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Statement of

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Acting Director, Office of Thrift Supervision

regarding

**Condition of Small Business and Commercial
Real Estate Lending in Local Markets**

before the

Committee on Financial Services and
the Committee on Small Business
United States House of Representatives

February 26, 2010

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Testimony on
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I. Introduction

Good morning Chairman Frank, Chairwoman Velazquez, Ranking Member Bachus, Ranking Member Graves and distinguished Members of the Committees. Thank you for the opportunity to testify on behalf of the Office of Thrift Supervision (OTS) on the issue of credit availability for consumers and businesses in the United States.

As we are all aware, credit is the lifeblood of the economy. The imperative to serve the credit needs of consumers, small businesses and neighborhoods lies at the heart of the U.S. thrift industry. The thrift charter was created to support consumers and communities and to ensure that credit would be available for American homeownership in good times and bad. It is the long-held position of the OTS that thrifts should never turn away good customers.

It is clear that the recession has driven lending down across the financial services industry from its peak before the crisis. This constriction is due in part to the current proliferation of loan defaults and losses in consumer, small business and commercial loans, which necessitate a heightened sensitivity to the risk that each institution is able to bear. However, the OTS and other regulators must be vigilant to ensure that the pendulum does not swing too far by denying credit to creditworthy borrowers and slowing the economic recovery.

The severe harm done to communities and financial institutions by the economic crisis reinforces the importance of achieving equilibrium between providing adequate credit and ensuring the safety and soundness of financial institutions and the entire financial system. This should be of utmost concern to banks, thrifts, regulators, legislators and anyone else involved in the effort to resolve this crisis.

In addition to supporting homeownership, OTS-regulated institutions are committed to making loans for small businesses. Small business lending is fully consistent with the purpose of the thrift charter and is a cornerstone of lending in communities. Loans are underwritten based on the borrower's personal ability to repay. For large commercial loans, such as those secured by high-rise office buildings and strip malls, sophisticated systems use criteria such as occupancy rates and income streams as underwriting considerations.

In our testimony today, we will present some of the factors we believe may be contributing to tightened credit, before discussing possible solutions. We will also address the Committee's questions regarding private equity investors.

II. Factors that Impede Extension of Credit for Consumers and Small Businesses

The condition of the economy is a major cause of the constriction in credit. The fallout from the economic deterioration has had an impact on credit availability in a variety of ways.

For example, fewer businesses are offering credit than before the recession. Many highly leveraged, under-regulated nonbank businesses that engaged in consumer, business and commercial lending — often with loose underwriting standards — have gone out of business. As a result, small business borrowers are more dependent on bank and thrift funding.

Unemployment, stock market declines and the downturn of the housing market have also had major impacts. Americans who do not have jobs have a hard time paying their mortgages and other bills. Declining home values have decreased consumers' net worth by cutting into home equity. Some would-be borrowers cannot afford down payments for home loans, while others are unable to qualify for loans.

The weak economy has driven consumer confidence lower and many consumers are trying to shore up their finances by spending less and saving more. Many consumers are reluctant to borrow for homes, cars or other major purchases; they are hesitant to spend money on anything beyond daily necessities.

The decline in consumer spending has, in turn, created weaknesses in the small business and commercial sectors. Evidence of weakness in these sectors can be seen in rising business bankruptcies, a slowdown in business expansion, increasing vacancy rates in commercial real estate and mounting commercial loan delinquencies.

U.S. financial institutions are feeling the effects of the stress among consumers and businesses in the form of rising levels of delinquent loans. Continuing decreases in asset quality, and increases in delinquencies and charge-offs for mortgages, credit cards and other types of consumer and business lending, require institutions to build their loan loss reserves and augment capital to preserve safety-and-soundness. Although these needs may place a strain on institutions' ability to lend, strengthening capital and reserves provides a critical foundation for maintaining institutions' stability and continued health.

Financial institutions have also learned a hard lesson about the merits of returning to the basics of sound loan underwriting. Lapses in loan underwriting can have severe, negative impacts on financial institutions, consumers and the economy. In the mid 2000s, the lending trend swung in the direction of easily available credit, sometimes to borrowers who could not demonstrate an ability to repay their loans, especially in an

environment of declining real estate values. Given this history, some tightening in credit is expected and needed. At the same time, we must ensure that the trend does not move too far and restrict credit availability to creditworthy borrowers. It is very much in the self-interest of lenders to welcome qualified small business borrowers with good credit and solid cash flows.

Credit availability is enhanced when financial institutions making loans for mortgages, consumer credit, small businesses and other types of credit transfer these loans off their own balance sheets by securitizing and selling them to third-party investors. The result is increased liquidity in the market and a transfer of some of the risk from the financial institutions. Before the current crisis, a large percentage of all types of loans in America were securitized. Without a vibrant securitization market, lenders and borrowers have had to find other sources of funds. Except for government-sponsored enterprises, such as Fannie Mae and Freddie Mac, the secondary market has not yet returned as a viable source for funding new credit. It will take some time for a fully functioning credit market, augmented by a strong secondary market, to reemerge. In the meantime, financial institutions must keep more of their loans in portfolio, creating the need to maintain higher capital levels to cushion against potential losses. This need for higher capital constricts lending.

The challenges that financial institutions face in the current financial environment have resulted in a marked increase in formal enforcement orders by the OTS related to safety-and-soundness. Under such actions, institutions are often required to maintain

capital levels above the well-capitalized standard. The OTS imposes these requirements on an institution-by-institution basis as necessary to provide a counterbalance to the elevated risks confronting these institutions. Although these types of cases are increasing, they remain relatively few in number.

There are also some operational issues that may also contribute to the difficulty for some consumers to get loans in a timely fashion. In reaction to the fallout from the current crisis, some financial institutions may have diverted resources from loan origination duties to loan servicing activities to handle defaults, foreclosures and foreclosure prevention initiatives, such as loan workouts and modifications. As resources are redirected back to lending operations, we would expect credit availability to improve.

Finally, uncertainties about the direction of public policy reforms may be having an impact on financial institutions' lending policies.

The Committee asked whether supervisors are specifically discouraging depository institutions from particular kinds of lending. To the contrary, the OTS is encouraging thrift institutions to make all types of loans allowed by statute, provided they are prudently underwritten to creditworthy borrowers.

Banks will increase credit supply when the economy improves, markets stabilize and banks are adequately capitalized to operate in their current economic environment.

However, there are actions that I believe can improve credit availability in the short term without sacrificing practices that promote safe and sound lending.

III. Recommendations and Actions to Expand Lending

As the regulator of an industry of savings associations dedicated to meeting the needs of the communities they serve, the OTS recognizes the critical role thrifts play in providing credit to small businesses and encourages them to continue to serve this important sector of the economy. Small manufacturers, retailers and service companies drive employment. Taxes paid by the businesses and employees support infrastructure, schools, social services and other activities in communities.

The OTS and other federal banking agencies issued guidance twice in recent months to prevent any possible overreaction by financial institutions that would make credit less available at a time when borrowers most need loans for small businesses and commercial real estate (CRE). To send a clear message to financial institutions and examiners, the agencies issued the "Policy Statement on Prudent Commercial Real Estate Loan Workouts" on October 29, 2009, and the "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers" on February 5, 2010.

The interagency Statement on Prudent Commercial Real Estate Loan Workouts is intended to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that supervisory policies and actions do not inadvertently curtail

the availability of credit to sound borrowers. It also states that examiners will take a balanced approach when reviewing an institution's CRE loans and workouts. The guidance states:

The regulators have found that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower. Examiners are expected to take a balanced approach in assessing the adequacy of an institution's risk management practices for loan workout activity. Financial institutions that implement prudent CRE loan workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classification. In addition, renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

The OTS believes this statement sends a clear message to financial institutions that they will not be criticized for making prudent CRE loans or for working with existing CRE borrowers who need to refinance or restructure their loans as long as they do it in a prudent manner.

We have limited data on how effective the guidance has been thus far; however, we are confident that it will have a positive effect over time.

The OTS, other federal financial regulatory agencies and state bank supervisors issued a second statement in February to encourage credit for creditworthy small business borrowers. The “Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers” underscores the responsibility of a regulated institution to understand the long-term viability of the borrower’s business and to focus on the strength of a borrower’s business plan, including its plan for the use and repayment of borrowed funds. This includes an understanding of the competition and local market conditions affecting the borrower’s business and not just national market trends, especially when local conditions may be more favorable. Further, while the regulators expect every institution to effectively monitor and manage credit concentrations, an institution should not automatically refuse credit to a sound small business borrower solely on the basis of the borrower’s particular industry or geographic location.

We believe the interagency statement will support and encourage institutions in their individual assessments of each small business borrower’s creditworthiness, and thus promote the prudent extension of credit to this sector of the economy.

The OTS ensures nationwide consistency in its guidance to the industry, taking steps to make certain that its regional offices do not discourage OTS-regulated institutions from lending by imposing on them stricter underwriting and examination practices than those prescribed by OTS policies. The OTS ensures that its regional offices implement national guidance consistently through several mechanisms. The agency holds monthly Regional Manager Group meetings where the Regional Directors

discuss supervisory and examination issues with senior management from Washington, D.C. The agency also holds bi-weekly conference calls with its Regional Deputy Directors to discuss problem bank cases, emerging issues, and to reinforce and discuss new guidance.

For example, OTS issued an internal staff bulletin on October 30, 2009 regarding CRE lending and CRE loan workouts. The bulletin announced the interagency policy statement on CRE loan workouts, provided a synopsis of how examiners should implement the guidance and also notified examination staff of an agency-wide policy conference call to discuss the guidance. OTS held the staff conference call for all examination and supervisory staff on November 19, 2009. The agency also published the presentation on its internal website for future staff reference. In addition to the internal communications, OTS released a Chief Executive Officer Memo (CEO Letter #325) to announce the new guidance to all OTS-regulated financial institutions. Through the combination of internal staff bulletins, external CEO memoranda, and internal staff briefings, the agency takes proactive steps to ensure consistency across the OTS regions in implementing guidance.

It is important to recognize that thrift institutions, as community-oriented lenders dedicated to serving the credit needs of the communities in which they lend, should be primary sources of credit to small businesses. OTS-regulated institutions make diligent efforts to serve the needs of these businesses and have been successful to a certain

degree. However, statutory caps on thrifts' small business lending sometimes make it difficult for them to fulfill these needs.

The Home Owners' Loan Act currently caps the aggregate amount of credit that thrifts can lend for commercial purposes at 20 percent of a savings institution's assets. Any commercial loans in excess of 10 percent must be small business loans.¹ Due to these limits, some thrifts are discouraged from entering this line of business altogether because they believe they will be unable to achieve sufficient economies of scale.

A legislative proposal that OTS supports would remove the cap entirely on small business lending and increase the cap on other commercial lending from 10 percent to 20 percent. This change would be completely consistent with the focus of the thrift charter on consumer and community lending. The existing ceiling on small business lending limits the pool of credit available to small businesses and limits thrifts' ability to provide credit that would help them serve the important needs of their communities.

A statutory change included in previous legislation and supported by OTS, which passed the House Financial Services Committee in the 108th, 109th and 110th Congresses and passed the full House of Representatives twice, would have increased credit for small-to medium-sized businesses by lifting these limitations on small business lending. We appreciate Chairman Frank's leadership in this effort and hope that this change can be included in future legislation.

¹ 12 USC 1464(c)(2)(A).

The Committee has asked for the views of the OTS on the pledge that President Obama made in his State of the Union address and again at a recent town hall forum in New Hampshire to provide an additional \$30 billion to community banks for lending to small businesses. The OTS fully supports the Administration's goal to stimulate small business lending to the extent that this can be done in a safe and sound manner with prudent underwriting.

IV. Private Equity Investors

Finally, the Committee asked for the agency's views on possible impediments and barriers private equity investors encounter in attempting to invest in failed and failing banks. An entity seeking to acquire control of an OTS-regulated savings association is subject to a variety of laws² and regulations³. OTS's enforcement of these laws and regulations ensures that the entities seeking control of an insured institution possess the necessary managerial and financial resources, both currently and prospectively, and that the controlling parties will operate the insured institution in a safe and sound manner that does not pose an insurance risk to the Deposit Insurance Fund. These laws also prevent new affiliations between entities that control savings associations and commercial firms, as required by Section 401(a) of the Gramm-Leach-Bliley Act. Further, OTS regulations set forth a process for entities seeking to rebut a determination of control that requires support of their contention that no controlling relationship will result from their ownership of the insured institution.

² Sections 10(c) and (e) of the Home Owners' Loan Act.

³ 12 C.F.R. Parts 574, 583, and 584.

In the OTS's opinion, the greatest impediment private capital investors face is a general misconception that these investors engage in risky activities that are inherently unsafe and unsound, and therefore incompatible with the fundamental principles of banking. The OTS does not accept, nor has it ever accepted, this blanket mischaracterization. The OTS continues to support the infusion of private equity capital into the financial system in appropriate circumstances.

On August 26, 2009, the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) adopted and issued the "Statement of Policy on Qualifications for Failed Bank Acquisitions." The statement sets forth the terms and conditions that the FDIC deems necessary for private capital investors to be eligible to bid on a proposed acquisition structure through the FDIC's resolution process. These criteria include, among others, requirements on capital commitments, continuity of ownership and business structure. Prior to the issuance of this statement, both the OTS and the Federal Reserve Board approved transactions involving private equity. Our recent experiences indicate that private equity applicants remain interested in investing in and acquiring control of insured institutions. These investors have expressed some concern, however, about the impact of the statement on their opportunity to provide good capital to a financial system that continues to require support.

Applications by private equity investors will continue to receive stringent scrutiny by the OTS to ensure compliance with applicable laws and regulations, and to ensure that control by such entities is consistent with safe and sound banking practices.

V. Conclusion

I have tried to put the current broad credit issues in some perspective and to make suggestions to hasten the return of adequate credit to the markets. However, while the economy is starting to show some positive signs and pockets of stability, it will take more time for a full recovery.

Again, we appreciate this opportunity to testify today on behalf of the OTS and look forward to working with you on these important issues in the future.