Six Reasons Why Banks Aren't Lending to Business
Or "A Rolling Loan Gathers No Loss"

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Abstract

Why aren't banks lending to business for their own portfolios? This study analyzes six good reasons for banks unwillingness or inability to lend to non-real estate business. Their unwillingness stems from a combination of bad loans on their books and fear on behalf of bank regulators that lending to business in a slow economy is too risky. As we will show, banks are flush with funds and should be able to make loans in their respective markets. Since banks face low borrowing costs, in some cases at virtually zero, they have chosen to invest in U.S. Treasury securities with no default risk. Why make risky loans to businesses when government regulators encourage banks to invest risk-free? We make three recommendations based on our analysis of the six reasons banks aren't lending: 1. Encourage regulators to be more lenient as to allow banks to amortize write downs of nonperforming loans over a five year period. 2. Congress should eliminate the prepayment penalty banks must pay the Federal Home Loan Banks on advances. 3. Bank regulatory policy should move to ease the regulatory pressure to "play it safe." These all mean that banks must use the resources they have accumulated to begin to make loans to small and medium size business in order to spur job creation.

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Introduction

The U.S. banking system still isn't lending after three years since the start of the financial crisis and two years after the crisis' darkest days in September 2008. Growth of the private sector is simply not possible without bank lending to business and consumers.[2] Small and medium size businesses have proven to be the engines of employment growth and the banking system is the primary lender to small businesses and households. With this lending comes growth. But the only loans that banks are originating are those that they can sell (or obtain insurance from) the Federal government (Fannie, Freddie, FHA).

So why aren't banks lending to business for their own portfolio? This study analyzes six good reasons for banks' unwillingness or inability to lend to non-real estate business. Their unwillingness stems from a combination of bad loans on their books and fear on behalf of bank regulators that lending to business in a slow economy is "too" risky. As we will show, banks are flush with funds and should be able to make loans in their respective markets. Since banks face low borrowing costs, virtually zero in some cases, they have chosen to invest in U.S. Treasury securities with no default risk.[3] Why make risky loans to businesses when government regulators encourage banks to invest risk-free? The answer might be that banks can't earn high enough returns on business loans to justify the risk. Presently, banks, other than the large money center banks, are lending to borrowers of average risk at about 6 percent for loans

[2] A recent article entitled "Small Business Can't Get Loans From Bailed-Out Banks in U.S." (Bloomberg, September 16, 2010) emphasized the unwillingness of big banks to lend to small business even when the banks are flush with cash and said "…they are lending as much as they safely can in an environment with few creditworthy small businesses and soft demand." This is after being recapitalized following unbridled lending in the 2002-2008 period.

[3] Bank investment in Treasury securities has risen by 312 percent (factor of 3) from 20009Q1 to 2010Q1. This is far in excess of increases in bank lending. See *Federal Deposit Insurance Corporation*, "Assets and Liabilities of FDIC-Insured Commercial Banks and Savings Institutions," various years, http://www2.fdic.gov/qbp/index.asp.

with a 360 day or more maturity.[4] With the Fed Funds rate at between 0 percent and 0.25 percent and CD rates at no more than 0.75 percent, banks can get a fairly substantial markup over the cost of funds by lending to business. Is this sufficient to attract borrowers to take on more debt?

A Review of the Present State of Bank Lending

Bank lending fosters business growth and increases employment and is the source of financing directly used by businesses to finance inventories, accounts receivable and business expansion. These loans by banks are reported to the bank regulators in the banks' reports of Income and Condition as Commercial and Industrial Loans (C&I). Other lending to business is primarily for real estate development, land acquisition or residential construction. These loans are not included in the C&I loans and are treated separately in our analysis for comparison.

Figure 1 shows the course of C&I lending over a number of business cycles since 1973. Business lending is highly cyclical and has become more so since the 1990-91 recession. The sharpness of the fall in C&I loans in the current recession has been the largest of any recession since the 1973-75 recession with year-over-year declines of 20 percent (Figure 2). From Q1-2009 to Q1-2010 banks reduced C&I lending by 17.1 percent, the largest decline of any loan category except Construction and Land Development. In contrast, the rapidity of the increase during the 2002-2007 economic boom was the greatest of any of the expansions since 1973. Based on the experience of the prior two recessions, it took C&I loans about 3½ to 4 years from their peaks to begin to recover (Figure 1). In the current recession the peak was reached in October 2008 so if C&I recovery behaves like it did in other recessions, we should expect it to turn around in late 2012. Without aggressive investment fueled by bank lending employment will not increase at a meaningful rate to reduce unemployment, stagnation might ensue, and the unemployment rate might be stuck at around 10 percent. Waiting until the Fall of 2012 for C&I loan

[4] Board of Governors of the Federal Reserve System, "Release E.9, Survey of Terms of Bank Lending," August 2-6 2010, http://www.federalreserve.gov/releases/e2/current/default.htm.

growth to resume may be seriously detrimental to fostering an economic expansion now in its infancy, all the while letting the federal deficit grow to perhaps unmanageable proportions leaving the U.S. with no alternative but to raise taxes. We offer policies that may spur bank lending to business and speed economic recovery. As has been asked by many, including ourselves -- why did we bailout the banks if they aren't contributing to economic recovery?[5]

1. Banks Lack Liquidity

An argument that is voiced by some economists is that banks lack the liquidity to make loans in such an inhospitable economic environment. This may have been the case in other recessions or post-recession periods, but it has not been the case for almost two years now. According to FDIC bank quarterly reports of condition, banks have increased investments in U.S. Government Securities between Q1-2009 to Q1-2010 from $31 billion to a record $157 billion or by more than five-fold. This is in sharp contrast to the 17 percent reduction in bank lending to business. Furthermore, bank deposits have grown by 2.7 percent since Q1-2009 and deposits at Federal Reserve Banks (immediately available funds) now stand at a record $1.1 trillion having increased by 52 percent over the same period. However, it must be mentioned that this growth has slowed to 35 percent from June 2009 to June 2010.[6] The conclusion from these data is inescapable: banks do not lack liquidity to make loans and should be encouraged to do so since these are higher-earning assets than the alternatives in which they are presently investing (the Fed pays 0.50 percent for deposits at Fed banks and C&I loans are earning a net interest margin of 3.7 percent).[7]

2. Regulators Are Constraining Bank Lending to Business

[5] *Supra*, note 1. See also, Shahien Nasiripour, "Another Monthly Drop In Lending By Biggest Bailed-Out Banks," *The Huffington Post,* May 19, 2010, http://www.huffingtonpost.com/2010/05/19/another-monthly-drop-in-l_n_582017.html.
[6] *Federal Deposit Insurance Corporation*, "Assets and Liabilities of FDIC-Insured Commercial Banks and Savings Institutions," various years, http://www2.fdic.gov/qbp/index.asp.
[7] *Federal Deposit Insurance Corporation*, "Assets and Liabilities of FDIC-Insured Commercial Banks and Savings Institutions, various years, http://www2.fdic.gov/qbp/index.asp."

In the 1990-1991 business cycle, bank regulators were roundly accused of constraining bank lending by overzealously applying prudential lending standards particularly as the Federal Deposit Insurance Corporation Improvement Act (FDICIA, signed in early 1991) was winding its way through Congress. However, regulator constraint is difficult to demonstrate empirically because regulators do not make public the results of bank examinations, supervisory discussions with management, or informal memoranda regarding their view of how much risky lending the bank should be doing. In periods such as the present, with economic conditions remaining unsettled and uncertain, bank supervisors don't want to see a deluge of bank failures because they were seen to allow banks to make risky business loans. Rather, bank supervisors "play it safe" even though constraining banks to invest in riskless U.S. Government Securities may harm earnings growth (the 1 year note yields 0.24 percent) and stunt a bank's ability to generate internal capital through retained earnings. Instead they are constraining bank lending to business because of the misperception that loan expansion in a slow economy is riskier than holding an already impaired asset and an extremely low earning government security. (Note: this portfolio has a certain loss on the underwater asset and no upside from the U.S. Government security to offset this loss.) This is not a diversified portfolio and demonstrates a portfolio allocation by bank supervisors that are ill-suited and ill-prepared to make business judgments for the banks they regulate. The evidence is simple: these same regulators failed to warn banks of excessive risk taking during the boom period of 2002-2007; they stood by while banks over-indulged in commercial real estate lending. In addition, they allowed banks to created vast sums of subprime mortgage loans and finance long term mortgage portfolios with short term commercial paper.

The current "play it safe" supervisory policy stance creates a "catch 22" for bankers and supervisors. Banks that need to add capital to meet regulatory or prudential operating capital standards are constrained by supervisors from taking on higher earning business lending for fear of excessive risk exposure.[8] Earnings from U.S. Government securities are not sufficient to create much internal capital, community banks are unable to go to the capital markets to raise equity like their larger brethren, and the necessary capital can't be generated for supervisors to permit taking on more risky borrowers. Following this logic, banks that have better than acceptable capital positions should be lending unless supervisory policy limits risk taking by banks due to an uncertain economic environment. Banks with lower capital ratios are considerably more susceptible to supervisory pressure to limit risk exposure. The regulatory constraint hypothesis of bank lending to business may be tested by comparing lending by banks that are less capitalized with those that are better capitalized of similar size and location. If we find that banks with greater capitalization are growing C&I loans faster than those with lesser capitalization, this suggests that the supervisory policy is selectively applied and perhaps rightly so. However, if there is no association, this implies that supervisory policy is only about preserving or depressing bank lending to business across the board simply to "play it safe."

Using data from the FDIC Reports of Condition for all banks for Q1-2009 and Q1-2010, the rate of growth of C&I lending for each commercial bank with C&I loans for the Q1-2009 report showed little association with either initial capital to asset ratios but did differ among bank sizes. Those banks with assets under $100 million and those over $10 billion in assets showed the greatest growth in C&I loans between the two reporting periods. Banks of sizes between these two either showed declines or very slow growth of C&I loans of 1.6 percent. These data also show that in the aggregate C&I loans declined by 17.1 percent over this 12-month period. These results suggest that supervisors have chosen to not discriminate among banks with differing capital levels, but have chosen the "play it safe" approach to bank regulation – what they consider a reasonably uniform policy of risk reduction.

3. Banks Lack the Capital to Make New Loans

There is little doubt that many banks need capital. However, if there is a capital shortage that inhibits banks' desire to lend, it is not obvious from the available bank financial reports. For example, equity

[8] This regulatory attitude is similar to what occurred during the 1990-1991 recession. See Peek and Rosengren (1995).

capital increased for all banks by 6.5 percent from Q1-2009 to Q1-2010 based on the Reports of Condition filed with the FDIC and other bank regulators.[9] Many banks had TARP capital infusions designed to increase their ability to remain solvent and be productive lenders. So far, even though banks have been able to increase capital so that this should not be a deterrent to bank lending to business, TARP capital infusions have done little to spur lending.

4. Banks Are Crowded Out of the Market

As it stands today, Fannie Mae, Freddie Mac, and the FHA purchase and/or insure over 90 percent of the residential mortgage market. This is a classic "crowding out" problem where the government becomes virtually the only game in town – it has borrowed heavily in order to fund Freddie and Fannie and their purchase of MBS in the market. As of Q1-2009, Freddie Mac and Fannie Mae have been provided $145 billion to support their capital and meet regulatory standards. The government guarantees for Fannie Mae and Freddie Mac are now formally explicit (although Fannie Mae and Freddie Mac denied that the guarantee existed for many years).[10]

And it appears that the FHA is actually crowding out their government siblings Fannie Mae and Freddie Mac. The FHA, which insures loans with down payments as low as 3.5 percent, insured $52.5 billion of home-purchase mortgages in the first quarter of 2010, compared with $46 billion of purchases of the debt by Fannie Mae and Freddie Mac. Ironically, the Obama Administration feels that the best way to work ourselves out of the housing crisis that was caused, in part, by low down payment loans is to make a lot more down payment loans (see Figure 4). That is, the Obama Administration is effectively doubling down on the housing market.

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[9] Federal Deposit Insurance Corporation, Assets and Liabilities of FDIC-Insured Commercial Banks and Savings Institutions, various years, http://www2.fdic.gov/qbp/index.asp.

[10] But the FHA insurance program is explicitly guaranteed even when Fannie Mae and Freddie Mac rabidly denied that they were guaranteed.

A second policy is the subsidy afforded GM, Chrysler, GMAC and GE Capital that gives them an edge to gain financing from the Commercial Paper market. This further crowds out banks from raising capital to fund the medium and small businesses that create the jobs in the U.S. Effectively these policies combine to utilize scarce capital that would be more productively used to fund business expansion as opposed to funding mortgage loans that have gone bad and companies that have demonstrated weak management, are "too big to fail," have little chance of paying off taxpayers and no chance of increasing employment.

5. Banks Have Too Many Bad Loans to Expand Lending Now

Our banking system is weighed-down with significant inventories of bad loans. Unfortunately, it is difficult to figure out the exact amount since the FDIC does not know the exact extent until it performs an onsite examination. But we have two indicators of the bad debt problem: 1) bank failures and 2) bank loan write-downs.

The number of bank failures in the United States this year hit 146 as of November 15, 2010.[11] Banks failures should well exceed the number of bank failures in 2009 of 140.[12] The primary reason for these bank failures is bad residential and commercial mortgage debt, not business loans.

The government's HAMP ("Making Home Affordable") program is adding to the problem facing the banks. HAMP essentially postpones realization of the bad loans. The negative equity problem facing households is a daunting one as is the high rate of unemployment. Banks and servicers should be allowed to modify loans as they deem appropriate without government interference.

The FDIC is still maintaining an "extend and pretend" strategy for commercial real estate loans. It would be far better for the FDIC to step up the sale of their distressed loan portfolio than attempting to have the loans modified. During the S&L crisis, the Federal Savings and Loan Insurance Corporation

[11] FDIC, "Failed Bank List," accessed September 21, 2010, http://www.fdic.gov/bank/individual/failed/banklist.html.
[12] *Ibid.*

attempted to modify loans then gave up and Congress followed by createing the Resolution Trust Corporation which sold the assets. Given the agonizingly slow economic recovery, the FDIC should enlist the help of the private sector in purchasing loans at a steep discount and for modification or sale rather than waiting for a miraculous economic recovery.

6. There Is No Demand by Credit Worthy Business Borrowers

The 12-month period from Q1-2009 to Q1-2010 over which we have studied C&I loan growth has exhibited a mild economic recovery with GDP growth of 2.9 percent (real and nominal). Although this is slow by standards of past recoveries in the first year, it is a positive start that should have spurred loan demand particularly as inventory accumulation was the most prominent source of growth. Aggregate demand growth was present, but only for automobiles ("cash for clunkers") and some consumer durables, both of which needed credit. Bank lending to business certainly could have been used to finance inventory accumulation and expansion of the support businesses in automobile and durable goods manufacturing. In addition, there seems to be a view recently expressed by Fed Chairman Bernanke that "with credit demand tepid and the economy still under stress, profitable lending opportunities have been relatively scarce for many of these banks," again reinforcing the supervisory angst over the slow economic recovery.[13] However, there is little evidence in the published statistics that bank lending was used to fund inventory accumulation. There is a "chicken and the egg" problem in business expansion – there needs to be demand for financing and the financing has to be forthcoming for the demand to grow. At the present time it appears that the funding part is lacking.

Conclusion and Recommendations

[13] Ben Bernanke, "The Supervisory Capital Assessment Program—One Year Later," Speech given to the Federal Reserve Bank of Chicago 46th Annual Conference on Bank Structure and Competition, Chicago, IL, May 6, 2010, http://www.federalreserve.gov/newsevents/speech/bernanke20100506a.htm.

1. Encourage regulators to be more lenient to allow banks to amortize write downs of nonperforming loans over a 5 year period. The overhang of bad real estate loans at banks, particularly commercial real estate loans at medium size and community banks, is substantial and needs to be funded. If banks write-off these loans now, capital will be impaired and regulators will be concerned for the viability of the banks. One way to encourage regulators to be more lenient is to allow banks to amortize write downs of nonperforming loans over a 5 year period. This would alleviate the one-time large capital loss, reduce the need to fund bad assets and encourage new lending. The Administration's current approach in contrast is to bailout community banks like in a "TARP-lite" vehicle.[14]

2. **Congress should eliminate the prepayment penalty banks must pay the Federal Home Loan Banks (FHLBank) on advances.** Banks face a stiff prepayment penalty for FHLBank advances. The penalty depends upon the difference between what the FHLBank would receive as a payment under the existing contract and what it would receive under the current interest rate for a maturity until the end of the contract. An example that FHLBank gives would create a prepayment charge of 1.714 percent of the remaining balance for a 2-year remaining maturity. The cost gets larger the wider the differential between the contract rate and current rates at the remaining maturity.

The implication of this policy is that banks will have to pay a substantial prepayment fee and will be deterred from switching from FHLBank advances to much cheaper deposits in the current interest rate environment. This policy reduces bank earnings and discourages banks from selling off the poor quality collateral for these FHLBank loans (usually mortgages or MBS) in order to get out from under bad loans. It essentially fixes a bank's portfolio in usually bad assets at a high funding cost. The elimination of the prepayment penalty would cause a significant drop in FHLBank borrowing, reduce their income and reduce crowding out by mortgage financing. The elimination of the policy may create a

[14] Daniel Wagner, "SPIN METER: Program Risks $30B to Save Weak Banks," Associated Press, August 1, 2010, http://abcnews.go.com/Business/wireStory?id=11298999.

tradeoff: which is more important to the economy, private bank lending or that of FHLBanks? We come down on the side of private bank lending.

3. Bank regulatory policy should move to ease the regulatory pressure to "play it safe." The most effective policy to spur bank lending to business is for bank regulators to ease restrictions on bank lending to business for well-documented business borrowers. The "play it safe" policy of putting restrictions on bank lending in a slow economy is detrimental to bank profits, capital accumulation and the local, regional and national economic recovery and employment. Without question banks must be lending to business borrowers who can demonstrate an ability to productively use the funds lent and to repay the loans on time and in full. However, without a growth in business lending, the economy will not grow and the recovery will be stifled. This same type of regulatory policy was in place during and after the 1990-91 recession in a number of areas of the U.S. At that time Congress voiced criticism of the regulators' overzealous approach to restricting lending. With the number of bank failures growing much more rapidly this year than last, FDIC reserves in negative territory by some $20 billion as of the first quarter of 2010, and the slow and uncertain economic recovery, it is no wonder that bank regulators are cautious. With this in mind, though, the ability to stimulate economic recovery and improve the conditions of banks means that banks must lend to business and not be held back by "play it safe" policies of bank regulation.

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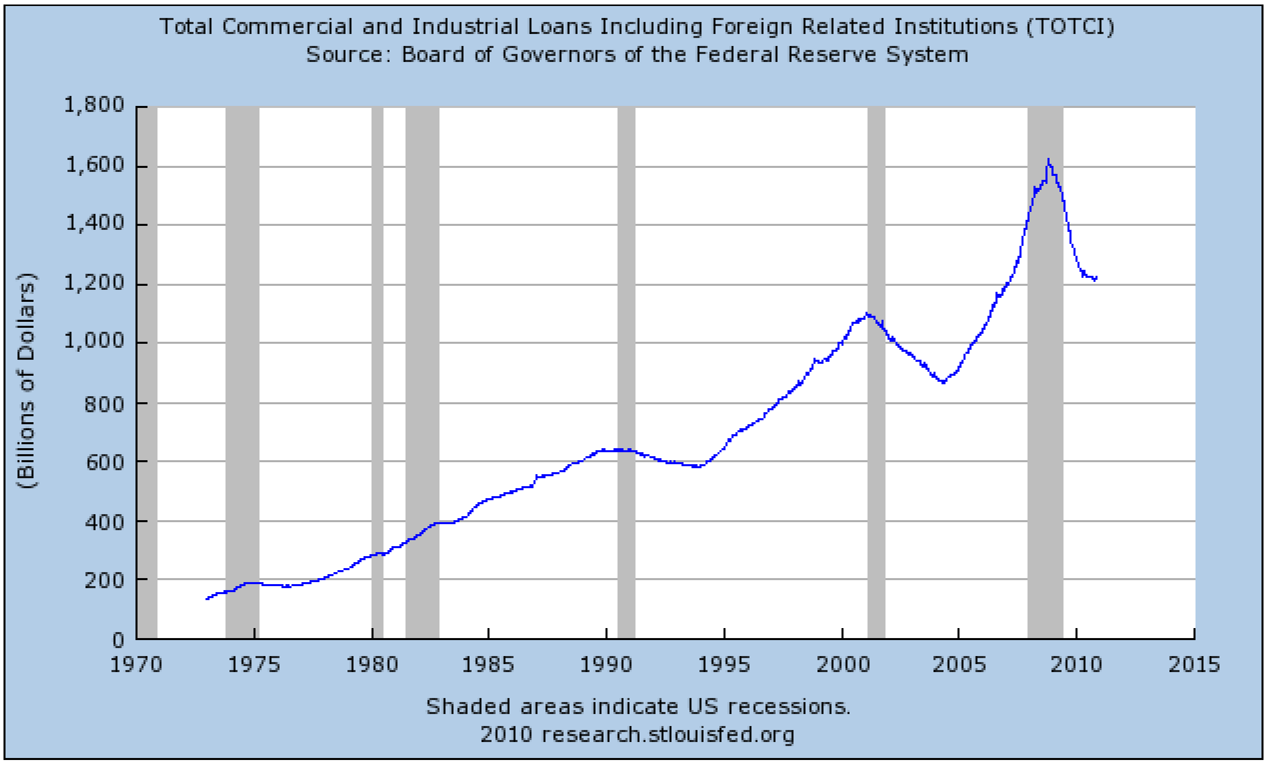
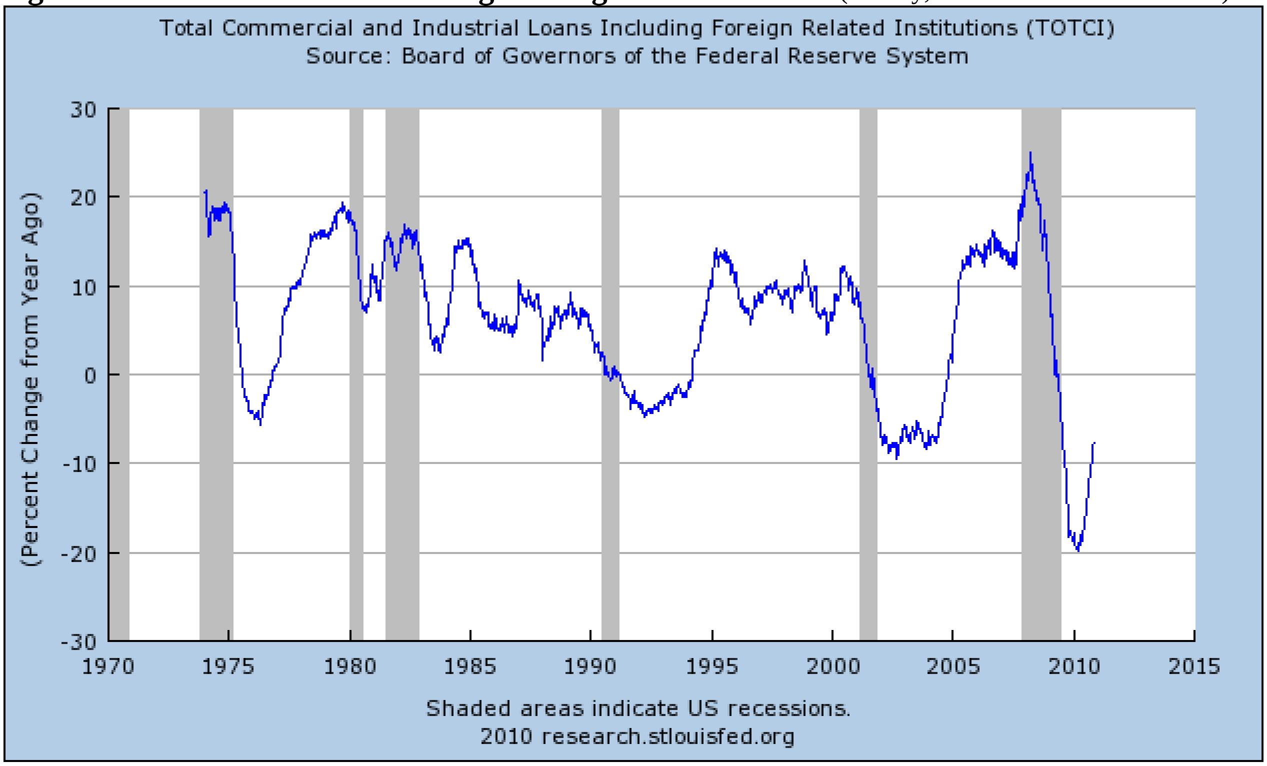
Figure 1: Commercial and Industrial Loans (weekly, 1973-01-03 to 2010-11-03)



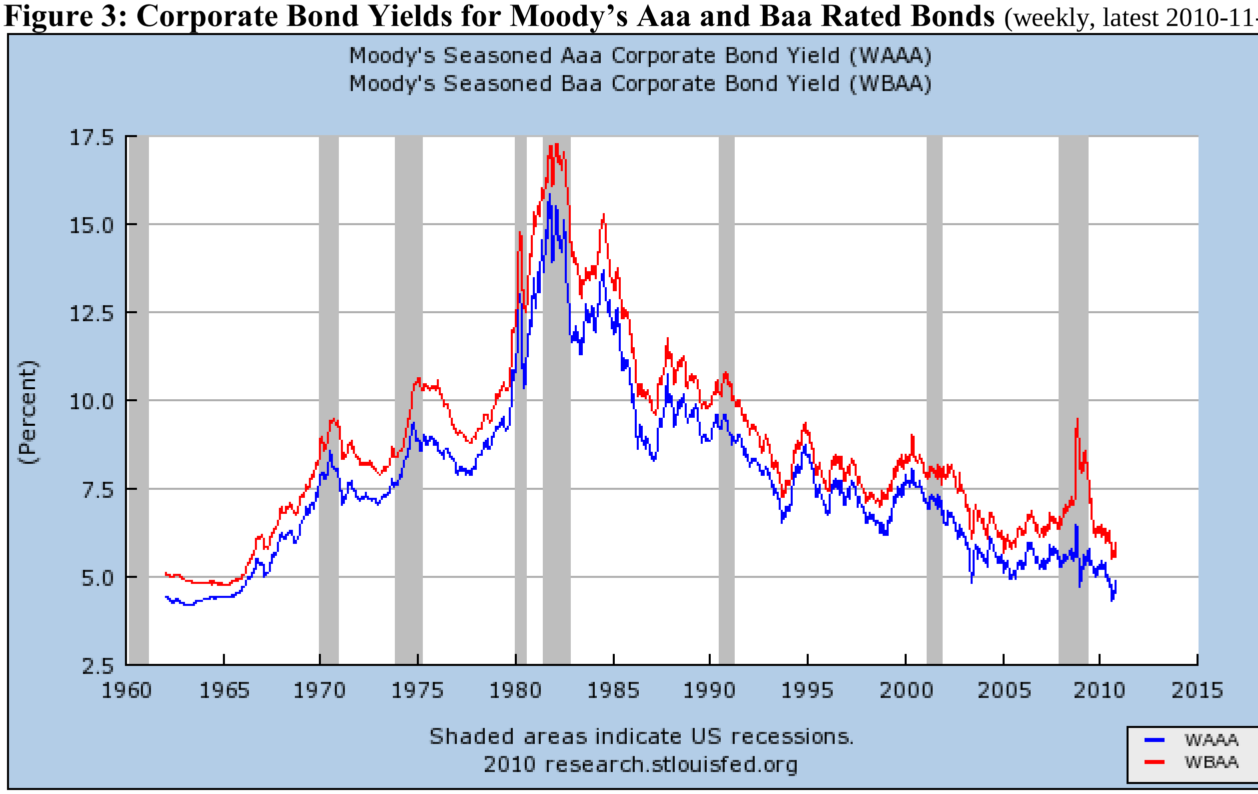
Source: Federal Reserve Weekly Reporting Banks, Federal Reserve Bank of St. Louis

Figure 2: Year-over-Year Percentage Changes in C&I Loans (weekly, 1973-01-03 to 2010-11-03)



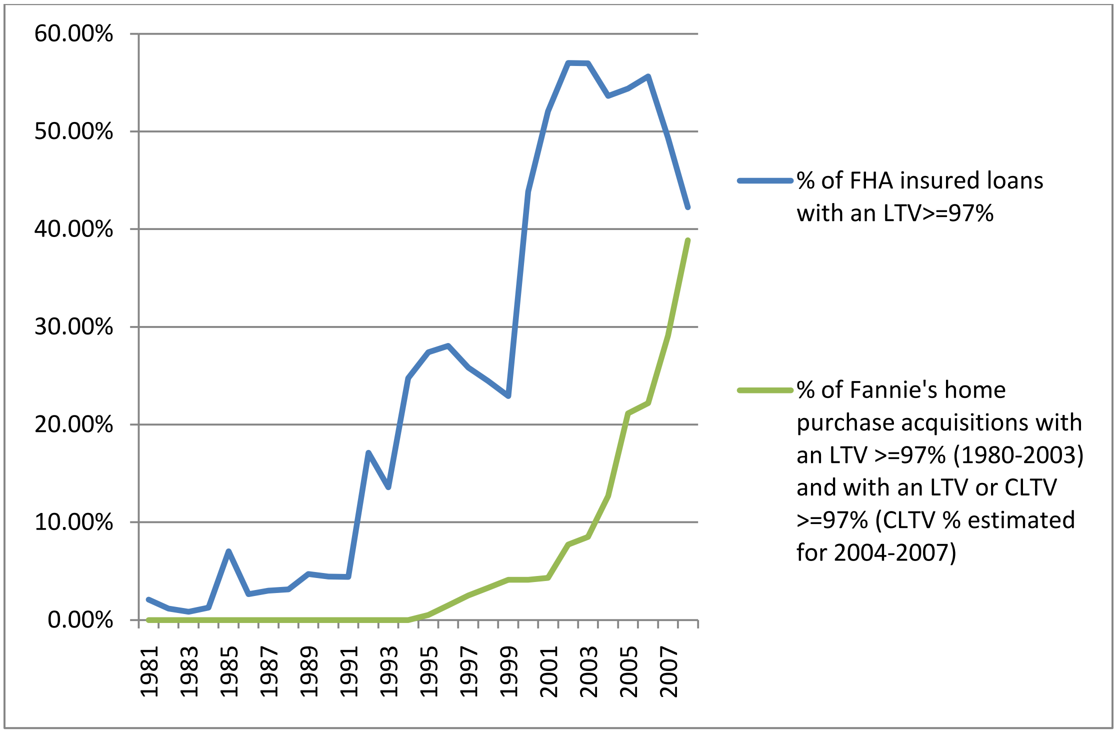
Source: Federal Reserve Weekly Reporting Banks, Federal Reserve Bank of St. Louis

Figure 3: Corporate Bond Yields for Moody's Aaa and Baa Rated Bonds (weekly, latest 2010-11-12)



Source: Federal Reserve Federal Reserve Bank of St. Louis and Federal Reserve Board, H.15 Release

Figure 4: Percentage of Low Down Payment Loans for FHA and Fannie Mae (annual)



Source: Ed Pinto, Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study, 2010.