Survey of Community Banks

Explores Credit Crunch

Restricted access to credit, especially decreased availability of bank credit to small businesses, is often cited as a potentially important factor in amplifying the recent recession's effects and contributing to the weakness of the subsequent expansion. *The 2010 Survey of First District Community Banks*, conducted by the Federal Reserve Bank of Boston in May 2010, examines how the supply of, and demand for, bank credit changed in late 2008.[1] The 2010 survey tries to explain how much community banks were willing and able to lend to local businesses that once were customers of large banks but lost access to credit in the financial crisis. In addition, it assesses to what extent the Small Business Administration (SBA) lending programs improved access to credit for small businesses.

The main finding is that community banks tightened lending standards for commercial loans moderately following the most acute phase of the crisis. The tightening was more severe for new customers than for those that already had a relationship with the responding bank. The survey results also suggest that the SBA programs were somewhat effective at promoting business lending among New England community banks, especially among SBA-preferred lenders.

Tightening of Bank Credit

Responses to the survey questions pertaining to changes in loan applications and originations during the fourth quarter of 2008 suggest moderate tightening of bank credit. More than 40 percent of respondents reported that the dollar volume of new originations remained essentially unchanged. However, there were more banks (40 percent) reporting a decrease in origination volume than an increase (16 percent). The most frequent response (43 percent) to the question about changes in the total number of applications for term loans and lines of credit was that overall applications were unchanged, but more bankers (41 percent) reported that applications decreased than reported that applications increased (16 percent).

According to data provided by respondent banks, applications for loans rose from 2006 to 2007 but fell from 2007 to 2010. The number of term loans originated started falling later in 2008, with the decline decelerating in 2010. The rate of decline for line-of-credit originations, however, accelerated rapidly, reaching more than 20 percent in 2010. The steeper decline is consistent with the researchers' hypothesis that, during the economic downturn, banks were more reluctant to grant new or renew existing lines of credit than to originate term loans.

The survey results provide preliminary evidence that businesses that had relied on large commercial banks for credit turned to community banks as large banks cut back on lending after subprime-induced balance sheet losses led to capital constraint. The tightening of business lending at the respondent community banks was more severe, however, for new customers. The respondents reported that everything else being equal, in 2008 and 2009, the bank was more likely to grant credit to customers with an existing relationship.

Also, the median approval rate for lines of credit and term loans fell more for applications from new customers than for overall applications between 2008-2009 and 2009-2010.[2] And the tightening of underwriting standards for both was reported to be greater for new customers than for existing customers.[3] The patterns suggest that community banks became tougher with new applicants after the shock of seeing Fannie Mae and Freddie Mac being taken into conservatorship in late 2008—identified by the representative bankers as the most relevant event of the financial crisis for local community banks.

SBA Programs

The survey also attempts to assess whether the SBA lending programs were effective in improving the availability of bank credit for small businesses during the crisis. SBA lending programs—many of them expanded by the American Recovery and Reinvestment Act of 2009—are meant to facilitate lending to small businesses. Key provisions in the ARRA include the following: the elimination of the up-front guaranty fee for loans with maturities greater than 12 months, and the extension of SBA guarantees to lenders up to 90 percent of the loan value for most 7(a) loans.[4] Additionally, thanks to permanent changes to the 504 Certified Development Company loan program, small businesses seeking to expand should be able to refinance existing loans used to purchase real estate and other fixed assets.[5]

Most respondents (106 banks, or 78 percent) indicated that they participated in at least one of the SBA programs. Furthermore, 35 percent of the respondent banks were SBA-preferred lenders, to which the SBA has delegated loan approval, closing, and most servicing and liquidation authority and responsibility. The survey asked the banks to estimate the percentage increase in the dollar value of business loans since 2008 made possible by the availability of SBA programs. Among the banks that

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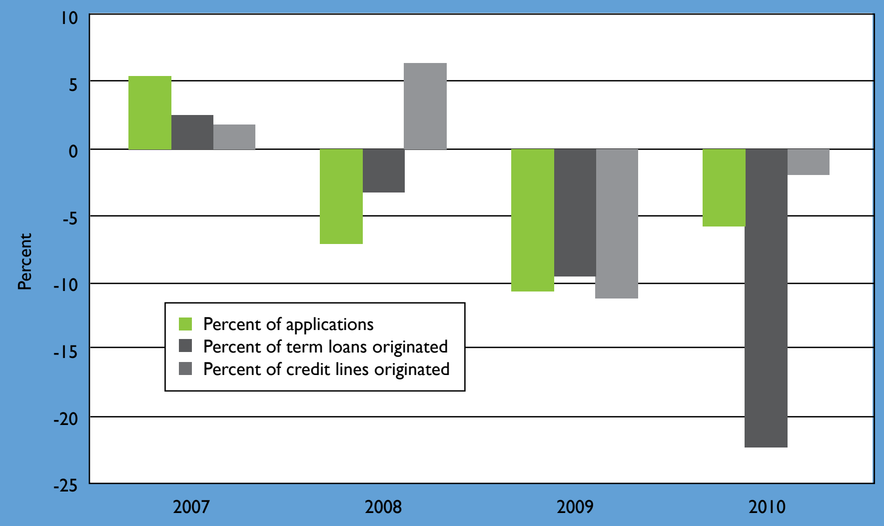
Growth Rate in Percent of Loan Applications and Originations



Note: Median of the balanced panel of 47 banks that reported data for all the sample years

responded, 38 percent reported that the SBA programs made no difference. The median increase in business loans attributed to SBA programs was 5 percent and the mean 11.38 percent. Unsurprisingly, SBA-preferred lenders were less likely to report that SBA programs made no difference (18 percent) and attributed higher value to the SBA program. The results suggest that the SBA programs were somewhat effective at promoting business lending among community banks in New England, especially among SBA-preferred lenders.

Implications

In summary, survey results suggest that New England's community banks tightened credit after the onset of the financial crisis, with the tightening greater for new customers than for existing customers. Tighter underwriting standards for new customers make sense from an individual bank's point of view. The bank may have private information regarding the credit worthiness of existing customers and a vested interest in the relationship. They may also worry about adverse selection. It is difficult to ascertain whether a business's line of credit was not renewed by another bank because that bank developed balance sheet problems or if the other bank had private information indicating that the business was a poor risk.

It is less obvious why underwriting standards for new customers should have been tightened more than for existing customers during the last two years. One possibility is that the community banks believed that information asymmetry had become more severe, since larger banks are likely to shed their most problematic customers. Another possible reason is that community banks wanted to slow the growth of their assets in the face of a rather uncertain economic outlook, while protecting their investment in relationships with existing customers.

Overall, community banks do not appear to have been able or willing to offset the contraction in the credit supply stemming from large banks' actions. The survey responses do provide some evidence in support of the efficacy of SBA lending programs in boosting the supply of credit to small businesses. This suggests that further expansion of the SBA programs could be effective in increasing the supply of credit to small businesses.

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Endnotes

[1] This article draws from Jihye Jeon, Judit Montoriol-Garriga, Robert K. Triest, and J. Christina Wang, *Evidence of a Credit Crunch? Results from the 2010 Survey of First District Banks* (public policy brief 10-3, Federal Reserve Bank of Boston, 2010), http://www.bos.frb.org/economic/ppb/2010/ppb103.pdf. Of the 268 banks receiving the questionnaire, 135 responded. The response rate for qualitative questions was far higher than for quantitative questions. Ninety-two percent of the banks (124 banks) provided answers to at least one of the qualitative questions. Only 62 percent (84 banks) answered one or more of the quantitative questions, and only 33 percent of them (44 banks) answered all of the quantitative questions.

[2] The median approval rate was calculated for only 41 banks whose answers were coherent. For other respondents, which were excluded from the calculation, the reported number of lines of credit originations plus the reported number of term-loan originations exceed the reported number of applications for both types of contracts.

[3] In regard to underwriting standards for lines of credit, most (57 percent) of the responding banks indicated that standards for existing customers remained basically unchanged, with nearly all the rest reporting that they had tightened standards somewhat (37 percent) or considerably (5 percent). By comparison, just 40 percent of respondents reported that standards for new customers were unchanged, whereas 51 percent reported that they had tightened somewhat for new customers, and 9 percent responded that they had tightened considerably. The responses to the questions about underwriting standards for term loans are similar but reflect somewhat less tightening.

[4] The 7(a) loan program provides loan guarantees to approved banks and other approved lenders in order to help small entrepreneurs start or expand businesses. The SBA expanded the eligibility criteria for 7(a) loans in May 2009.

[5] The 504 program provides small businesses with long-term, fixed-rate financing to acquire fixed assets for expansion or modernization.