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STATEMENT OF

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on

CREDIT AVAILABILITY FOR SMALL BUSINESSES

before the

FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
U.S. HOUSE OF REPRESENTATIVES

November 30, 2009
Southfield, Michigan

Chairman Moore and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the availability of credit to small- and medium-sized businesses. As federal insurer for all banks and thrifts, and primary federal supervisor for just over 5,000 state chartered banks, including approximately 100 headquartered in Michigan, the FDIC is very aware of the challenges faced by financial institutions and their customers during these difficult economic times.

FDIC-insured institutions are a major source of financing for small businesses. FDIC insured banks and thrifts supply over 60 percent of the credit used by small businesses to run and grow their businesses. Most of these institutions are community banks. We share your concerns about making commercial loans available to these Main Street businesses across the country. This recession has had a major impact on the community institutions that traditionally lend to small business. The number of problem institutions and bank failures has risen steadily as the effects of this recession -- which began in the financial markets -- have taken hold in many parts of the country.

As a result, credit availability has suffered. This is due not only to more conservative credit standards by lenders, but also due to the erosion of collateral values and the financial condition of borrowers. The focus again is on the ability of borrowers to repay their loans, which means determining that loans are affordable and sustainable over the long term. Few would argue that a return to fundamentals in credit underwriting is not warranted after the excesses that were observed in some sectors leading up to the recent crisis. At the same time, bank supervisors are encouraging FDIC-insured lenders to deal with problem loans and recognize losses where necessary, while encouraging loan workouts where they are appropriate.

In my testimony, I will briefly describe the conditions currently creating obstacles to credit availability and credit conditions generally, as well as in Michigan. I also will discuss the efforts the FDIC is making to encourage prudent lending.

Factors Affecting Overall Credit Availability

Earlier in this decade, credit was generally abundant for many types of U.S. borrowers including large firms, small businesses, and households. Borrowers enjoyed relatively low cost financing which stimulated economic growth and a housing boom in many areas of the country. However, we now know that a significant amount of this lending was poorly underwritten. Conditions in the financial markets masked substantial credit risks that were inherent in the lending practices, resulting in loans that were not sustainable once home prices stopped rising and credit conditions became more stringent. This, in turn, resulted in large losses to financial institutions and other creditors when economic conditions did not match overly optimistic expectations. The emergence of large volumes of problem real estate loans led to a dramatic shift in credit market liquidity since mid-2007 that has changed the landscape for lenders and borrowers alike.

Across the country, financial services companies that make or arrange loans have significantly tightened credit standards as they seek to preserve capital and reduce credit losses. Tighter credit standards and weak demand among both commercial and household borrowers have contributed to five consecutive quarters of declining loan balances at FDIC-insured institutions. Bankers are understandably concerned about credit quality as delinquencies, credit losses, and repossessed assets have risen substantially since the beginning of 2008. Recent measures of credit quality have weakened to levels not seen since the 1990-1991 recession.

Loan Growth by Asset Size Groups, Third Quarter 2009

Asset Size	Number of Institutions	Number Reporting Decline in Loans	Number Reporting Increase in Loans	Aggregate Total Loans 3Q 2009 ($ Billions)	Aggregate Net Change in Loans 2Q 09 - 3Q 09 ($ Billions)	Percent Change
> $100 Billion *	53	41	12	4,137	-155	-3.62%
$10 - $100 Billion	77	62	15	1,270	-40	-3.04%
$1 - $10 Billion	568	357	211	981	-15	-1.46%
< $1 Billion	7,401	3,274	4,127	1,029	0	0.02%
All Insured Institutions	8,099	3,734	4,365	7,418	-209	-2.82%

* The Greater than $100 Billion category includes affiliates that would otherwise fall in smaller size groups.
Data have been adjusted to reflect mergers and acquisitions in the prior quarter.
Source: Call Reports and Thrift Financial Reports

Obstacles to Credit Availability for Michigan and the Midwest

The financial data for banks in Michigan and the industrial Midwest in general reflect the ongoing struggle of the U.S. manufacturing sector, which contracted throughout this decade. Unlike employment growth among other sectors, job growth in the U.S. manufacturing sector did not rebound after the 2001 recession, even while overall U.S. economic growth was strong. Payroll employment in Michigan has declined by over 800,000 jobs, or 17 percent, since December 2000, with over half of these losses occurring within the manufacturing sector itself. The recent economic crisis served to compound the challenges faced by Michigan's manufacturing companies, especially its automotive and auto supplier companies. Michigan has experienced a sharp increase in joblessness since the start of the national recession in December 2007. The state's unemployment rate has more than doubled from 7.3 percent to 15.1 percent, well above the national rate of 10.2 percent. Long-term economic distress has contributed to higher than average past due rates for Michigan financial institutions throughout the decade. More recently, loss rates on problem loans have increased as the effects of the recession have intensified.

Perhaps the best way to compare lending patterns in Michigan to the rest of the nation is to focus on *community institutions*, or banks and thrifts with assets of $1 billion or less, which tend to lend mostly in their local areas. At Michigan community institutions, asset quality has been in a long downward trend, resulting from a generally depressed economic environment and exceptionally high levels of unemployment.

Michigan's ongoing economic challenges are evident in increasing levels of noncurrent loans across virtually all categories. As of September 30, 2009, the ratio of noncurrent loans to total loans was 3.93 percent, up from 3.18 percent one year earlier.[1] This compares to a noncurrent loan rate of 3.32 percent for all U.S. community institutions. Net charge-offs for Michigan community institutions totaled a substantial 1.30 percent through September 2009, compared to 0.89 during the same period a year

[1] *Noncurrent loans* are 90 days or more past due or in nonaccrual status.

ago.   Also, through the third quarter, 39 percent of Michigan's insured financial institutions were unprofitable.

Credit quality deterioration has been broad based among the major loan types. Construction and development (C&D) loan portfolios in Michigan community institutions reported the highest noncurrent rate of any loan type at 14.24 percent as of September 30, 2009, up from 12.52 percent one year earlier. However, C&D loans represent a moderate share of Michigan community institutions' total loans, at seven percent -- somewhat less than the levels held by community institutions nationwide.

Community institutions in Michigan are more heavily concentrated in nonfarm nonresidential real estate loans and one-to-four family residential loans, which collectively comprise 64 percent of loan portfolios in the state compared to 55 percent for the U.S. as a whole. Credit losses and noncurrent loan rates on these portfolios are elevated and above national levels.

Michigan community institutions have contracted their loan portfolios somewhat during the past year. On a merger-adjusted basis, community institutions in Michigan saw total loans and leases decline by 1.8 percent during the year ending September 30, 2009, compared to loan growth of 2.9 percent a year ago and peak loan growth of 9.6 percent in 2004. Most loan categories receded during the past year. In fact, among the largest loan categories, representing at least 10 percent of the total loan portfolio, only nonfarm nonresidential real estate loans grew -- increasing by 4.2 percent. By comparison, community institutions nationwide grew their loan portfolios by 2.2 percent during the past year on a merger-adjusted basis, and their largest loan type, nonfarm nonresidential real estate, grew by 9.7 percent.

Small Business Lending

With respect to small business lending, available data do not clearly distinguish recent trends in the availability of small business credit in Michigan compared to the nation as a whole. Recent surveys of small businesses conducted by the National Federation of Independent Business (NFIB) show that while small business loans have clearly become more difficult to obtain, deteriorating business conditions appear to represent an even larger problem.

In the October NFIB 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 14 percentage points -- among the highest margins recorded since 1981. However, at the same time, 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.

As of October, the percent of respondents citing “finance and interest rates” as their single most important business problem stood at just 4 percent, compared to 5 percent one year ago. By comparison, a 33 percent plurality of respondents cited "poor sales" as their biggest business problem, up from 23 percent a year ago.

Ensuring the provision of credit to small businesses has been a policy priority since the onset of the financial crisis last Fall. The American Recovery and Reinvestment Acct (ARRA), signed into law last February, 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.[2]

Supervisory Response to Tight Credit Conditions

A strong policy response is warranted by the historic dislocations in U.S. real estate markets and economic activity that have created a challenging environment for small business lenders and borrowers alike. Since March 2006, home prices in Detroit have fallen by 45 percent on average as measured by the S&P-Case Shiller home price index, while home prices in 20 large U.S. cities (including Detroit) have fallen by 30

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

percent. Price indices for commercial real estate properties have fallen by similar magnitudes. These declines in real estate prices have impaired the value of collateral that small business borrowers frequently pledge to obtain funding at the same time that their cash flows are being affected by weak sales.

This dramatic deterioration in real estate market conditions has made it clear that some institutions were carrying excessive concentrations of real estate loans or had employed weak underwriting standards that are now contributing to losses. While the banking supervisors issued a number of warnings to the industry and provided guidance for enhancing risk management in the period leading up to the real estate bust, it seems clear in retrospect that the agencies could have articulated their concerns in a clearer and more timely fashion. And after almost a decade of economic distress in Michigan and the longest and deepest U.S. recession since the 1930s, even institutions that employed sound lending and risk management practices are seeing an increase in problem loans.

Bankers are well aware of these current credit conditions, observing first hand the challenges that their borrowers face every day. This environment has caused some lenders to seek refuge in more liquid, low-risk investments, such as U.S. Treasury securities, rather than taking on additional lending risks. Moreover, banks with large concentrations of credit in the real estate sector in many cases are seeking to reduce those exposures.

The FDIC is committed to ensuring that our examiners understand their proper role and carry out their responsibilities in an objective and even handed manner. The examination process focuses on assessing banks' own risk management process and identifying any weaknesses for consideration and correction by bank management.

For the past several years, the FDIC and the other banking agencies expressed growing concern about the relaxed underwriting standards and non-traditional mortgage products that were increasingly evident in the marketplace. As long as real estate values continued to rise, or even remained stable, the true nature of some of these poorly underwritten and poorly structured loans was masked. While a significant portion of the risky lending was done outside the regulated banking industry, its impact on the market has affected all participants.

We understand the critical role that credit availability plays as the lifeblood of the national economy, especially for small businesses. We also recognize the tight credit conditions in the market and continue to identify strategies for improving the current situation. Over the past couple of years, we have issued several guidance papers to the institutions we regulate to encourage banks to maintain the availability of credit. In November 2008, we joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*. The statement reinforces our 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 foreclosure.

Building on previous guidance, in October of this year the regulators again called attention to credit availability by issuing a policy statement on *Prudent Commercial Real Estate Loan Workouts.* The issuance encourages banks to continue making good loans to commercial real estate borrowers -- most of which are small businesses -- and to work with borrowers that are experiencing difficulties in their repayment capacity because of the economic downturn. This guidance provides a framework to enable examiners to adhere to a balanced approach in assessing an institution's risk management practices for loan workout activity in light of economic circumstances and realistic business alternatives. Our examination professionals have received specific instruction on properly applying the aforementioned guidance in the supervision of FDIC supervised institutions.

In light of the present challenges facing banks and their customers, we continue to reach out to financial institutions, in efforts to identify potential obstacles to sound lending. In doing so, we have established an Advisory Committee on Community Banking, which provides advice and recommendations to the FDIC on a broad range of policy issues that have a particular impact on small community banks throughout the United States. The Committee will review various issues related to the latest examination policies/procedures, credit/lending practices, deposit insurance assessments, insurance coverage issues, and regulatory compliance matters, as well as any obstacles to the continued growth and ability of community banks to extend financial services in their local markets in the current environment.

Conclusion

We all have a mutual interest of seeing community banks thrive and continue to support their local communities. People are rightly worried about the economy, their jobs, paying their bills, and keeping their homes. A strong network of healthy community-based lenders can be a stabilizing force by providing credit for consumers and small businesses.

Prudent, responsible lending is good business and benefits everyone. Community 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. A majority of the banks in the Midwest have largely avoided the undue concentrations and reckless lending practices that led to the present crisis, and most of them have a solid capital and funding base and will be in a good position to help finance the recovery.

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. We expect that the ongoing process of loss recognition and balance sheet repair that banks and thrifts have undertaken in recent quarters will, over time, put the industry in a better position to meet a rising demand for credit as the economy recovers.

Further, we support the Administration's proposals to expand the Small Business Administration loan programs, to cut taxes for small businesses, and to make low-cost capital available to small business lenders. These proposals are concrete steps to address the very real problems facing Main Street businesses as a result of the recession and the historic distress in real estate markets.

Thank you for the opportunity to testify today, and I would be happy to take any questions.