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**U.S. Banks ARE Lending
An Open Letter to the United States Congress**

Chicago, IL, February 2, 2009 – Banks in the United States ARE lending. In the midst of so much misleading information around lending activities of U.S. banks, as well as banks' use of the federal bailout money, Treasury Strategies partners, Anthony J. Carfang and Cathryn R. Gregg, are compelled to set the record straight with the open letter to congress that appears below.

Dear Legislators:

The cries in the legislative chambers are growing louder by the day. "We need to force banks to begin lending!" "Bank lending is frozen!" "Banks are sitting on their TARP bailout money." Major news outlets have covered the current crises with stories on banks' failure to lend. Congress is planning tighter regulation and supervision aimed at requiring banks to lend.

Yet Treasury Strategies' analysis of Federal Reserve data shows the underlying premise that banks are not lending appears to be mistaken. Consider the following:

- Lending by domestic commercial banks, now at nearly \$7.2 trillion, grew 5.3% during 2008 and at a 5.5% annualized rate in the fourth quarter.
- Bank lending growth is broad based. Commercial, consumer and real estate loan totals all grew during the fourth quarter and during 2008 as a whole.
- Recent regulatory change has created disincentives to lending, yet lending continues to grow. For example, the Fed's policy of paying interest on excess bank reserves actually pays banks to NOT lend money to consumers and businesses.
- Businesses and consumers are de-leveraging, thereby decreasing their borrowing demand, yet bank lending continues to grow. Thus bank lending as a share of total lending is increasing.

Loan Growth

The Fed's own statistics show solid loan growth across key economic sectors. Commercial loans grew by 2.4% during the fourth quarter. Consumer loans and real estate loans grew by 3.4% and 3.0% respectively during the quarter. The only category to decline was inter-bank loans/repurchase agreements, which accounts for less than 5% of all lending. Despite numerous anecdotes of borrowers facing difficulty, this evidence clearly shows banks ARE lending to businesses and consumers.

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One key measure of lending activity is the “loan to deposit” ratio. A higher ratio indicates aggressive lending; a lower ratio indicates tight money. At the height of the dot com bubble, this ratio reached a frothy 105%. In 2004, it hit a low of 93.8%. Today, it stands at 98.6%, near the midpoint of its ten-year range. Typically, during an economic downturn, lending decreases, terms become more restrictive, and cyclical business and consumers with inadequate credit capacity have difficulty borrowing at all. The good news is that during this current cycle, aggregate lending is not decreasing.

In the last week, several Internet and major news outlets have printed stories about bank lending dropping by 1.4% in the fourth quarter. This is a technically correct statistic for the ten banks in the study. However, the third quarter numbers of these banks were inflated by a record \$194 billion spike in lending activity that occurred during the final days of September following the collapse of Lehman and AIG. Adjusting for that aberration, the 1.4% drop actually becomes a 1.3% gain. No similar spike occurred at year end. To provide perspective around this lending spike, the largest spike prior September 2008 was \$118 billion on September 12, 2001.

Disincentives to Bank Lending

Recent regulatory changes in the banking sector have had unintended consequences, some of which create disincentives to bank lending. Yet, in spite of these disincentives, lending continues to grow.

On October 1, 2008, the Federal Reserve began paying interest on bank reserves. These are deposits that banks keep at the Fed rather than lending out to customers. So in essence, the Fed is paying banks to NOT lend. The net effect is immense. Cash on the balance sheets of US banks, the category which includes reserves, ballooned from roughly \$300 billion to \$1 trillion during the fourth quarter. Thus, while authorities were pumping money into banks via TARP and publicly exhorting banks to lend the funds out, they were also simultaneously inducing funds to remain on reserve at the banks by paying reserve interest.

Regulators also redoubled their focus on bank capital during this period. Over the long term, capital is the cushion to tide a bank over during rough spots. In theory, capital is depleted during times of difficulty and replenished as conditions improve. However, this time around, regulators are keen on requiring banks to maintain capital at peak levels rather than allowing them to consume some of their cushion. Banks must either park additional capital in their equity accounts or reduce the size of their balance sheets. Both options constrain lending expansion.

Mark to market accounting is a third regulatory obstacle impeding loan growth. There is considerable debate about the propriety of requiring banks to use today’s distressed prices as their marks, thereby creating non-cash accounting losses and depleting regulatory capital.



Yet in the face of these loan-stifling regulations, we see year over year and fourth quarter growth in aggregate commercial bank lending.

Summary

The notion that banks are not lending seems to be false. The Federal Reserve's own data show that lending is robust and growing. With loan growth and loan deposit ratios hovering near historical norms, indications are that current lending levels are prudent. Therefore, additional regulation or legislation around bank lending could be misguided and disruptive at best. At worst, it risks distorting the markets and possibly leads to a round of imprudent lending, thereby prolonging the downturn. With loan demand declining as a result of de-leveraging, there is a serious risk that mandated lending would result in bad loans being made to unqualified borrowers.

We at Treasury Strategies believe that with respect to commercial banks, regulators would better serve the public interest by remedying the disincentives to lending discussed above.

Respectfully,



Anthony J. Carfang, Partner



Cathryn R. Gregg, Partner

