Banking Sector Analysis

Senior Loan Officer Survey, January 2016

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Lending Environment Reflects Underlying Economic Trends

- **Lending standards for C&I and CRE loans continued tightening in Q4 2015**
- **Residential loan demand showed signs of weakening, while lending criteria kept easing**
- **Consumer loans saw solid demand and slightly eased standards**
- **In 2016, bankers expect an increase in the originations of C&I loans, no change in residential and a decrease in multifamily property and construction/development loans**
- **Bankers expect the quality of C&I and some CRE loans to deteriorate in 2016**

The most recent Federal Reserve Senior Loan Officer Survey (SLOS) reflects many of the developments that emerged in the economy in the third and fourth quarters of 2015. The downturn in the oil and gas industry as well as the slowdown in the manufacturing sector resulted in a slowing demand for loans, an expected deterioration in loan quality, and tighter C&I and CRE lending standards. The demand for residential mortgages showed signs of slowing but was still positive, while lending standards eased. The demand for consumer finance remained strong and standards kept easing, in line with the strong domestic consumer environment driving the U.S. economy.

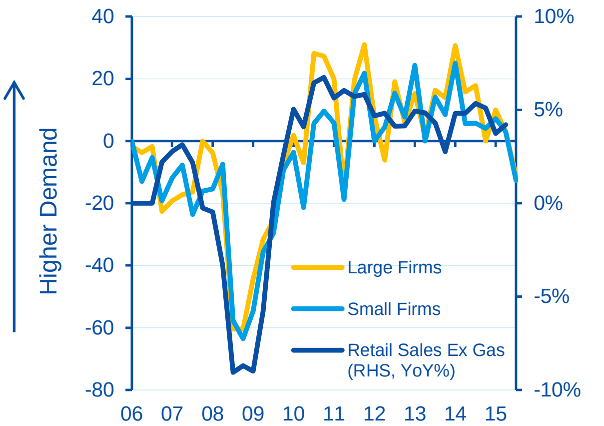
C&I Credit: Demand Starting to Slow while Standards Continue to Tighten

Most respondents reported unchanged demand. Among the rest, more reported moderately weaker demand than stronger demand, following a trend of positive but slowing demand in the first three quarters of 2015 (Chart 1). The reasons for this, in order of given importance, were decreased plant or equipment investment, inventory financing needs and merger or acquisition needs. The number of reported inquiries for additional or increased C&I lines was almost unchanged. C&I loans have been the strongest growing category of loans in the banking industry over the last several years, and this recent slowdown coincides with the decline in business confidence in the third and fourth quarters.

The few respondents that reported changes in lending standards indicated moderate tightening for the second consecutive trimester, coinciding with the recent decrease in business confidence (Chart 2). The top two reasons reported were the worsening of industry-specific problems and a less favorable or more uncertain economic outlook, which is likely driven by the deteriorated situation in the oil and gas and manufacturing industries. The banks that reported easing standards or terms (mostly terms) cited more aggressive competition from other banks or nonbank lenders as the driver behind this change.

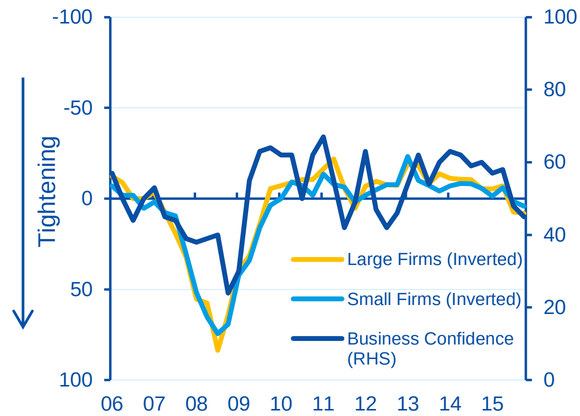
While the loan standards tightened, the terms of loans generally eased, except in the case of premiums charged on riskier loans and the use of loan covenants. This is a continuation of the trend from the third quarter and indicates that banks are willing to lend, but are becoming more discerning when it comes to some clients and loans.

Chart 1
C&I Loan Demand and Retail Sales



Source: Haver & BBVA Research

Chart 2
Net Tightening of C&I Loan Standards and Business Confidence

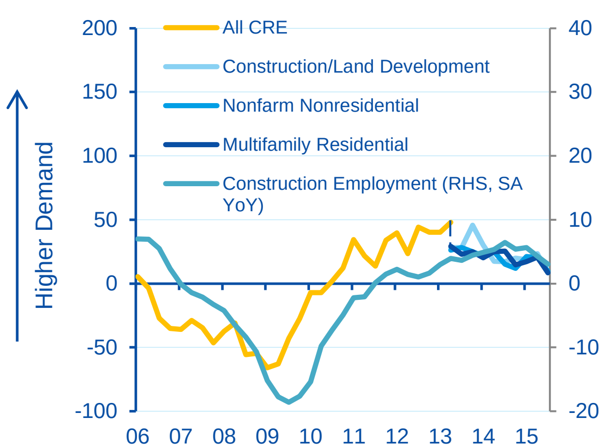


Source: Haver & BBVA Research

CRE Credit: Resilient Demand as Banks Become More Cautious

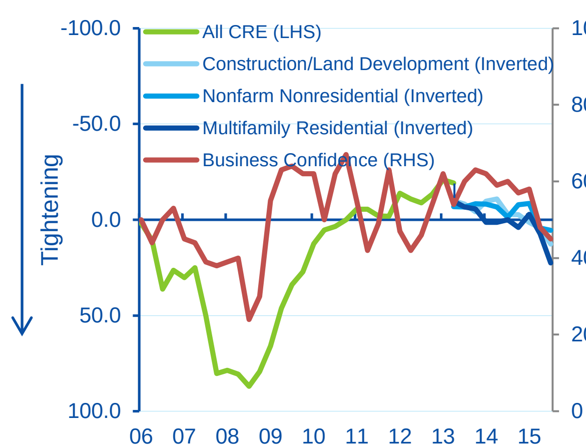
The number of banks reporting higher demand for CRE loans in the last quarter was significant (Chart 3). With attractive cap rate risk premiums, CRE performed very well in 2015, but slowed down slightly in the fourth quarter, especially in parts of the country exposed to the oil and gas industry or impacted by oversupply. While most banks reported unchanged credit standards, more banks indicated tightening rather than easing, especially in the case of multifamily residential and construction/land development loans (Chart 4). This trend of tightening standards is in line with expectations as CRE valuations have started to raise red flags and banks have become more careful lending in locations experiencing strong supply or being adversely affected by the slowdown in their local industries. The uncertain impact that interest rates would have on CRE lending also contributed to this trend.

Chart 3
CRE Loan Demand and Construction Employment



Source: Haver & BBVA Research

Chart 4
Net Tightening of CRE Loan Standards and Business Confidence

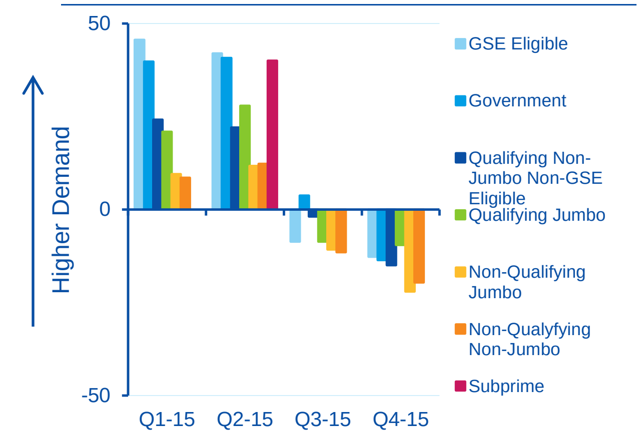


Source: Haver & BBVA Research

Residential Mortgage Loans: Weakening Demand, but Growth Still Positive

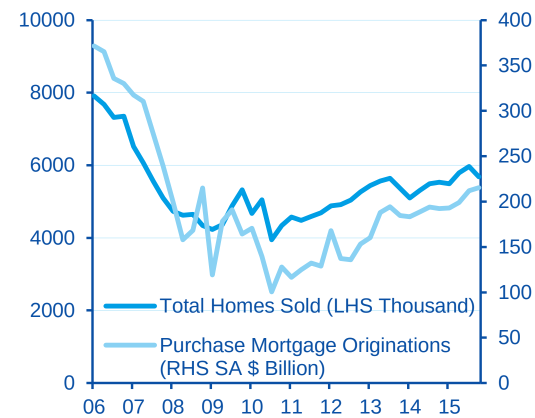
After the strong growth in demand for residential mortgage loans in the first half of 2015, demand in the third and fourth quarters weakened (Chart 5). The gains in the first half coincided with the increase in the number of total homes sold, while the subsequent weakening coincided with the slower home sales in the fourth quarter (Chart 6). As the recovery in the housing market progresses, the demand for mortgages will likely continue to grow, but at a gradual pace, as home price appreciation is expected to slow. Last quarter, lending standards kept easing for all loan types with the exception of subprime mortgages (Chart 7). The demand for home equity loans continued to increase, although at a slower rate than in the third quarter, while credit standards remained roughly unchanged (Chart 8).

Chart 5
Residential Loan Demand



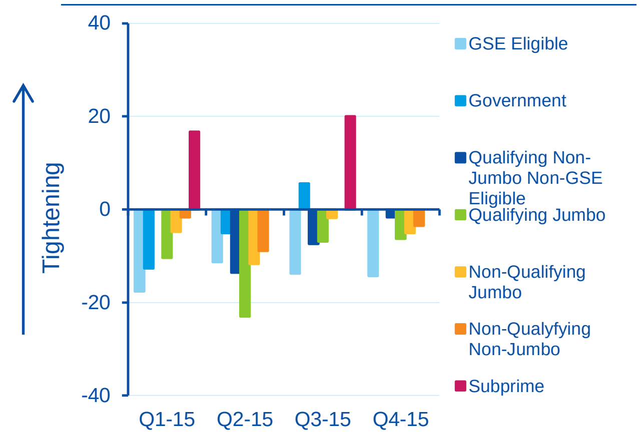
Source: Haver & BBVA Research

Chart 6
Mortgage Originations and Home Sales



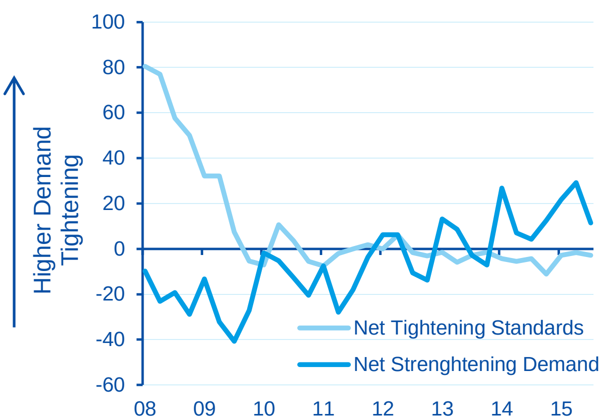
Source: Haver & BBVA Research

Chart 7
Net Tightening of Residential Loan Standards



Source: Haver & BBVA Research

Chart 8
Home Equity Loans Demand and Net Tightening of Loan Standards

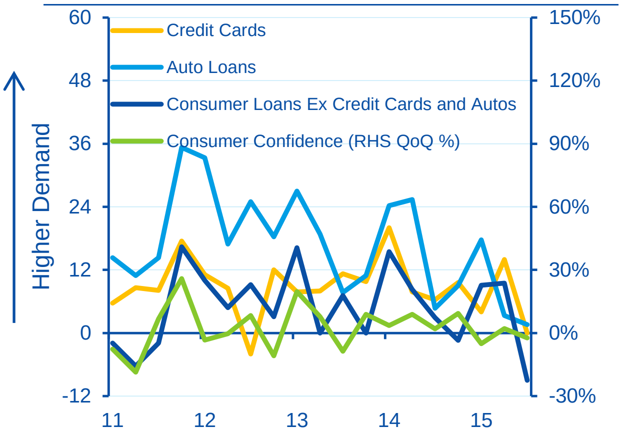


Source: Haver & BBVA Research

Consumer Credit: Unchanged Demand and Supportive Credit Standards

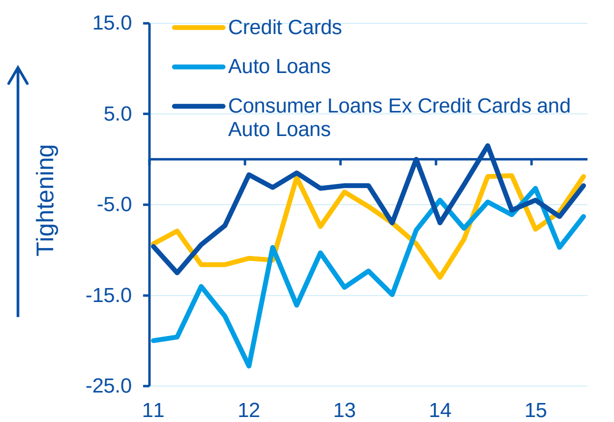
The survey respondents reported that demand for credit card loans and auto loans remained unchanged in the fourth quarter, while the demand for other consumer loans weakened slightly (Chart 9). This was driven by solid consumer confidence, unchanged from the third quarter, as well as by improving unemployment levels. Consumer credit, particularly revolving credit, which has been growing since 2014, is set to continue growing in the upcoming period. Sustained economic growth and low energy prices will continue to support the demand for light motor vehicles, and financing will continue to be favorable, even with the gradual rise in interest rates. While some banks reported that standards were easing for consumer credit (Chart 10), the overwhelming majority of respondents reported that standards have remained basically unchanged, which is supportive of further growth of this credit category.

Chart 9
Consumer Credit Demand and Consumer Confidence



Source: Haver & BBVA Research

Chart 10
Net Tightening of Consumer Loan Criteria



Source: Haver & BBVA Research

Expectations for 2016: Solid Volumes and Higher Interest Rates, but Deteriorated Loan Quality of Some Business Loans

This survey also contained questions on the respondents' expectations for 2016. On the whole, respondents reported an expected increase in originations of C&I loans, with no change in nonfarm nonresidential property loans and a decrease in multifamily property and construction/land development loan originations. On the whole, the respondents did not expect changes in the volume of originations of residential mortgages.

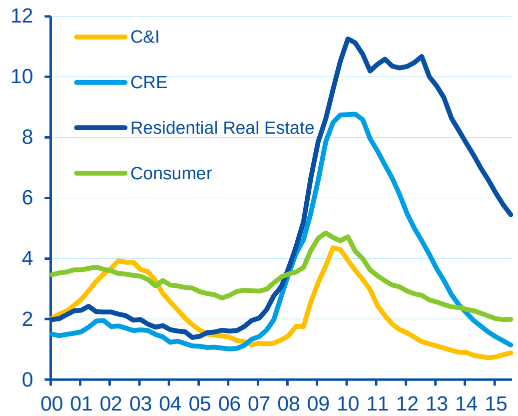
The respondents also reported an expected tightening in lending standards for C&I and CRE loans, with many anticipating an increase in the average level of interest rates for these loans. On net, respondents expect the average spread of loan rates over banks' cost of funds to increase somewhat, and a majority believe that interest rates for residential mortgages will rise.

The respondents also expect that C&I loan quality will deteriorate, while a few also anticipate deteriorated quality for multifamily residential property loans and auto loans.

Bottom Line: Decent 2016, Despite Deteriorated Loan Quality

Like the previous, this latest survey shows that the banks are ready to meet the growth in demand, but are becoming watchful for riskier loans, especially C&I loans, for which delinquency rates have already started increasing (Chart 11). Bankers expect 2016 to bring deteriorated loan quality in some categories, but also increased interest rates and spread of loan rates over the banks' cost of funds, as well as positive developments in regards to origination volumes. The latest survey is in line with our view of 2016, in which we expect the banking industry to benefit from the overall growth of the economy, despite the slowdown in some sectors.

Chart 11
Delinquency Rates



Source: Haver & BBVA Research