The stated agenda for this hearing was to list five impediments to lending to small and medium sized businesses from a regulatory perspective, which is quite clear cut and neatly packaged, unfortunately the reality of the current economic environment does not tie up into a very neat package. While regulations are taking a toll on the banking environment in general and lending specifically, there are not simply a set of five regulations that I can easily point to with confidence and state that their removal will fix the problem.

Regulation is certainly an issue with appraisals as affected by FIRREA, Stress Testing which was a directive of the US Treasury, Global cash flow, UCA cash flow testing requirements and new capital levels associated with commercial real estate all have made it difficult to lend. Most of these are guidance rather than regulation, however, for the banker; guidance has become as critical to follow as regulation, without the certainty. Finally, the new regulations that are to come from the Dodd-Frank Legislation and the newly created Consumer Financial Protection Bureau have brought a host of unknowns on top of the current regulatory burden.

FIRREA

FIRREA appraisal standards have created a problem not just with new credits but also with existing credits in conjunction with the real property stress testing that bankers now perform. This regulation in many cases has resulted in capital calls on loans secured by commercial real estate, as the current rents and capitalization rate of the property have been negatively impacted causing a direct devaluation of the properties. While the idea to limit banks exposure to this type of risk is a noble one, unwinding the loan based on the borrower's and guarantor's lack of ability to meet the capital call has been very damaging to the economy. This has led to a number of performing loans becoming foreclosed commercial properties that have been liquidated and in turn brought the broader commercial real estate market down.

The thought process behind this action was to limit speculation on real estate. However, in many instances this has also damaged commercial real estate that is owned by operating companies and used to house their physical plant. While an exemption of $1,000,000 is in FIRREA, many small and most middle market companies would not qualify for the exemption. Therefore, a loan renewal will trigger a new appraisal requirement, if the new appraisal is below the threshold of Loan to Value required by the bank's policies or outside of defined regulatory thresholds, the loan would need to be reduced through a capital call.

Mass media reports of the level of cash held by corporations have been widely discussed over the past two years. While most public companies do have a very strong liquid balance sheet, this is not necessarily true for the small and medium sized firms that make up the bulk of community bank customers, and local employers. Capital calls have been very detrimental to these firms, further stressing the commercial real estate market and in many cases the employment market.

Stress Testing

Stress testing has been a very effective tool to determine the health of commercial real estate loans over the past three years. This has also led most banks to perform annual reviews of all term loans whether they are real estate related or not to determine the overall risk inherent in the portfolio. Identification of the weakest assets of any bank is important, however, it comes with the question of what to do with those assets.

The answer in most cases is to re-margin the asset, requiring additional capital to be brought in and reduce the outstanding balance on the loan. This has happened many times over the past four years and in many instances has been deemed to be the deleveraging that has been so badly needed in our economy.

Theoretically the deleveraging of balance sheets should make the companies much more attractive to banks; this has not been the case in most instances. Unfortunately, while the total leverage of the asset has been reduced, the overall leverage of the project is still at the regulatory maximum, therefore, no additional borrowing capacity has been created; this results in a company that has depleted cash, depleted capital, and the leverage ratio of the company is unchanged. In all, the company is actually weaker.   An asset value drop led to a liability drop, and a smaller, less liquid company, which is not a recipe for success.

While this is fundamentally bad for the company, the bank has managed to keep a performing loan that is appropriately leveraged. Should the company not have the resources to reduce the balance of the loan in line with the current market value then the bank has the option of foreclosing on the property, or working with the borrower on a troubled debt restructure. In either case this is a negative for both the company as well as the bank.

From the bank’s perspective additional capital will have to be allocated to the loan as its risk rating increases and current income will need to be provided for the potential losses and placed in the loan and lease loss reserve account.

From the borrower’s perspective it could easily mean a corporate and a personal bankruptcy which is potentially very damaging to the operating company and its personnel.

Global Cash Flow/UCA Cash Flow

Global cash flow and the increased use of UCA Cash Flow have been touted as additional ways to reduce or identify risk in the bank's portfolios. While I am in general agreement with each of these, they both also have strong negatives attached. Global Cash Flow has no standard at this time and is being done differently in practically every bank. It has been my experience that even Federal and State Examiners show marked differences in the way they treat Global Cash Flow. This is so pervasive that from Examiner to Examiner on the same examination team there can be marked differences in the way this is calculated.

Global Cash Flow is vital to understanding a business but it truly has no industry standard, and one should be developed. This would help the banks and the business owners as well.

UCA Cash Flow is a very good form, and is in fact an industry standard, however, the guidance at this point is to have a standard measure for cash flow leverage. This is again a neat and tidy package that simply does not work in most instances. Cash flow leverage on a retail store, a manufacturer, or wholesale distributor are remarkably different. Industry to industry the rates can also change as well as by the asset/liability structure of the company. Total leverage on a business needs to be completed on a case by case basis and a standard while well meaning serves to limit credit, not risk.

Capital Levels on Commercial Real Estate

Capital levels as they are applied to Commercial Real Estate (CRE) are also a significant drag to lending for small and medium sized businesses. Regulatory Guidance suggests that safe and sound banking practices would limit land and land development loans to 100% of capital with a maximum of 300% of capital for all CRE, inclusive of the land development portfolio.

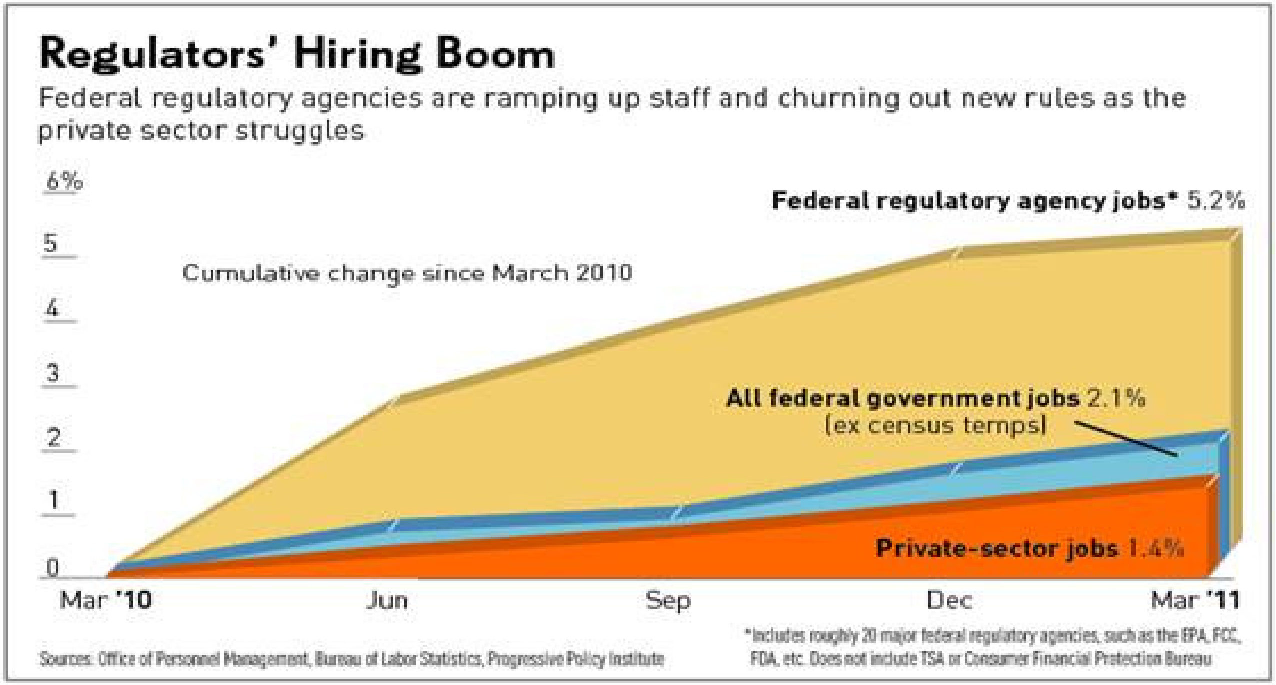
In the Western United States where most banks are dependent on real estate lending to survive, this is difficult. Compounding matters is the definition of CRE. For example, a production facility for oil drilling components, paid for by the sale of the oil drilling components is a real estate loan if the physical plant is used as collateral. While owner occupied real estate has its own definition, it is still included in the leverage ratio, and can effectively reduce a bank's ability to lend.

At the point in time when a bank becomes over leveraged on CRE, there are only two ways out for the bank, raise capital through earnings or the sale of stock or sell performing loans to reduce the numerator. Currently in Colorado there are a number of banks selling loans, as capital is nearly impossible to raise in today’s market. Investors are chasing yield therefore they have become a ready market for the purchase of commercial loans as this is viewed as a good way to increase yield over CD’s and Treasury Securities. When a bank is selling loans, they are in fact no longer lending at all in most cases and are not a good source of capital for the community.

Regulatory Change

All of the new laws that have been passed will lead to new regulation, and this has been happening at a much quicker pace than at any time in the past. Each new regulation, as it is written will be very expensive for banks to understand and implement. At the current pace of regulation, the regulators are not even sure what each new regulation means, how it will be tested for compliance, and how it will be administered. If Examiners don’t understand the requirements of the regulation, the regulated will have great difficulty and expense in complying with these new regulations, not to mention guidance.

In fact, with the new Consumer Financial Protection Bureau and changes from Dodd-Frank, the pace of regulatory hires has increased simply to keep up with the level of new regulation that must be absorbed by the regulators. On the other hand, banks across the country continue to cut staff simply to survive. In the past several weeks more than 9,500 banking jobs have been eliminated at four banks, and additional layoffs at other primarily large banks seems imminent, the common theme has been stated as regulatory burden. This regulatory burden is being shared by new staff at the Federal level and being absorbed by less staff in the banks.


Regulators' Hiring Boom

Federal regulatory agencies are ramping up staff and churning out new rules as the private sector struggles

*Includes roughly 20 major federal regulatory agencies, such as the EPA, FCC, FDA, etc. Does not include TSA or Consumer Financial Protection Bureau

Sources: Office of Personnel Management, Bureau of Labor Statistics, Progressive Policy Institute

This simple uncertainty has fueled many industry groups over the past several years including Risk Management Associates, Independent Community Banks of America, and The American Bankers Association, not to mention fifty states worth of local industry groups. Information flowing out of these groups to bankers on a daily basis could easily account for two hours per day, just to fully comprehend the information being sent out. Our Nations community bankers cannot spend a quarter of their time simply digesting the changes that Washington is contemplating, but we also cannot afford to ignore it.

Regulation is simply a portion of the lending issue for community banks at this time.

The primary barrier to bank credit currently is a combination of factors, regulatory, economic, and perception of the future from the point of view of the borrowers. From a regulatory perspective the FIRREA, Stress Testing and capital limitations are the primary risk areas for banks and have fundamentally changed the marketing efforts of officers. The economic conditions have made many companies simply too great a risk for a bank to do business with, and finally those that can borrow are facing a very uncertain market making borrowing seem too risky.