted a roundtable discussion earlier this month focusing on how regulators and financial institutions can work together to improve credit availability. Representatives from the banking industry were invited to share their concerns and insights with the federal bank regulators and representatives from state banking agencies. The attendees agreed that open, two-way communication between the regulators and the industry was vital to ensuring that safety and soundness considerations are well balanced with the

[6] See: http://www.fdic.gov/news/news/press/2008/pr08115.html

critical need of providing credit to businesses and consumers. I believe this was a very productive meeting, and look forward to working with the industry and our colleagues at the other agencies to ensure credit remains available during this challenging period.

One of the important points that came out of the session was the need for ongoing dialog between bankers and their regulators as they work jointly toward a solution to the current financial crisis. Toward this end, Chairman Bair announced last week that the FDIC is creating a new senior level office to expand community bank outreach. In conjunction with this office, the FDIC plans to establish an advisory committee to address the unique concerns of this segment of the banking community.

As part of our ongoing supervisory assessment of banks that participate in federal financial stability programs, the FDIC is taking into account how available capital is deployed to make responsible loans. It is necessary and prudent for banking organizations to track the use of the funds made available through federal programs and provide appropriate information about the use of these funds. On January 12, 2009, the FDIC issued a Financial Institution Letter titled *Monitoring the Use of Funding from Federal Financial Stability and Guarantee Programs* (FDIC FIL-1-2009),[7] advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community. Equally important to this process is providing this information to investors and the public. This Financial

[7] See: http://www.fdic.gov/news/news/financial/2009/fil09001.html

Institution Letter advises insured institutions to include information about their use of the funds in public reports, such as shareholder reports and financial statements.

Internally at the FDIC, we have issued guidance to our bank examiners for evaluating participating banks' use of funds received through the TARP Capital Purchase Program and the Temporary Liquidity Guarantee Program, as well as the associated executive compensation restrictions mandated by the Emergency Economic Stabilization Act. Examination guidelines for the new Public-Private Investment Fund will be forthcoming. During examinations, our supervisory staff will be reviewing banks' efforts in these areas and will make comments as appropriate to bank management. We will review banks' internal metrics on the loan origination activity, as well as more broad data on loan balances in specific loan categories as reported in Call Reports and other published financial data. Our examiners also will be considering these issues when they assign CAMELS composite and component ratings. The FDIC will measure and assess participating institutions' success in deploying TARP capital and other financial support from various federal initiatives to ensure that funds are used in a manner consistent with the intent of Congress, namely to support lending to U.S. businesses and households.

Conclusion

FDIC-insured banks are uniquely equipped to meet the credit needs of their local markets, and have a proven tradition of doing so, through good times and bad. Banks should be encouraged to make good loans, work with borrowers that are experiencing difficulties during this challenging period whenever possible, avoid unnecessary foreclosures, and continue to ensure that the credit needs of their communities are fulfilled. 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.