



Reality of Bank Lending

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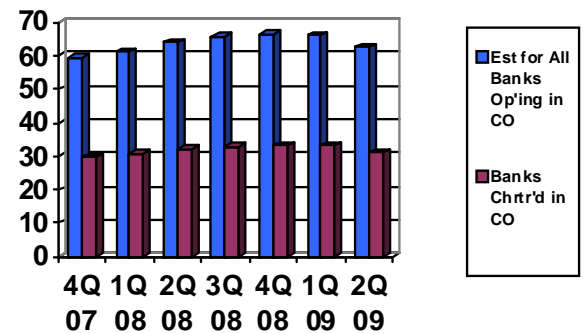
Banking takes appropriate responsibility for its prudent loan standards. We also think customers and the public deserve to understand other factors that significantly impact the ability to get credit in this environment.

ISSUE – The lack of lending (heavily criticized by the public, media, and public officials) reflects low loan demand and is attributable to ❶ borrower creditworthiness issues, ❷ lender financial constraints, and ❸ regulators' tougher standards, and is exacerbated by the ❹ greatly diminished role of nonbank lenders recently. For business borrowers who are key to an economic recovery and already have financial strain this means banks are their primary source of credit and banks are unable to make many of the loans for the reasons stated. This is especially difficult for loans secured by real estate.

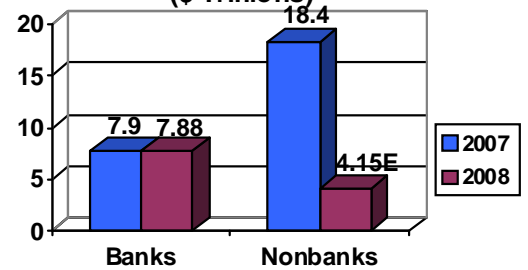
SCOPE OF ISSUE

- **Bank lending** – Despite the financial turmoil in 2008, banks in Colorado increased lending 11.7%, when most states and the U.S. declined. Colorado loans subsided approximately .8% in the 1st quarter 2009, and 5% in the 2nd quarter 2009. (About 2 of that 5% is from a single bank failure.)
- **Nonbank lending** – Decades ago banks provided 70% of loans in the U.S.; bank lending has grown over the decades. The nonbank sector has grown even faster so that in recent years nonbanks provided 70% of U.S. credit and banks provided only 30%. In certain segments like retail and restaurants nonbanks supplied even more credit. The turmoil in the last third of 2008 eliminated many nonbank entities and severely damaged others. The result is that nonbank lenders which previously financed a lot of American commerce especially including real estate are a fraction of their former size. That means borrowers have fewer options and customers (particularly commercial and commercial real estate customers) are more reliant upon bank lending. In many refinancings, banks replace now nonexistent nonbank lending.
- **Borrower needs** – Loan demand at banks is down across the board due to customer caution and economic uncertainty (except for home mortgages). Some individual customers (business and consumer) have had financial deterioration causing a very critical need for credit for them.

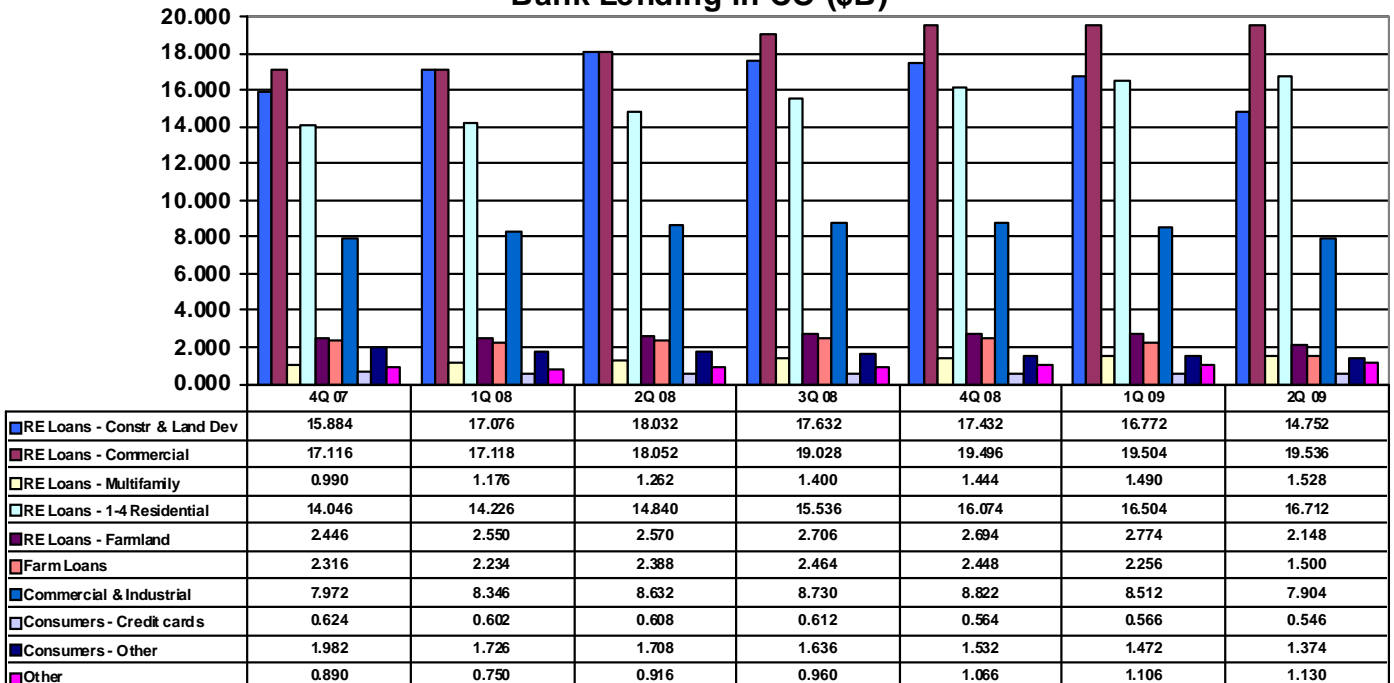
Total Loans by Banks in CO (\$B)



Lending in U.S. (\$ Trillions)



Bank Lending in CO (\$B)



Lending levels reflect low demand, borrower creditworthiness issues, lender financial constraints, regulators' tougher standards, and nonbanks' reduced role.

BORROWER CREDITWORTHINESS

As asset values dropped for many businesses recently they were forced to seek borrowed funds. Often their financial statements deteriorated in the last year meaning many do not qualify for loans now; their assets are worth less and their capacity to repay loans has declined. Most nonbank lenders who previously had lower lending standards than banks have disappeared or have tightened lending standards to look more like traditional prudent bank lending. Borrowers' sales or receivables are down, decreasing cash flow needed to repay debt.

LENDER CONSTRAINTS

As borrowers have difficulty, banks' loan losses grow. Those losses deplete bank capital which governs a bank's ability to lend. Banks maintained or perhaps modestly increased lending standards in the last year. Banks' prudent standards create higher quality loans and result in banks having fewer loan problems than lenders with weaker standards. Those bank loan standards generally have allowed banks to weather the current economy. The impact on customers is that those seeking credit may not qualify due to their own deterioration and/or the lenders' cautious standards. If banks were to lower loan standards that would result in more loan repayment problems. Loan standards are the single biggest factor in keeping banks healthy.

CHANGING STANDARDS IN BANK REGULATION – COUNTER CYCLICAL NATURE DAMAGES LENDING

Despite borrowers' and lenders' constraints there are loans that banks could make if they were permitted. Banking is a highly regulated business; examiners scrutinize lending practices and individual loans. We know regulators have a job to do: regulate and examine banks to assure their safety and minimize the chance of bank failure.

Consistency in their approach would benefit everyone: banks, regulators, and the public. A lesson from previous cycles is that it takes time for real estate values to come back. Banks that are working with borrowers in an effort to allow time to sell the property, but not at distressed levels, aren't given any flexibility in this environment.

Changing regulatory standards are causing problems. Bank capital is the cushion against loan losses, and it is being used as intended in this era of loan defaults. Regulators aren't maintaining standards as in previous downturns, but are significantly increasing them. Failing to distinguish between banks and nonbanks, public misperception of who and what caused last fall's crises and the safety of real banks – along with Congressional comments against banks (when they actually mean nonbanks) – prompts regulators to raise standards more. That political pressure drives regulators' over-reaction; they "crack down" on banks to minimize the chance of failure "on their watch." Enforcement actions from bank regulators were once the rare exception and now are commonplace.

If banking was a lending machine:

- Congress/public/media have their foot on the **accelerator** – saying "go faster, lend more money," but
- Bank regulators have their foot on the **brake** – saying "no you don't, we don't want banks taking any risk."

Each bank has a unique situation. This economic downturn requires experienced field examiners. Many examiners lack this experience and then have a tendency to react strongly with subjective judgments that deter lending.

The Colorado Bankers Association stresses prudent regulation; sound regulation of banks is essential. We don't

KEY BACKGROUND ITEMS

- **Bank** – A financial institution that holds deposits and makes loans, and is heavily regulated and examined by government agencies. Banks are cautious/conservative in lending practices in order to remain safe and sound. Regulators hold banks to standards that don't apply to other lenders. Banks always have "bank" in their name and always are FDIC insured.
- **"Bank" in common usage** – The public and media misuse the word "bank" to describe any entity in financial services, failing to distinguish between real banks and nonbanks. Thus the sins largely attributable to nonbanks are erroneously attributed to banks, especially in 2008. This has prompted unwarranted concern for bank safety and lending practices; the underlying public anxiety largely is caused by practices of nonbanks, but reported in the media as "banks."
- **Bank regulation** – Bank regulators dictate bank practices and examine banks for compliance in order to protect the depositors. Bank regulation restricts banks to safe practices and loans so they can repay depositors their funds, as required by law, when the customers want. Bank regulators include Colorado Division of Banking, FDIC, Federal Reserve, Comptroller of the Currency...
- **Capital** – The owners' investment in the bank, which the owner loses if things go badly. Capital is the safety cushion that protects a business against losses that inevitably arise from time to time.
- **Nonbank** – A financial services provider not subject to banks' heavy regulation – such as mortgage companies, securities firms, insurance companies, finance companies, Fannie Mae/Freddie Mac, secondary market (purchasers of loans), mutual funds, hedge funds...

seek regulatory laxness; we seek prudent loans and smart regulation. It is essential to economic recovery. Misguided regulatory actions can constrain bank lending. It can be argued regulators aren't tough enough in good times for banks, and are too demanding in rough times. We believe there are several areas of over-reaction by regulators and examiners that discourage or preclude bank lending. That has consequences not only for banks but very importantly for bank customers and the entire economy that depends on bank lending now more than ever.

CHANGING REGULATORY STANDARDS

Specifically CBA has concerns about: (See endnotes for detailed descriptions of these three issues.)

- Significant increases in capital standards (while we're coping with this tough economy) ¹,
- Concentration standards ("too many" loans in one area, triggering lending restrictions) ², and
- Loan downgrades (grading the loan as nonperforming [thus prompting capital decreases and lending restrictions] even when the borrower hasn't missed a payment and has the ability to make future payments) ³.

These factors combine to negatively impact borrowers in several ways. The growing capital pressure on banks in an environment where it is difficult to obtain outside investment capital often translates into shrinking the bank. That's done by reducing lending. That is compounded by the exit of nonbanks from lending – leaving banks as essentially the only source for many loans. When a bank's focus is on complying with complex regulatory matters it can't keep its first priority on serving customers and the community.

COMMERCIAL REAL ESTATE (CRE)

- Federal regulators' 2006 "guidance" now is a firm policy. It has a big impact on borrowers. A bank is considered to have a CRE concentration and needs heightened risk management practices if:
 - loans for construction, land development, and other land (dirt loans) are at $\geq 100\%$ of total capital, or
 - loans for construction, land development, and other land and loans secured by multifamily and nonfarm nonresidential property (excluding loans secured by owner-occupied properties) are $\geq 300\%$ of total capital.
- Heightened risk management elements for CRE lending include: capital exceeding regulatory minimums, strict board and management oversight, underwriting, risk assessment and monitoring of CRE loans, portfolio risk management, management information systems, market analysis, stress testing, and strategic planning.

Changing regulatory standards in capital requirements, loan concentrations, and loan downgrades often result from subjective judgments and national benchmarks. They disallow recovery of real estate values over time, and often prompt shrinkage of the bank which reduces lending and greatly impacts customers.

REGULATORS' ACTIONS

Many banks nationwide are now subject to regulators' written enforcement actions. Broad elements common to recent written agreements include:

- Increase capital to X% in 3-6 months or sooner,
- Decrease dependence on noncore funding,
- Change management or senior officers,
- Comply with stringent documentation and approval requirements on any loan over \$X00,000,
- Improve credit underwriting and administration (details specified by regulators),
- Develop a program that makes loan officers accountable for any exceptions to lending policies,
- Submit a written report designed to manage the risk in the bank's commercial real estate loan portfolio,
- Submit quarterly/monthly monitoring of concentration reports that stratify the commercial real estate portfolio by product type and location,
- Reduce the volume of problem loans by ensuring management addresses and intervenes to resolve problem credit situations,
- Submit a plan to reduce the bank's problem loans,
- Implement a policy for maintaining an adequate allowance for loan and lease losses...

CONCLUSION – Bank lending plays a critical role in our economic recovery. Borrowers and lenders are addressing financial constraints and are working through issues. Bank regulation and examination are essential to a sound banking system. CBA recognizes this essential role but also believes regulators are impairing bank lending and thus the recovery by overly aggressive actions in capital standards, concentration standards, and loan downgrades. CBA is providing essential information to bankers, public officials, the public, and major customer groups.

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¹ Significant increases in capital standards – In previous downturns regulators maintained and enforced existing standards as the banks worked through loan problems. Now it appears we are facing increasing standards that are extremely difficult to meet during the recession and greatly reduce bank lending when communities and businesses depend on that so much. Maintenance of standards is appropriate; increasing them in this environment creates a huge problem.

- Capital standards for banks are critical. *Well Capitalized* (the highest of regulators' ratings of bank capital) has been increased to from 10% to 12% or higher for risk-based capital (required capital levels that vary according to the bank's risk profile). That's for a "normal" community bank without CRE or consumer credit concentrations. Capital or reserve requirements (for loan losses) can be higher for banks with those concentrations and depending on their asset quality and practices. Not only has the percent of risk-based capital increased but so has the risk-weighting on many assets, meaning banks take a double hit. Risk-based capital is a complex calculation where all of a bank's assets are weighted depending on their potential risk. Some assets, like cash, have a 0% risk weighting. Others, like loans may have a much higher risk-weighting of up to 100%. The higher the risk weighting the more capital a bank must have to guard against losses for that asset. As assets are downgraded, they are assigned a higher risk weighting. The industry is experiencing a sharp increase in regulator downgraded assets; many downgrades are the result of declining property values. So not only has the capital ratio a bank must maintain increased to 12%, but the amount of risk-weights has also increased. This makes the increase in capital much more significant than a 1% or 2% increase.
- Examiners say the definition of *Well Capitalized* hasn't changed, arguing that additional required capital is due to increased classified levels, increasing past dues, deteriorating economic conditions... They also argue that the levels included in the definitions are minimums and adverse conditions, either economic or bank specific, justify the need for additional capital. Examiners (sometimes without adequate experience) make subjective judgments on loan values, often using national benchmarks rather than local conditions. The end result is an increase in capital requirements based on subjective judgments on loans, individually and in aggregate.
- If a \$100 million bank (a small community bank) is required to increase capital 1% (from 11% to 12%) it is possible but difficult to raise that additional \$1 million from investors. Investors are hard to convince to invest in this environment, partially due to concern about further regulatory requirements on banks. A common strategy when a bank is unable to raise outside capital is to shrink the bank. That allows the \$11 million in capital (11% of the \$100 million bank) to grow to 12% by downsizing the bank's assets about \$8.5 million to \$91.5 million. Since loans make up a huge proportion of a bank's assets the practical way to do that is to decrease total loans by not granting new credit or not renewing loans when due. And there's a practical difficulty in shrinking loans: today borrowers aren't able to pay off loans without selling the distressed commercial real estate for which there's little market. This can produce a downward spiral.
- It seems no matter what the level in a bank's loan loss reserves, the number is not enough to an examiner. The bank's methodology is criticized continually until the bank gets the number much higher. Loan loss reserve expense lowers net income, thus causing regulator concern about capital, leading to more criticism about safety and soundness. Given the difficulty some banks are facing trying to raise outside capital in this environment, it results in worsening conditions for some banks.
- These factors create issues for the bank and the customer. We know that lack of access to credit can hurt asset values for the customer – and for other property owners whose values are reflected in appraisals based on the value of the customer's assets.

² Concentration standards – It is perceived that regulators are raising other standards. Limits on how much of a bank's lending can be concentrated in a particular area are shifting. Concentration standards limit permissible bank lending in total or in areas of concentration.

- For example loan concentrations in agriculture or commercial real estate can effectively translate into the bank's inability to lend in those areas.
- Real estate – Limitations on commercial real estate deserve special mention. In 2006 bank regulators published a guidance on this subject that is no longer a guide but now is viewed as a hard and fast rule. In short, a bank may not have over 300% of its capital in commercial real estate loans. Using the \$100 million bank example with \$12 million of capital (12%) it could not make commercial real estate (CRE) loans in excess of \$36 million. The industry-wide average in Colorado is that banks have 320% of capital in CRE loans (more for some banks) – because our economy is significantly based on real estate. To meet the limit, CRE loans need to be reduced industry-wide to the 300% level. That translates for the Colorado banking industry into reducing CRE loans by at least \$2.4 billion (out of the existing \$38.4 billion CRE portfolio – a reduction of 6%+ in CRE lending) – at a time when borrowers are trying to obtain more credit.

³ Loan downgrades – Regulators' definition of performance on a loan is changing in a way that downgrades loan scoring – resulting in “classified” or “doubtful” loans that then require bank actions including charges against capital. Loan downgrades can result from an over abundance of regulator caution rather than for true bank safety and soundness reasons. Regulators use national "benchmarks" that negate the benefit of local knowledge and long term loan relationships. Loans paying as agreed, loans with fully funded interest reserves and other loans are being downgraded. This causes an increase in the bank's reserve for loan losses – which means even less lending. Banks are the primary CRE lenders; nonbanks previously active in this market are now greatly diminished.

- An example of the changing regulator view of loan performance is classification of a loan that is not performing as planned by the bank and the customer (for example they had planned for a real estate developer to have sold X lots at \$X price by now and that hasn't happened) although the loan is performing OK (for example that same borrower hasn't missed a payment and has the ability to make future payments). The loan may be classified or downgraded.
- Examiners are taking a very conservative view on appraisals, and requiring discounts on appraised values. This lowers the amount of “lendable” dollars in the community in general, and very specifically on that one deal. This contributes to downward pressure on real estate values.
- Subjective criteria for loan grading have changed although regulators will argue it hasn't. Examiners have a single-minded approach in loan grading in that any deviation from the original primary source of repayment results in a sub-standard grade or worse. For example, if sales of a development or construction project have slowed but guarantor strength is sufficient to cash flow the loan over a permissible amortization period, either through monthly payments or annual reductions in principal, the guarantor strength will not prevent the loan from being downgraded. Construction and development projects that have slowed, not stalled, but are not selling in accordance with the original estimate of the appraiser are also being classified. The appraisers don't know how long it will take for the project to sell out but are required to make estimates in that regard. If the project takes 3 years to sell versus the appraiser's earlier estimate of 2 years and the loan is performing (interest kept current and regular principal payments through sales), the classification and consequent regulator criticism/pressures on the loan only puts hardship on the bank and the borrower. Also, performing seasoned real estate loans with a low loan to value likely will be classified if the bank is unable to demonstrate where the cash for the payments is coming from (this may be due to poor quality financial reporting on behalf of the borrower – not a good thing but not necessarily justification for a classified loan) but the payments have been made as agreed for years and are likely to continue. This is particularly troublesome where the loan to value is very conservative, say 50% or less. While it is true that the bank may not be able to document where the payments are coming from, the examiner cannot document that the payments will not continue as they have for the past several years, but the examiners make the call and the more criticism they level against the bank the more they press for additional capital.