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WHEN WILL LOAN GROWTH REBOUND?

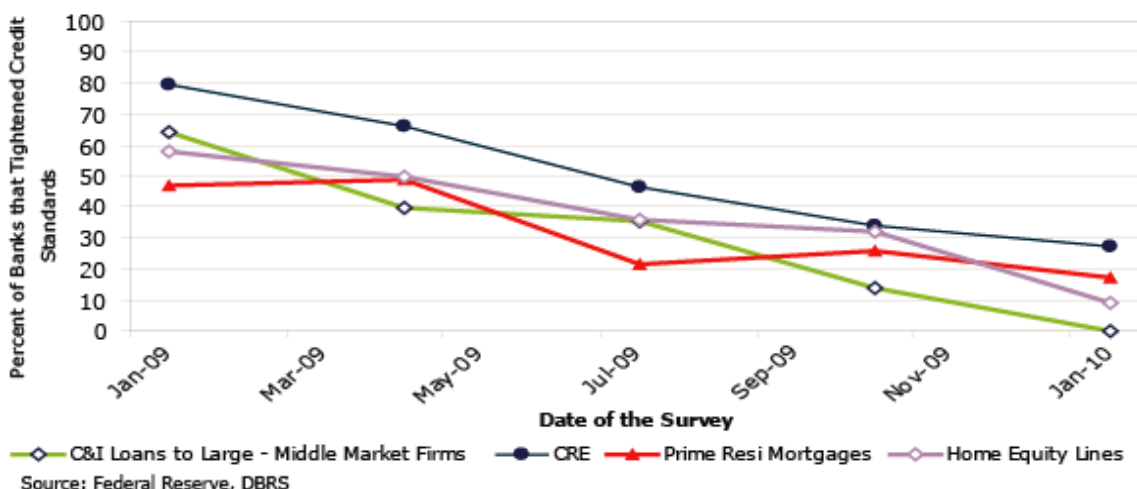
It's been over two years since the economic downturn officially began. Many banks have failed, others continue to limp along, and some, although strained, remain profitable with solid credit fundamentals. The lack of loan growth is one common theme for banks in this economically challenging environment. With modestly improved economic conditions, including higher GDP and a slight decline in the unemployment rate, will loan expansion occur any time soon? According to the January 2010 Fed survey of senior loan officers, probably not in the short term, but there is more hope over the intermediate term. Indeed there were several positive elements in the survey, which provide some optimism for future portfolio growth. Specifically, the Fed survey reported that fewer banks tightened their lending standards during 4Q09; a trend that was fairly consistent for the entire year. Moreover, 83% of responding banks anticipate C&I loan quality for large and middle-market firms (annual sales greater than \$50 million) to stabilize at current levels or improve during 2010.

DBRS's view is that loan growth will remain elusive over the near-term, yet may start to materially rise towards the end of 2010, especially if macroeconomic conditions continue to improve. DBRS notes that when portfolios recover, they will be led by increases in commercial line utilization and commercial and industrial (C&I) loans. The lack of loan growth continues to reflect both supply and demand issues. The unclear economic picture coupled with strained bank fundamentals continues to pressure banks' appetite to lend. Meanwhile, stressed business conditions and high unemployment continue to strain business and household demand for credit.

The Federal Reserve Board of Governors January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices (Survey) is consistent with DBRS's view. The Survey, which is based on the responses of 55 domestic banks and 23 U.S. branches and agencies of foreign banks, addressed changes in supply and demand for loans to businesses and households over the previous three months, as well as queried bank management about their 2010 outlook for asset quality. Here we discuss the domestic bank component of the Survey.

The bulk of Bank respondents in the Survey left underwriting standards unchanged across most loan types during 4Q09. Positively, fewer banks tightened standards during the quarter, as mentioned previously. Nonetheless a few of the responding banks tightened standards for commercial real estate (CRE), C&I loans to small firms (annual sales under \$50 million), prime residential mortgages, home equity lines of credit and credit cards (please see the chart below). Interestingly, a few banks eased standards for C&I loans to large and middle – market firms.

Tightening Credit Standards for Domestic Commercial Banks, Jan 2009 - Jan 2010



Demand (excluding seasonal variation) continues to be weak across most loan types. On a sequential quarter basis, most banks in the Survey reported about the same to slightly improved demand for C&I loans from large and middle-market firms, while demand for CRE, revolving home equity lines of credit and consumer loans was about the same to slightly down. Of interest, demand for prime residential mortgages reflected a

notable negative shift during the quarter, perhaps indicating that purchasers in line to take advantage of the government's home buyers tax credit program has been exhausted.

Positively, the Survey indicates that banks may be close to reaching asset quality stabilization for C&I loans, assuming that economic activity progresses in line with the consensus forecast. 48% of respondents expect delinquencies and charge-offs for C&I loans to large and middle-market firms to improve during 2010. Moreover, 34% of respondents expect delinquencies and charge-offs for C&I loan to small firms to improve during the year. Conversely, banks are somewhat more negative regarding CRE loans, as approximately 49% of respondents anticipate continued asset quality deterioration from current levels. Respondents' outlook for prime residential mortgages were much improved from last year, but still slightly skewed towards deterioration. Banks also still have a fairly negative opinion for home equity lines of credit; however, only 33% of respondents anticipate loan quality will deteriorate versus 83% for the prior year.

Rating Implications

Over the intermediate term, macroeconomic conditions will continue to pressure bank asset quality. As such, credit costs are expected to remain elevated. DBRS continues to pay close attention to each bank's ability to maintain core earnings and capital, which are necessary to absorb credit costs. DBRS notes that banks that are better able to maintain or grow their loan portfolios will be better able to sustain their net interest income and core earnings. DBRS comments that Banks with elevated or steepening credit costs and contracting core earnings may be subject to negative ratings pressure.

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