

# US loan demand slows, terms stiffen, & money growth ebbs

Roger Kubarych

- The Fed's quarterly survey of bank lending officers showed further tightening of lending standards and shrinking of loan demand by businesses, real estate developers, and households.
- The latest hard data on commercial and industrial loans, real estate lending, and consumer finance echo this pattern. So do the money supply figures, which show slower growth, and the Fed's weekly balance-sheet maneuvers, which net out to almost no change since the rapid build-up in assets during the market meltdown last fall.
- The implication is that the Fed is becoming more relaxed about conditions in the financial markets and is not aggressively seeking to juice up the money supply or to undertake a new round of large-scale purchases of commercial paper or other private sector credits.
- Even the much ballyhooed Term Asset-Backed Securities Lending program, TALF, has barely gotten off the ground. However, this week the Fed formally announced expansion in the TALF to include commercial real estate mortgage-backed securities, CMBS. That may spur a new group of participants may soon decide to sign up. At least, the Fed Chairman hopes they will.

## Bankers report both further tightening in lending standards and slack demand for new loans by businesses and households

The Federal Reserve released the quarterly "Senior Loan Officer Opinion Survey on Bank Lending Practices." The results can easily be summarized:

1. Lending standards for commercial and industrial loans are already strict, so about three-fifths of the 52 domestic banks responding to the Fed survey report they have left them unchanged. Of the remainder, only a couple are tightening standards "considerably." The rest are tightening them "somewhat." However, the cost of credit lines has been raised by two-thirds of the banks. And lending spreads have been widened by more than three-quarters of them. Implication: banks are ready to lend, but customers have to meet more stringent conditions and pay higher fees and interest rates. Why are banks still toughening up? Everybody cites the weak economy. Almost all cite "industry-specific problems" (such as plunging real estate values or the ailing auto industry). Most admit their banks have a diminished tolerance to take risks. But only a minority says it is because their institutions are capital constrained. And a mere handful cites deterioration of their banks' liquidity positions.
2. Demand for commercial and industrial loans is sinking, report two-thirds of the responding banks. The reasons behind the shrinkage of loan demand essentially track all aspects of a recession. They include lower inventory financing needs, hardly surprising since firms in every sector of the economy are drastically cutting inventory investment; lower accounts receivable financing; a universal plunge in business capital expenditures; and less merger & acquisition activity to fund. What is not important, say the bankers, are customers flocking to non-bank competitors offering better lending terms. Almost nobody sees that happening.
3. Conditions are not much better in the commercial real estate sector. In past Fed lending surveys, terms on commercial real estate loans were tightened sooner and more aggressively than any other market segment. Two-thirds of the banks continue to impose tougher terms; only a third reports no change, and nobody is easing lending standards. As for the demand for loans, almost three-quarters report moderate or substantial contraction in demand, not surprising given the progressive weakening of office, retail, and other types of commercial real estate development throughout the country.

4. Things are improving in the residential mortgage business, however. Half of the respondents are tightening standards for prime borrowers. But about half actually are experiencing an increase in mortgage demand, while only 15% report a decline in demand. There is even a small increase in demand from the riskier segments, so-called “alt-A” and “jumbo” mortgages. Half the bankers are also taking a tougher stance with respect to home equity lines of credit. Like the primary mortgage market, demand for home equity lines of credit is mixed. About half the respondents see weaker demand, while about 20% of the banks are experiencing stronger demand for this type of credit (which is frequently used to finance purchases of autos and home improvements, or even children’s college expenses).

5. Consumer lending standards – for credit cards, student loans, and auto loans – are getting a little tougher, but rather selectively. For example, for consumer installment loans, almost all respondents report unchanged lending standards. But for credit card lines, more than half report tighter terms and approval standards. And most of the bankers say that they have lowered lines of credit, established higher interest rates, increased fees, and imposed stricter payment conditions. These developments have not gone unnoticed. US Senator Charles Schumer of New York has been critical of the Federal Reserve for not giving greater urgency to a promised study of credit card lending abuses that Congress has demanded. He rebuked Fed Chairman Bernanke on this matter at this week’s Joint Economic Committee meeting (Schumer is the vice-chairman of the group).

6. Finally, the Fed asked some special questions about lending standards for financing international trade and got some interesting differences between US-chartered banks and branches of foreign banks operating in the US. Of the 52 US banks in the survey, only two-thirds finance exports and imports. Most have tightened lending standards over the preceding three months. All cite recessions here and abroad as the main reason. Many report greater concerns about problems in individual countries and troubled industries. Nearly all say their banks have reduced tolerance for taking risk. And three-quarters report lessened demand for trade financing.

Now compare these responses to those of foreign-headquartered banks. Eighteen of twenty-two (i.e. over 80%) in the sample are typically involved in trade financing. A little over half have been tightening lending standards in this area. All cite the worsening global economic situation. But several foreign banks, unlike US counterparts, cite a deterioration of the parent banks’ capital or liquidity positions as a reason for tightening standards. And all are worried about foreign country risk. As for the demand for trade financing, the responses were neatly balanced: while most said it was unchanged, half the rest saw declines but the other half actually reported increases. In sum, foreign banking institutions, traditionally more internationally-active than most US banks, seem to be better positioned to take advantage of lending opportunities, even in a worldwide economic slowdown that has been disproportionately bad for international trade.

The opinions of bank lending officers are not just snapshots of current market conditions. They often give valuable clues as to future financial conditions and the availability of credit to various sectors of the economy. What is unique in the Fed’s April survey is that almost every banker, whether from a US or a non-US institution, believes that the credit quality of their bank’s existing loan portfolios will continue to deteriorate in the period ahead. Taken at face value, these responses are consistent with the recession for at least several more months, if not longer.

## **Money supply oscillates wildly, while credit growth tapers off**

Money supply growth peaked in the last few months of 2008, as the Fed ratcheted up its balance sheet to provide direct support to particular segments of the financial system. Monthly movements in money growth can fluctuate widely and can differ sharply for any particular month for different definitions of money. The bottom line is that annualized growth rates have been more volatile in the past six months than at any other time since records have been kept. For M1, the range has been between +56.7% and -16.4%; for M2 between +26.0% and -3.0.

What has accounted for these astonishing fluctuations? Three factors: wide swings in checkable deposits, big increases in small time deposits (in M2, not M1), and unusual volatility in money market mutual fund investments (also solely in M2). These are the monetary manifestations of the often-cited surge in risk aversion, further enhanced by the decision of the Federal Deposit Insurance Corporation to insure bank deposits without limit last fall. That made it unnecessary even for sophisticated investors to personally evaluate the creditworthiness of individual banks or to go through the hassle of distributing their capital protected short-term assets across a number of banks. This far-reaching change in the familiar rules of the game had an immediate impact on depositor behavior. For the various measures of the monetary aggregates, the effects were electrifying, but not necessarily influential on the overall economy.

What has been more relevant for the economy has been the behavior of bank credit decisions. Since end-September 2008, with one exception – deposits at the Fed (otherwise known as excess reserves, which have exploded) – most channels of credit creation have shown modest growth or small declines: especially lending to securities dealers. There certainly was no across-the-board retrenchment in outstanding credit. But getting new loans became increasingly difficult as banks preferred the safety of the Fed or US Treasuries to securitized assets or conventional loans.

#### **BANKS IN THE US: ASSETS ROSE, BUT ONLY SLOWLY, AS THE CREDIT CRUNCH UNFOLDED**

<i>Selected categories USD bn</i>	<i>22 Apr 09</i>	<i>Sep 08</i>	<i>Mar 08</i>
<b>Total assets</b>	12075	11330	11173
<b>Securities</b>	2627	2538	2554
<b>Loans &amp; leases</b>			
Commercial & industrial	1514	1537	1480
Real estate	3798	3660	3659
Consumer	876	854	818
Security firms	194	327	301
Interbank loans	448	469	445
<b>Cash assets</b> (mostly at Fed)	1096	372	310
Other assets	1058	1036	1010

Source: Federal Reserve, UniCredit Research

### **Fed's balance sheet levels off as extreme risk aversion subsides**

Chairman Bernanke gave a brief “on the one hand, on the other” review of signs of tentative improvement in financial market conditions to the members of Congress who belong to the Joint Economic Committee. Here is what he said:

“Among the markets that have recently begun to function a bit better are the markets for short-term funding, including the interbank markets and the commercial paper market. In particular, concerns about credit risk in those markets appear to have receded somewhat, there is more lending at longer maturities, and interest rates have declined. The modest improvement in funding conditions has contributed to diminished use of the Federal Reserve's liquidity facilities for financial institutions and of our commercial paper facility. The volume of foreign central bank liquidity swaps has also declined as dollar funding conditions have eased.”

A quick look at the changes in the Fed's balance sheet substantiates his conclusions. Here is what has happened since the beginning of the crisis in mid-2007: The Fed sharply reduced its traditional holdings of US Treasury obligations, almost completely eliminating Treasury bills from its portfolio and thus accommodating the shift toward diminished risk tolerance of the banks. The Fed introduced a number of programs to provide increased liquidity to the banks, notably the Term Auction Facility. It also introduced programs that directly supported particular sectors of the financial system, especially the commercial paper market and the mortgage-backed securities market. The Term Asset-backed Securities Lending Facility, TALF, was meant to extend this approach into other segments by reviving securitization. The new program has not been particularly attractive to market participants yet (only about USD 20 bn in originations so far, a

very long way from the USD 1 trillion announced upper limit). But the Fed chairman still sounds optimistic about its potential, following announcement this week of its extension into the field of commercial mortgage-backed securities.

The table below shows the situation today, as compared to the composition of the Fed assets and liabilities back in December 2008, when total assets peaked, and June 2007, before the crisis broke out.

#### FED BALANCE SHEET REACTS TO MARKET MOOD SWINGS

<i>Selected categories USD bn</i>	End-April 2009	17 Dec 2008, asset peak	End-June 2007
<b>Reserve bank credit</b>	2050	2239	851
Securities	983	494	790
US Treasuries	549	493	790
Govt Agencies	68	18	20
Mortgage-backed	366	0	0
Repos	0	80	20
Term auction credit	404	448	na
Other Loans	101	207	0.1
Commercial paper funding facility	182	319	na
Maiden Lane LLC (Bear Stearns)	26	27	na
Maiden Lane II, III (AIG)	46	40	na
Central bank swaps	250	583	0
Other assets	58	27	44
<b>Liabilities</b>	2021	2267	836
Currency	863	841	775
Reverse repos	67	71	30
Deposits	1078	1287	20
Bank reserves	813	802	16
Treasury, genl a/c	63	120	4
UST, supplementary	200	364	na
other	14	67	10

Source: Federal Reserve, H-4.1 report, UniCredit Research

Since December 2008 the commercial paper market has begun to unthaw, and the Fed's holdings have declined accordingly. The shortage of dollars in world interbank markets has also subsided although some central banks are still making use of the swap facility (presumably the Bank of Mexico among them). But the Fed remains resolved to support the residential mortgage-backed securities market and the GSEs (Fannie, Freddie, and the Federal Home Loan banks).

Finally, the heavily-publicized decision of the Fed to start a systematic program of purchases of longer-term US Treasury notes and bonds has been implemented gingerly, even unenthusiastically. We have long felt the Fed has no intention of pegging any particular level of US Treasury yields. After this week's FOMC meeting, the Fed blandly stated that it "will continue to carefully monitor the size and composition of the Federal Reserve's balance sheet in light of financial and economic developments." It did not promise to buy more long-term Treasuries. Those market participants who had convinced themselves that a major effort would be made to hold down long-term Treasury yields were sorely disappointed, as the yield on 10-year US Treasury notes subsequently climbed above 3.20% without encountering any resistance from the Fed.

US bond and stock market participants alike are now more confident that financial fragility is diminishing and that the credit crunch will gradually ease. But no consensus has emerged on how

vigorous an economic recovery might be. Bernanke's JEC testimony suggested that the Fed is tilting toward a more modest recovery than its previous published forecasts suggested. If that note of caution is accurate, it could limit the further advance of equity prices but temper the sell-off of long-term Treasuries.

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*The author is chief US economist, UniCredit Group Research, and Henry Kaufman Adjunct Fellow for International Economics and Finance, Council on Foreign Relations. This note is reprinted with permission of the author.*