Key Insights and Issues Related to Small Business Lending

- **What happened and where do we stand?**

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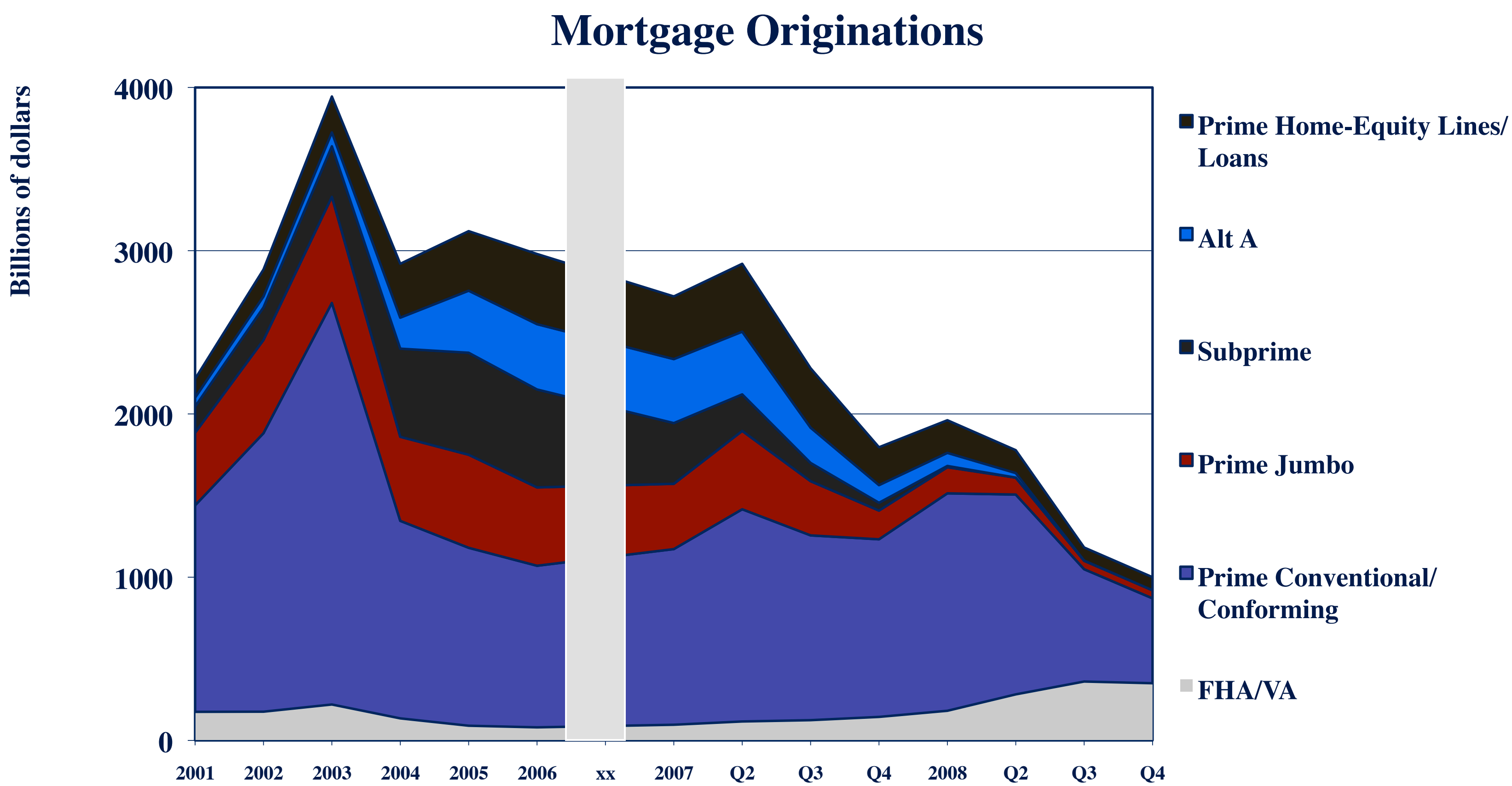
Remember the fall of 2008?

"The financial crisis that gripped the United States last fall was unprecedented in type and magnitude. It began with an asset bubble in housing, expanded into the subprime mortgage crisis, escalated into a severe freeze-up of the interbank lending market, and culminated in intervention by the United States and other industrialized countries to rescue their banking systems. During a remarkable 19-day stretch, the federal government took over the two largest players in the mortgage market, allowed a large investment bank to go bankrupt, bailed out one of the world's largest insurance companies, and steered a major financial institution through the largest bank failure in U.S. history."*

Congressional Oversight Report on the Troubled Asset Relief Program, December 9, 2009

** Reference is to the fall of 2008*

What happened? Favorable mortgage rates made it easier to purchase a home.



Quarterly figures for 2007 and 2008 expressed at an annual rate.
Source: Inside Mortgage Finance, January 30, 200i9

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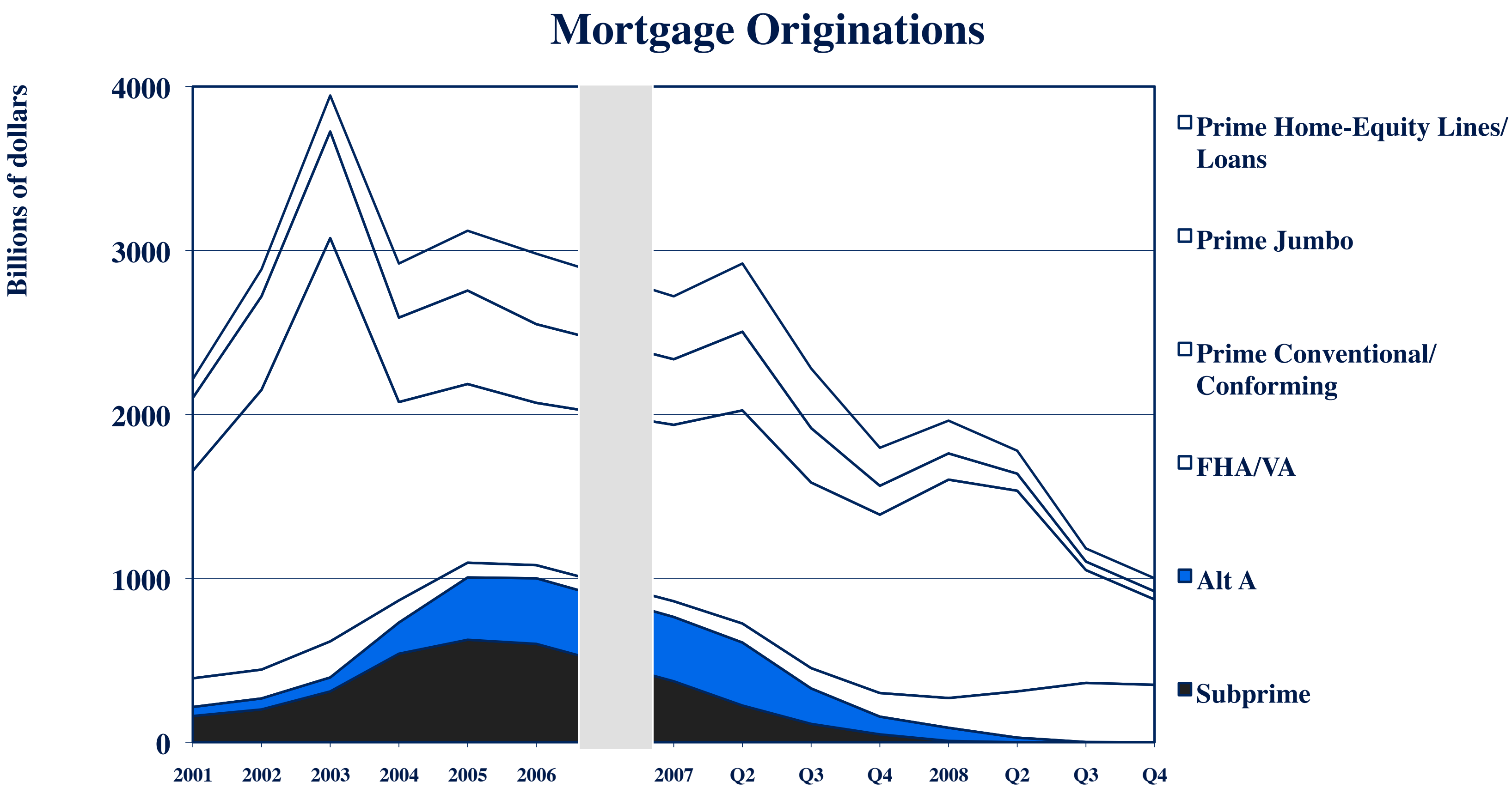
And new nontraditional mortgage products made it easier for less creditworthy individuals to get a mortgage.



Quarterly figures for 2007 and 2008 expressed at an annual rate.
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Subprime mortgages were high risk, with repayment often linked to an increase in house prices.

	Subprime Mortgages – 2005-2006 Vintages
> 78%	Subprime mortgages with adjustable rates (including hybrids)
40%	Subprime mortgages with reduced documentation
98%	Combined loan-to-value ratio
55%	Share of subprime mortgages that were cash-out refinances
90%	Share of subprime mortgages originated through broker or wholesale channel

Sources: Mortgage Bankers Association, Loan Performance Corp.

The mortgages were transformed into securities, making the risk difficult to see.

The mortgages were pipelined through mortgage companies

- Mortgage companies specializing in these obligations originated volumes of mortgages for sale to investment banks.

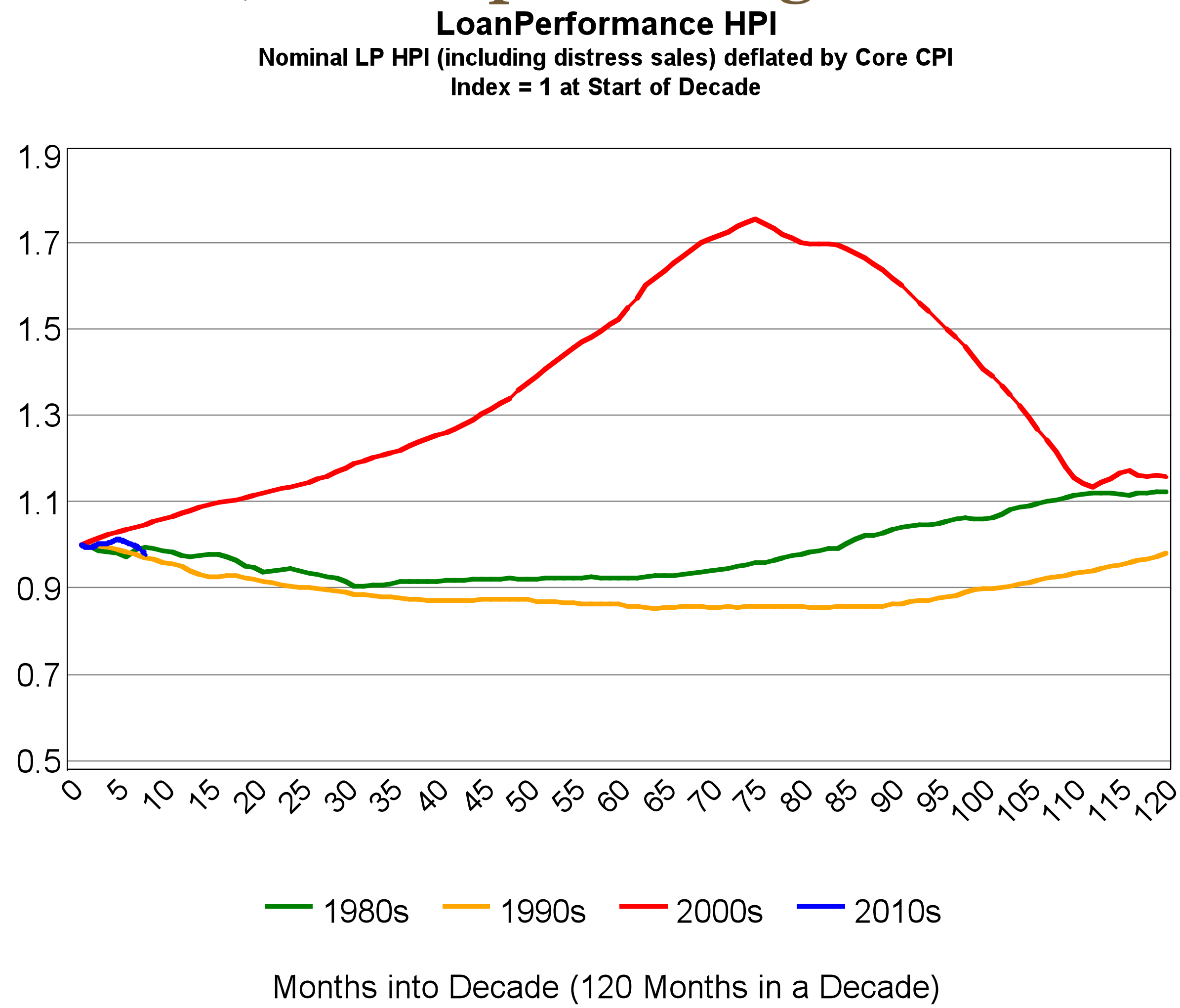
Subprime mortgages were typically transformed into "mortgage-backed securities"

- The mortgages were grouped into payment and risk "tranches" and sold as "collateralized mortgage obligations."
- And sometimes, other assets or enhancements were added to the collateralized mortgage obligation to create a "collateralized debt obligation."

The U.S. "spread the risk"

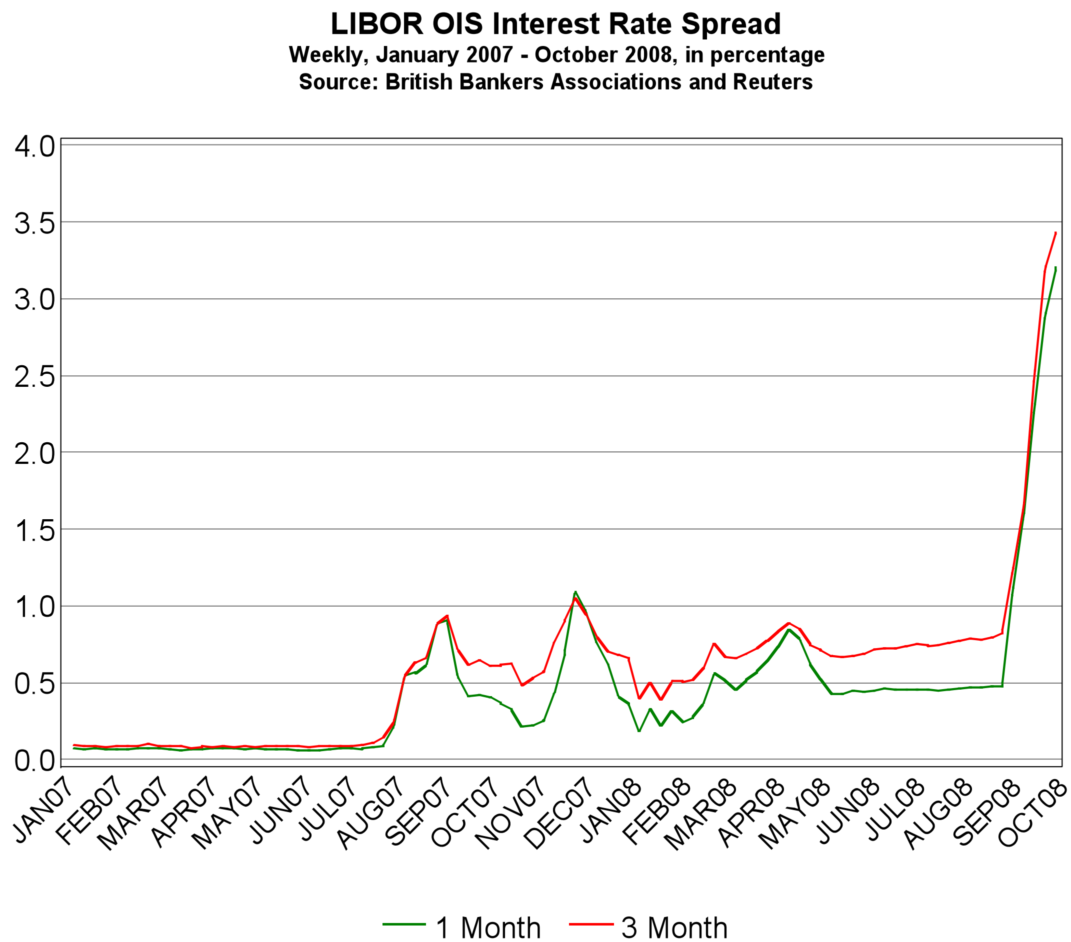
- The securities were sold to investors around the world or held in in the trading books of investment banks.

And then, house prices began to fall.



SOURCE: BLS and Loan Performance/Haver Analytics

Financial markets feared the solvency of important counterparties; the country faced a financial crisis.



The crisis required a massive response.

"First Responders" to the financial crisis

Federal Reserve
- Provided funds (liquidity) to stabilize financial markets

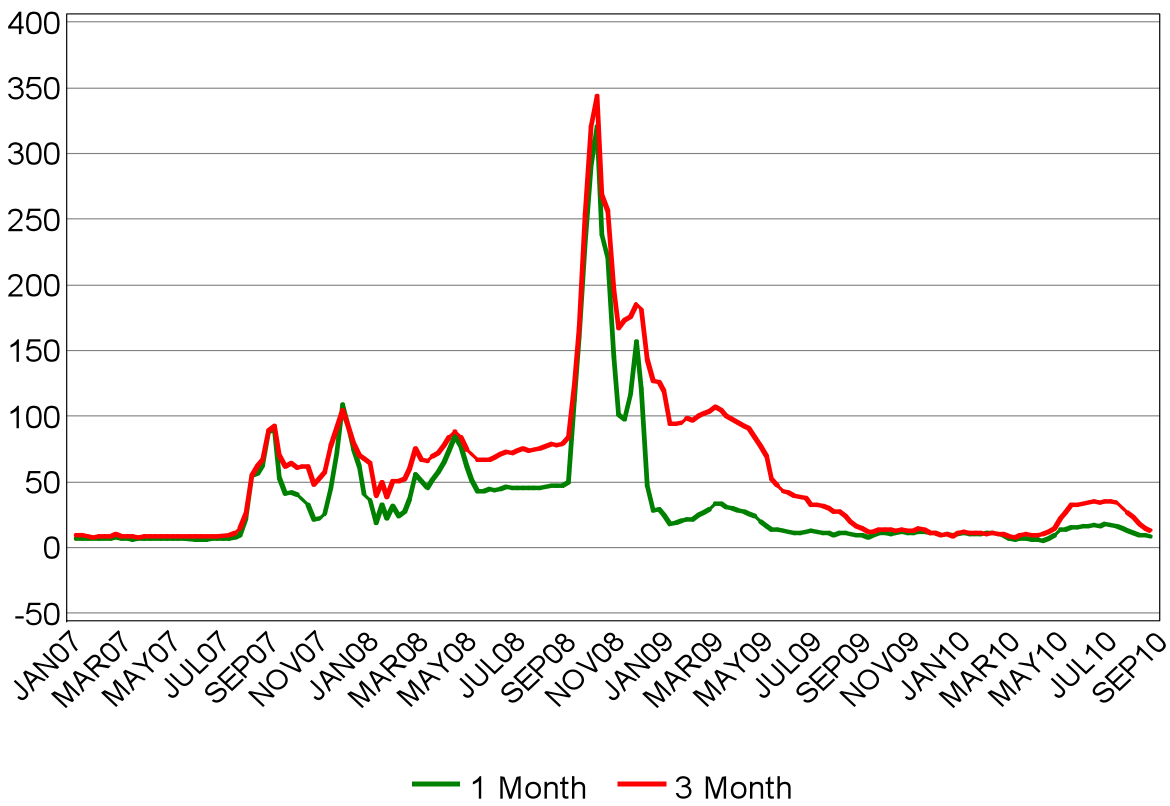
United States Government
- Funded the Troubled Asset Relief Program, the $800 billion economic stimulus, Cash for Clunkers, Homebuyer Tax Credit, extended unemployment benefits.

Federal Deposit Insurance Corporation
- Raised bank deposit insurance limits and provided other bank debt guarantees.

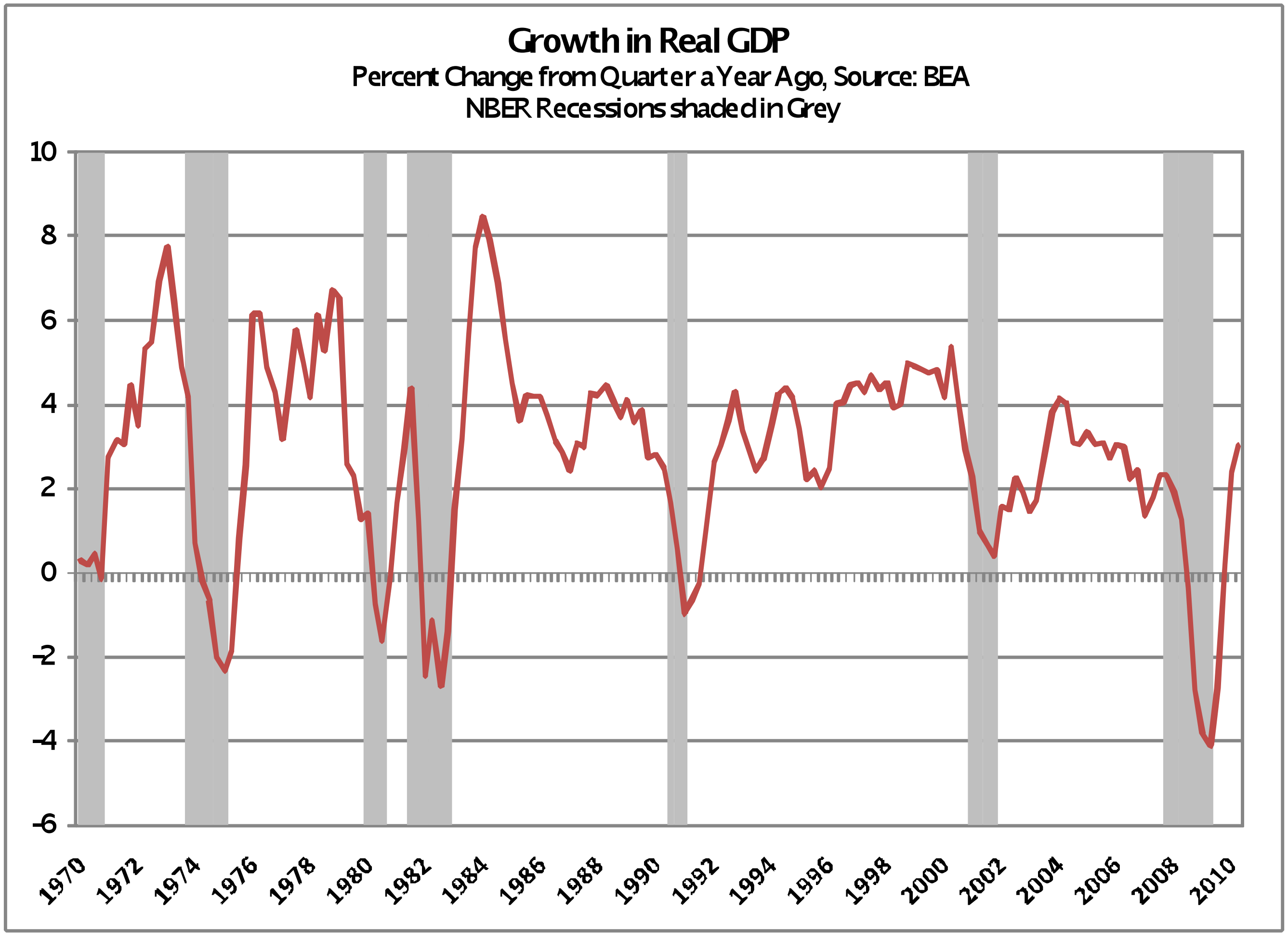
While the actions avoided a collapse of the financial system…

LIBOR OIS Interest Rate Spread

Weekly, January 2007 - October 2010, in basis points
Source: British Bankers Associations and Reuters



we did not avoid the "Great Recession."

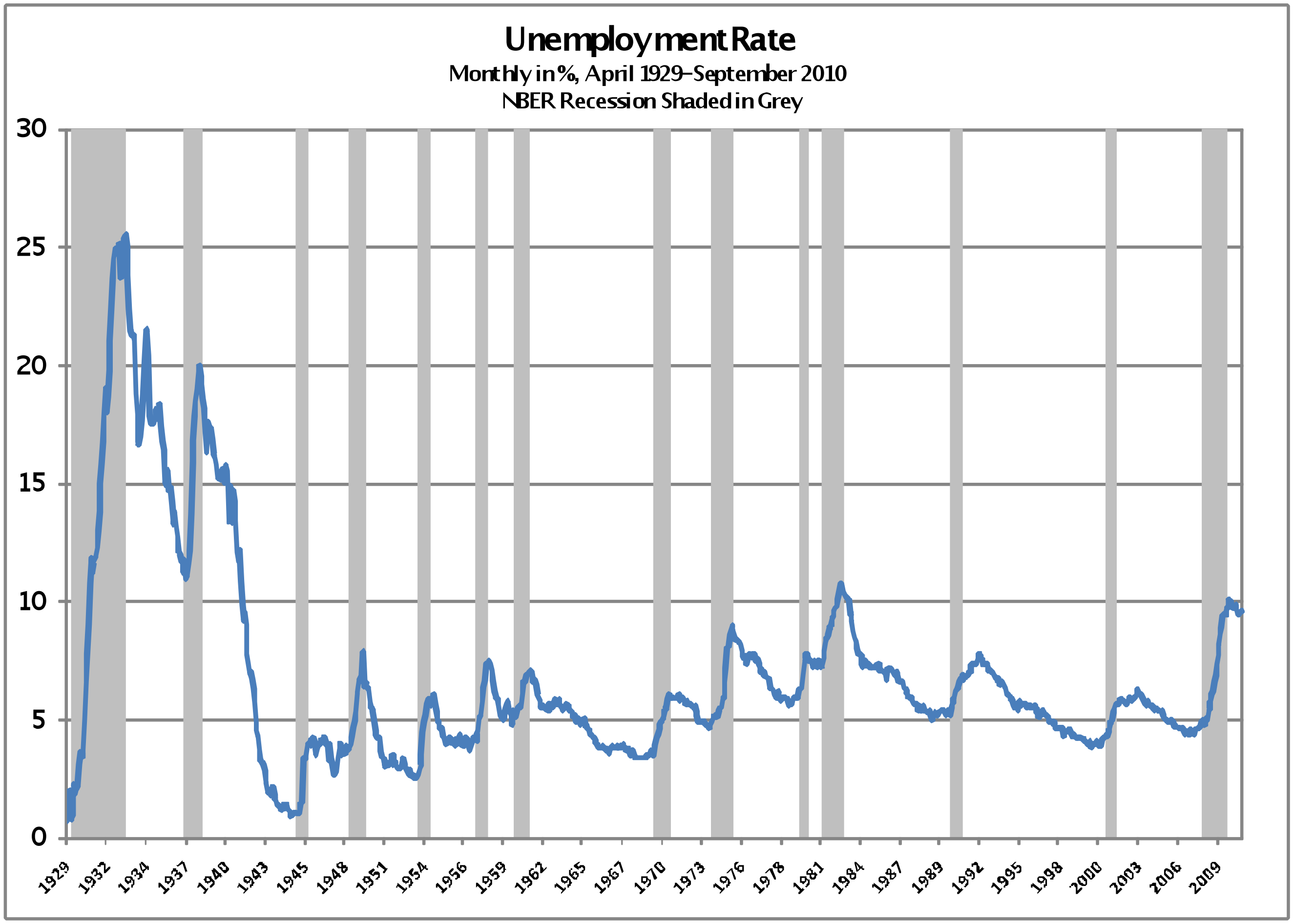


Home prices have collapsed in some markets.

Geographic Area	Market Peak	Market Trough	Peak to Current Percent Decline
Boston	November 2005	April 2009	13.7
Chicago	March 2007	March 2010	26.4
Denver	March 2006	February 2009	10.3
Los Angeles	April 2006	May 2009	36.6
Las Vegas	April 2006	August 2010	57.5
Miami	May 2006	May 2009	47.5
New York City	May 2006	March 2010	19.4
San Diego	March 2006	May 2009	35.8
San Francisco	March 2006	April 2009	36.2
Washington, D.C.	March 2006	March 2009	26.5

Source: Case-Shiller, through August 2010 release

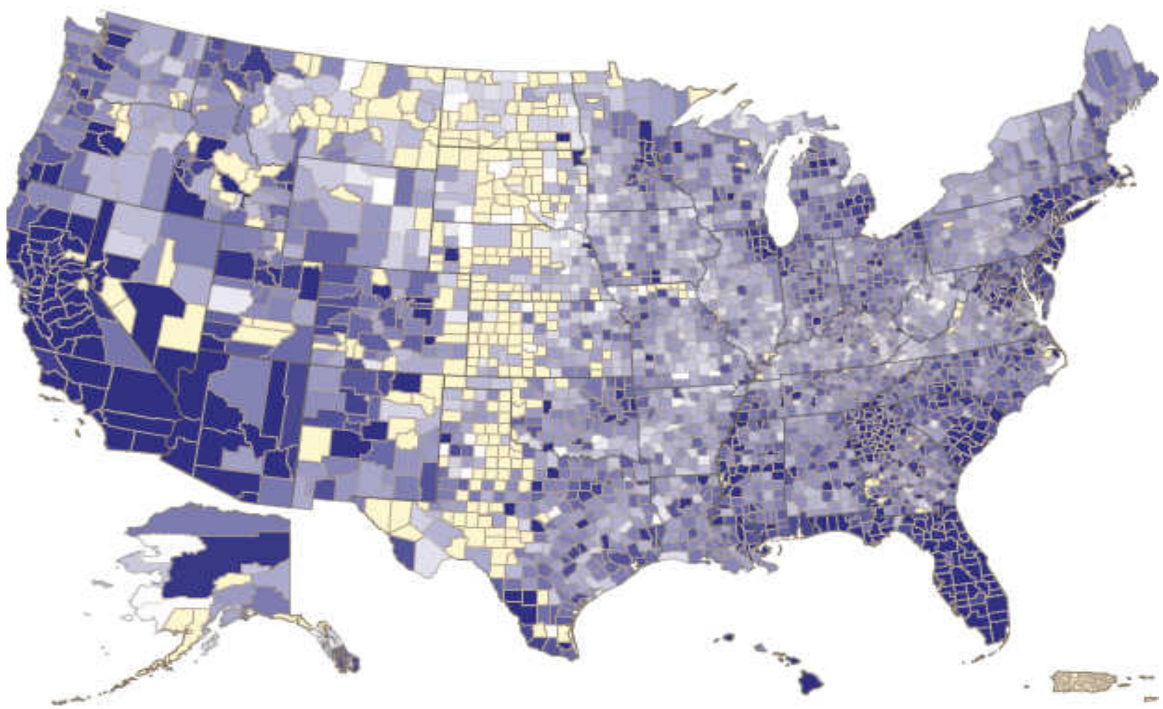
Unemployment remains undesirably high.



Gray bars indicate recession periods

Approximately 8 percent of all mortgages are seriously delinquent.

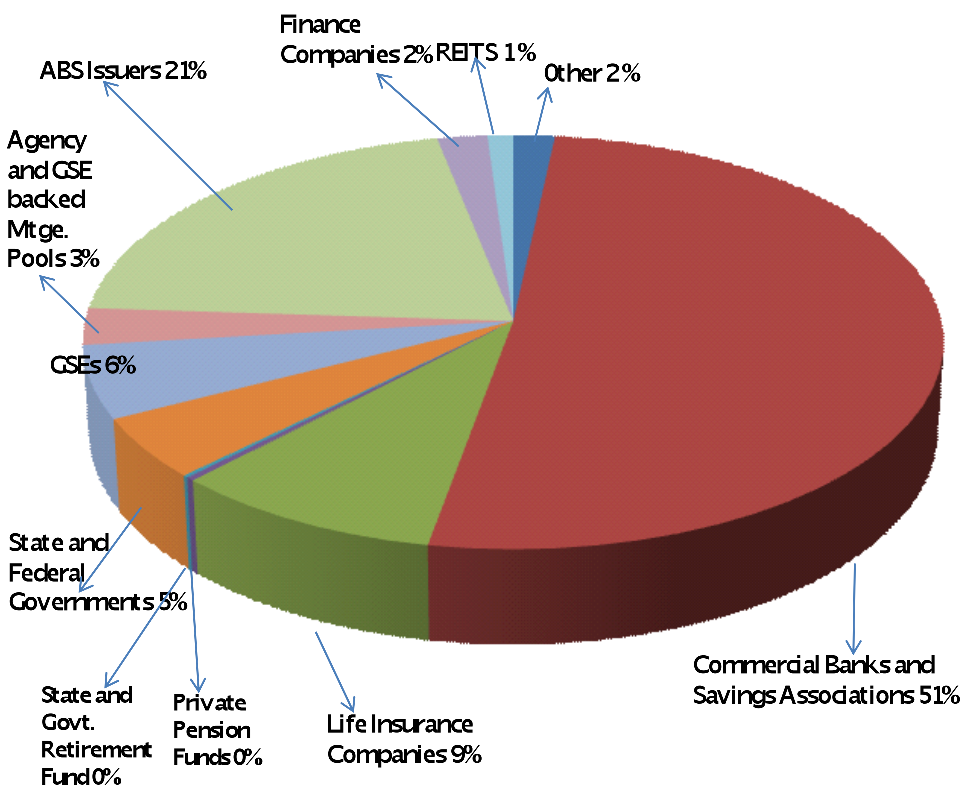
All - Mortgage Delinquency Rate 90+ Days - Current (2010Q2)



Darker shading indicates higher percentage.

Source: Federal Reserve Bank of New York Credit Conditions maps

And, unfortunately, the fall-out has spilled over into the commercial real estate loan portfolios of banks.

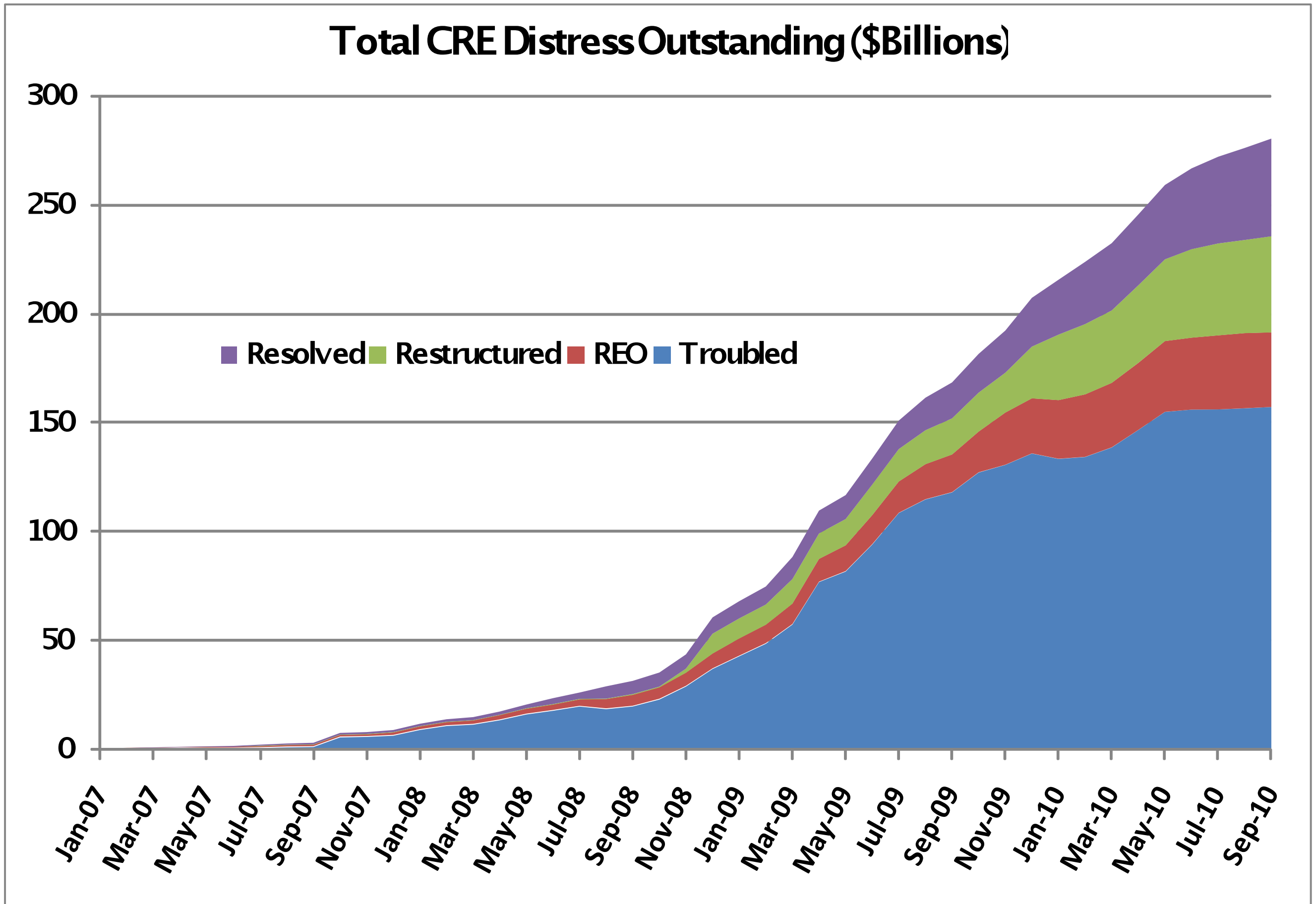


Updated with 2Q2009 data

Total Commercial and Multifamily Debt Outstanding: **$3.4 Trillion**

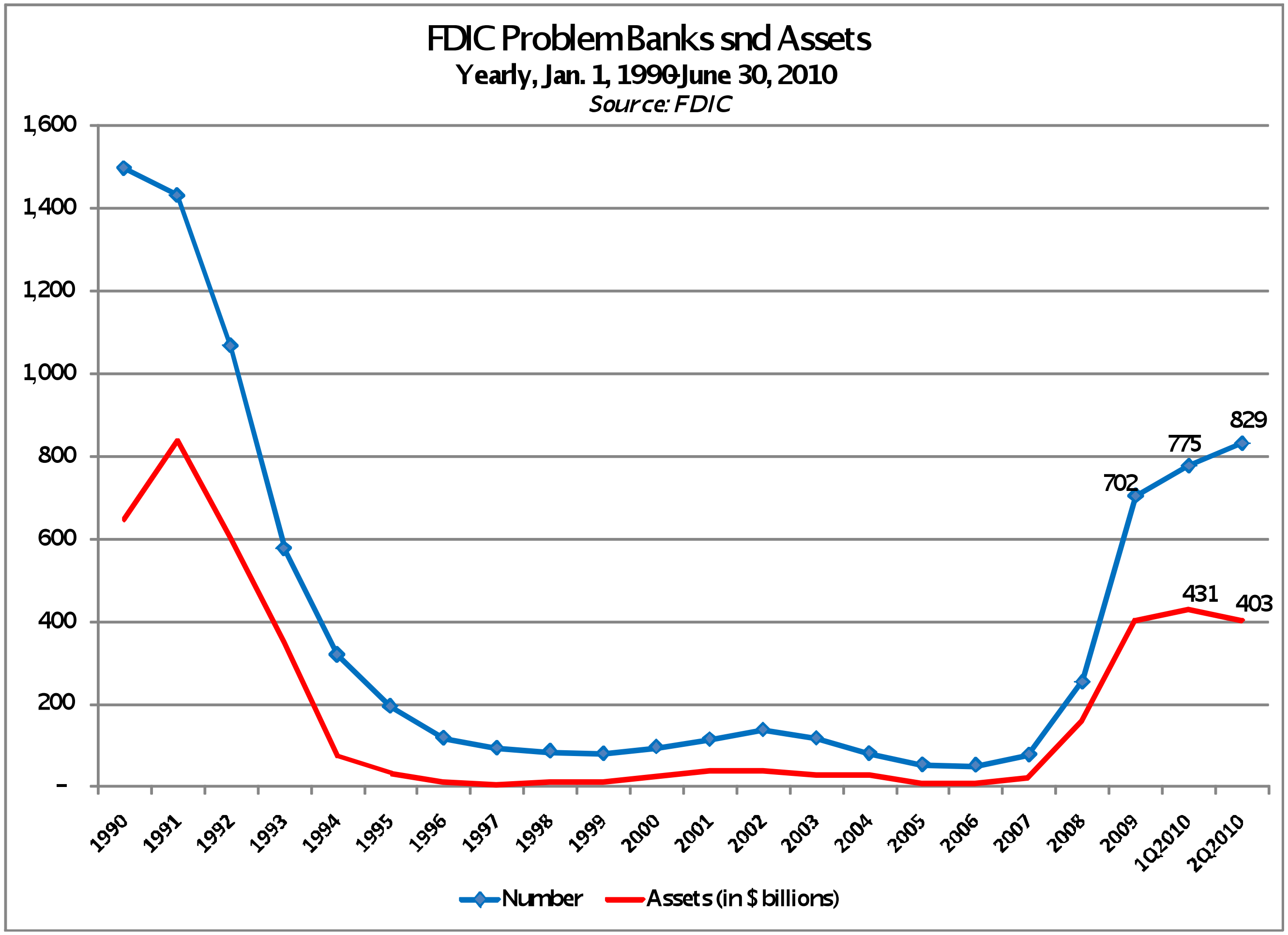
Total CRE Outstanding in Commercial Banks and Savings Institutions: **$1.7 Trillion**

Troubled commercial real estate loans remain at stubbornly high levels, but have been stable over the last three months.

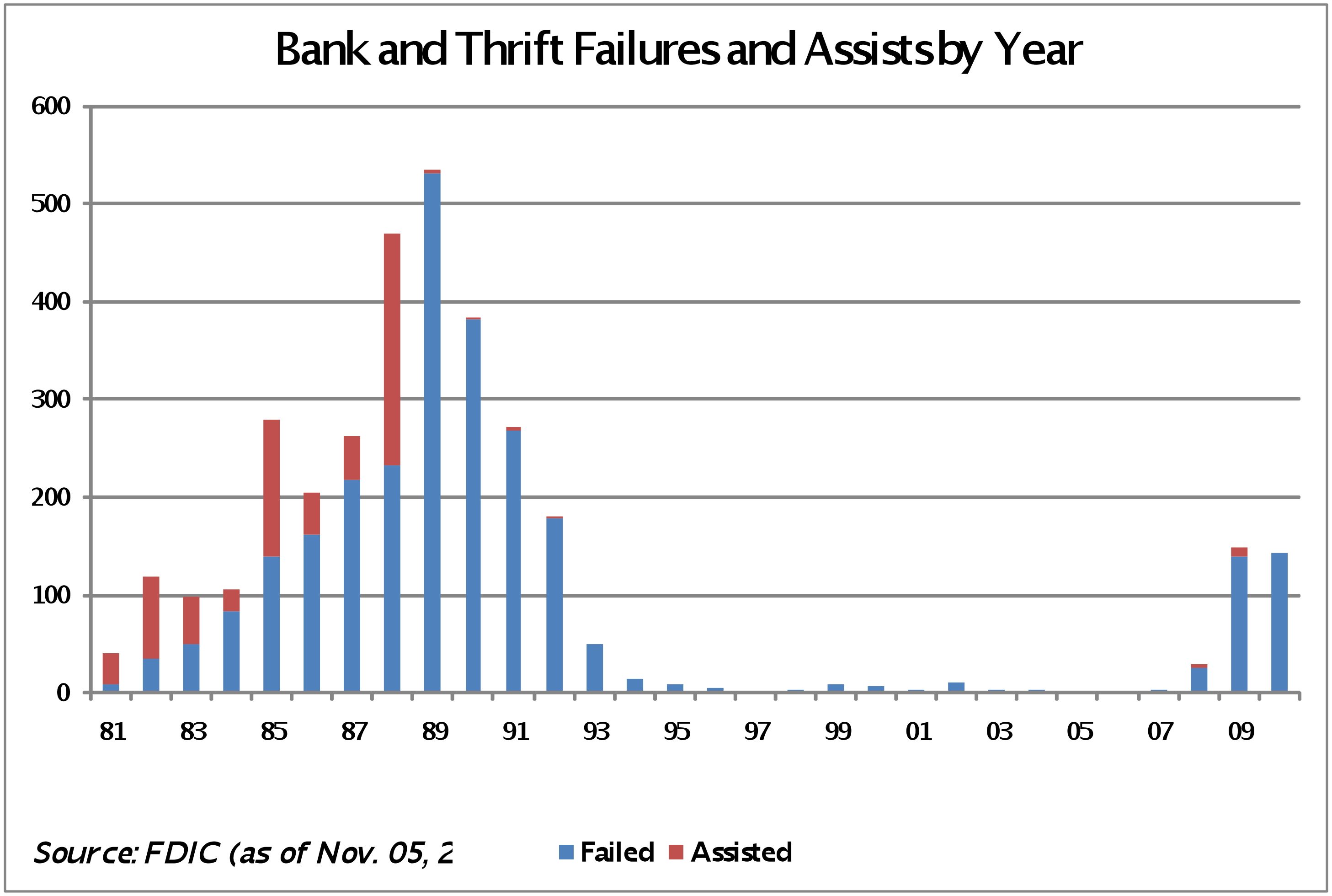


Source: Real Capital Analyt

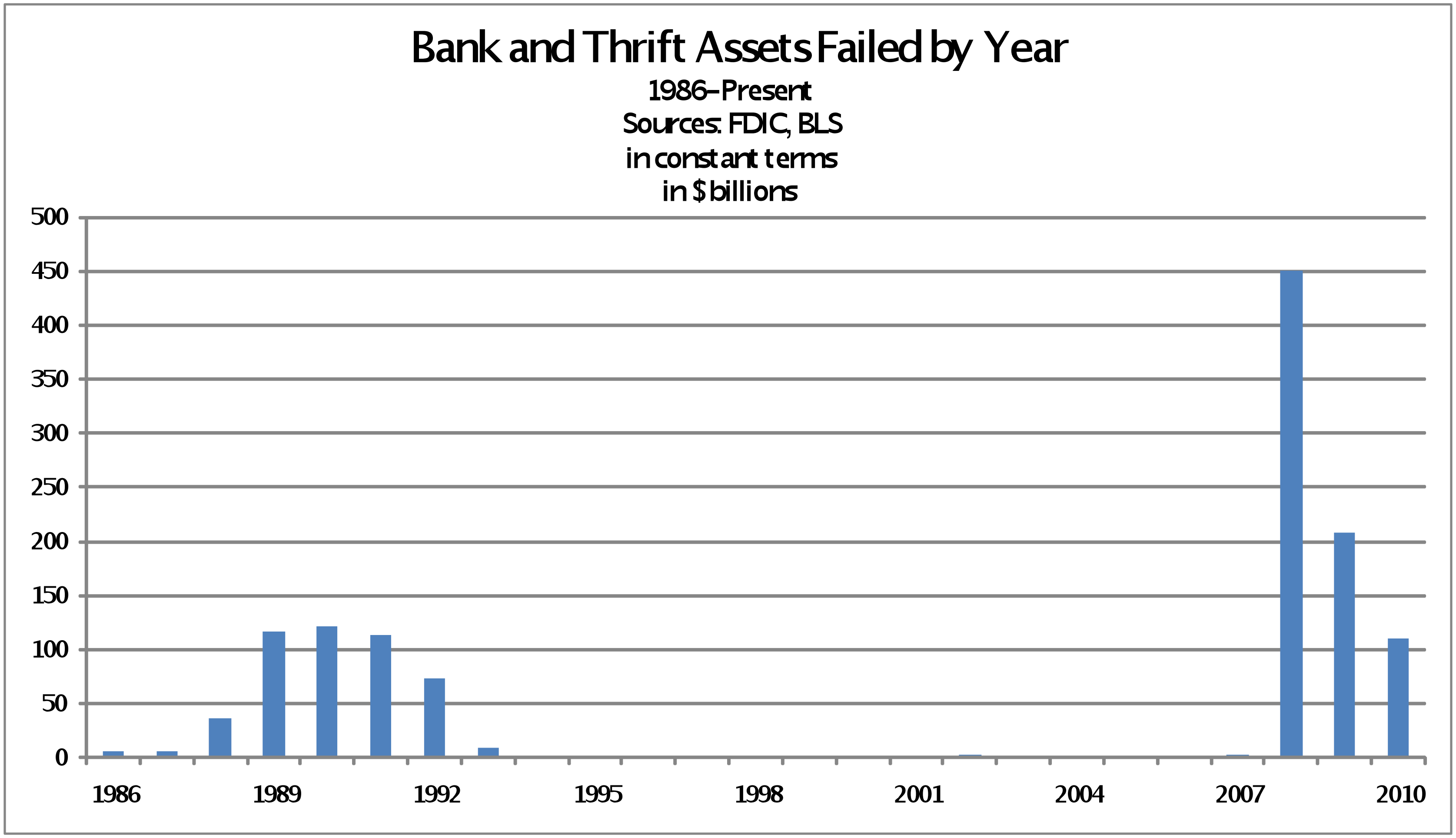
Given the stress, the number of banks on the FDIC's problem bank list continues to grow.



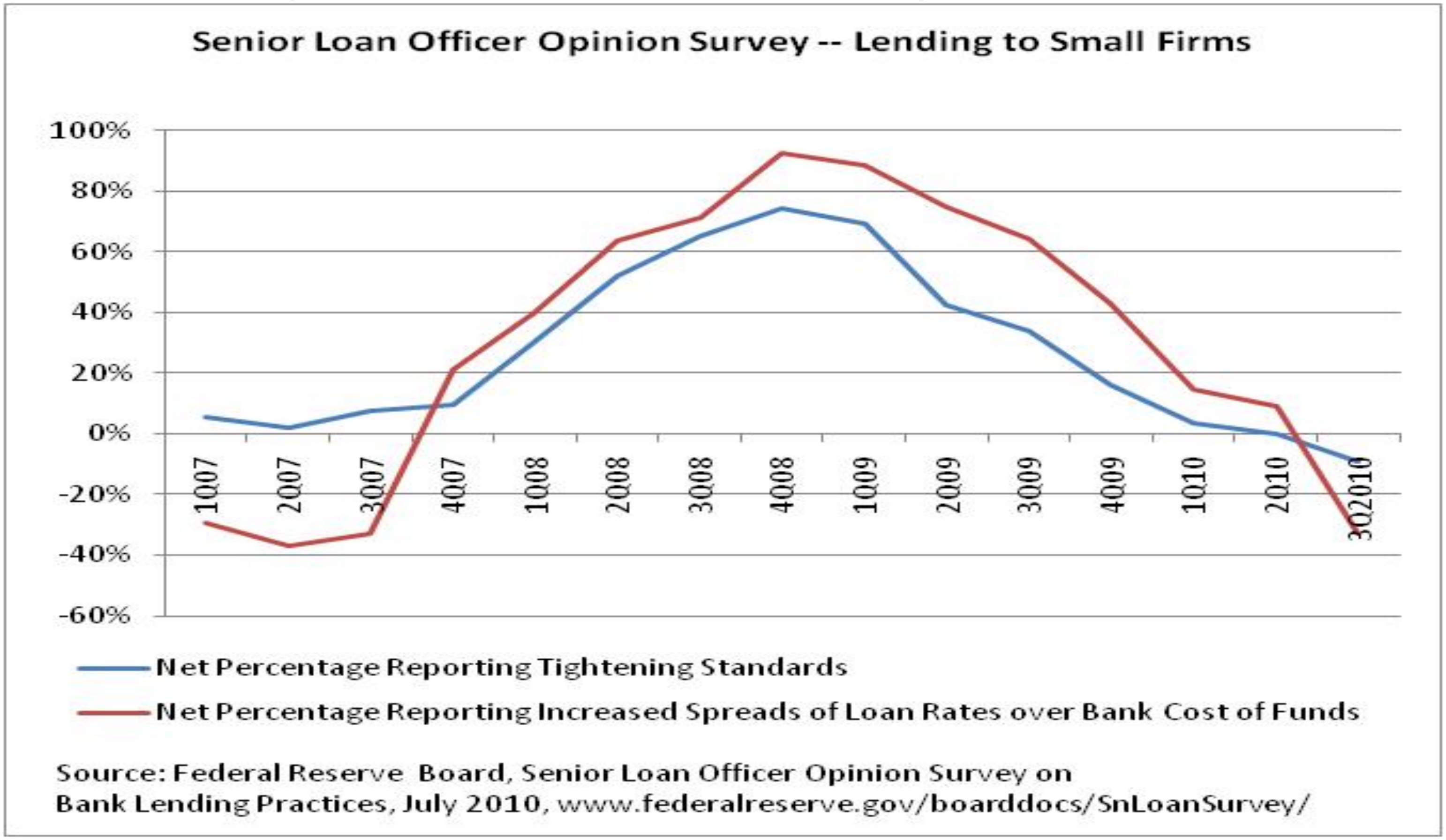
And bank failures are increasing.



When put into constant terms, it appears that assets of failed banks will exceed the 1980s.



In response to the challenges, banks have tightened their lending standards.



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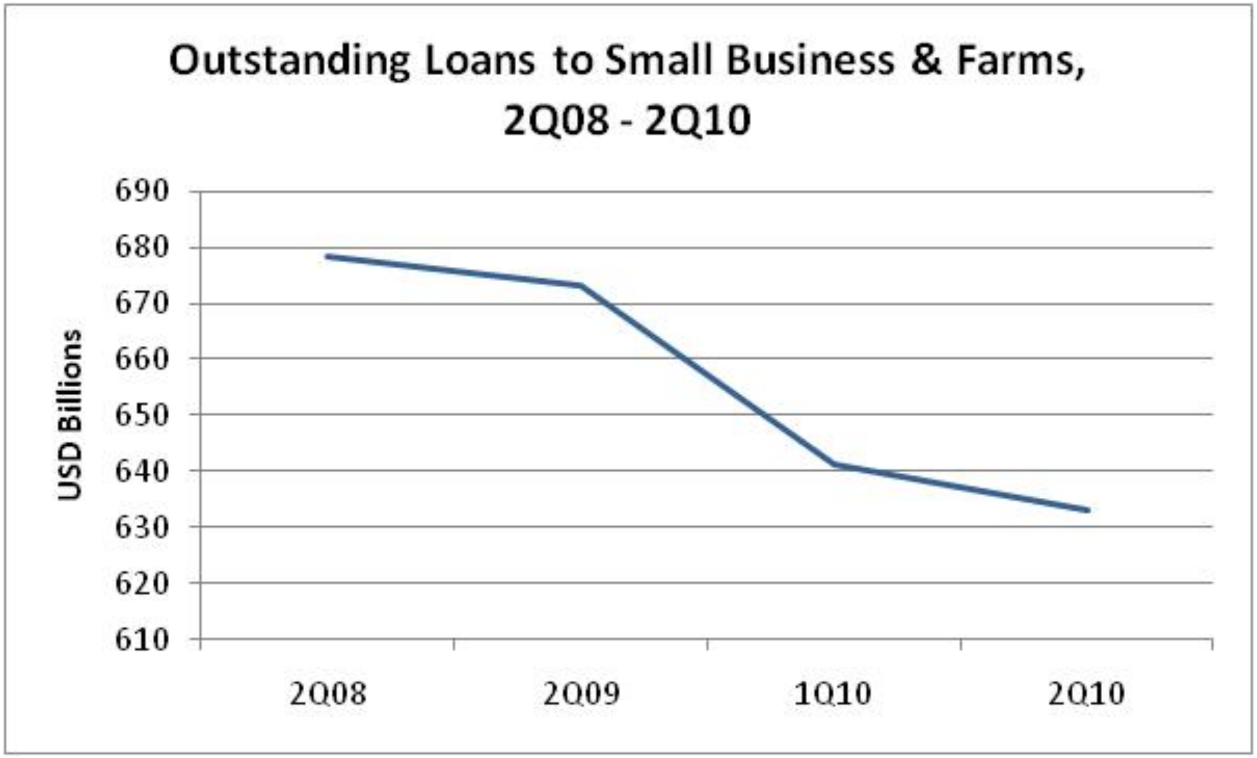
The change in standards, combined with effects of the recession, has resulted in a decline in bank lending.



Source: Commercial Bank Consolidated Report of Condition (Call Report), where small business loans, as reported in the Call Report FFIEC 031 and 041, schedule RC-C, part II are defined as loans with original amounts of $1 million or less that are secured by nonfarm nonresidential properties or commercial and industrial loans plus loans with original balances of $500,000 or less for agricultural production or secured by farmland. This data was collected on an annual basis every the second quarter, but will be collected quarterly beginning first quarter 2010.

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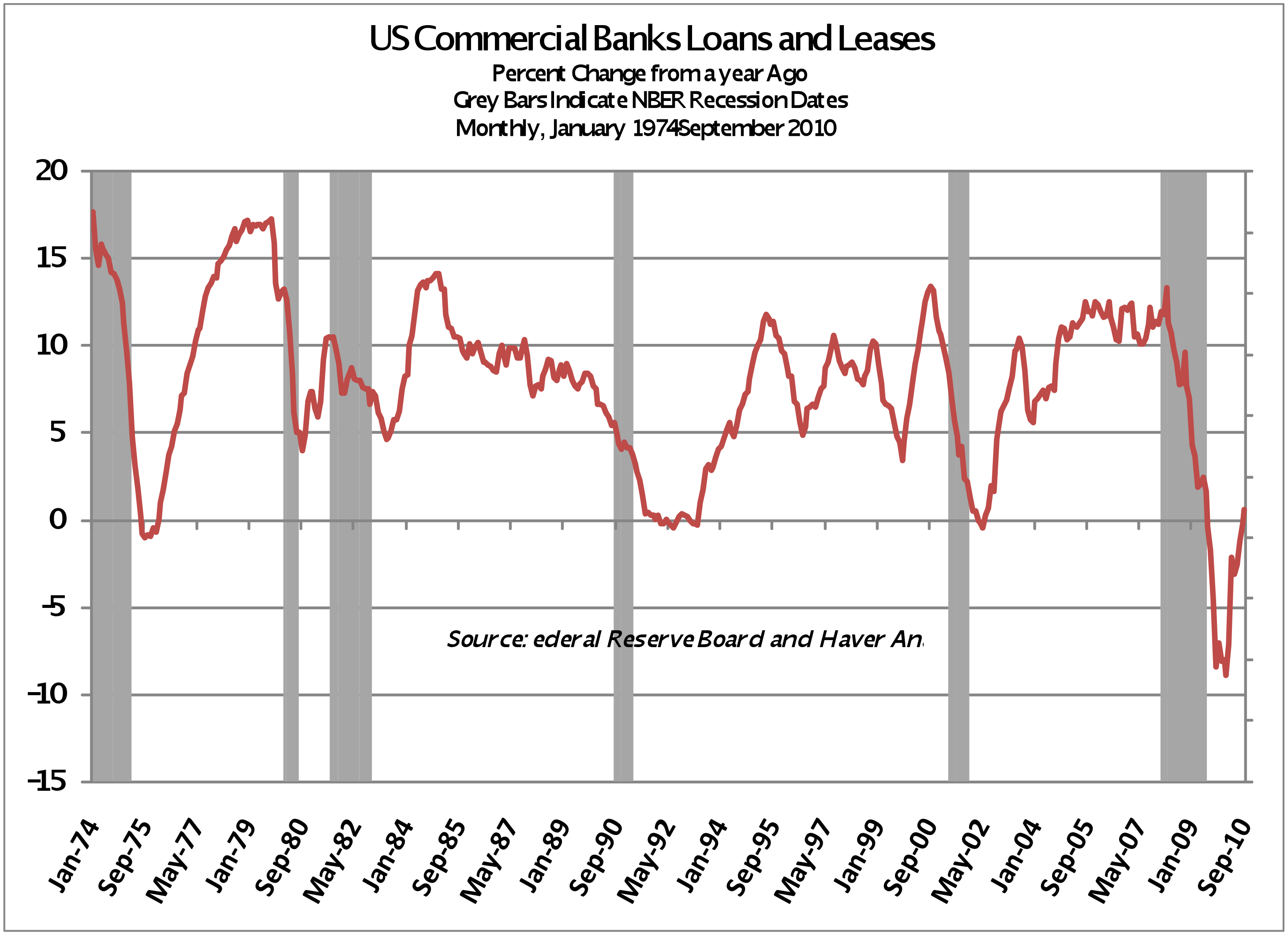
Putting the decline in lending into perspective.



Small businesses argue that credit is not available; banks argue that creditworthy small businesses are not drawing on their lines. What's the truth?

Tighter underwriting standards

- Greater focus on cash flow
- Higher personal credit thresholds, including credit score
- Additional collateral requirements
- Real estate often serves as a collateral for small business loans, and real estate values have declined significantly in some regions

Resource Constraints

- Over 800 banks are dealing with a significant volume of problem loans
- Banks losing money have a smaller capital base from which to lend

Regulatory Environment

- Banks are reluctant to make loans to businesses with irregular patterns of profitability for fear of regulatory criticism
- Some banks are struggling to meet regulatory capital requirements

All Funding Sources Have Been Affected

- The smallest businesses are the ones with a limited financial history or irregular pattern of profitability and have historically been most difficult to finance
- Their traditional sources have all been affected by the recession, changes in credit availability and changes in terms
  - Credit cards
  - Family and friends
  - Home equity loans

Other sources of Funding are Limited

- Alternative funding, such as through the Small Business Administration, has only met part of the need

What are the opportunities going forward?

- Continued and consistent dialogue – such as the dialogue today!
- Potentially greater Community Reinvestment Act (CRA) consideration for community development loans and investments.
- Greater encouragement for investors to make equity investments in community development entities that lend or invest in small businesses.
- Opportunities from the new Small Business Jobs and Credit Act.