

BANKS, LENDING, SMALL BUSINESSES AND CAPITAL ACCESS IN THE GREAT RECESSION

Joint Legislative Economic Development & Global Engagement Oversight Committee

North Carolina General Assembly

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Good morning. My name is Ray Grace, and I serve as Chief Deputy Commissioner at the Office of the Commissioner of Banks, where I have worked in various capacities the past 37 years.

Banking has been defined very simply as buying and selling money. Banks buy deposits from people who have excess funds, and sell that money by lending it to those who have a need for funds and, presumably, the wherewithal to repay it.

They pay interest on the deposits, and charge interest for the loans, and to the extent they receive more in interest for the money lent than they pay for the money bought, they live off the margin and, *ceteris paribus*, life is good. This model works best when the loans are repaid.

If there is anything I have observed over my years as a bank examiner and regulator, it is that, fundamentally, banks want to lend money. It's just what they do. Why? Because loans characteristically provide the highest return on a bank's balance sheet. So when banks aren't lending money, you know something's amiss.

Although aggregate bank lending has declined recently, community banks actually continued to lend, even during the Great Recession that began in late 2007- early 2008, until last year. The overall decline in lending stems from consolidated industry numbers, which are heavily distorted by money-center banks that enjoy a dominant share of the national market. Those banks did sharply curtail their lending, pulling the national numbers down, while turning back to the "carry trade," i.e., investment banking, currency exchange, bond and equity trading, they were doing for earnings prior to 2007.

Banks under \$10B in total assets, on the other hand, were still lending through this period, though at a diminishing rate that culminated in a slight decline in 2010. This is significant, as community bank lending to small business is a critical driver of the economy. According to FDIC statistics, community banks control about 11% of total bank assets, but made over 40% of small business loans in 2010.

Banks larger than \$10B in total deposits controlled 67.0% of all bank deposits nationwide at June 30, 2007. By June 30 of this year, four years into the Great Recession, they controlled 72.4%. So interestingly, despite the TARP program, the recession and the passage of Dodd-Frank and “too-big-to-fail,” consolidation of the industry and growth of the big banks continues.

I said that, fundamentally, banks want to lend, so when they stop or curtail lending, there is clearly a problem. There are actually several.

First, in the wake of the bursting real estate bubble in 4Q07, real estate values plummeted and the floor fell out from under the economy. Banks that had been lending heavily on commercial real estate, which included many in the Southeast and other high-growth regions of the nation, suddenly found themselves holding the debt of developer-borrowers who could not service their loans because of a sudden dearth of buyers, while the value of real estate collateral, previously thought to offer an ample margin of protection, fell as much as 50% virtually overnight.

The resultant losses quickly depleted their capital and decimated their earnings, and the need to devote attention to collection, workout and liquidation efforts further hampered their ability to conduct business as usual.

Areas of the state that experienced the greatest real estate value inflation were, not surprisingly, hardest hit by the deflationary spiral. These included coastal North Carolina, especially beach properties, and the mountains of Western North Carolina, which had been enjoying strong growth from retirement and vacation home development and sales. As recession set in around the country, people who might otherwise have retired and bought homes in North Carolina, postponed retirement, or could not sell their homes in the down market, and so could not afford to move. Similarly, potential vacation home buyers were forced, or elected, to retrench.

Other markets around the state were impacted by the recession due to high and rising unemployment rates, and reduced rates of in-migration, as the national workforce became less mobile, again because of inability to sell their homes. As real estate values fell, an increasing number of homeowners found themselves “underwater,” prompting some to engage in so-called “strategic defaults.”

In 2005 and 2006, no banks failed anywhere in the U.S. In 2007, three went down. In 2008, another 25 were closed; in 2009, 140 more failed, including two in Wilmington, North Carolina, the first failures here since 1991. According to the FDIC, 2010's 157 failures are believed to be the high-water mark for failures in this cycle. Thus far in 2011, 90 banks have failed, including two in Asheville, North Carolina.

The Southeast has been hard hit by the wave of bank failures. Georgia is the national epicenter, having lost 21 banks this year and over 70 since 2008. Florida is right behind, with 12 this year and 56 since 2008.

As the Great Recession set in, bank regulators across the nation moved to address the problem. The rapidly inflating real estate bubble had not gone un-noticed, and by 2006, after considerable controversy, the federal agencies issued guidance to financial institutions cautioning against concentrations of aggregate commercial real estate (“CRE”) loans greater than 300% of capital, and concentrations of acquisition, development and construction (“ADC”) loans of more than 100% of capital. The controversy revolved around whether these numbers constituted “guidance” or hard limits, but in any event, CRE and ADC loans came sharply into focus in the examinations of banks. Whether guidance or hard limits soon became irrelevant; it was too late in the party to prevent the hangover. Led by the subprime mortgages, the bubble burst late the following year.

Federal bank regulators were excoriated in public hearings in the Washington blame-game, and the pressure was quickly passed along to the banks, which faced increasingly harsh examinations and balance sheets under assault from heavy loan losses and the intake of large amounts of hard-to-move, costly-to-hold Other Real Estate Owned. CRE and ADC loans went from the bankers’ bread and butter to toxic overnight.

Many formerly healthy banks found themselves under restrictive orders from their regulators, running the gamut from informal board resolutions or memoranda of understanding, to formal cease-and-desist orders. Whether formal or informal, each of these orders placed their recipients under various restrictive covenants. Orders imposed by our federal colleagues have been particularly stringent, and the standards by which they are imposed have often been inflexible and, in some instances, contrary to their intended purpose. In large part this is a function of federal legislation imposed at the end of the last major recession in the early 90s.

One such restriction common to many of the orders compels the bank to reduce its concentration of CRE and ADC loans. As more and more banks are operating under these restrictions, in an environment where many banks, including those without enforcement actions, are already trying to reduce the amount of CRE and ADC loans on their books, it obviously becomes very difficult to obtain or even renew loans of this type.

Another common provision, driven by federal regulation, is a requirement to reduce or eliminate dependence on so-called “brokered,” or “wholesale” deposits, in favor of locally-generated retail “Core” deposits. This can induce a liquidity crisis where none previously existed.

Nearly all regulatory enforcement actions now carry a capital maintenance provision that either requires the bank to raise its capital ratios to a higher level, or maintain its capital at a certain minimum level, or both.

Interest in bank equities, particularly small bank equities, quickly dried up in 2008, and those private equity groups that were interested early on were subjected to intense scrutiny and lengthy application processes that in many cases resulted in failure of transactions that might otherwise have brought needed capital into the banking system. If a small bank is ordered to quickly increase its capital in this environment, it is unlikely to come from a public equity offering. That leaves the bank with two alternatives; sell the bank, also difficult now, and for the same reasons, or shrink the bank. Most banks follow the shrinkage strategy, which also curtails lending and dissipates earning assets to the detriment of earnings.

Lending is also approached very cautiously in an economic environment where borrower defaults are increasingly common, and banks are concerned about high risks in the face of low returns and flinty-eyed regulators. Loans that are made are held to a much higher standard of quality and documentation than during the run-up to the recession.

Finally, loan demand from credit-worthy small businesses has been very soft, as those businesses have lacked demand from their own customers, and are reluctant to expand in an uncertain landscape.

The recently concluded Small Business Lending Fund initiative by the U.S. Treasury, announced as a \$30 billion program, wound up deploying only \$4.0 billion among 332 banks nationwide; only 933 of the nation's 7,500 banks even applied. Of those who applied and were funded, 137 used the funds to refinance their TARP funding. In North Carolina, only 6 banks were approved, receiving an aggregate of \$99.2 million. Of this, nearly \$74 million was used to refinance TARP funding. Why?

In my opinion, it was largely because those banks, and indeed most banks now, have ample funding to make loans. Funding is not the problem. The problems are a combination of lack of demand for quality loans, or lack of demand for the "right kind" of loans, for which, read "not CRE or ADC loans," and, of course, the large number of banks that are constrained from making those loans because of regulatory enforcement actions or by virtue of the amount of such loans already on their books.

So, what's the outlook? Not surprisingly, it all depends on the economy. Until economic activity picks up and unemployment trends down, community banks are undergoing tough scrutiny of their lending activities, and are unlikely to risk precious capital, and their survival, on any but the highest quality loans. Documentation standards for those loans that do get made are extremely stringent.

There are, however, some hopeful signs. Over the past year, the Federal Reserve finally approved a transaction in which Community One and Bank of Granite were acquired by a group wanting to merge the two troubled institutions into a single bank, thereby pulling them both back from the brink of failure and infusing the combined entity with \$310 million in new capital. This can only help the communities they serve in central and Piedmont North Carolina, and the hard-hit Unifour region of the state. Piedmont Community Bank Holdings was allowed to acquire a controlling interest in Crescent State Bank, bringing in \$75 million in new capital. North

American Financial Holdings bought a controlling interest in Capital Bank, bringing \$181 million to the table.

SBA loans in North Carolina were up by 37% in the first quarter of 2011. The numbers suggest that the deterioration of asset quality in North Carolina banks may have bottomed out in 2010; profitability is slowly turning in the right direction in what is, after all, a fragile and tentative recovery at best. Anecdotally, we are beginning to hear from some bankers that small business loan demand is picking up, albeit tentatively.

Ironically, as the equity and financial markets have stumbled and lurched about in recent months, the megabanks are rediscovering the virtues of small business lending, and are refocusing their marketing efforts in that direction in search of earnings. While this will increase competition for top quality loans, it may also create a new challenge for already-strapped community banks, as the big banks seek to lure away their best customers from a finite pool of desirable loan opportunities.

To sum up, banks do want, and need, to lend to small businesses and their other traditional customers. The deep and persistent recession in which we find ourselves has made that lending problematic because it has dramatically reduced collateral values, especially real estate, reduced the ability of businesses to generate revenue with which to support and repay debt, and prompted a much more rigorous and inflexible regime of federal bank regulation. The latter may, indeed, actually be working to stifle what might otherwise be a stronger economic recovery.

Questions?

Please note we have included in your information packet a number of charts and graphs supporting the narrative. We will, of course, be happy to try to answer any questions you may have about these materials.