# Elizabeth A Duke: Restoring credit to communities

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, at the fifty-third Annual Western Independent Bankers Conference, Scottsdale, Arizona, 31 March 2010.

*The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.*

* * *

Good Morning. I am pleased to be here today to address the Western Independent Bankers Annual Conference. As many of you know, I spent most of my career as a community banker. What you may not know is that I first became CEO of a community bank under an unusual set of circumstances. I found myself in the CEO's seat unexpectedly, after the sudden death of my mentor, the man who had taught me banking and with whom I had started and built that bank carefully over the years. In addition, it was August 1991, which I'm sure you will recognize as the peak of the last credit crisis.

It was a typical community bank. We loaned inside our market to customers who had been with us for many years. As the economy weakened in the early 1990s, those customers struggled and the value of their collateral dropped. Neither we nor our customers had caused the crisis, but we still had to face it and deal with it. Throughout those challenging years, we had some successful workouts and some that were not so successful. Sound familiar?

So, I have experienced banking crises from different perspectives throughout my career. Having dealt with the last banking crisis as a banker, I understand the stress many of you and many of your customers feel today. I also know firsthand the importance of recognizing problems early and tackling them head on. Having experienced the more recent crisis at the Fed, I can assure you that this environment is every bit as stressful for your regulators.

Even in the best of times, lending involves judgment. So does bank supervision. During times of stress, the judgment calls get more difficult and more critical. An economy and its financial system are inextricably intertwined and bank supervisors are charged with maintaining the safety and soundness of the system without impeding the flow of loans to creditworthy borrowers. The linkages that connect community banks, the communities they serve, and their bank supervisors, are especially interwoven and essential.

Now I am happy to report that our bank and, for the most part, our customers pulled through that crisis in the early 1990s. And I continued to lend to many of those same customers for another 15 years. I am pleased to see that you have chosen as the theme for this conference "Solutions for the Changing Environment" as it indicates confidence that you too will continue to thrive and support your communities. For it is critical that you do so: Our economy needs strong community banks that are able to meet the financial needs of their communities and their customers.

In my remarks today, I intend to focus on your role as lenders. First, I will discuss commercial real estate, the loan category that for most community banks is causing the most stress and receiving the most attention. Then I would like to talk about credit availability for small businesses, a key customer segment for community banks. Finally, I will offer some thoughts about the role of supervisors in encouraging the flow of loans to creditworthy borrowers. Throughout the discussion, I will focus on recent loan guidance issued by the Federal Reserve along with our fellow banking regulators and the steps we at the Fed are taking to ensure that the policies we set in Washington make it into the field to the examiners you see in your banks.

Before I begin, I would like to make one point of clarification: When I reference community bank statistics, I will refer to the segment of banks with less than $10 billion in total assets.

## Banking and financial conditions

While conditions in some financial markets have improved markedly in recent months, conditions in the banking sector continue to be weak. The largest banks were modestly profitable during 2009, but community banks as a group reported a loss of $4.1 billion and showed a negative return on assets of 0.17 percent. Community bank losses were driven primarily by large loan loss provision expenses, as well as a decline in net interest margins related in part to a substantial increase in nonperforming assets.

There are signs that these problems might be reaching a plateau in some loan categories, but delinquencies and charge-off rates grew steadily last year and the nonperforming assets ratio for community banks is now approaching five percent, a level considerably higher than the previous highs reached in the late 1980s and early 1990s. In addition, although capital ratios at many banks have improved substantially since the start of the crisis, other institutions continue to face serious questions about capital adequacy due to weak loan quality, subpar earnings, and uncertainty about future conditions. Together, these developments have led to an increase in the number of problem banks to the highest level since the early 1990s. The rate of bank failures has accelerated and appears likely to remain elevated for some time. While most banks remain sound, appropriately capitalized, and profitable, this can be difficult to remember in the midst of strained banking conditions and weekly bank failures.

The coordinated efforts and initiatives of the Federal Reserve, the U.S. Treasury Department, and other government agencies have contributed to the progress we have achieved in stabilizing the financial markets and the banking system. I think it is important to note that most of these efforts were directed at the system as a whole and were made available to banks of all sizes.

For example, in September 2008, when a prominent money market fund “broke the buck” (that is, its net asset value fell below one dollar), the Treasury Department initiated a temporary guarantee program to avert a run on other money market mutual funds. Then, in response to bankers’ concerns about the adverse impact that unlimited guarantees for money market funds would have on bank deposits, the Treasury adjusted the guarantee to cover only balances in place on the date the guarantee was issued. That is, funds that were already in the money market mutual fund accounts were guaranteed so they would not run out, but no guarantee was offered for new investments that might cause runs out of depository institutions and into the funds. A few weeks later, the deposit insurance limit was temporarily increased to $250,000, an increase that had long been sought by community banks.

In addition, under the Temporary Liquidity Guarantee Program (TLGP), the Federal Deposit Insurance Corporation (FDIC) made available unlimited insurance for demand deposits. Later the program was modified to also cover Interest on Lawyers Trust Accounts (IOLTAs) and low-interest Negotiable Order of Withdrawal (NOW) accounts. These initiatives proved tremendously beneficial to community banks and their small business customers during the crisis and have been instrumental in returning some measure of stability to deposit markets.

Other efforts to calm markets were also designed to directly assist banks of all sizes. For example, more than three-fourths of the companies that received funds from the Troubled Asset Relief Program (TARP) capital purchase program were, in fact, community banks. In addition, the Debt Guarantee Program put in place by the FDIC under the TLGP has also been available to community banks, helping to support market confidence. And the Federal Reserve’s discount window lending as well as the Term Auction Facility, which offered discount window funding through auctions, were available to banks regardless of size and benefited community as well as larger banking organizations.

Looking back over the past two years, I have reached the conclusion that these programs, taken as a whole and combined with other steps taken by policymakers and bankers themselves, have had a dramatically positive effect on financial conditions and have brought us far beyond the near panic that we experienced in the latter half of 2008. Importantly, these initiatives were in many cases tailored to ensure that they were available to, and supportive of, community banks. So although I understand that there will be significant additional challenges ahead to improve the condition and performance of community banks, you can take some comfort in knowing that policymakers are aware of the importance of your institutions and are sensitive to the unique challenges that you face.

### Improving lending conditions

All of these measures have helped foster stability in the financial system. However, banks still have significant delinquencies in their loan portfolios and some small businesses and consumers still report trouble obtaining credit. In addition, although loan balances at the smallest banks – those with total assets of $1 billion or less – in the aggregate fell only modestly during 2009, loans outstanding for all other banks dropped more sharply. Some observers attribute this decline in loans outstanding to overzealous bank examiners, but I believe the causes are numerous and more complicated. Regardless of the cause, the decline is of great concern and we must work together to reverse the trend. As the financial crisis unfolded, the Federal Reserve, in collaboration with the other banking regulators, issued lending guidance on three occasions, stressing the need for balance in the approaches used by bankers to approve loans and by bank examiners in reviewing loans:

- in November 2008, regulators issued guidance stressing the importance of continuing to make prudent loans to creditworthy customers;[1]
- in October 2009, the agencies issued guidance covering commercial real estate (CRE) loans and workouts;[2] and
- in February of this year, we issued guidance regarding loans to small businesses.[3]

### Commercial real estate loans and workouts

The ongoing deterioration in commercial real estate loans is perhaps of greatest concern for community bankers. These loans make up more than 30 percent of community bank assets and have deteriorated sharply as fundamentals in property markets have weakened. Performance problems have been most striking in construction and development loans, especially for those that finance residential development, but have been significant in other loan segments as well. Altogether, CRE loans seriously delinquent, on nonaccrual status, or held as other real estate owned (OREO) – including all construction loans, loans secured by nonfarm nonresidential properties, and loans secured by multifamily properties – represented nearly eight percent of commercial real estate loans and related OREO at year-end 2009, and almost one-quarter of the total risk-based capital at community banks.

Given the risks associated with CRE lending, banking agencies have for the past several years focused on assessing community bank exposures to commercial real estate and pushing institutions to enhance their risk-management processes for this segment of their portfolios. As problems surfaced we recognized that loan restructurings are often in the best

---

[1] For more information, see Board of Governors of the Federal Reserve System (2008), “Interagency Statement on Meeting the Needs of Creditworthy Borrowers”, press release, November 12.

[2] For more information, see Board of Governors of the Federal Reserve System (2009), “Federal Reserve Adopts Policy Statement Supporting Prudent Commercial Real Estate (CRE) Loan Workouts”, press release, October 30.

[3] For more information, see Board of Governors of the Federal Reserve System (2010), “Regulators Issue Statement on Lending to Creditworthy Small Businesses”, press release, February 5.

interest of both the bank and the borrower and encouraged banks to explore opportunities to work with their borrowers to appropriately restructure problem loans.

My recent conversations with bankers have been heavily focused on concerns about loan classification standards. Some of you have told me that you feel that examiners are not always taking a balanced approach to the assessment of commercial real estate loan restructurings. On the other side of the table, I hear from examiners that they feel some banks have been slow to acknowledge declines in commercial real estate project cash flows and collateral values. The new guidance is intended to bridge this apparent gap in perceptions and to promote both prudent commercial real estate loan workouts by banks and balanced and consistent reviews of these loans by the supervisory agencies.

The October 2009 CRE guidance includes a number of examples drawn from common loan situations and specifies classification treatment for alternate scenarios that depend on actions taken by the bank and the borrower. As we were finalizing the guidance, I sat down with our supervision staff and went through each of the examples as if we were in a loan closing conference. Based on what was discussed during those conversations and my close reading of the guidance, I think the best way to bridge the gap in perception is through well-documented facts. For example, to support the value of a construction project, the bank would need current information on the project status, including an estimate of the cost to complete. It would also need documentation of the method of realizing value for the completed project. For instance, if the borrower has a take-out permanent loan commitment, the file should include an update on the status of the commitment including any conditions to closing. If the property is under a sales contract, the bank should document the buyers' continued willingness and ability to close. If the bank is relying on other resources of borrowers or guarantors for repayment, it should have global cash flow information to be able to assess their ability to continue to carry the loan until conditions improve. The fact that the loan has a good payment history and is performing is important, but not sufficient to make the case that resources are available to keep it current in the future. Finally, the bank should have either a current appraisal or sufficient current market information to credibly update the assumptions in the most recent appraisal. If market conditions are changing rapidly, "current information" may need to be more up-to-date than is usually the case. Examiners generally are not expected to challenge the underlying valuation assumptions, including discount rates and capitalization rates, used in appraisals or evaluations when these assumptions differ only in a limited way from norms that would generally be associated with the collateral under review.

Loans will be classified and valued on the basis of cash flow first, and collateral value second. Assessments of cash flow and valuation will be much more reliable if based on solid documentation. In the absence of documentation, examiners will have to make assumptions. Most loans should fall into one of three categories:

- First, if available cash flow, including the willingness and ability of any guarantors to provide cash support, is sufficient to carry a construction project to completion or to amortize a completed project on reasonable terms at a market rate of interest, the loan should not be classified;
- If, on the other hand, there is no available cash flow to carry the loan and repayment can only come from the sale of the collateral, an amount equal to the value of the collateral less selling expenses will be classified and any remaining amount charged off; and
- Finally, if cash flow is sufficient to partially amortize the loan, the bank may be able to restructure the loan into two parts, one of which is supported by cash flow and therefore a pass, and the second of which is less supported and so would be classified.

This guidance is designed to address workouts and restructurings of problem credit, but the clarification of loan classification standards should also give bankers some confidence in evaluating new loans for both credit risk and risk of classification. Overall, the guidance urges both lenders and examiners to take a balanced approach in assessing borrowers' debt servicing capacity and to make realistic assessments of collateral valuations.

Importantly, at the Federal Reserve we have complemented these issuances with training programs for examiners and outreach to the banking industry to underscore the importance of sound lending practices. In January, Federal Reserve staff instituted a System-wide examiner training initiative that will reach Federal Reserve and state examiners all across the United States. Additionally, an interagency training program has been developed specifically for examiners reviewing CRE loans as part of the interagency Shared National Credit Program, which includes the largest commercial real estate loans in the nation.

We are working hard to track the progress and effectiveness of this guidance. Before issuing the guidance, Federal Reserve staff surveyed examiners to gain a better understanding of the banks' workout practices. Going forward, the information that we collected will serve as a baseline for assessing the impact of the supervisory guidance. We also are asking examiners to capture, where possible, information on troubled debt restructurings and other types of loan workouts and dispositions as part of the ongoing examination process. In addition, we are exploring the feasibility of more formal statistical approaches for measuring and evaluating the effectiveness of the November 2009 interagency CRE workout and restructuring policy statement. We continue to receive and evaluate comments and feedback from supervised banks and I can assure you we will consider the need for adjustments if feedback suggests they are needed.

## Small business lending

Now I would like to turn to small business lending. Small businesses are, in many cases, the most important customer segment for community banks. And because community banks are an important source of credit for small businesses, their challenges and their fates are closely linked. Despite the best efforts of bankers and regulators, we continue to hear of the difficulties experienced by small businesses in obtaining credit. A recent study conducted by the National Federation of Independent Business (NFIB) found that of small employers who attempted to borrow in 2009, about half received all the credit they wanted. But nearly one-quarter received no credit at all. A similar study in 2005 found nearly 90 percent of small employers had most or all their credit needs met and only eight percent obtained no credit.

Even though conditions in financial markets have continued to improve in 2010, access to credit remains restricted for many smaller businesses, who largely depend on banks for credit. Risk spreads on small business loans at banks have continued to rise, and the decline in loans outstanding has been stark.

A number of factors are contributing to the reduced supply of bank loans. For instance, in response to an increase in the number of delinquent and nonperforming loans, many banks have reduced existing lines of credit sharply and have tightened their standards and terms for new credit. In other cases, banks with capital positions that have been eroded by losses or those with limited access to capital markets may be reducing risk assets to improve their capital positions, especially amid continued uncertainty about the economic outlook and possible future loan losses.

A number of government programs intended to increase the supply of credit are currently in place or under consideration and a variety of approaches may be needed to address the different barriers to bank lending. For example, to offset bank concerns about the level of credit risk, increases in the availability of Small Business Administration (SBA) guarantees and streamlining of the SBA application process may be helping to increase bank lending to small businesses. Indeed, in recent testimony before the House Financial Services Committee, the SBA reported significant growth in the number of banks using its programs.

If, on the other hand, community bank lending is restricted by concern about capital positions, the Treasury proposal to transfer $30 billion from TARP to establish a Small Business Lending Fund (SBLF) could stimulate lending by providing capital without the perceived stigma or conditions of TARP and at a lower cost to community banks that increase small business lending. If approved, the program would also allow community banks that received capital in the original TARP program to convert to SBLF and lower their interest payments by increasing loans to small businesses, something many are already doing.

The reduction in the availability of credit, however, is not the whole story. There is also less demand for credit by sound firms. As businesses reduced inventory levels and capital spending, they tended to pay down debt and build cash positions. Indeed, in the most recent NFIB study, 34 percent of businesses reported lower sales as their biggest problem while only 3 percent cited lack of credit. And while some potential borrowers seek less credit, others are no longer qualified to borrow. Weakened balance sheets, reduced income, falling real estate collateral values, and in some cases, a recent history of payment problems, have made it difficult for some businesses and consumers to qualify for loans, especially under the current stricter standards.

Other factors unique to the current financial environment may also be weighing on the ability of small businesses to borrow. A significant fraction of small businesses rely upon personal assets and consumer credit to fund their operations. Thus, small businesses are affected by tight conditions for consumer credit in addition to those for business credit. Many small businesspeople rely on their homes or business real estate to secure their business loans. As collateral values have declined, their borrowing capacity has been reduced. Finally, small business lending often is based on relationships that are solidified over time. Sometimes those relationships are broken as a result of the bank's inability to lend, such as when banks fail or when they reduce lending due to strains or concentrations in their own portfolios. In those circumstances, small businesses may find it quite difficult to establish similar arrangements with a new bank.

Improvements in a number of the conditions that depressed lending in 2009, however, lead me to be somewhat optimistic that we will begin to see an increase in bank loans later this year. Economic conditions, the most important determinant of the demand for and availability of small business lending, have improved considerably since the early and middle part of last year. In response, bank attitudes toward lending, including small business lending, may be shifting. In the Federal Reserve's Senior Loan Officer Opinion Survey conducted in January, the number of banks that reported having eased credit standards for small business lending over the previous three months about matched the number that reported having tightened lending standards for the first time since before the crisis began, in the summer of 2007.

## Restoring the flow of credit in the economy

Ultimately, the most important step policymakers can take to support community banks and improve credit availability to small businesses, as well as other businesses and households, is to achieve a sustainable economic recovery. Over the course of the past two years, the Federal Reserve has taken aggressive action in response to the financial crisis to help improve financial market conditions and to promote the flow of credit to households and businesses. We have acted on multiple fronts by instituting accommodative monetary policy, expanding existing liquidity programs for depository institutions, and establishing new liquidity facilities to support market functioning. Throughout this period, the Federal Reserve has placed particular emphasis on ensuring that its supervision and examination policies do not inadvertently impede sound lending to businesses, both large and small, and we will continue to do so. Actions taken to stabilize the largest banks during the crisis have received a lot of attention. However, I think it is equally important to note the degree to which banks of all sizes were offered access to the same loan, guarantee, and capital facilities. We should never forget that the objective was to save the system as a whole, not just a handful of large institutions. As attention turns from saving the financial system to strengthening it, any proposed solution must address the assignment of responsibility for regulation and supervision. During the financial crisis, I saw firsthand how important it was that the Fed have a complete view of the financial landscape and how successful was the interaction among the Fed's divisions in crafting solutions to the many different problems we confronted.

As of the end of 2009, the Federal Reserve supervised 4,974 top-tier bank holding companies, 844 state member banks and 177 foreign banking organizations operating in the United States. State member banks range from very small community banks to banks with assets of more than $100 billion. Bank holding companies vary similarly in size and now include a number of companies with more of their financial business outside of bank subsidiaries than inside them. I believe that having a window into such varied parts of our financial system is important and that it would be a mistake to focus Fed supervision on only the largest companies.

Our strengths as a supervisor include our experience in supervision, knowledge of the markets, and understanding of the economy. And our role in supervision strengthens our performance in other roles. Lending issues have been central to our discussions of monetary policy, at least in my time with the Fed. If you look at the maximum amount reached by each of our lending facilities, we loaned almost $2 trillion in a very short time as we worked to stabilize financial markets. Those loans are now paid down to less than $100 billion. We never could have done that as quickly, as smoothly, or with zero loss without an extensive knowledge of the industry and institutions as well as staff across the country with banking expertise.

## Conclusion

In summary, the recent financial crisis has underscored the importance of community banking, especially the role you play in providing credit to the local businesses in your community. Even though the environment is challenging and some community banks face significant stress, most community banks are fundamentally sound and will remain so. It is encouraging to see in your conference agenda that you are looking forward to returning to a more stable model of community banking, one focused on prudent underwriting, risk-appropriate pricing, portfolio diversification, and stable deposit funding.

At the Federal Reserve we will continue to work to strengthen the economy and to ensure that our supervision and examination policies do not inadvertently impede sound lending by community banks. As we do so, it is important that we hear from you about the economic conditions in your communities and any problems you face in meeting the needs of creditworthy borrowers.

I thank you again for the invitation to join you today and look forward to your questions or comments.