Banking Watch

US

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Economic Analysis

US
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Senior Loan Officer Survey 2011Q4

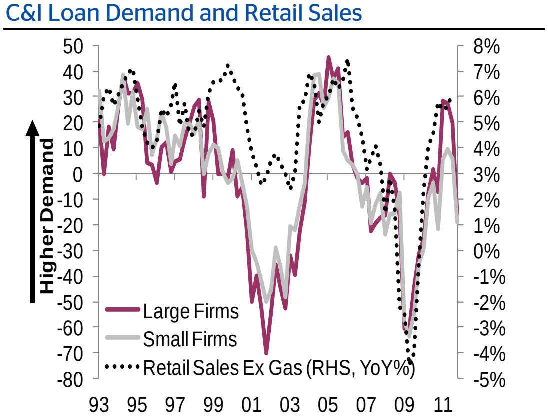
Survey suggests no economic push from lending standards

- **C&I standards tighten and demand weakens; Europe turmoil a factor**
- **Real estate standards remain tight, demand outlook still fragile**
- **Easing in credit card and auto loans as asset quality subsides**

C&I Credit: Tightened standards likely to further declines in demand

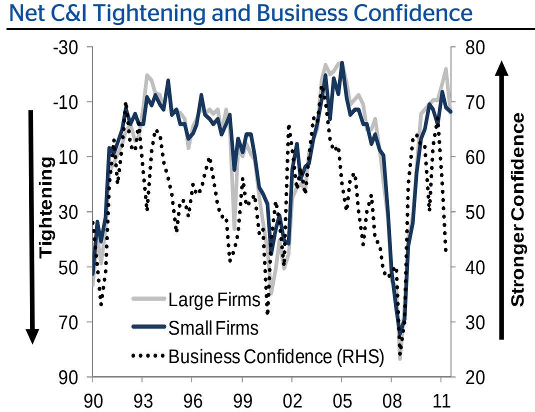
The latest Federal Reserve Senior Loan Officer Survey (SLOS) reveals a tightening in lending standards and lower demand for commercial and industrial (C&I) loans compared to the previous quarter. Some of the change was a consequence of the European sovereign debt crisis, which caused banks to be wary of lending to both financial and nonfinancial firms with significant exposures to the region. Inquires for decreases in lines of credit outnumber inquiries for increases in lines of credit. Most domestic banks (about half of which make loans or extend credit to European firms) tightened standards on C&I loans. Respondents cited a variety of reasons aside from the crisis in Europe, including reduced tolerance for risk, decreased liquidity in the secondary market, and rising concerns related to the effects of government policies. Among the few banks that did ease standards, the main reason was to counteract more aggressive competition from other lenders. These banks mostly undertook easing via cuts to loan rate spreads over the cost of funds as well as reductions in the use of interest rate floors. According to the survey, net interest rate premiums on riskier loans increased. Demand for C&I loans was weaker than in the previous quarter, mostly due to an increase in internally generated funds among customers. In general, most banks acknowledged a "less favorable or more uncertain economic outlook" as the primary determinant of activity in the third quarter. The slight tightening of standards and decrease in demand for commercial and industrial loans is consistent with our supposition that C&I lending is likely to slow over the next several months. C&I lending is currently growing at a 9% YoY rate, which is potentially faster than warranted by economic growth.

Chart 1
C&I Loan Demand and Retail Sales



Source: Federal Reserve and Haver Analytics

Chart 2
Net C&I Tightening and Business Confidence

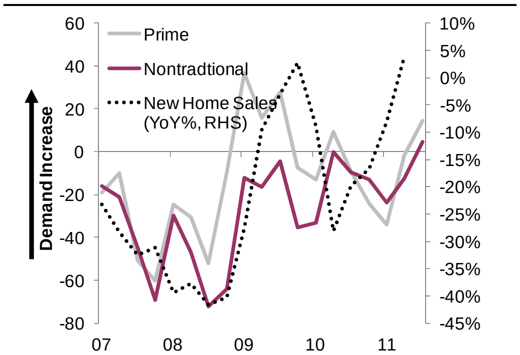


Source: Federal Reserve and The Conference Board

Real estate credit: Conditions have not recovered enough to boost demand

Activity related to commercial and residential real estate loans remained relatively unchanged compared to last quarter due to continued weakness in the housing market. Commercial real estate (CRE) lending standards hover near their tightest levels since 2005, making it difficult to incite demand. In particular, more banks reported weaker demand for home equity loans in the third quarter. On the upside, demand for home loans did increase from the last survey; however, this data may reflect a rise in refinancing activity rather than demand for new houses. Although the residential market continues to suffer, we expect that conditions have already hit rock bottom and should begin to turn around slowly in the coming quarters.

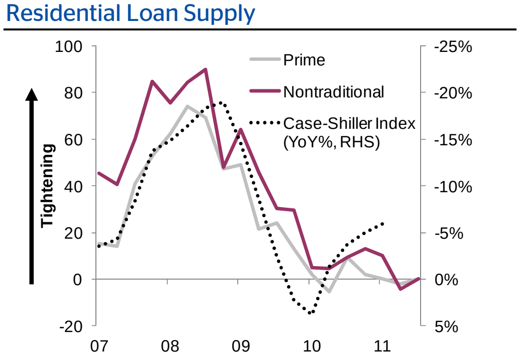
Chart 3
Residential Loan Demand Conditions



Source: Federal Reserve and Haver Analytics

Demand for prime and nontraditional closed-end loans have improved since last quarter but remain negative. Similarly, new home sales have increased on a YoY basis, but it appears that consumer interest in residential investment remains weak. While mortgage rates are extremely low, credit conditions have not eased enough to positively impact demand for housing. Recent initiatives by the Obama administration aim to spur refinancing activity by underwater households, which is an attempt to break the impasse in residential investment.

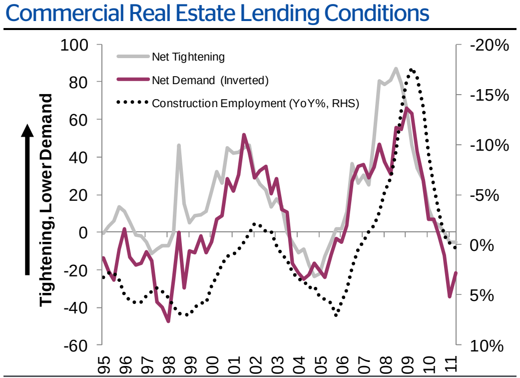
Chart 4
Residential Loan Supply



Source: Federal Reserve and Haver Analytics

Standards on prime residential loans and home equity lines of credit remain on the border of net tightening and loosening territory. Distressed properties continue to threaten the housing market, keeping prices at extreme lows. Increased uncertainty over the housing price forecast will likely encourage banks to proceed with caution when setting limits and standards in their originations. Furthermore, consumers may continue to shun housing as an investment class until their confidence is restored in stabilized house price indices.

Chart 5
Commercial Real Estate Lending Conditions



Source: Federal Reserve and Haver Analytics

CRE demand fell back slightly from last quarter and loan growth is still declining in terms of YoY rates. Delinquencies and high charge-off rates have prevented banks from easing standards, but a gradual improvement is expected over the next year. Yields are expected to remain low for the near future, which should help to improve CRE capitalization rates and make the market more attractive for opportunistic investors.

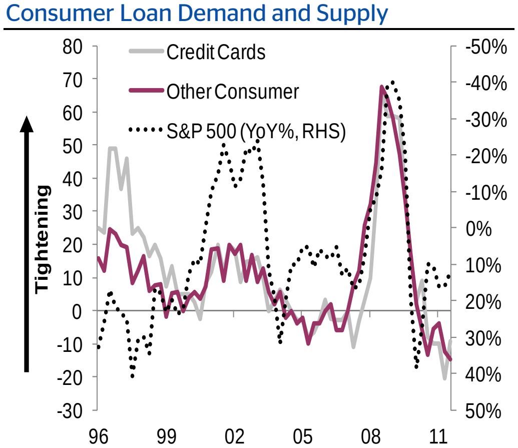
Consumer lending: Marginal progress in consumer lending

Despite considerable tightness in most other loan types, "modest fractions of banks" reported easing standards on some consumer lending. These banks mostly focused on easing consumer credit card and auto loans via lengthened maximum maturities and lowered minimum required credit scores. Overall, demand for consumer loans was unchanged, with some increases in credit card and auto loan demand offsetting declines for other types of consumer loans. While personal consumption expenditures have fared better than expected in recent months, we continue to expect reluctance among consumers to take on more debt until uncertainties regarding the future outlook have declined. Direct mailings of credit card offerings are reaching elevated levels, meaning competition for consumers is increasing despite the sluggishness of actual consumer financing activity.

Bottom line: Global uncertainties impact lending strategy of survey respondents

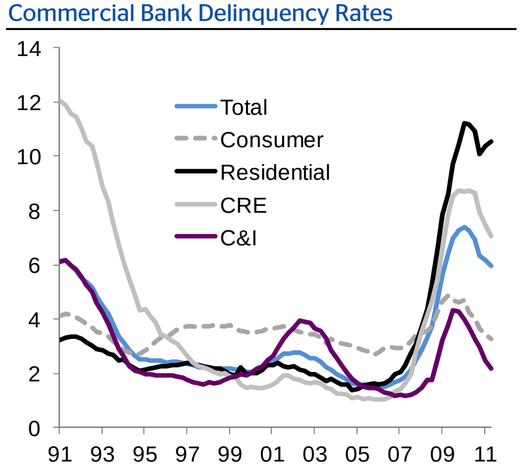
Details in this quarter's SLOS suggest spillover effects from the ongoing debt crisis in Europe, with some influence on C&I lending standards. As in the case of the past few surveys, commercial and residential real estate conditions have yet to recover from the housing crisis. In particular, the Federal Reserve has highlighted tight real estate lending standards as one possible weight on the economic recovery. Although consumers remain hesitant to take on more debt, easing in credit card and auto loans may be the bright spot for increased demand in the coming months. Uncertainties over employment and home prices, in addition to added pressures from global slowdowns, will drag on lending activity. Overall, the survey suggests no boost to economic growth from lending standards, which are not showing any substantive or widespread loosening. Credit will therefore complement, but not drive, the recovery as the banking system grows in tandem with the economy.

Chart 6
Consumer Loan Demand and Supply



Source: Federal Reserve and BBVA Research

Chart 7
Commercial Bank Delinquency Rates



Source: Federal Reserve