

US bankers: What they say, what their customers say

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- Responses of bankers to the Federal Reserve's latest quarterly survey of loan officers indicate that lending standards have been tightened further, a gradual process that began in mid-2007.
- But bankers reject the notion that they are the cause of a credit crunch. Instead, they insist that loan demand has shrunk because of the uncertain economic climate.
- Official data show that bank lending has been reduced only modestly since last October. But there are lags in the process by which tougher conditions on new credit lines eventually show up as lower levels of bank loans. So far very few businesses cite the obvious decline in credit availability as a serious problem.
- The implication is that the full impact of restrained credit availability lies well into the future. The Fed's extraordinary efforts to support segments of the credit market will be insufficient by themselves to generate a meaningful economic recovery.

Senior Loan Officers' message to the Fed: Tighter lending standards ahead

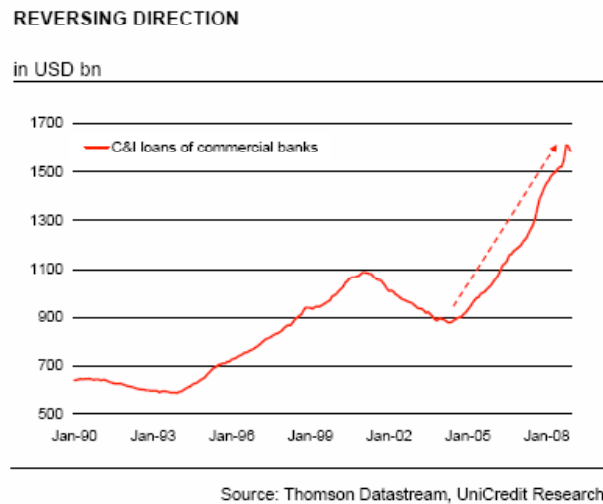
The 50 or so domestically-chartered banks that respond to the Fed's quarterly survey say they are tightening standards for approving loans to just about every sector. By comparison, the 23 foreign-related institutions operating in the US that respond to the survey have become even more restrictive than US banks in approving new credit lines to businesses, their main activity in this country. The majority of both US and foreign-related institutions have been tightening credit standards for commercial and industrial, C&I, loans since the middle of 2007. Eventually they will get as tight as they need to be to filter out all but the most creditworthy borrowers. But the response "no longer tightening standards" will not mean that banks are again eager to lend, only that they are comfortable with a narrower, more creditworthy customer base. And for US banks, TARP capital injections do not change things: taxpayer funds are mostly there to cover expected losses on bad loans and toxic securities acquired during the go-go days of easy access to credit. The clear implication is that the credit crunch has many months to run.

Both US and foreign-related institutions say they are stiffening terms on loans. For business borrowers, that means tougher limits on maximum size of credit lines, shorter maximum maturities, higher costs to secure a credit line, and much wider spreads of loan rates over bank cost of funds, especially for riskier loans. The details of loan agreements are also moving in the banks' direction. Loan covenants are being tightened, while collateralization requirements are getting stricter. All together, these and previous tightening actions have effectively reversed a decade-long trend toward a whole host of concessions banks made to borrowers, especially the big private equity funds, when credit availability seemed to be virtually unlimited. Those days are long gone. Indeed, when asked by the Fed for the principal motivation for tighter terms and conditions, about half the respondents said that less aggressive competition from other banks, non-bank lenders or the capital markets was a somewhat important reason.

Even more important in bank decisions to tighten lending terms, however, were broader economic problems and market deterioration. Every respondent cited the less favorable economic outlook. Nearly every bank pointed to a worsening of financial problems in specific industries. Almost all respondents acknowledged a reduced tolerance for risk. By contrast, opinions were mixed regarding the importance of defaults by borrowers in public markets: some said they were, but more said they weren't. A similar split was recorded on the question of decreased liquidity in the secondary market for commercial and industrial loans. It has been a consideration for some but not for the majority.

What about lending standards for real estate? In the home mortgage area, the answer is that some banks are tightening further, but at a lessened pace since standards had been become considerably more restrictive throughout the past year. In the commercial real estate sector, banks had reacted preemptively by beginning to move toward restrictive lending standards in the first few months of 2006. By the end of 2007, 80% of respondents reported a tightening of terms and conditions. That same proportion of banks has put into effect increasingly restrictive covenants, reduced loan to value ratios, and wider lending margins ever since.

Despite the progressive tightening of standards, the impact on actual lending was negligible. To the contrary, loans to both residential and commercial real estate continued to increase for US banks well into the fall of 2008. (Foreign-related banks in the Fed's sample are generally inactive in this sector, according to the H.8 report.) This reflects the time delay involved in financing large-scale projects from inception through eventual sale in the marketplace. But the responding banks started to report weaker demand for both residential mortgages and commercial real estate loans around the middle of 2006. And on the commercial side, the collapse of demand strikingly paralleled the sharp drop that occurred after the collapse of the high tech bubble, when vacancy rates for office buildings, manufacturing and distribution facilities, and even shopping malls quickly escalated. This is shown in the chart below.



So the brunt of the effect of a combination of tighter lending standards and weaker demand for new loans probably won't show up in the data for several more months. Outstanding loans can then be expected to contract for some time, perhaps several years, thereafter.

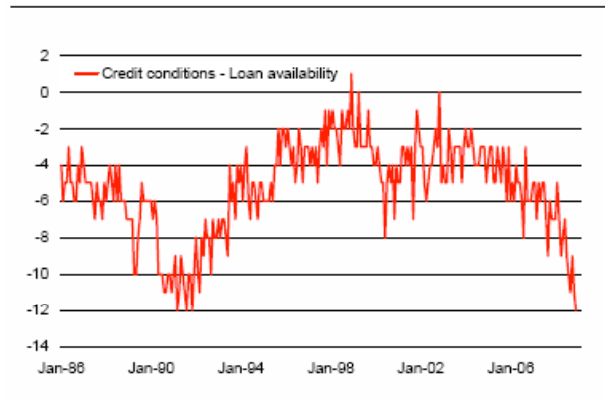
What bank customers are saying

Small and medium-sized businesses borrow for a relatively small number of reasons: to finance working capital needs, for example, wages & salaries and accounts receivable; to finance inventories; and to fund in part plant and equipment expenditures. For large corporations, banks are relied on for many other financial services, including loans for mergers and acquisitions or to fund share buy-back programs.

The regular surveys of small businesses conducted by the National Federation of Independent Businesses provides a gold mine of information of current conditions in this all important sector of the US economy (all important, because it accounts for the majority of job creation). The latest survey describes conditions as of December 2008 but it is unlikely that things changed very much one way or the other in January. Here are the main findings:

Loan availability is continuing to recede and it has returned to the depth of the 1990-91 recession. The net percentage of regular borrowers (who represent about a third of total small businesses sampled) reporting "easier" credit conditions less those reporting "harder" conditions is now at -12. [See chart below] Expectations of credit conditions three months down the road have also deteriorated but remain well above those in the post-high tech bubble period of 2002-4. The relative cost of loans, when available, has clearly declined this year, but average interest rate paid appears to have stalled between 6.5%-7.0%. That is well above the current posted prime lending rate of 4.25%.

LOANS HARDER TO GET



Source: Federal Reserve, UniCredit Research

Inventory intentions have sharply declined in the past year. Actual inventory levels are the lowest since the series began in 1986. Planned inventories are higher, but declining irregularly. Therefore, the demand for credit to finance inventories has definitely fallen and may remain subdued. Actual capital expenditures have declined gradually since 2004, with acceleration in the pace of decline in 2008. Planned capital expenditures have plunged to levels that are lower than at any point in the past twenty years. That too will suppress demand for new loans by small businesses.

When asked what it is the most important problem facing the respondent's firm, the number one answer is "poor sales", followed by "taxes." Of the nine choices, amazingly finance and interest rates placed last, with only 3% citing it. How long can that complacency last?

Implications for the economy

It is obvious that troubled companies in distressed industries like autos no longer have access to normal credit channels. The Big Three US auto makers have already been forced to petition the US government for loans, and the terrible results of January car sales will make even that source of emergency funding less assured. But there are millions of small and medium-sized enterprises in the US that so far have not been beaten up by the recession to the extent that they are cut off from normal sources of credit, most significantly, their usual banker. Yet, banks are in the process of imposing far stricter conditions on C&I and commercial real estate loans, which represent the bulk of the credit they provide to the business sector. While only about 12% of businesses tell surveys that they have been denied credit, and only a handful of respondents to the NFIB small business survey say access to finance and interest costs are their main problem, that situation is almost certain to worsen in the months ahead. Therefore, the Fed's exceptional monetary accommodation will be unable to single-handedly overcome powerful recessionary forces in the US economy impacting both the supply and the demand for credit.

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