ECONOMICS MADE EASY 09
A Journalism Workshop

Evolution of Lending by Large and Small Banks

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Overview

- Changes in the competitive environment for banks
- Trends in lending patterns for large and small banks
- The current recession and the banking environment
- Large and small bank responses to the current cycle

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Forces of Change

- Technology
  - Risk modeling, credit scoring, pricing
    - More lenders can evaluate a borrower's risk and price accordingly
      - Household credit scores
      - Ratings of structured securities
  - Internet applications and access
- Financial innovation
  - New products created to hedge or off-load risk
    - Markets often international
    - Increased nonbank funding of loans

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Forces of Change

- Banks in a more competitive environment
  - From nonbanks (investment banks, nonbank lenders, derivatives markets)
  - From international institutions and funds
  - Across state lines
  - Banks adapt to the environment by moving to lending markets where they have competitive advantages or where there is less competition

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Changes in Borrowing

- Households
  - Credit scoring has increased access to credit card debt
  - Home equity lines of credit
  - Internet competition for auto loans and mortgages
- Corporations
  - Greater access to nonbank or market funding

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Generalizations – Large and Small Banks

Large – greater than $10 billion in total assets
Small – less than $10 billion in total assets

- Larger institutions
  - Compete in complex financial markets
  - Diversify across products, customers, and geography
  - Analyze and mitigate risks that arise from loan concentrations
  - Develop business strategies as environments change
- Smaller institutions
  - Adapt to competition by specializing locally
  - Exploit local knowledge and relationships
  - Little pricing power in lending markets

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Loan Definitions

- Commercial & Industrial Loans (C&I)
  - Loans to nonfarm businesses – not secured by real estate
- Consumer Loans
  - Credit cards, auto loans, student loans, other household borrowing (excludes mortgages)
- Commercial Real Estate (CRE)
  - Multifamily developments (condos, apartments)
  - Office, retail, warehouses
    - Excludes loans secured by owner-occupied real estate
  - Construction and land development
    - May be for residential development

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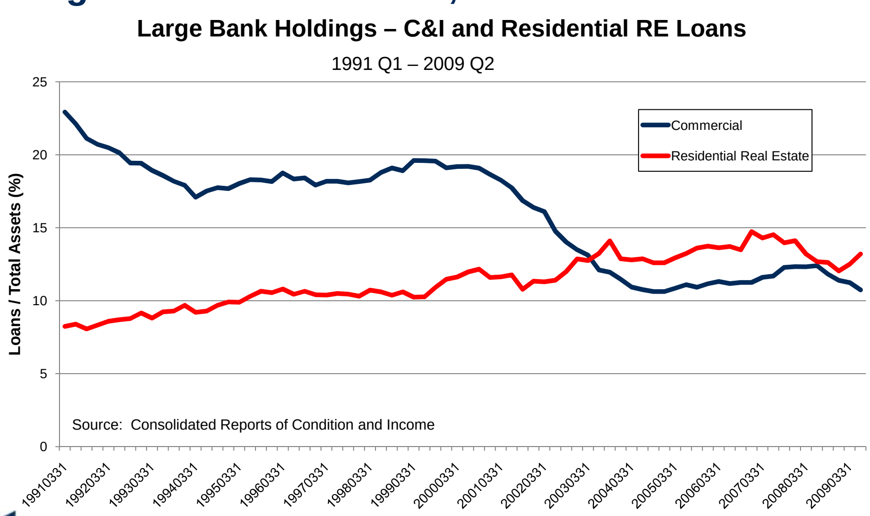
Larger Banks – Less C&I, More Residential



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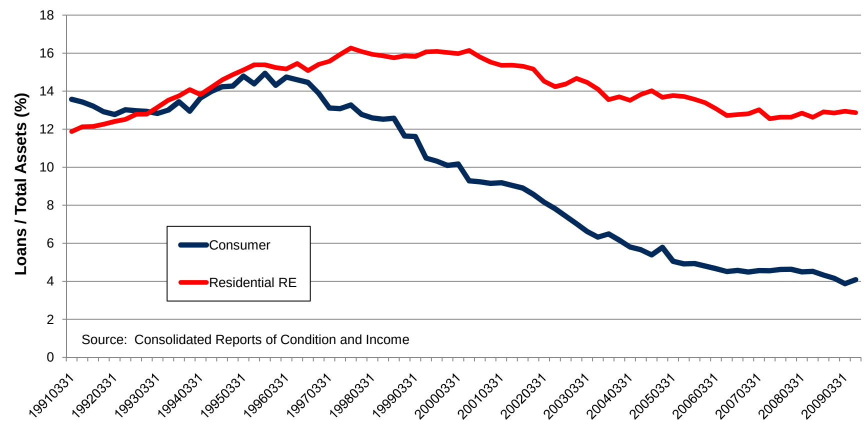
Smaller Banks Hold Fewer Consumer Loans

Small Bank Holdings – Consumer and Residential RE Loans

1991 Q1 – 2009 Q2



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Smaller Banks – Focus on CRE

- Small bank CRE concentrations grow
  - Relative to large banks and as a percent of capital
- Adaptation to competitive environment
  - Households and businesses increasingly shop for better rates
  - Large banks exploit technical expertise and economies of scale
  - Smaller banks increasingly find business opportunities in CRE
    - Using valuable knowledge of local economy and local businesses

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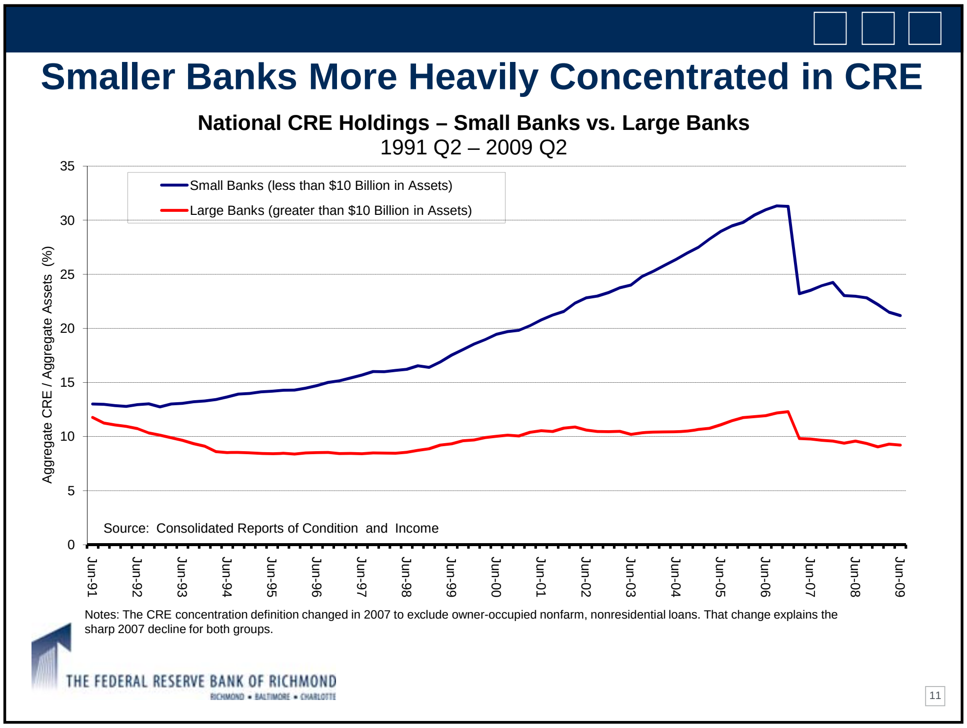
Smaller Banks More Heavily Concentrated in CRE
National CRE Holdings – Small Banks vs. Large Banks
1991 Q2 – 2009 Q2
Small Banks (less than $10 Billion in Assets)
Large Banks (greater than $10 Billion in Assets)
Aggregate CRE / Aggregate Assets (%)
Source: Consolidated Reports of Condition and Income
Jun-91 Jun-92 Jun-93 Jun-94 Jun-95 Jun-96 Jun-97 Jun-98 Jun-99 Jun-00 Jun-01 Jun-02 Jun-03 Jun-04 Jun-05 Jun-06 Jun-07 Jun-08 Jun-09
Notes: The CRE concentration definition changed in 2007 to exclude owner-occupied nonfarm, nonresidential loans. That change explains the sharp 2007 decline for both groups.
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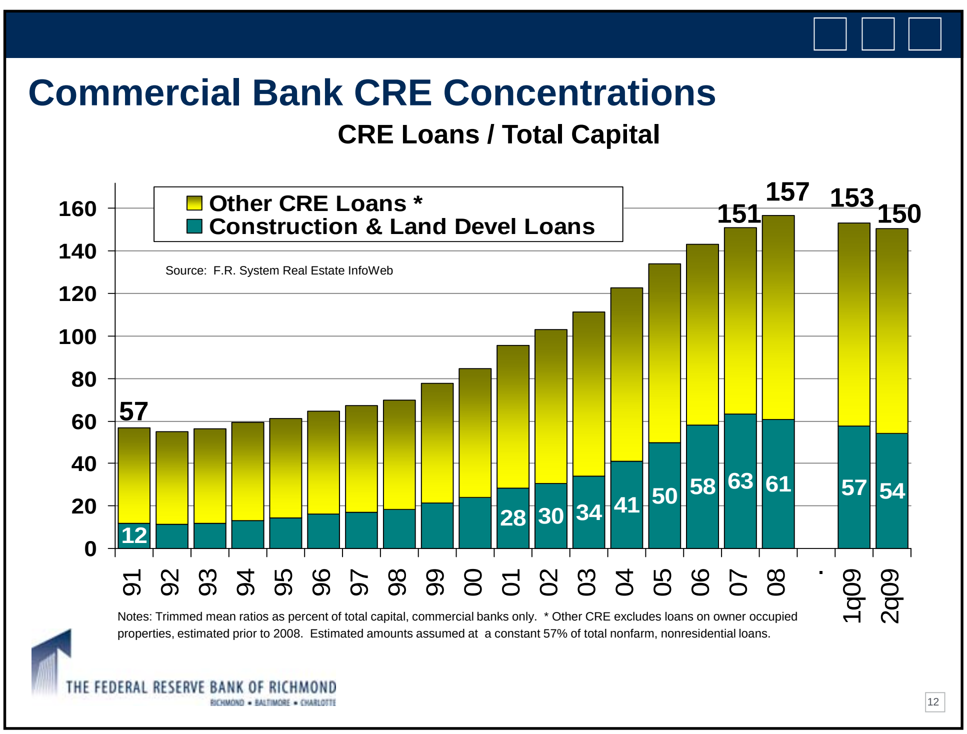
Commercial Bank CRE Concentrations
CRE Loans / Total Capital
Other CRE Loans *
Construction & Land Devel Loans
Source: F.R. System Real Estate InfoWeb
57 151 157 153 150
12 28 30 34 41 50 58 63 61 57 54
91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 1q09 2q09
Notes: Trimmed mean ratios as percent of total capital, commercial banks only. * Other CRE excludes loans on owner occupied properties, estimated prior to 2008. Estimated amounts assumed at a constant 57% of total nonfarm, nonresidential loans.
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Another Perspective – Loan Default Risk

- Banks estimate probability of default
  - Estimates may be formal or informal
  - Based on:
    - Borrower's financial condition
    - Borrower's credit history
    - **Aggregate credit history of similar borrowers**

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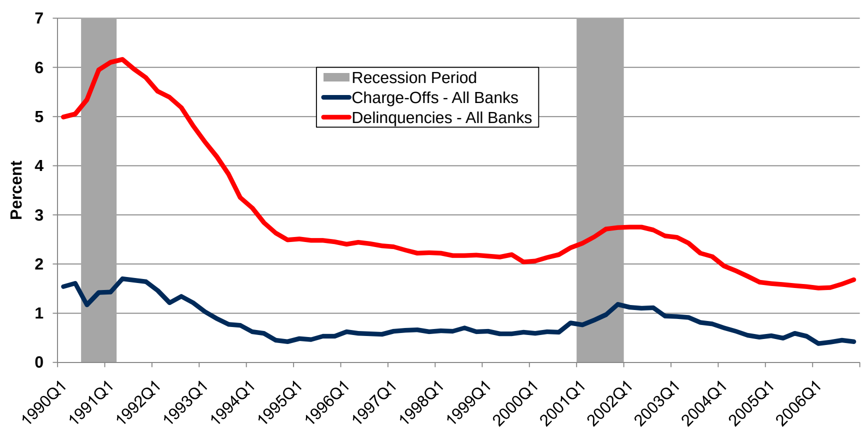
1992 – 2006: Sweet Spot in the Credit Cycle

Charge-Offs and Delinquencies, all banks, all loan categories



Source: Federal Reserve Statistical Release

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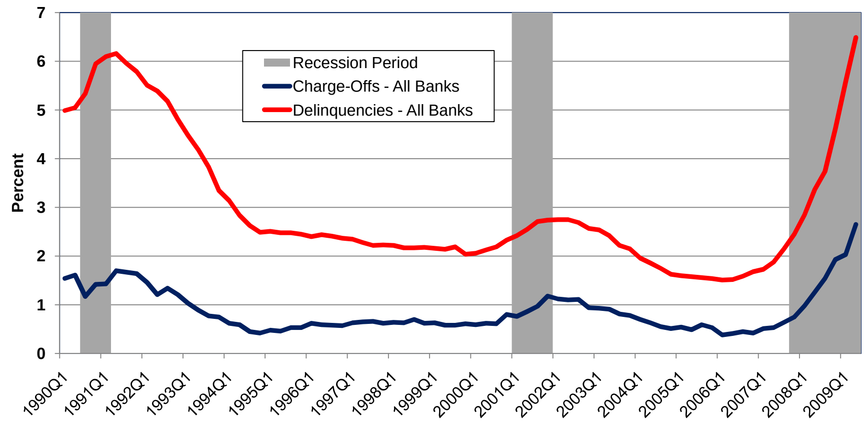
2007: The Rest of the Story

Charge-Offs and Delinquencies, all banks, all loan categories



Source: Federal Reserve Statistical Release

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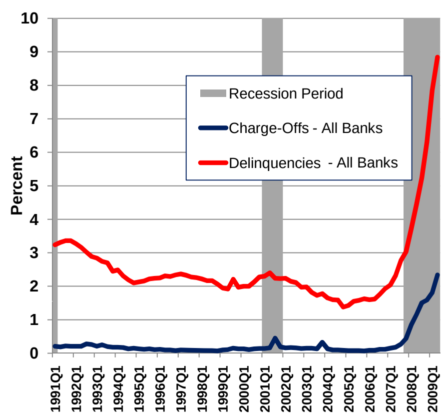
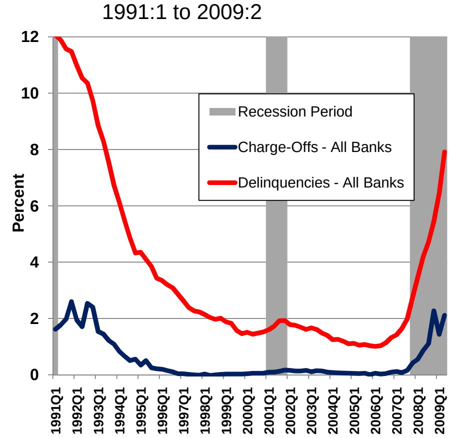
Real Estate Leads the Way

Residential Real Estate
1991:1 to 2009:2



Commercial Real Estate
1991:1 to 2009:2



Source: Federal Reserve Statistical Release

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The Current Crisis and Banks – Broad Overview

- Initially due to complex financial instruments and markets
  - Assets backed by residential real estate
  - “Toxic assets” largely originated and held by GSEs, nonbank institutions, and large banks
  - Most vulnerable were banks with concentrations of “toxic assets” and whose liquidity was dependent on market conditions
- Ongoing recession affects loan quality of all banks
  - Most vulnerable are any banks with loan concentrations in troubled regions or loan categories

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Large Banks – Post “Meltdown”

- Adapted to losses by
  - Reducing exposures to troubled assets
  - Strengthening risk management processes
  - Diversifying liquidity sources
  - Shoring up capital levels
- 2009 earnings low but show signs of recovery

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Market Perceives Falling Risk for Large Banks

Bank Credit Default Swap Spreads (CDS), 5YR Senior
Daily, January 2007 to September 2009

Source: Markit.com CDS

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Small Banks – Less Diversified

- More vulnerable to geographic and loan category concentrations
- Less ability to diversify funding sources
- As a group, 2009 earnings are low

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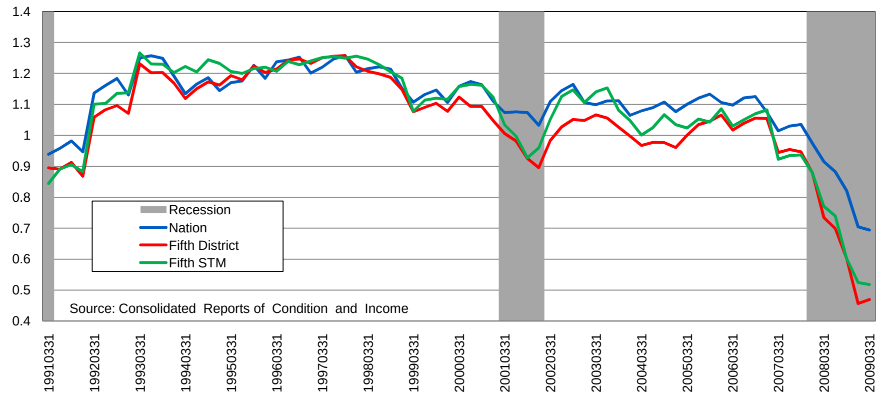
Bank Earnings Are Suffering

Median Commercial Bank Return on Average Assets



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Outlook

- Banks continue to work through troubled loans and mitigate risks
- Earnings are low
- But, opportunities exist for banks with relatively clean balance sheets

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