THE WALL STREET JOURNAL.
WSJ.com

BUSINESS | FEBRUARY 24, 2010

Lending Falls at Epic Pace

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U.S. banks posted last year their sharpest decline in lending since 1942, suggesting that the industry's continued slide is making it harder for the economy to recover.

While top-tier banks are recovering at a faster clip, the rest of the industry is still suffering, according to a quarterly report from the Federal Deposit Insurance Corp. Banks fighting for survival, especially those plagued by losses on commercial real estate, are less willing to extend loans, siphoning credit from businesses and consumers.

Besides registering their biggest full-year decline in total loans outstanding in 67 years, U.S. banks set a number of grim milestones. According to the FDIC, the number of U.S. banks at risk of failing hit a 16-year high at 702. More than 5% of all loans were at least three months past due, the highest level recorded in the 26 years the data have been collected. And the problems are expected to last through 2010.

FDIC Chairman Sheila Bair said banks are "bumping along the bottom of the credit cycle" and that the number of bank failures in 2010 will likely eclipse the 140 recorded last year.

The struggling U.S. banking industry remains a problem for policy makers eager for banks to lend again. Lawmakers on Capitol Hill and administration officials have pushed banks to lend, particularly in light of the billions in taxpayer aid injected into the financial industry over the past two years. Banking groups and their members counter that they're under pressure from regulators to be more prudent and that demand from struggling consumers and businesses isn't there.

Initiatives such as the Obama administration's $30 billion small-business lending program will rely on banks making loans at a time when many of those same firms are wrestling with a rising tide of commercial real estate problems or being told to add to their reserves by regulators.

Some small-business owners say they could expand if they could just get a loan. Nick Sachs, president of Homewatch CareGivers Cincinnati-Metro, says he's been asking banks for a loan of $150,000 to $250,000 since 2008. He says his home-health-care franchise could hire 20 to 30 aides and even one or two office assistants.

After being rejected for a loan by Huntington Bancshares Inc. over a year ago, Mr. Sachs recently re-applied to the Columbus, Ohio, bank. He did so in part because Huntington said in February that it would double its annual small-business lending over the next three years and extend credit to as many as 27,000 more businesses.

"My conversation with the banker was identical to the conversations in 2008," Mr. Sachs said. In both cases, Huntington's representative suggested that a loan from the government's Small Business Administration would be the best fit for the company. The banker collected the paperwork for the application, like tax returns and a business plan, Sachs said, but didn't ask many questions about how the company planned to use the funds. "I am very doubtful," he said. "I've been down this road before."

Maureen Brown, a Huntington spokeswoman, said the bank's "turnaround loans" have been well-received. She said the bank doesn't comment on individual loan applicants. Huntington has posted a string of five quarterly losses dating to 2008.

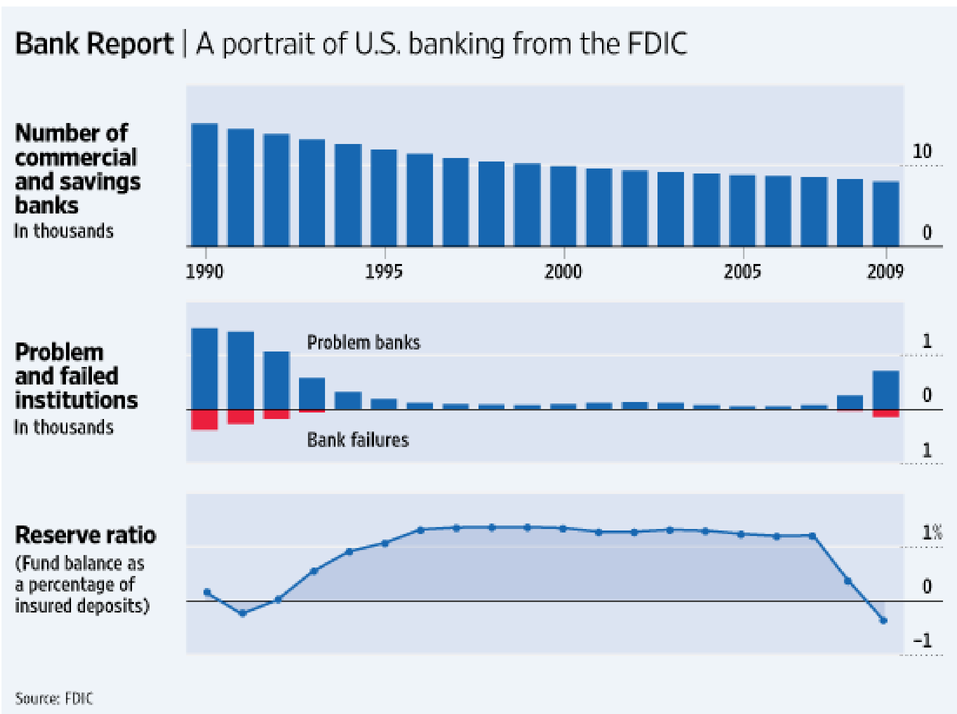
The FDIC said that the decline in loan balances in the quarter hit all major categories—from construction to commercial loans and residential mortgages—with the exception of credit card loans.

It remains unclear whether the sharp decline in loans outstanding stems from banks' tightening standards and a fear of lending or from weak demand from potential borrowers spooked by the downturn. Another cause could be banks actively reducing the size of their loan portfolios, creating a natural decline.

Most surveys suggest a combination of factors is at play. A January survey by the Federal Reserve of senior loan officers showed banks have slowed their efforts to tighten lending standards, but have not backed off the more stringent loan terms they put in place over the past two years. The same report, however, also showed that demand for loans from businesses and consumers continues to fall.

"Lending has been weak and spending by businesses and consumers has also been weak," FDIC Chief Economist Richard Brown said.

Bankers, on the other hand, say creditworthy borrowers are hard to come by. Fifth Third Bancorp recently extended a $3.5 million line of credit to Chicago-based One Hope United after the state of Illinois, beset by a budget crisis, delayed payments to the child-and-family-services provider.



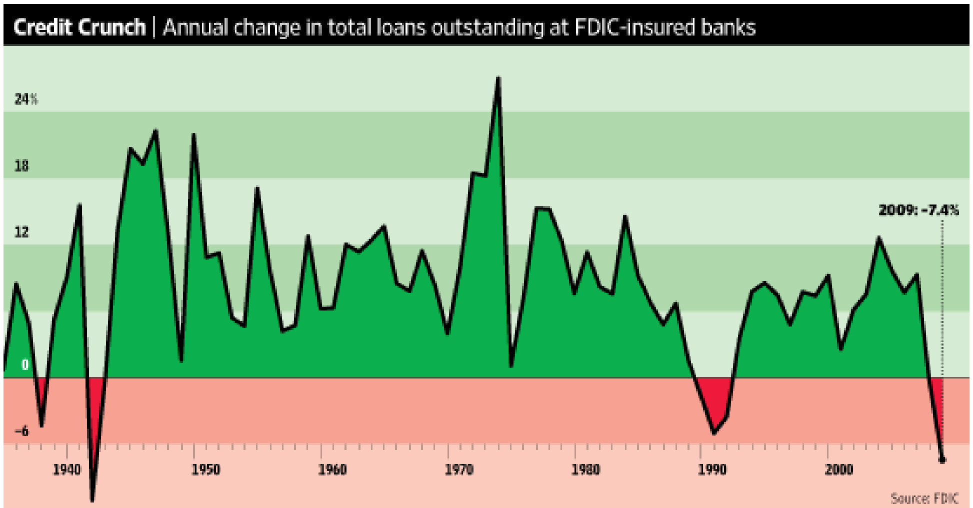
Steve Abbey, Fifth Third senior vice president, said One Hope United is a rare exception of a nonprofit borrower that could qualify for credit from Fifth Third because of a cash crunch. Most other nonprofits that need cash right now, "haven't set themselves up to borrow money and pay it back," Mr. Abbey said. "They just need money."

The FDIC's Ms. Bair said officials are eager for banks to make loans in their communities, putting the onus on the bigger institutions to do more small-business lending. "The larger institutions I think need to step up to the plate here too," Ms. Bair said, describing as "significant" the declines in their loan balances and credit lines.

One issue complicating banks' ability to lend is the looming problem of troubled commercial-real-estate loans. The FDIC's Mr. Brown said these loans take longer than residential mortgages to go bad, dragging out the hit to a bank's balance sheet.

The FDIC's report revealed that asset-quality indicators for banks continued to deteriorate in the fourth quarter as borrowers continued to fall behind on their loans. Banks wrote down $53 billion in loans in the final three months of last year. The quarterly write-off rate was the highest ever recorded in the 26 years the FDIC has collected the data. A total of $391.3 billion of all loans and leases, or 5.4%, were at least three months past due at the end of 2009.

"While the economy is moving ahead banking results tend to lag behind," Mr. Brown said. "The problem loans and the earnings of the industry will improve somewhat after the economy improves."



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