



Funding Growth: Trends in Small Business Lending in New Hampshire

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*In cooperation with
Community Bankers Association of New Hampshire*

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Executive Summary

This report uses required bank regulatory filings to document trends in the volume of small business loans in New Hampshire and the U.S. over the past several years. It examines changes in the supply of small business credit in NH from different types of banks as well as changes in the volume of loans by size of loan. The report examines how changes in the volume of small business credit in New Hampshire has been affected by the demand for loans, and how some financial and regulatory considerations of banks have contributed to recent lending trends.

Key Findings Include:

- In 2009, during the depths of the recession, the volume of small business lending in NH declined by \$312 million or 14.6 percent, compared to a decline nationally of 22.1 percent.
- Nationwide credit card banks and commercial lenders, with no retail branches in New Hampshire, accounted for \$238 million or 76 percent of the reduction in small business credit in New Hampshire in 2009.
- Banks with at least one depository retail branch in New Hampshire had a \$74 million reduction in loan volume in 2009.
- Community banks in New Hampshire increased their small business lending throughout the recession. Loan volumes at community banks increased by \$64 million (4.7%) in 2008, \$97 million (6.8%) in 2009, and \$70 million (4.6%) in 2010. In contrast, U.S. banks with less than \$1 billion in assets had a 2.3 percent decrease in small business loans in 2009, and a 6.2 percent decline in 2010.
- Business loan delinquencies have increased dramatically at NH banks, especially at NH's largest banks, suggesting that fewer businesses are able to qualify for loans.
- Rising business loan delinquencies required NH banks to increase their reserves against future loan defaults, reducing the supply of funds available for lending.
- Surveys by the Federal Reserve Bank and the National Federation of Independent Businesses, as well as data on net borrowing (new borrowing less retiring of debt) by non-corporate businesses indicate that the demand for small business loans has not recovered to pre-recession levels.
- Increased oversight and regulation required NH's largest banks to increase their capital and reduce their leverage, limiting their ability to increase the supply of credit.
- Recent job growth in New Hampshire suggests that the demand for credit will be increasing. Any public policies designed to influence the supply of credit must have a solid understanding of the dynamics affecting the small business credit market if they are to be effective and not have unintended consequences.

I. Introduction and Overview

It has been nearly three years since the U.S. economy officially entered recession in December of 2007, and more than two years since the financial crisis in the Fall of 2008 caused a massive disruption in the flow of business and consumer credit. It has also been nearly one year since the New Hampshire Bankers Association issued its last report on bank lending in the Granite State: “Credit Where Credit is Due: Trends in Small Business Lending in NH.”

That report documented an overall decline in small business credit in NH during the first year of the recession (2008). As importantly, the report indicated that trends in the supply of credit varied greatly across different types of lenders in New Hampshire. Specifically, it showed that small business lending by New Hampshire’s community banks continued to increase, even during the recession, while lending in NH by commercial lenders with no depository institutions in the state and nationwide credit card banks declined.

Since that January 2010 report, signs of an economic recovery have emerged, especially in NH where 12,400 private sector jobs were added during the months of January through October of 2010, and 16,300 jobs were added between October 2009 and October 2010. But questions about the availability of credit for small businesses remain and are likely to increase as the economy continues to recover and the demand for small business and consumer credit rises. Nationwide, outstanding loans to small businesses dropped from over \$711 billion in the second quarter of 2008 to approximately \$652 billion in the first quarter of 2010.¹

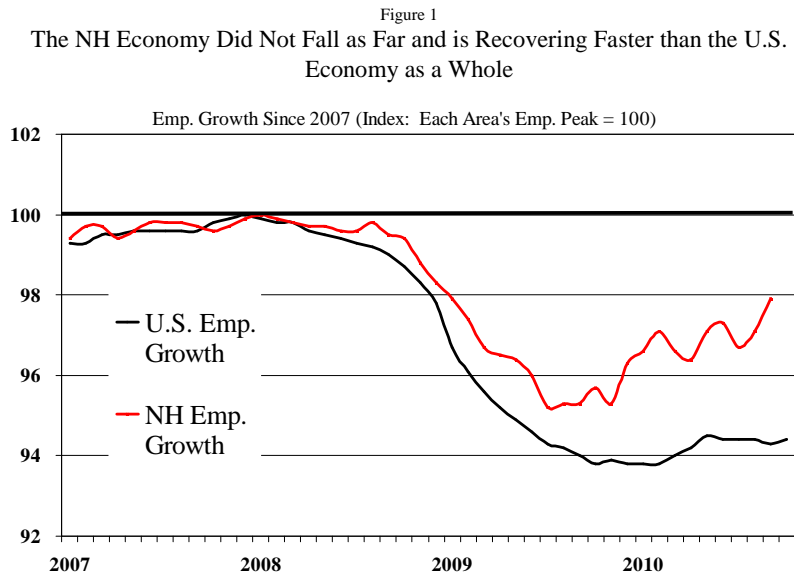
There remains, however, an incomplete understanding of the forces affecting the volume of small business credit in NH and the nation. While good data on the supply of credit is available from lenders and federal regulators, empirical data on the demand for credit is less direct and generally limited to surveys such as the Federal Reserve’s “Senior Loan Officer Survey”, and the National Federation of Independent Businesses’ “Small Business Economic Trends.” Each of these surveys of the demand for loans found reduced or limited demand for credit during the recession and through the early stages of recovery. Increased scrutiny of lending practices and financial regulatory reforms at the federal level may have also affected the ability of banks to make loans at the same time many businesses have chosen to de-leverage in response to the recession and its aftermath.

As economic and employment growth again become a dominant public policy issue in New Hampshire and the nation, it will be critical for policymakers to identify the economic and public policy factors most likely to contribute to stronger economic growth. Nationally, there appears to be a continued desire by policymakers to increase small business lending. Whether any national or state level initiative to spur small business lending is successful is contingent upon several factors, including a thorough understanding of lending trends, and an accurate diagnosis of the economic, financial, and regulatory factors that contribute to them. To the extent that contraction in small business lending reflects a shortfall of demand rather than an insufficient supply of credit, any supply-side solutions that seek to influence bank lending will be ineffective. This report helps inform public policy by contributing to an understanding of the dynamics of small business lending in NH.

¹ Federal Deposit Insurance Corporation. “Statistics on Depository Institutions”, accessed online at [www.fdic.gov/http://www2.fdic.gov/sdi/main.asp](http://www2.fdic.gov/sdi/main.asp).

II. Trends in Small Business Lending in New Hampshire.

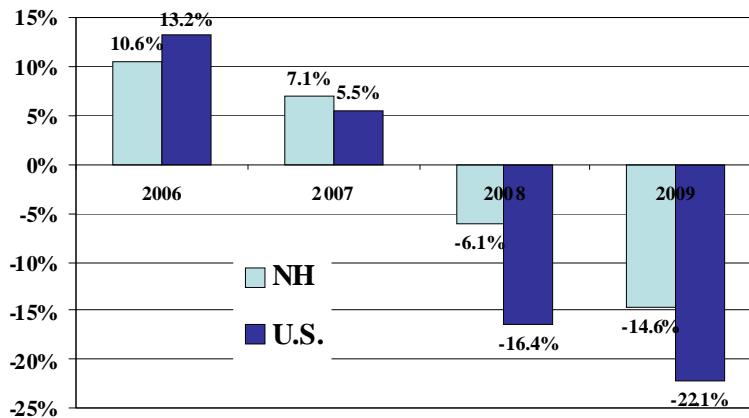
NH's economy did not fall as far as the U.S. economy did, and the NH economy is recovering faster (Figure 1). Nevertheless, the volume of small business loans declined in NH during 2009, as the depths of the recession occurred and economic growth bottomed in the middle of the year.



Using both Community Reinvestment Act (CRA) and quarterly call report data, we estimate that the volume of small business credit declined by more than 14 percent in NH during 2009. Although NH's economy was badly hurt during the recession, its relatively stronger economic performance, relative to the U.S., is reflected in small business lending. The dollar volume of small business loans in the U.S. fell by 22 percent, a decline more than 50 percent larger than the reduction in small business lending that occurred in NH (Figure 2).

It is not surprising that the volume of small business loans decreased in New Hampshire in 2009, as the recession deepened and as the full effects of the nation's financial crisis took hold. NH was hurt badly during this recession, but less so than the U.S. economy. That would not have happened if the state's financial system was weakened and bank lending had fallen further in NH than it did across the country. Still, it is important to understanding the dynamics underlying changes in small business loan volume in NH if we are to have confidence that credit markets in New Hampshire are healthy enough to fuel the state's return to prosperity and to maintain its position as the strongest economy in the region.

Figure 2
 Total Loans to Small Business in NH Dropped by 14.6% in 2009 as the Economy Hit Bottom. Nationally, Small Business Lending Declined by 22.1%



Beyond Aggregate Loan Volume: Trends Among Different Types of Lenders

The aggregate volume of small business credit masks important information about the supply of credit from different types of business lenders. Some lenders, like New Hampshire’s community banks, continued to increase small business lending even during the recession. In part, this reflects NH small businesses establishing or re-establishing credit relationships with local banks after the financial crisis disrupted credit markets across the country.

Others lenders, like some nationwide business credit card banks, reduced lines of credit, cancelled cards, or simply stopped issuing business credit. This was the case with one lender with \$13 million in NH small business loans in 2008, but \$0 dollars in 2009.² The number of business and personal credit cards in circulation has fallen 24 percent since peaking in 2008.³ Business credit card loans by nationwide credit card lenders fell by \$190 million in NH in 2009, accounting for 60 percent of the overall decline in small business credit in the state that year. Credit cards, along with home equity lines of credit, are important sources of funds for the smallest businesses in New Hampshire. Across the country, both of these credit sources have been among the largest contractions of any forms of credit.

As we did in our January 2010 report on small business lending, this report groups small business lenders into three categories for analysis:

- Nationwide credit card banks which provide business credit cards (and credit cards to individuals but the numbers here reflect only business credit cards). Credit cards are an important source of credit for many of the smallest businesses and have retrenched dramatically across the country over the past two years. These banks generally have no physical presence in the state to which they lend.
- Commercial lenders that primarily lend to business. These lenders generally have no

² Advanta Corp stopped issuing new cards in 2009, then filed for bankruptcy and went into FDIC receivership.

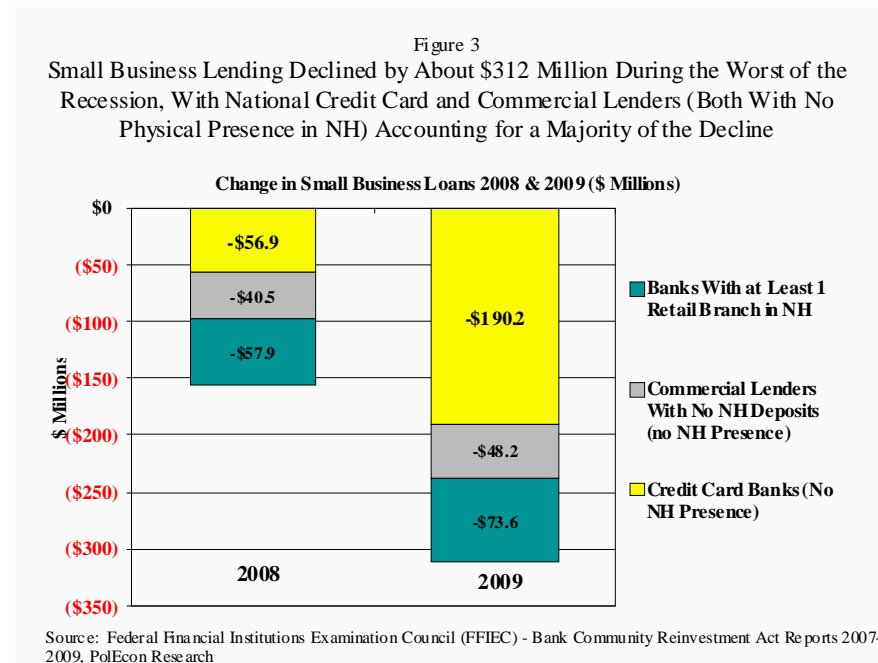
³ Mark Zandi, “U.S. Macro Outlook”. *Economy.com*, December 22, 2009.

physical presence (branches) in most of the states in which they make loans and do little or no retail banking.

- Banks with at least one depository institution in NH. These retail banks include community banks, large national banks, regional, and multi-state banks that have one or more branch offices in NH.

Nationwide Lenders and Banks With No Branches in NH Account for 76% of the Decline in Small Business Credit

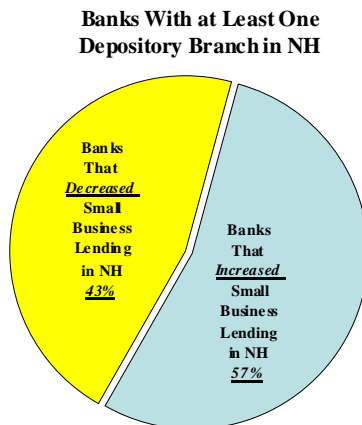
Figure 3 shows that, at the depths of the recession, small business credit declined by about \$312 million in NH compared to 2008, or about twice the decline that occurred in 2008 when the nation first entered recession and the financial crisis hit in the Fall of that year. As was the case in 2008, the decline in small business loan volume was most significant among nationwide credit card lenders and commercial lenders with no depository institutions in New Hampshire. Many of the largest of these institutions were weakened by the financial crisis and they were subject to more scrutiny over lending practices following the financial crisis. They were also most likely to be facing uncertainty over financial industry regulatory reforms being debated at the national level. In general, the types of lenders and institutions that showed the greatest declines in small business lending in 2008 and 2009 were also the institutions most likely to be constrained, by external and internal financial factors, in their ability to make loans. In Section III of this report, we document and discuss some of the lending constraints faced by banks, especially large national or regional banks, operating in New Hampshire during the recession and in its aftermath.



The data in Figure 3 does not suggest that all business credit card banks, or all commercial lenders without a branch bank in NH reduced small business lending in the state. In the aggregate, however, the sum of the changes in lending among institutions in these categories resulted in a lower volume of loans in 2009 than in 2008. Among banks with at least one retail

branch in NH, small business lending declined by about \$74 million, however, 57 percent of the retail banks with at least one branch in NH increased their small business lending in 2009 compared to 2008 (Figure 4).

Figure 4
Despite an Overall Decline in Small Business Loans Among Banks With at Least One Depository Branch in NH, A Majority of These Banks Increased Small Business Lending in 2009



Community Banks Continued To Increase Small Business Lending Throughout the Recession

For banks that lend predominately in NH - NH community banks - we can use more recent data from the June 2010 quarterly regulatory filing to assess the volume of small business lending in NH. Figure 5 shows that small business lending by NH community banks continued to increase throughout the recession. The volume of small business lending increased by 4.6 percent at NH community banks from June 2009 to June 2010 compared to a 7.2 percent decline among all U.S. community banks.⁴

⁴ For this analysis we defined U.S. “community banks” as commercial and savings banks with less than \$1 billion in assets. This operational definition is the most similar to the characteristics that define NH’s community banks and thus offers the best comparison for analytical purposes.

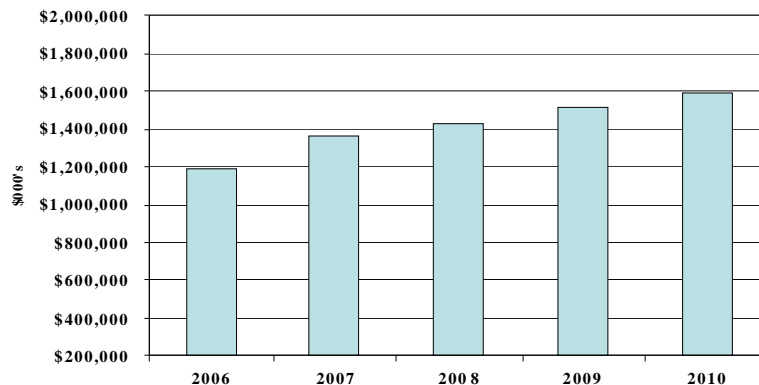
The Smallest Loans Continue To Be The Most Affected

Despite a consistent increase in small business loan volume by NH's community banks, volume in the smallest loan category, under \$100,000, declined in both 2009 and 2010. This drop suggests that the smallest businesses have seen larger declines in credit than overall small business lending trends indicate. Both home equity and credit cards are used more extensively by the smallest firms to finance their operations and both sources have declined nationwide this recession. But it is also true that the length and severity of this recession disproportionately harmed the smallest businesses reducing their need for working capital and making them less creditworthy when they are in need of credit. Surveys by the National Federation of Independent Businesses continue to indicate that low demand for credit among the nation's smallest businesses:

"Interest rates are low, yes, but there is little motivation to borrow even cheap money since there are few uses that promise a return on their investment. Most owners (75 percent) feel it is not a good time to expand their firms."⁵

Figure 6 shows that loans of less than \$100,000 are the only category of small business loans to have declined at NH community banks during the recession.

Figure 5
Small Business Lending by NH Community Banks
Continues to Grow Through Recession and as NH Recovers



Source: FDIC Quarterly Call Report Data

⁵ William C. Dunkleberg, Holly Wade, "NFIB Small Business Economic Trends", National Federation of Independent Businesses, November, 2010.

III. Both Supply and Demand Account For Reduced Loan Volume

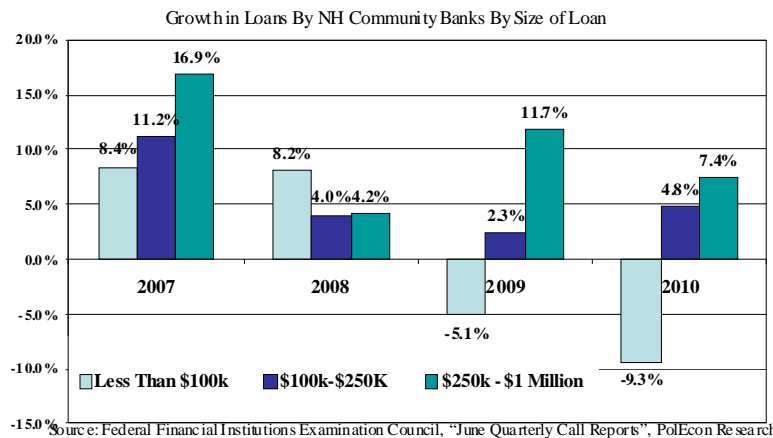
There are many reasons why small business lending has contracted in New Hampshire and throughout the country since the recession began. Because hard data (as opposed to survey data) is only collected and reported on the supply of credit, and not the demand for credit, changes in the volume of small business loans are often attributed entirely to changes in supply or the willingness of banks to supply credit. But ignoring demand factors that influence the volume of credit will produce an inaccurate understanding of the small business credit market and result in ineffective or counterproductive policies directed at increasing credit availability.

The Demand for Small Business Loans

Among the demand factors thought to influence the volume of small business credit in recent years include:

- Reduced sales have lowered growth and expansion plans and reduced the borrowing needs of many small businesses.
- De-leveraging by many small businesses after a period of rapidly increased borrowing.
- Recession-induced damages to the balance sheet of most small businesses have

Figure 6
Loans to the Smallest Businesses, (the Smallest Sized Loans), Decreased During the Recession. But the Smallest Businesses Were Also Hardest Hit (Decline in Sales and Employment) This Recession.

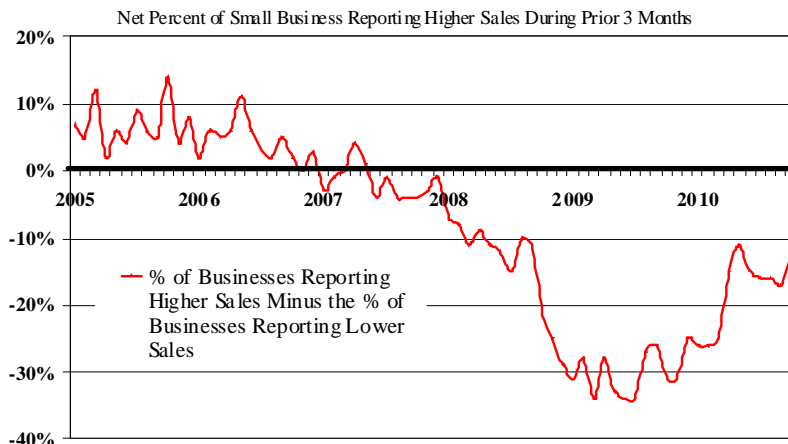


produced fewer creditworthy borrowers.

- Declines in collateral values, often a small business owner's home, but also commercial real estate, have limited borrower's ability to access credit.

According to surveys by the National Federation of Independent Businesses, a lack of sales continues to be the biggest problem facing small businesses. The net percentage of

Figure 7
 Small Businesses Have Been Especially Hard Hit This Recession, A Lack of Sales Continues to be Their Primary Problem and a Major Contributor to Reduced Demand for Loans

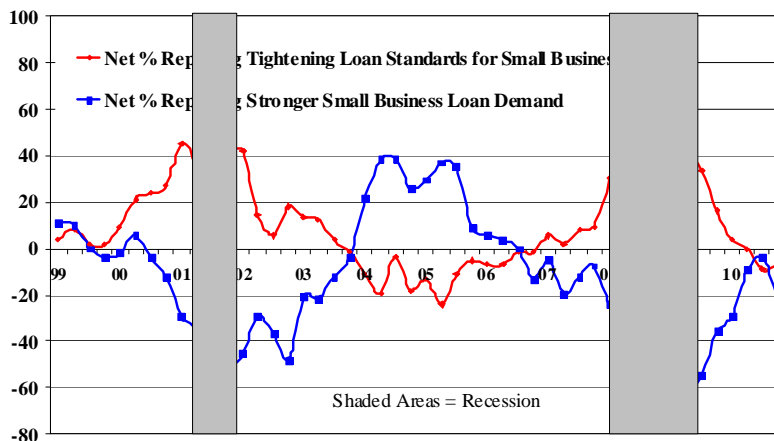


Source: National Federation of Independent Businesses (NFIB) Economic Trends Survey, November 2010.

businesses reporting higher sales over the past three months, minus the percentage sales increases (Figure 7) continues to show that more businesses are experiencing sales declines than are experiencing sales increases. One result is lower investment and less need for credit.

According to the Federal Reserve’s quarterly “Senior Loan Officer Survey”, demand for loans from small businesses plummeted after the financial panic that began in the Fall of 2008. As of the third-quarter of 2010, more senior loan officers continue to report lower demand for loans from small businesses than report increased demand for loans, even as more senior loan officers report that bank lending standards are loosening. Figure 8 shows that demand for loans typically declines during recessions and credit standards tighten as the finances of businesses become more strained: that pattern has been followed to the extreme during the current recession.

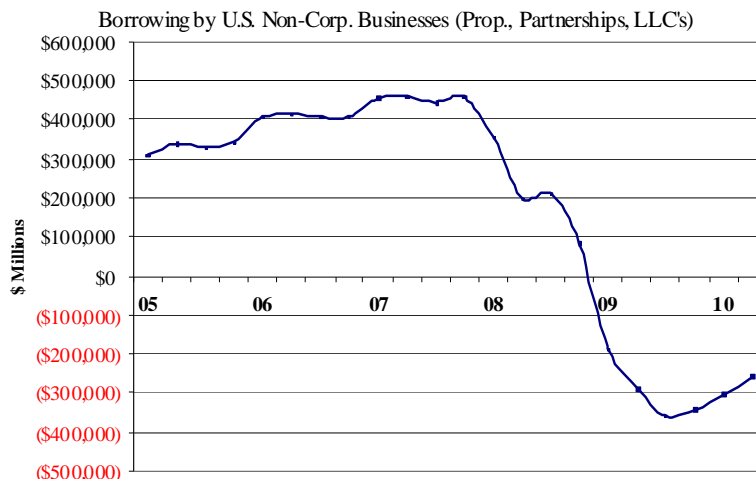
Figure 8
 Demand for Small Business Credit Has Been Declining at the Same Time Standards are no Longer Tightening



Sources: Federal Reserve Board Senior Loan Officer Survey

Hard data on the demand for small business loans is non-existent but one surrogate measure is the net borrowing on non-corporate, non-farm businesses, reported in the Federal Reserve Board of Governor’s quarterly statistical release *Flow of Funds Accounts of the United States*. The data on net borrowing of non-corporate businesses reflects new credit minus retirement of existing debt by proprietorships, partnerships and limited liability companies. Figure 9 shows that the aggregate net borrowing of these businesses follows a pattern similar to the net percentage of businesses experiencing sales increases presented in Figure 7, a significant drop during the recession. Figure 9 suggests that non-corporate businesses have been de-leveraging, or retiring more debt than they have been adding since 2009.

Figure 9
 Net Borrowing by Non-Corporate Businesses (a Surrogate for Small Businesses)
 Plummeted During the Recession and is Recovering Slowly

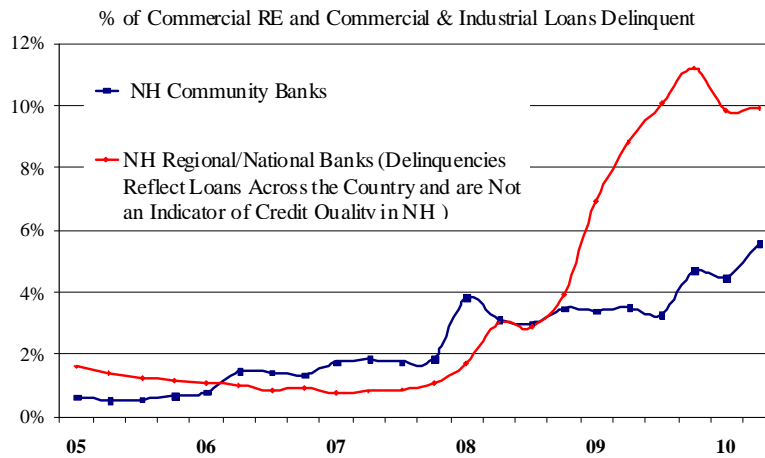


Source: Federal Reserve Bank Board of Governors, *Flow of Funds Accounts*, September 17, 2010

The “Effective Demand” For Small Business Loans Has Fallen

“Effective demand” is a measure that combines the desire or demand for a good or service along with the resources necessary to obtain it. While most households may want a new automobile, or a 50-inch plasma television, many fewer have the resources in addition to the desire (combined the “effective demand”) to obtain them. For businesses, there is no direct measure of effective demand for loans because there is no publicly available source of financial information available for most small businesses. Anecdotal and survey reports of unmet credit needs provide an incomplete measure of demand because they provide no information about the financial condition of potential borrowers.

Figure 10
 Recession-Induced Rising Commercial Loan Delinquencies Are Partly Responsible
 for Curtailed Business Lending by NH's Large Regional/National Banks



One surrogate measure of the overall financial position of businesses is the percentage of business loans that are delinquent. Few policymakers would argue that the financial condition of households in New Hampshire today is as strong as it was three or four years ago, and few would suggest that extending additional credit to households with weaker balance sheets is a prescription for improving the financial health of households. As Figure 10 shows, the financial health of business borrowers at New Hampshire banks has deteriorated, especially at NH's large national and regional banks where the volume of small business loans has declined in recent years.⁶

Despite an economy that is slowly recovering, business loan delinquencies remain high.

Survey-based and surrogate measures suggest that the demand for small business loans in NH has declined, and “effective demand” has likely declined even more. Both are contributing to lower volumes of small business lending in New Hampshire. Going forward, increased regulatory scrutiny and problems with credit quality (high delinquency rates) may make it more difficult for banks to heed calls for more small business lending even as the economic recovery accelerates.

Several Supply Issues Can Limit Small Business Lending

To the extent that the contraction in credit is attributable to reductions in supply as opposed to lower demand for loans, several explanations have been offered, including:

- Rising delinquencies have increased the loan loss reserves of banks, reducing lending capacity.

⁶ Delinquency rates for NH's national and regional banks reflect the entire regional and national loan portfolio of these banks. For all banks, delinquency rates here are determined by adding the percentage of loans that are delinquent in each category.

- Increased capital requirements under new banking regulations require that banks either raise more capital, (which can be difficult in a weaker economy), or reduce assets, (which can mean fewer small business loans are made).
- New financial regulations either require or have banks re-evaluating lending practices.

Rising delinquencies this recession required NH banks to increase their reserves against the possibility that more business and other loans might default. This reduces the supply of funds banks have available to make loans. As Figure 11 shows, loan loss reserves increased sharply at NH's large national and regional banks in response to rising business loan (Figure 10) and other delinquencies.

Figure 11
Loan Loss Reserves Have Increased Sharply at the Largest Banks in NH in Response to Rising Business and Other Loan Delinquencies During the Recession

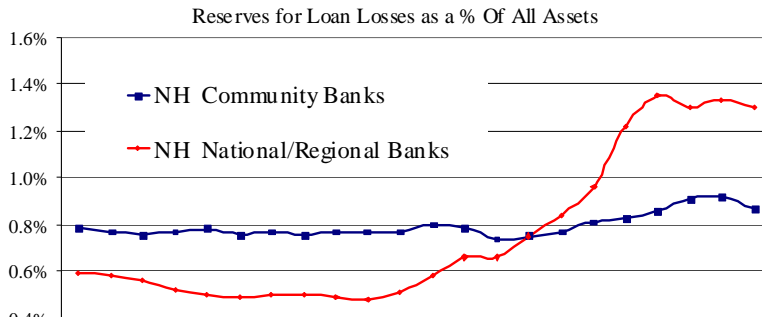
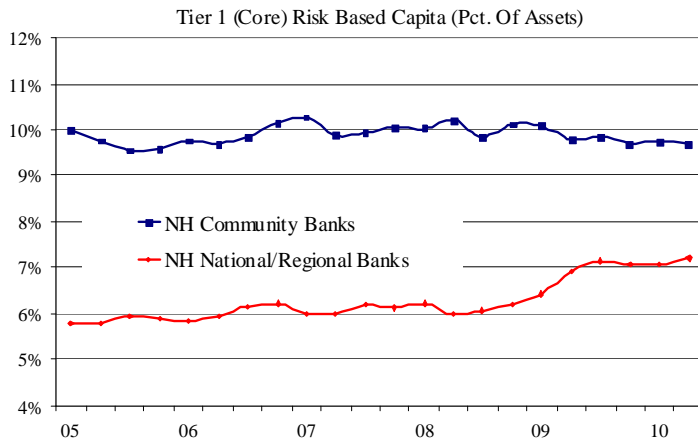


Figure 12
Core Risk-Based Capital Has Risen at NH's National/Regional Banks. While Producing a Safer Financial System, It Also Implies a Reduction in Funds Available to Extend Credit to Businesses and Households



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oundness of the r banks that reduce ile increasing the of lending. Again, the financial crisis it related to the es are beyond the hat the supply of igness or desire of

IV. Conclusions

NH lost over 30,000 jobs during the “great recession” but has re-gained half of those jobs, including 12,400 jobs during the months from January to October of 2010. As difficult as the recent recession has been, the recession of 1990 and 1991 was more punishing for NH.⁷ The 1990-1991 recession was more severe in NH than was the recent recession, and more severe in NH than it was in the nation, because it was amplified by the effects of a larger financial crisis in New England that culminated in the failure of large and small banks throughout the region. The resulting disruption in credit markets dramatically deepened and prolonged NH’s economic contraction into the early 1990s. In contrast, the recession that began in 2008 has had less affect on the banking industry in NH.

As the U.S. and NH economies hit bottom in 2009, the volume of small business lending in NH declined, but that decline was only about one-half the size of the decline in small business lending across the country. Moreover, NH’s community banks increased their lending to small businesses in recent years, including each year of the recession. NH’s more stable (than the U.S. as a whole) banking industry during this recession is one reason why NH suffered fewer economic and employment losses than occurred in a majority of states and why the state is recovering jobs at a faster rate than is the nation.

This report highlights several of the factors that have contributed to recent declines in small business loans in NH. Those factors include both lower demand for credit from many small businesses who disproportionately felt the effects of the 2008-2009 recession, as well as factors affecting the supply of credit, such as increased delinquencies and loan defaults at banks, the need for banks to reserve against losses, higher bank capital requirements, and increased regulatory scrutiny, each of which diminish the supply of loanable funds.

NH’s recent job growth would not be possible in the absence of a healthy banking system capable and willing to make credit available to small businesses. Policymakers, looking for ways to increase job growth in NH, should be mindful that policies directed at increasing the supply of small business loans will be ineffective as long as a lack of loan demand (or “effective demand”) is a major contributor to declines in the volume of small business lending. Efforts to increase the “effective demand” for home purchase loans is a primary cause of the financial crisis that led to the nation’s financial crisis in 2008. Although small business loan demand appears to be increasing, it is not yet where it stood prior to the recession.

Policymakers should also be wary of populist sentiments directed at banks that may directly or indirectly decrease the ability of banks to make loans and ultimately reduce the supply of small business credit in the Granite State. Nationally, some banks have made well publicized mistakes that have resulted in increased regulations and scrutiny that may also impact the ability of more prudent banks to provide needed credit to businesses and individuals in their communities. Understanding the factors affecting the volume of small business credit in NH is the first step toward sound policymaking.

⁷ New Hampshire lost over 58,000 jobs during the 1990-91 recession, or about 10 percent of total employment. NH lost 30,000 jobs (peak-to-trough) during the 2008-2009 recession, or about 4.5 percent of all jobs.

Appendix A: Data, Methods, and Limitations

To capture small business lending trends in NH among lending institutions of all types, our analysis uses annual Community Reinvestment Act (CRA) reports filed with the Federal Financial Institutions Examination Council (FFIEC) to supplement the quarterly *Consolidated Reports of Condition and Income of Banks* or “call report” filed by each bank with the Federal Deposit Insurance Corporation (FDIC). Prior to 2010, small business lending was reported only on a bank’s June quarterly call report. Concerns about the availability of data on small business lending have led federal regulators to now require that each quarterly call report filed by banks have data on small business lending. For smaller banks that lend primarily in one state, the latest small business lending data can be analyzed approximately two-months after the end of each quarter. But analyzing small business lending in New Hampshire by financial institutions that make loans throughout the nation or region (such as large commercial lenders, credit card companies, and nationwide or regional banks) requires banks report lending activity on a state-by-state basis. That reporting occurs annually in the Community Reinvestment Act filings required by banks with assets over \$1 billion.⁸ The most recent CRA small business lending data is for 2009, while quarterly call report data is available through June 2010. These two sources of small business lending data have differences but both are necessary to capture a more complete picture of small business lending than is offered by either individually.

CRA reports require large banks and multi-state and nationwide lenders to report on their lending activity at the state and county level (others may report voluntarily), allowing analysts to isolate the lending activity in NH of large, multi-state, regional, and national lenders. In combination, the CRA and June quarterly call reports provide a more complete picture of small business lending trends in a state but limitations remain.

One limitation in the data is that because more and better data exist on the supply of small business credit than on the demand for credit, changes in supply present an incomplete picture of the small business credit market. The Federal Financial Institutions Examinations Council, with whom CRA reports are filed, specifically warns against interpreting CRA lending data in the absence of evidence of the demand for loans in any geographic area.⁹ Lack of data may account for why perspectives on credit availability differ among potential borrowers, lenders, and analysts according to the U.S. Administrator of Small Business Administration.¹⁰ Anecdotal evidence on the demand for credit is not a substitute for empirical data.

The second limitation is that the CRA reports that are required for assessing the lending patterns of larger banks that make loans across the nation or a region are reported with a significant lag and the most recent data is for 2009. Thus we do not have the latest trends in lending among large banks as the economy has begun to recover.

⁸ The threshold for reporting is adjusted annually. In 2008, it was \$1.061 billion. In 2009, it was \$1.109 billion and in 2010, it is \$1.098 billion.

⁹ According to the Federal Financial Institutions Examinations Council: “Interpreting the CRA data can be challenging”. Although CRA data provides information on extensions of credit in a geographic area, they do not indicate the amount or nature of the overall demand for credit in that area. Consequently, caution should be used in drawing conclusions from analyses using only CRA data, as differences in local loan volume may reflect differences in local demand.”

¹⁰ Mills

On the supply side, CRA data for a state such as New Hampshire will typically include a different number of lenders each year, because only larger banks are required to report although smaller lenders may voluntarily choose to do so. Call report data may also be affected by changes in ownership, charter or location of a bank. An example of this is when an out-of-state bank acquires a New Hampshire bank, lending data for the New Hampshire bank would be included in the quarterly call reports of the acquiring out-of-state bank and not appear in the aggregate small business lending data for NH banks. It may or may not be reported in future years on CRA reports depending on whether the acquiring bank reports CRA data. In this situation, it would appear that small business lending in NH had declined by the amount of lending by the acquired bank when the change in ownership may not have affected the supply of credit in NH at all. This report overcomes some of these limitations by examining change in lending by a consistent set of banks over a number of years by adjusting for any acquisition, mergers, or changes in reporting status by individual banks. The result is a more accurate picture of how lending patterns and the supply of credit has changed among a consistent set of banks over time.

In total, data limitations suggest that the estimates of changes in the supply of loans produced in this and other reports on credit markets should be viewed as an accurate assessment of the direction of change in credit in a region, with somewhat less accuracy in estimates of the specific dollar volume of change.