



Why Banks (still) aren't Making (more) Business Loans?

Mismatch between the Political, Economic and Regulatory Environment

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President Obama and the Congress are throwing billions of dollars at the banking industry. Why are banks not making more loans?

From the bank's perspective, the government money comes with strings attached that are unclear or too onerous.

The ground is shifting fast enough that banks are still not lending freely to each other, not to mention lending to businesses.

The economic challenges mean many businesses that would have been credit-worthy last year may be in a riskier, weakened condition.

The banks are not rewarded for making those riskier loans, even to current business borrowers. The regulators penalize them for doing so.

In this uncertain environment, it is difficult for banks to raise needed capital to deal with higher risk and continue (or start again) to lend.

Banks are lending, but many people think they are not lending enough.

Regulatory climate and restricted lending

The mandate to increase lending is colliding with what regulators call 'safety and soundness'.

We find this in business, personal, commercial and real estate borrowing.

Even in the best of times, there is a healthy tension between loan originators and underwriters.

Everyone agrees regulators are rightly concerned with safety and soundness. The unanswered question is how to modify that focus, if at all, to make more credit available to business.

"The current bank regulatory climate is causing many community banks to unnecessarily restrict their lending activities," says R. Michael S. Menzies, Sr. He is the CEO of Easton Bank and Trust Company and President of the Independent Community Bankers of America.

In his March 2009 testimony to congress, he focused on the disconnect between the actions of the regulators and the stated goal of banking agencies. The agencies expect banks to "fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers."

In citing examples from banks around the country Mr. Menzies said, "In this climate, community bankers may avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital."

Federal government gives and takes

In some cases, an action of the federal government directly contributes to an adverse condition. It can lead to another branch of the federal government taking corrective action against the bank.

The FDIC issued a notice to a large community bank requiring ‘*prompt corrective action*’ to raise \$20 million in capital.

Along with over 1,000 community banks, this bank recorded losses from investments in preferred shares of Freddie Mac and Fannie Mae. The \$20 million shortfall is less than the amount of the loss the bank incurred when the federal government seized those organizations.

Uncharted waters

“Getting through a recession triggered by a credit crisis puts us in uncharted waters to be sure,” said FDIC Chairman Sheila C. Bair in her address to the American Banking Association.

The uncharted waters create these disconnects. In some cases, the delay in getting us all on the same page is making a bad situation worse.

Rich Shulmistra is a commercial underwriter with RBC Bank, a large regional bank in the Southeast. He told me of a recent decision to extend interest-only payments for a business borrower. Their Debt Coverage Ratio (DCR) had dipped below the agreed 1.2. (The DCR indicates the amount of cashflow available that exceeds expected debt payments.)

“This borrower is still making all payments as agreed and I expect will continue to do so,” he said. “However, the loan will be downgraded which will impact required

loan loss reserves and ultimately, the funds available to lend.”

Banks are actually paying a penalty to hang in there with business borrowers who they believe are still credit worthy.

In an open forum, I asked Ken Parsons if the regulators should modify ‘credit-worthy indicators’ for our current economic conditions to be more realistic. A director with the Independent Community Bankers of America and Chairman of Venture Financial Group, Parsons said, “I don’t advocate that regulators revise the way they rate loans. They just need to not overreact.”

Banks want to lend

Banks see it as their mission to fund businesses while fulfilling their duty to shareholders.

Here is what the government needs to get right before banks are willing and able to increase lending:

- Agreement and understanding between bankers and regulators on how the rules have changed, if at all, in assessing business credit-worthiness
- Flexibility by the regulators regarding write-down of loans that are paying as agreed, even if some underlying covenants are not being met
- Clarity on the impact to a bank of participating in bail-out programs
- Confidence that the rules for those programs won’t change after the bank has signed on
- Congruence in the ‘lend more’ message regulators are pushing from

Washington D.C. and the 'conserve capital' message regulators are demanding at the bank

The banks are working hard on these problems through their professional associations. The government is working the problem, too.

Updated Guidance to Examiners

In a Supervisory Memorandum dated April 2009, the Comptroller of the Currency updated guidance for Examiners.

"Banks have flexibility in choosing the alternative that will maximize the bank's recovery on each troubled loan. Accordingly, bank management should not be criticized for continuing to carry workout loans as long as they have

- A well-conceived and effective workout plan for the borrower;
- Effective internal controls to manage the level of such loans;
- Properly risk rated the loan; and,
- Properly considered the loans when determining the level of the [Loan Loss Reserves]."

It may take some time for this guidance on flexibility and lack of criticism to trickle down into bankers' experience when the regulators come to call.

The Needed Match

When the politicians, the regulators and the bankers get on the same page, we'll finally see a match between what the public and the politicians think the banks ought to lend and what the banks believe they can lend.



Linda Keith CPA works with financial institutions to improve loan quality. Contact her at 360-866-1982 or Linda@LindaKeithCPA.com for a free, customizable 'Income Documentation and Analysis Checklist' for your bank. www.LindaKeithCPA.com.