

Structural Impediments Hamper Efforts to Increase Bank Lending

April 2010

Everyone from business executives and consumers to politicians and bankers agrees that jump-starting bank lending to U.S. companies is a critical step in getting the economy back on track and, as such, ranks as one of our top national priorities.

Despite this consensus, commercial and industrial lending remains mired at levels far below the targets set by government and the banks themselves — and getting the situation turned around might be much harder than most people think. The reason: Although the primary causes of today's depressed lending activity can undoubtedly be found in the real estate collapse, credit crisis and economic recession, there are also structural impediments within the banking industry that will have to be overcome before lending can rise to desired levels.

New research by Greenwich Associates and FTRANS suggests two structural factors are hampering banks' efforts to increase commercial and industrial lending: a shortage of experienced C&I bankers and outdated organizational frameworks that lack the strong central controls required in today's market and regulatory environment.

Missed Targets for Commercial and Industrial Lending

There is no doubt that U.S. banks are working hard to remake portfolios still dominated by the commercial real estate loans made during the real estate boom. Eighty-six percent of the banks participating in the Greenwich Associates/FTRANS study said they are working to diversify their portfolios away from commercial real estate and toward higher levels of core C&I lending.

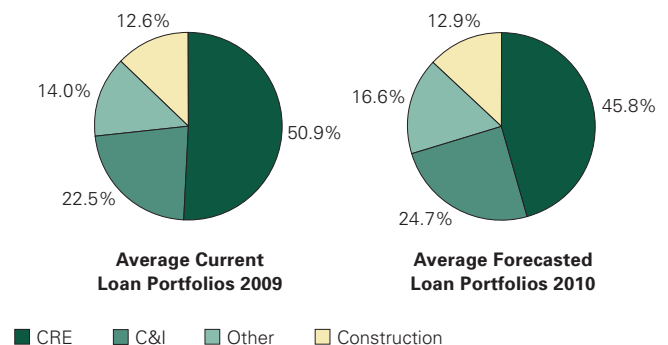
In 2009, commercial real estate made up about half the portfolios of U.S. banks, with C&I loans constituting 22.5%. The banks forecast that in 2010, CRE would shrink to an average 45.8% of their overall portfolios, with C&I loans growing to 24.7%. Despite considerable prodding from regulators — and considerable support from government — banks have consistently fallen short of C&I lending goals. In fact, from 2008 to 2009 bank loan portfolios actually moved in the opposite direction, with C&I loans declining approximately 8.5% on average as a share of portfolios and CRE loans growing modestly.

To some extent, the uneven pace at which banks are increasing commercial and industrial lending activity is no surprise. Traditionally, banks have been slow — in

many cases overly slow — to resume lending to companies in the early stages of an economic recovery. The severity of the current crisis and its origins within the banking sector have left banks understandably cautious. Contributing to this sense of conservatism has been pressure put on individual banks by concerned regulators to increase loan-to-deposit ratios — pressure that, from the standpoint of banks on the receiving end, is often directly at odds with the stated goals of politicians seeking accelerated lending activity in the service of a strong economic recovery.

“At the same time, the depth and duration of the economic downturn has taken a serious toll on U.S. companies, degrading the creditworthiness of potential borrowers at precisely the time banks have been forced to rein in balance sheets and tighten lending standards,” says Greenwich Associates consultant Ronald Balmer.

Forecasted Loan Portfolio Mix — 2010



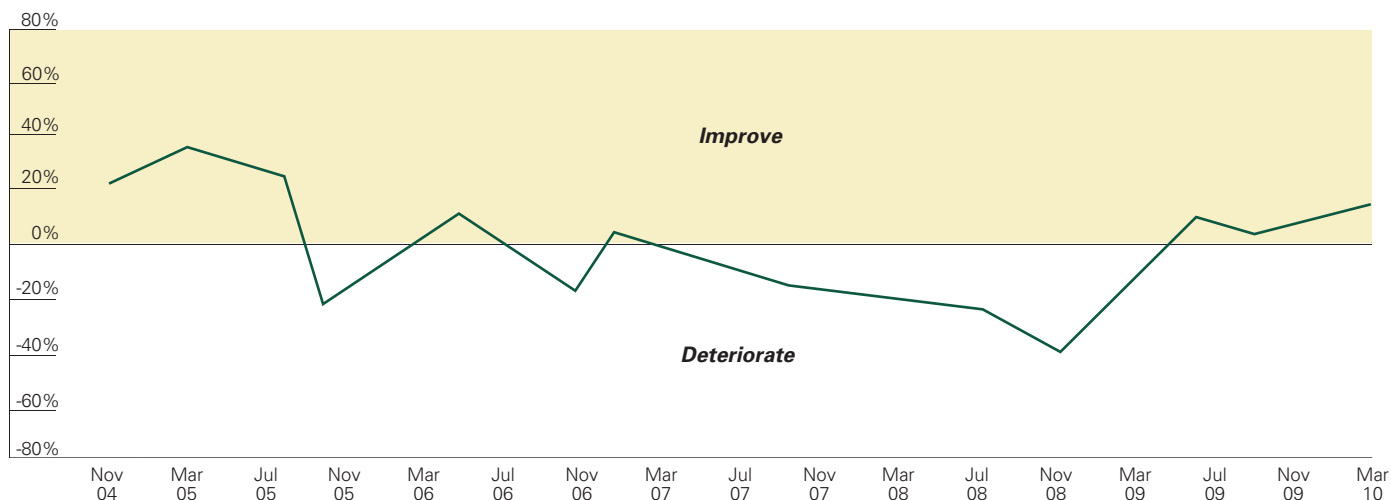
Note: Based on responses from 18 banks.
Source: 2010 Greenwich Associates/FTRANS Study

A Death of C&I Experience

Even when the economic recovery begins to stabilize the businesses and balance sheets of both companies and banks, there will remain significant hurdles for banks to overcome in order to achieve significantly higher levels of C&I lending. The first of these: a lack of bankers with significant experience in C&I lending.

The real estate boom that peaked in 2005 transformed the businesses of regional and community banks in the United States and dominated the time and attention of U.S. bankers. Many bankers in this country have been focused almost exclusively on real estate for a decade or more. As a result, they have little experience in C&I and other types of lending. Among bankers that do specialize

Greenwich Optimism Index – Small Businesses



Note: The Greenwich Optimism Index is the net score of companies who feel that the economy will improve versus deteriorate. Based on the results of quarterly surveys of more than 500 small businesses and mid-sized companies. Source: Greenwich Market Pulse v36

in C&I, average tenure with their current banks is 15.7 years — a relatively high number for the industry, and one that suggests an aging workforce that will soon begin to see large numbers of experienced bankers retire.

This is a serious issue for banks, because CRE lending and C&I lending require different skill sets. The job of a commercial real estate banker is to obtain new loans and generate new fee income, with a near total focus on credit analysis. C&I bankers have a much broader mandate that includes prospecting in their specific market, underwriting cash flows, monitoring commercial borrowers on an ongoing basis and cross-selling ancillary products such as treasury management services, insurance and wealth management, trust and investment services.

At large banks with the resources and scale required to support permanent training programs, transitioning a bank relationship manager from commercial real estate to commercial and industrial lending is not too onerous a burden. Among resource-constrained regional and community banks however, training programs have atrophied in recent years or been eliminated entirely. The lack of established training programs will make it difficult for many U.S. banks to quickly transform existing CRE bankers into productive C&I relationship managers, a delay that will serve as a drag on efforts to expand commercial and industrial loan portfolios.

Outdated and Decentralized Systems

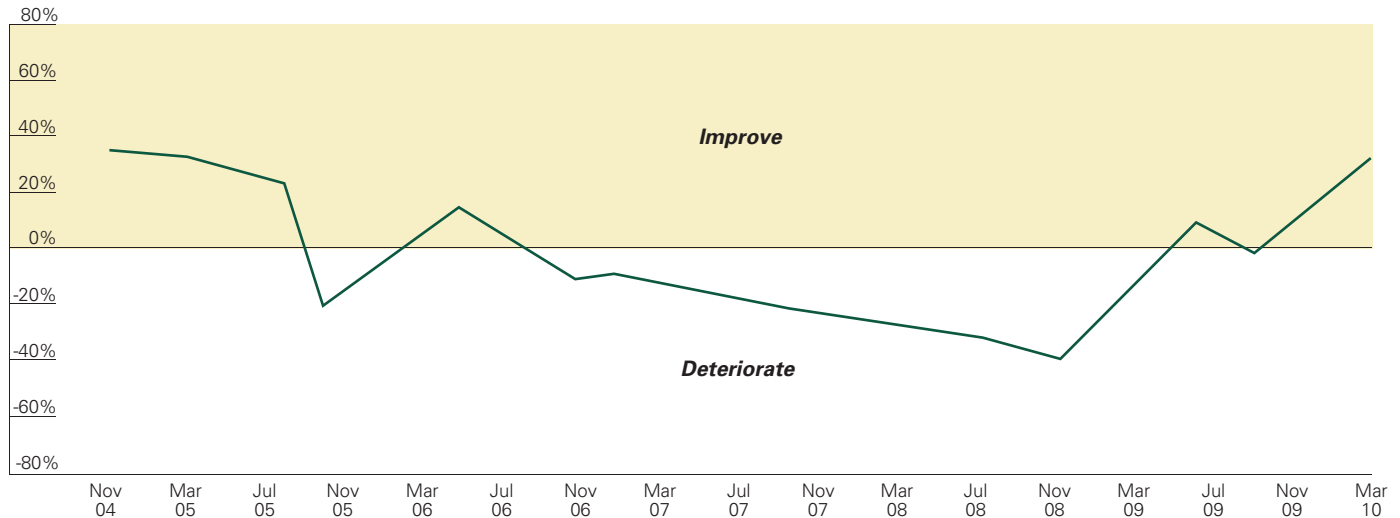
Also working against these efforts are the decentralized systems and organizational structures still in place at many smaller regional banks. In the current recessionary environment, centralized systems for credit approval, underwriting, risk management and ongoing monitoring

are essential in all types of large-scale lending. In C&I lending, these centralized functions must also be supported with robust and relatively sophisticated systems designed to provide an understanding of collateral at the level of client accounts receivables and inventories. Most large regional banks in the United States started out with decentralized processes that allowed for credit approval and other functions to be carried out at the local level. This decentralized organization was often at least partially the result of growth through acquisition. Over the past decade however, virtually all these large regionals have restructured and centralized operations. “Unfortunately, many smaller banks have yet to take this step, and as a result lack the strong central controls required to support significantly higher levels of C&I lending in today’s market,” says FTRANS CEO Dan Drechsel.

Conclusion

Banks’ devotion to real estate lending in the decade leading up to the market collapse is at the root of the current industry crisis. The sudden deterioration of loan portfolio quality caused by the bursting of the real estate bubble and the related crisis in global credit markets has forced banks to curtail commercial and industrial lending activity. This slowdown in lending has in turn deepened and perhaps lengthened the economic recession by depriving companies of capital they need to run and grow their businesses. Banks’ past reliance on real estate lending has also left the industry structurally unprepared for a sudden shift into commercial and industrial lending. A lack of experienced C&I bankers and strong central controls for credit approval, risk management, regulatory pressures, and other key functions is hampering banks’ efforts to pick up the pace of C&I lending and diversify their portfolios away from CRE. These factors help to explain why banks

Greenwich Optimism Index – Mid-Sized Companies



Note: The Greenwich Optimism Index is the net score of companies who feel that the economy will improve versus deteriorate. Based on the results of quarterly surveys of more than 500 small businesses and mid-sized companies. Source: Greenwich Market Pulse v36

in past months have consistently fallen short of corporate lending targets set by their own management teams and regulators. Unfortunately for banks, companies and the economy as a whole, these structural issues will take time to address, and they will likely continue to impede efforts to speed the pace of C&I lending, even as the economic recovery progresses.

Greenwich Associates consultant Ronald Balmer is a recognized expert in the fields of Customer and Employee Metrics. He has led customer and employee initiatives at dozens of organizations, including Federal Express, The Ritz Carlton Hotel Company, Mars, Wachovia, Bank of America, Eastman, and MCI/Verizon.

FTRANS CEO Dan Drechsel is known for his extensive experience developing, managing, and selling enabling technology solutions and has served in senior management positions within the financial technology industry at firms such as SI, SAP and CheckFree.

Methodology

Interviews were conducted by phone at the end of 2009 with 18 banks in the United States. Banks with assets of \$2–30 billion were interviewed about their asset composition and their current and expected loan portfolios.



FTRANS provides banks and other financial institutions with solutions to more effectively and efficiently utilize client accounts receivables (A/R) as collateral for small and medium (SMB) lending. Through continuous collateral monitoring and visibility, FTRANS enables financial institutions to manage portfolio and collateral risk more effectively which in turn allows banks to increase commercial deposits and lending in the underserved SMB market.

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