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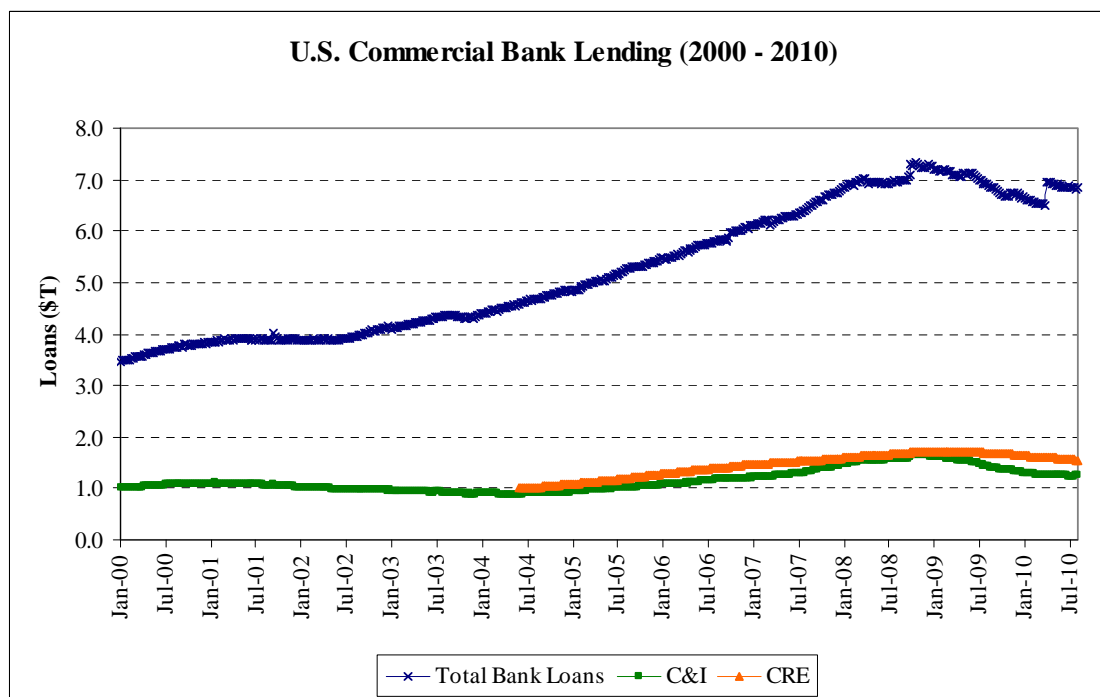
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## COMMERCIAL BANKS AWAIT A BUSINESS RECOVERY...

Axiomatic to an economic recovery is the active participation of large, middle-market and small businesses. Since the beginnings of the recent financial crisis, U.S. businesses have been in survival mode. Early in the crisis, businesses drew their credit lines (where available) to ride through the tough environment with as much liquidity as possible. Companies primarily focused on expense reduction in 2008 and 2009 by trimming inventories, cutting staff and rationalizing each and every expense line item. Companies have also built up cash reserves to weather the storm.

The struggles of businesses have impacted nearly all commercial banks. The most profound impact has been the overall decline in commercial lending as weak demand and loan charge-offs have eroded outstanding loan balances. Federal Reserve Bank statistical data indicates that while commercial real estate (CRE) lending has been relatively stable and contracted only 10% since its high in December 2008 (see Exhibit 1), Commercial and Industrial loans (C&I) have dropped more than 25% since their October 2008 peak. Most commercial banks have noted that line utilization remains anemic with demand flat to slightly up over the past few months. DBRS notes, however, over the past decade commercial loan growth was better managed and absolute growth was constrained relative to consumer loans, such as residential mortgages and home equity, as illustrated in Exhibit 1.

Exhibit 1



Source: Federal Reserve Statistical Release H.8, SA

The other side of the balance sheet, however, finds most commercial banks flush with business deposits, particularly noninterest bearing as businesses maintain strong liquidity positions. This phenomenon has been beneficial in both improving the core deposit funding and lowering the funding costs of many commercial banks. These deposits and low funding costs may prove fleeting, however, when the economy improves and interest rates rise.

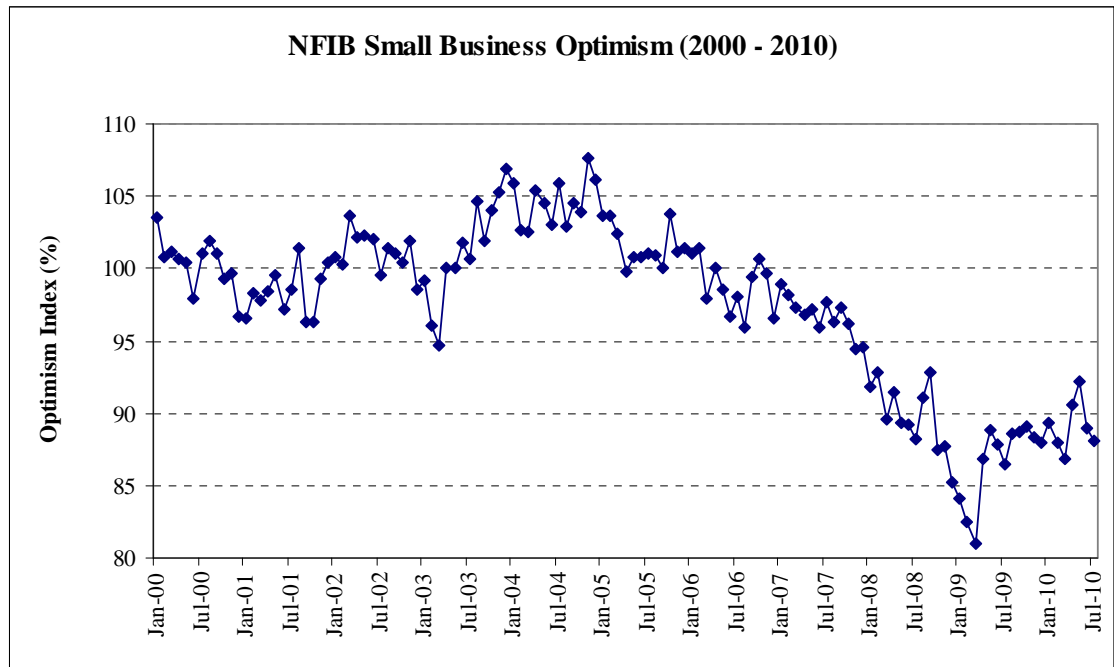
The July 2010 Senior Loan Officer Survey confirmed the commercial lending trends noted above with a few additional insights. Small company loan underwriting standards eased for the first time since late 2006. Additionally, some banks reported the pricing of C&I loans improved for companies of all sizes as banks compete to book assets. Loan demand was little changed after declining in the beginning of year.

Small and Medium sized Enterprises (SME's) have become an increasingly important customer segment for banks. SME's provide a fertile ground of diversified companies to appeal to specific lender expertise and provide ample opportunities for suitable risk-adjusted profits for banks. In the current economic downturn,

interest rates have fallen to record lows and large corporations have been able to access capital markets directly thereby disintermediating commercial banks from lending to many of these customers. SME customers have therefore become more valuable than ever and many banks have set up specialized lending teams targeting specific SME companies and/or industries. Moreover, these companies may have limited borrowing needs and may primarily be deposit and business services customers.

The SME's that have survived thus far have adjusted their businesses to the current economic environment. In order to grow, however, they need to be confident in future growth opportunities and that confidence is currently absent. Small business optimism has recovered only marginally from its March 2009 low; however, optimism is persistently tracking at 30 year lows which is unprecedented and reflects a lack of confidence in economic policy (See Exhibit 2). The many uncertainties facing businesses regarding the general economy, taxation and employee benefits continue to weigh heavily on business owners.

**Exhibit 2**



Source: NFIB Research Foundation

DBRS also currently sees a high degree of uncertainty in the U.S. economy. The more likely scenario continues to be a weak economic recovery with atypically high unemployment and a slowly recovering housing market. Unlikely, but remotely possible is a “double-dip” or return to recession which would be damaging to businesses and financial institutions. Bank will benefit as the economy recovers and businesses gain confidence from higher transaction and lending levels.

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