

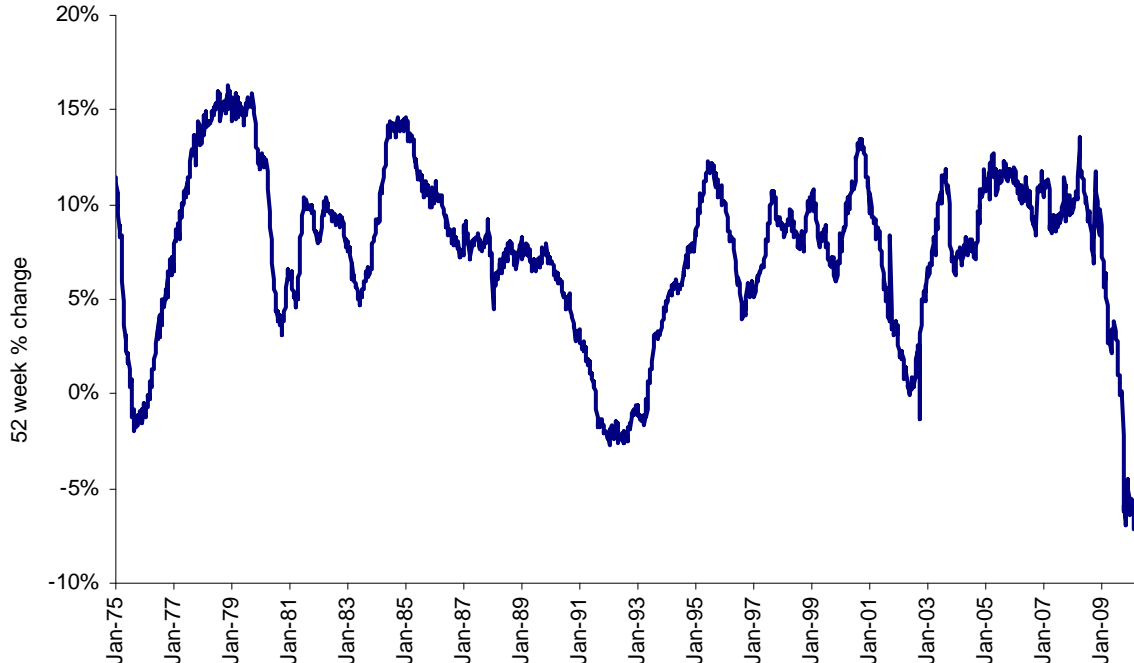
February 24, 2010

Bank Loans Fall More; Washington Ineffective

Today's Wall Street Journal headline reads: "Lending Falls at Epic Pace." It uses data from the quarterly FDIC report, which showed that bank loans outstanding at year-end 2009 were 7.4% below the level at year-end 2008. The article includes anecdotes to show that applications for loans are not translating into loans. It quotes FDIC Chair Sheila Bair on small business lending saying: "The larger institutions I think need to step up to the plate here too."

- The FDIC data is consistent with the Fed data we've been using to track the lending problem. It shows bank loans down 5.6% from end-2008 to end-2009. The Fed's "survey of terms of business lending" shows that a one-week sample of commercial and industrial lending (the flow of loans) was down 45% in early November 2009 from early November 2008 (latest data available).

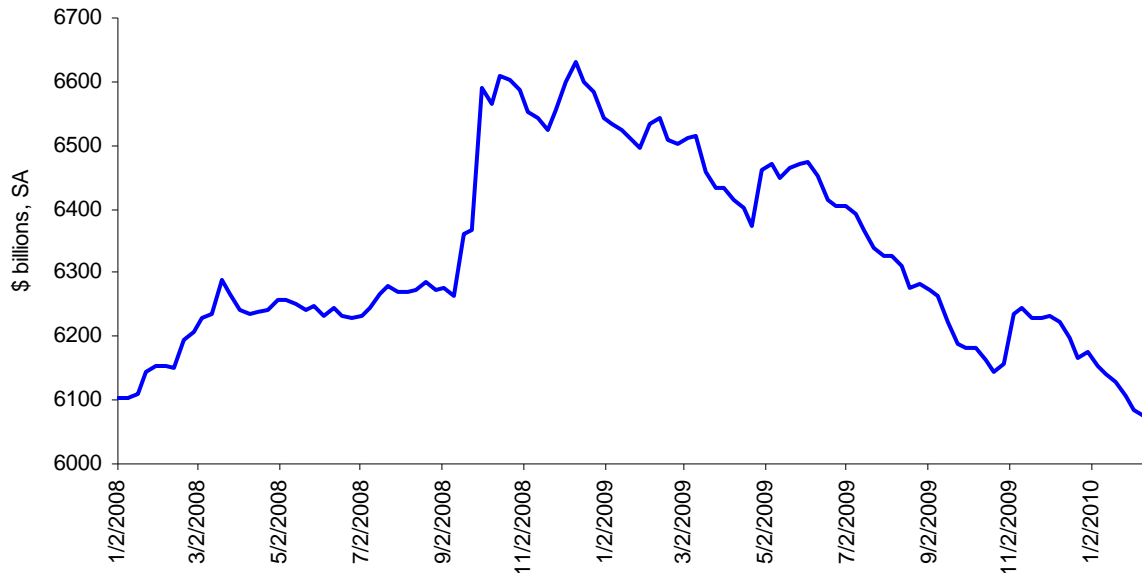
Fed Data on Loans and Leases Outstanding (yoy change, last obs. 2/10/10)



Source: Federal Reserve Board; Encima Global

- Per the Fed, loans and leases outstanding have fallen from a peak of \$6.6 trillion near the end of 2008 to \$6.1 trillion on February 10.

Loans and Leases Outstanding (last obs. February 10, 2010)



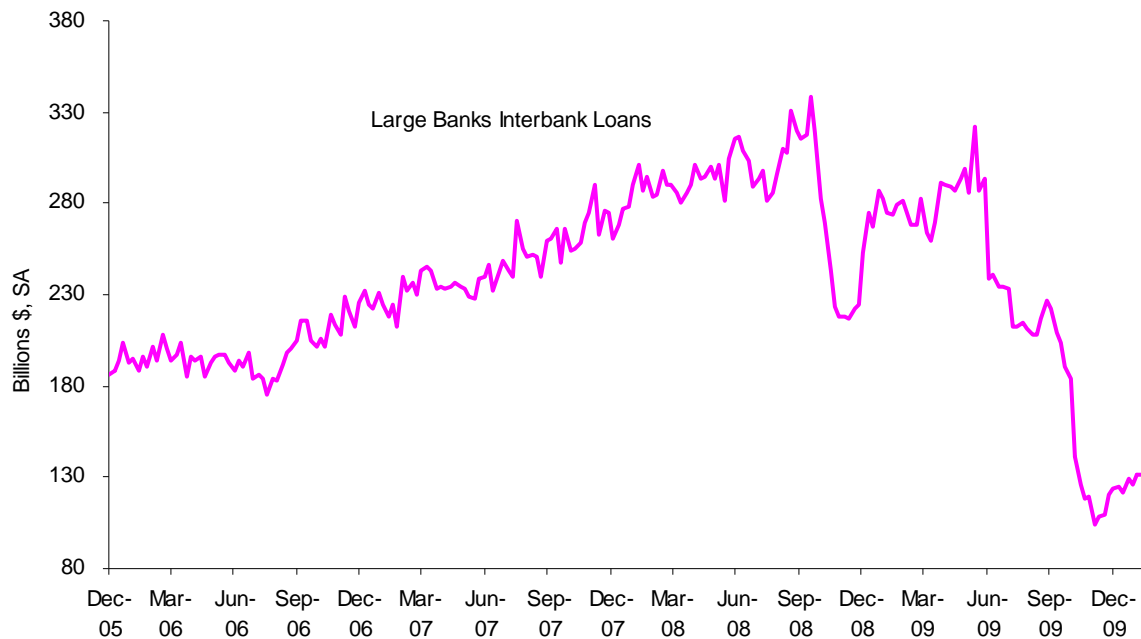
Source: Federal Reserve Board; Encima Global

- While regulators (including Bair) say they want banks to lend, we think the accounting and regulatory capital concepts they are using still discourage lending. In the November 25, 2009 Washington Post, Bair said: “We need to see banks making more loans to their business customers.” On November 1, 2009 Tim Geithner said on Meet the Press that banks should lend. On November 5, Comptroller of the Currency John Dugan said that banks would not be pressed to raise capital, especially smaller banks. In the November 5 WSJ, House Banking Chair Barney Frank said that banks should lend.
- In a March 10, 2009 speech, Fed Chairman Bernanke said: “Because banks typically find raising capital to be difficult in economic downturns or periods of financial stress, their best means of boosting their regulatory capital ratios during difficult periods may be to reduce new lending, perhaps more so than is justified by the credit environment.”
- But showing the regulatory problem is not fixed, the December 8, 2009 NY Times quotes FASB chief Robert Herz’s call for changes in regulatory policy: “**Handcuffing regulators to GAAP** or distorting GAAP to always fit the needs of regulators is **inconsistent with the different purposes of financial reporting and prudential regulation.**”
- We think clear guidance to bank regulators to stop applying mark-to-market concepts to capital adequacy could at any point have broken this downward lending spiral. Our January 20, 2009 piece, Washington Squashing Financials, said: “Washington still hasn’t stopped the application of mark-to-market accounting to regulatory capital. Both Secretary Paulson and Fed Chairman Bernanke have correctly mentioned the problem of pro-cyclicality in speeches. But they haven’t actively broken the spiral caused by the opaque CDS market, momentum-based bond downgrades, auditor liability concerns,

and straight-line assumptions that non-cash losses will turn into cash losses years later... Newly-created banks with no legacy costs could bring new capital to the industry, but they can't get leverage because they don't have the government imprimatur. Washington's focus is on retaining deposits at old banks and helping them leverage their declining capital base (through loan guarantees, facilities, etc.)"

- We discussed the big picture problem of Washington's regulatory over-reach in a November 10, 2008 Forbes article called Containing Washington's Power Bulge: "Big government is walking away as the knock-out winner over the private sector in the latest financial crisis... The solution offered by big government is even bigger government. If unchecked, the Washington "fix" for the financial crisis would create its biggest power expansion since the New Deal... In creating a new fund within the Treasury, Washington gains responsibility for extracting \$700 billion from the private sector. It will decide what debt instruments to purchase and how to manage and eventually sell them... **Like the Treasury, the Federal Deposit Insurance Corp. is in a Washington-size expansion phase, protecting much of the nation's banks' deposits and many loans and directing the bank consolidation process.**"
- The near-zero Fed funds rate is also a critical part of the problem. See David's December 4, 2009 WSJ article Near-Zero Rates Hurting Economy: "More than a year after the heart of the panic, the Fed is still promising near-zero interest rates for an extended period and buying over \$3 billion per day of expensive mortgage securities as part of a \$1.25 trillion purchase plan. Capital is being rationed not on price but on availability and connections. The government gets the most, foreigners second, Wall Street and big companies third, with not much left over... For small businesses and new workers, capital rationing is devastating, spelling business failures and painful layoffs. Thousands of start-ups won't launch due to credit shortages, in part because the government and corporations took more credit than they needed (because it was so cheap)."
- The near-zero Fed funds rate is disrupting the interbank market (as Professor Ron McKinnon has observed) and bank lending. See Fed Data Shows Worsening Small Business Credit Drain in Q3 2009 (December 10, 2009).

Interbank Loans by Large Banks (last obs. February 10, 2010)



Source: Federal Reserve Board; Encima Global

The most recent survey of the National Federation of Independent Businesses (released February 9) found that business owners reported the lowest percentage of members with borrowing needs satisfied at 27% and the highest number unsatisfied at 11% for at least this recession cycle. Our January 22 piece Small Business Prospects also showed that small businesses were cautious and that credit conditions were getting tighter per NFIB surveys.

- This tightness in credit causes circularity -- the shortage of lending hurts small businesses and commercial real estate; real estate price declines hit banks which further curtail lending. See our February 2, 2010 piece, Commercial Real Estate Problems: Obstacle to Small Business.

Other background pieces available on the website:

- Drain on Small Businesses from Banks, Credit Markets and Regulators (October 15, 2009) discussed many factors that bite small business lending.
- Pall in Venture Capital: Economic Sluggishness Likely to Persist (February 22, 2010).

Notes: This email and attachment are confidential and intended solely for the use of the individual to whom they are addressed. Encima Global LLC does not accept liability for the content, or for the consequences of any actions taken on the basis of the information provided. The information is not necessarily complete, and we make no warranty as to its accuracy.