December 9, 2009

To: Members of the Committee on Commerce and the Banks Committee

Fr: Connecticut Bankers Association

Re: The Commercial Credit Crisis

The subprime crisis had many impacts on the economy, borrowers, businesses, the financial services industry in general and the banking industry in particular. As we have reported in the past, community banks in Connecticut did not actively originate subprime loans and as such did not contribute to the original problem. And, these banks have been typically well capitalized, safe and sound, and continue to be part of the solution that is bringing our local and national economy out of the recession.

Most people are aware of the credit contraction on the residential mortgage side of the lending environment, but a less publicized contraction has occurred on the commercial side. This is true for the commercial mortgages, commercial loans, lines of credit and construction development loans. There are many reasons that the number and amount of commercial loans have recently declined. They include the recession, the disappearance of non-bank commercial lenders, a negative economic cycle for business and that impact on creditworthiness, bank capital requirements, and increased regulatory scrutiny of bank commercial loan portfolios.

One has to remember that over the last decade there were many different types of commercial lenders in addition to banks, who were actively lending in the Connecticut marketplace. Venture Capitalists, Subprime Commercial Mortgage Lenders, Wall Street Investment Banks and Hedge Funds were some of these major "non-banks" who competed for the banks traditional customers, the "middle market" businesses. These non-bank commercial lenders typically had less restrictive underwriting guidelines than banks and invested in riskier loans that were higher priced to the borrower.

Those non-bank lenders needed a steady supply of capital, which was supplied by investors willing to risk their money, and by packaging and selling off certain loans to recapitalize those lenders. Just as in the subprime residential mortgage crisis, when the U.S. economy slipped into recession, investors lost confidence in the commercial marketplace and the non-bank capital dried up. Many of the subprime commercial mortgage companies went out of business. Wall Street fully retreated from the marketplace and Venture Capitalists held onto their cash versus investing in local businesses.

At the same time, the economy sank into one of the worst downturns since the 1983 recession, with unemployment rates in sections of the State reaching 10%. During the current recession, which "technically" ended last quarter, profitability for many businesses evaporated, housing and commercial real estate values depreciated and foreclosures and bankruptcies soared.

During this economic contraction, community banks across the State have continued to do what they always have strived to do - safely and soundly invest the deposits their customers entrust them with, into loans for local businesses and communities.

The safety-and-soundness of any given bank is ultimately determined by the bank regulators, and there are many of them. They include the Federal Reserve, the State Department of Banking, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The collective regulatory position on how much capital a bank needs to be safe-and-sound is directly related to the number of loans and the level of loan risk, associated with that capital. In tough economic times, regulators typically like to see banks take stronger capital positions and originate loans having a lower level of risk.

Because there is only so much capital that a bank has to lend against, it may result in less loans being originated on an industry-wide basis, depending on the health of a particular state's banking industry. The Connecticut banking industry however, is stronger than a number of other states, and a number of institutions have actually increased their commercial lending during the last year. The reason Connecticut banks are able to continue to lend, is because of sound management and prudent loan underwriting policies.

Just last year the FDIC Chairperson, Sheila Bair reminded the entire banking industry of the importance of strengthening overall risk-management frameworks and maintaining strong capital and loan loss allowances on commercial real estate loans, and Connecticut banks have done that.

At the same time, bank regulators have increased their scrutiny of commercial lending portfolios during their annual examinations of the banks they regulate. Some regulators, such as the OTS, have changed their view on certain previously allowed credit enhancements, such as "interest reserves". This raises the concern amongst some bankers that the performing/non-performing loan condition that existed during the early 1990's recession may reoccur, due to a possible over-tightening of regulatory guidelines for lending.

These regulatory guidelines for lending take the form of loan underwriting policies in every bank. These underwriting policies are what commercial borrowers have to meet in order to have credit extended to their businesses. When any borrower goes to a bank they must prepare themselves for a thorough underwriting process that allows the bank to determine the level of risk associated with the loan. That level of risk will directly translate into the amount of capital that a bank has to reserve against the loan, in case of a default. The riskier the loan is, the more capital that must be reserved. This is where the regulatory classification of "risk based capital" comes from. If a bank allocates all its capital to its existing loan portfolio, it may become "loaned up" and either has to sell a portion of its loan portfolio or raise more capital, to continue lending in its marketplace.

For many banks, access to the markets in which they could obtain additional capital has either shrunk, disappeared or is too expensive to access. Until more ready access to capital is restored, a careful balance must be maintained in each institution, to ensure continuous service to the customers and communities that depend on them.

Banks in Connecticut stand ready to provide credit to all businesses. They must however, provide that credit in a way that adheres to regulatory guidelines, accounting rules, laws and a host of other conditions which are reviewed by regulators, auditors and attorneys on a regular basis. When regulatory scrutiny increases during a downturn, so does the scrutiny that a banker must gives for a loan whether residential or commercial.

That increased scrutiny during the underwriting process may result in borrowers having to provide more documentation, larger down payments or a variety of other requirements. Those borrowers, who did businesses with non-bank commercial lenders, may find an unfamiliar and rigorous system of underwriting, that their previous lender may not have employed. Existing customers may have experience changed economic conditions that move their businesses into a risk category that is outside of the banks underwriting policies. A loan approval during favorable economic times doesn't automatically translate into an approval during bad economic times.

As you see from our statement, credit cycles have many moving parts and players to them. The Connecticut banking community stands committed to working with government, customers and communities towards a workable balance between the regulatory requirements we have to adhere to, and the ever changing needs of the local marketplace.