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# STATEMENT OF


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on

# CONDITION OF SMALL BUSINESS AND COMMERCIAL REAL ESTATE LENDING IN LOCAL MARKETS

before the

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COMMITTEE ON SMALL BUSINESS
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Chairman Frank, Chairman Velazquez, Ranking Member Bachus, Ranking Member Graves and members of the Committees, 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 and commercial real estate.

The events surrounding the financial crisis of late 2008 have taken a heavy toll on real economic activity across our nation. The extraordinary policy responses to that crisis were highly effective in stabilizing global financial markets and laying the foundation for economic recovery. However, the large dislocations that have taken place in real estate and credit markets continue to inhibit the pace of that economic recovery, contributing to persistent high unemployment and slow growth in consumer and business spending. Resolving these credit market dislocations will take time. Still, the pace of the economic recovery can be enhanced by 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 households and businesses.

Adverse credit conditions and stressed balance sheets have created a difficult environment for both borrowers and lenders. The weakened economy has contributed to an overall decline in both the demand for and the supply of small business credit. Large banks have significantly cut back on lines of credit to consumers and small businesses. In addition, small and mid-sized institutions, who tend to make business loans secured by residential and commercial real estate properties, are dealing with the effects of large declines in real estate values, which tend to reduce the collateral coverage of existing loans and make it more difficult for household and small business borrowers to qualify for new credit. This dynamic is contributing to persistent weakness in local economic conditions that is placing further stress on credit performance at small and mid-sized banks that serve those communities.

In response to these challenging economic circumstances, banks are clearly taking more care in evaluating applications for credit. While this more conservative 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 encourage institutions, regularly and clearly, to continue to make soundly structured and underwritten loans. Acknowledging this responsibility, the FDIC and the other federal banking regulators supplemented prior guidance and issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* earlier this month to emphasize that examiners will follow a balanced approach in assessing small-business lending. The Statement recognizes that many small businesses are experiencing difficulty in obtaining and renewing credit to support their operations. It is clear that for a number of reasons small business credit availability has tightened, particularly at the largest institutions. The FDIC and the other banking regulators believe that continued sound lending to creditworthy borrowers is critical to the long-term success and health of the small business sector -- and their lenders.

The Statement indicates that financial institutions should understand the long-term viability of a borrower's business, and focus on the strength of a borrowers' business plan to manage risk rather than using portfolio management models that rely primarily on general inputs, such as a borrower's geographic location or industry. This new guidance states that examiners will not adversely classify loans solely on the basis of a decline in the collateral value below the loan balance, or the borrower's association with a particularly stressed industry or geographic location.

In my testimony, I will briefly describe credit quality at FDIC-insured institutions, trends in the availability of credit, and conditions currently creating obstacles to credit availability. I also will 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.

**Credit Quality and Lending Activity at FDIC-Insured Institutions**

Expenses for troubled loans continue to weigh heavily on the industry. The industry earned less than $1 billion in the fourth quarter, 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 $10.0 billion less (-14.1 percent) than they set aside in the fourth quarter of 2008. Net charge-offs of loans and leases totaled $53.0 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 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

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

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 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.

Much of the decline in loan balances occurred at larger institutions. Institutions with total assets greater than $100 billion as of December 31$^{st}$ reported an aggregate net decline in total loans and leases of $116.8 billion in the quarter, or over 90 percent of the total industry decline. On a merger-adjusted basis, at community banks that filed reports as of December 31$^{st}$, 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. | | | | | |

## Factors Affecting Small Business Lending

Weak economic conditions have created an extremely challenging business environment, 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 January 2010 -- and persistent labor market weakness poses ongoing risks to the business outlook. Small business optimism remained near record low levels in December, 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 December 2009, as did the demand for credit to finance such projects.[3] Similarly, in the Federal Reserve's 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 December 2009 survey, the percent of respondents who

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[2] "NFIB Small Business Economic Trends," January 2010.
[3] "NFIB Small Business Economic Trends," January 2010.
[4] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, January 2010, http://www.federalreserve.gov/boarddocs/SnLoanSurvey/

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, near the record high in 1980. In addition, the percent of respondents citing “finance and interest rates” as their single most important business problem stood at just 4 percent, compared to 3 percent one year ago. By comparison, a 34 percent plurality of respondents cited “poor sales” as their biggest business problem, up from 27 percent a year 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 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 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

[5] “NFIB Small Business Economic Trends,” January 2010.

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.

**Commercial Real Estate**

The deep recession, in combination with ongoing credit market disruptions for market-based CRE financing, has made this a particularly challenging environment for commercial real estate. The loss of more than 8 million jobs since the onset of the recession has reduced demand for office space and other CRE property types, leading to deterioration in fundamental factors such as rental rates and vacancy rates. Against a backdrop of weak fundamentals, investors have been re-evaluating their required rate of return on commercial properties, leading to a sharp rise in "cap rates" and lower market valuations for commercial properties. Finally, CRE financing has been harder to obtain since last year's financial crisis. There were no commercial mortgage-backed securities (CMBS) issued between July 2008 and May 2009 and only $5.1 billion has been issued since then. Commercial mortgage lenders are also reassessing their underwriting standards. According to the Federal Reserve's *Senior Loan Officers Survey*, a majority of lenders surveyed reported tightening underwriting standards during the financial crisis in

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

late 2008 and into 2009. Even according to the most recent survey in January 2010, more than one-fourth of lenders surveyed continued to report tightening underwriting standards, while none reported easing underwriting standards.[7]

Nationally, prices for CRE properties as measured by the Moody's/REAL Commercial Property Price Index are more than 40 percent below their October 2007 peak. As of fourth quarter 2009, quarterly rent growth has been negative across all major CRE property types nationally for at least the past year. Asking rents for all major CRE property types nationally were lower on a year-over-year basis.[8]

The most prominent area of risk for rising credit losses at FDIC-insured institutions during the next several quarters continues to be in CRE lending. While financing vehicles such as CMBS had emerged as significant CRE funding sources in recent years, FDIC-insured institutions still hold the largest share of commercial mortgage debt outstanding, and their dollar volume exposure to CRE loans stands at a historic high. As of December 31, 2009, CRE loans totaled almost $1.8 trillion, or 24.9 percent of total loans and leases. In terms of concentrations of credit, CRE at FDIC-insured institutions represented 133 percent of total risk-based capital, lower than the 151 percent seen one year earlier, but still significantly higher than levels at the beginning of the decade.

[7] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, January 2010, http://www.federalreserve.gov/boarddocs/SnLoanSurvey/
[8] Property and Portfolio Research

The large and widespread decline in the value of residential and commercial real estate over the past two to three years represents a major dislocation to certain lending markets. Small firms tend to borrow on a secured basis because it helps them obtain more credit on more advantageous terms than would be the case for an unsecured loan. As of September 2009, just over half of the total liabilities of nonfarm noncorporate businesses (many of which are small businesses) took the form of mortgage loans.

It is clear that the decline in the value of collateral impacts the ability of business borrowers to obtain new credit or renew existing lines. In many instances, this can result in fewer new loans being granted, less additional credit being made available under existing lines, and demands for additional collateral. Declines in real estate values have reduced the collateral coverage for many secured loans, raising their effective loan-to-value ratio.

The widespread problem of eroding collateral positions represents a serious dislocation in small business loan markets at present. It is also a problem that the federal banking agencies have directly addressed through the October 2009 *Policy Statement on Prudent Commercial Real Estate Workouts.* While these efforts to help banks and borrowers work together can help to reduce unnecessary foreclosures and preserve credit relationships in many cases, they can do little to correct the underlying problem of lower asset values. This is a problem that can only be resolved over time, as problem loans are dealt with and market conditions return to normal.

Losses in CRE portfolios thus far have been most prominent in construction and development (C&D) loans. As noted previously, noncurrent and net charge-off rates for C&D loans are both at record high levels. Outside of construction portfolios, losses on loans backed by CRE properties have been modest to this point. Net charge-offs on loans backed by nonfarm, nonresidential properties have been just $11.3 billion over the past eight quarters. Over this period, however, the noncurrent loan ratio in this category has nearly quadrupled to 3.82 percent, and we believe it will rise further. It is likely that increased vacancy rates and lower rental income will translate into more borrowers unable to cover their debt service. The ultimate scale of losses in the CRE loan portfolio will very much depend on the pace of recovery in the U.S. economy and financial markets during the next few years.

**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 Congress' and the public's 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.

We recognize that the supervisory process mirrors the underlying economic, financial, and managerial challenges that many banks are facing. Even at the most troubled institutions, our primary goal is to help the institution return to financial health and sound operation.

I would like to emphasize that 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, we have an on-going dialogue with our regional directors about credit availability. It has been 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.

We have also reached out to the industry to help us frame policies and supervisory procedures that will help lenders navigate through this credit cycle and become more comfortable extending and renewing loans. One of the first steps in this process was to establish the FDIC's Advisory Committee on Community Banking in mid-2009 to better enable our Board and senior management to have a dialogue with the industry on how we can improve our supervisory programs and foster improved availability of credit. The Advisory Committee met most recently on January 28th where we discussed many of the issues we are discussing today in this testimony -- issues facing the community bankers including credit availability and access to the capital markets. We also discussed interest rate risk exposure, funding issues and other topics of interest to community bankers in this current financial environment. The Advisory Committee will continue to meet regularly and provide direct input from community bankers on the many critical issues they currently face. Our expectation is that, together, we can come up with creative solutions to address some of the difficult challenges facing the industry. Community banks are the lifeblood of their communities, making loans to countless individuals, small businesses, not-for-profit organizations and other community-based organizations, so we must ensure the continued viability of well-run community banks.

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. We have been providing this encouragement since the onset of the current crisis. In March 2008, we issued 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.

More recently, 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.

As I mentioned earlier, the regulators have also issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* on February 5th, 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.

We will continue our dialogue on credit availability with the banking industry, members of Congress, and the public in 2010. As I stated earlier, bank lending is an essential aspect of economic growth and will be vital to facilitating a recovery. 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

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. However, in the wake of the longest and deepest recession since the 1930s, 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, I am 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.