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Credit Trends:

U.S. Credit Comment: Lending Standards Tighten (Premium)

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The Senior Loan Officer Opinion Survey on Bank Lending Practices for July through September showed that general lending conditions continued along a constricting trend. The tightening of lending standards in the mortgage-loan market has spilled over into the market for commercial and industrial (C&I) loans. Most banks have cited uncertainty about the economy as the general reason behind the tougher C&I loan conditions.

The bond market has experienced similar constraints, as investors have demanded higher risk premiums in both the bond and leveraged-loan markets, which is particularly significant given the decline of aggregate credit quality. With 33% of firms rated 'B' or below, tighter lending conditions could pressure those that are already highly leveraged. As investors become more risk averse and banks become reluctant to extend credit lines, firms in distress may not be able to find financing. While the market is not yet at this point, we caution that this risk is still possible.

Further, if lending standards become too strict, economic activity will suffer because firms and consumers may be unable to finance investments and purchases. However, recent federal funds rate cuts should help offset the higher loan premiums and keep borrowing costs from choking economic activity. Key observations from this survey are:

- Of the domestic banks surveyed, 19.2% reported stricter lending conditions for large- and medium-sized C&I loans, and 9.6% reported tighter lending conditions for small-sized C&I loans (see Chart 1). Demand for C&I loans also slipped, as 17.3% reported lower demand for large- and medium-sized C&I loans, and 7.7% reported lower demand for small-sized C&I loans (see Chart 2). The lower demand was somewhat surprising, because after the credit disruption in late August and September, some firms had to tap credit lines. Moreover, some firms that had funded through commercial paper had to turn to bank lines instead.
- Chart 1 and Chart 2 show the general trend of economic activity (measured by year-over-year percentage change in real GDP) and supply-and-demand conditions in the C&I market. Lending conditions tend to tighten as economic growth begins to slow, because lenders factor the increase in default risk into their loan-making decisions. Aggregate demand for capital also slows as firms reduce investments. However, demand from distressed firms increases because less profits amplify the need for additional capital to remain solvent. Of course, these firms are at the highest risk of being closed out of both the bond market and bank loan market.
- The risk premium in public markets has increased since July, evident by the widening of interest-rate spreads in both the bond and loan markets. Investment-grade and speculative-grade bonds spreads have increased by 31 basis points (bps) and 111 bps, respectively, between July and October (see Chart 3). Pro rata 'B+'/'B' rated leveraged loans LIBOR spreads increased to 297 bps on Oct. 25 from 265 bps in July. Higher borrowing costs and more risk-averse investors could keep some lower rated firms from accessing the bond or leveraged-loan market.
- Special questions regarding backup lines of credit for commercial paper (CP) show that banks have tightened standards on asset-backed and CP programs rated 'A2'/'P2'. Outstanding asset-backed CP has decreased to \$874.7 billion on Oct. 31 from \$1.174 trillion in July
- Mortgage-lending standards continue to be restrained, with 40.8% reporting a tightening in prime and 55.5% reporting a tightening in subprime. The perceived demand for mortgages has also fallen—51% report a drop in prime loan demand, and 45% report a decrease in subprime loan demand.

- More stringent mortgage-lending standards will continue to hurt the homebuilders sector as some buyers will be precluded from funds. Moreover, as banks widen the spread related to the cost of funds to stabilize their risk/reward profiles, borrowers will have higher mortgage costs and less disposable income. If increasing mortgage costs reduces disposable income, sectors, such as consumer products, retail and restaurants, automotive, and media and entertainment, that are sensitive to consumer budgets will feel the pinch. The survey also showed that 26% tightened standards for noncredit card consumer loans; though for discretionary sectors, standards for credit card loans did not see any significant restriction.
- Commercial mortgage lending standards also became stricter, with 52% of respondents reporting tightening standards. Banks may be beginning to worry about risk in the commercial mortgage market as the economy winds down. Moreover, delinquencies in commercial mortgage-backed securities increased in the third-quarter as property fundamentals softened.

Chart 1

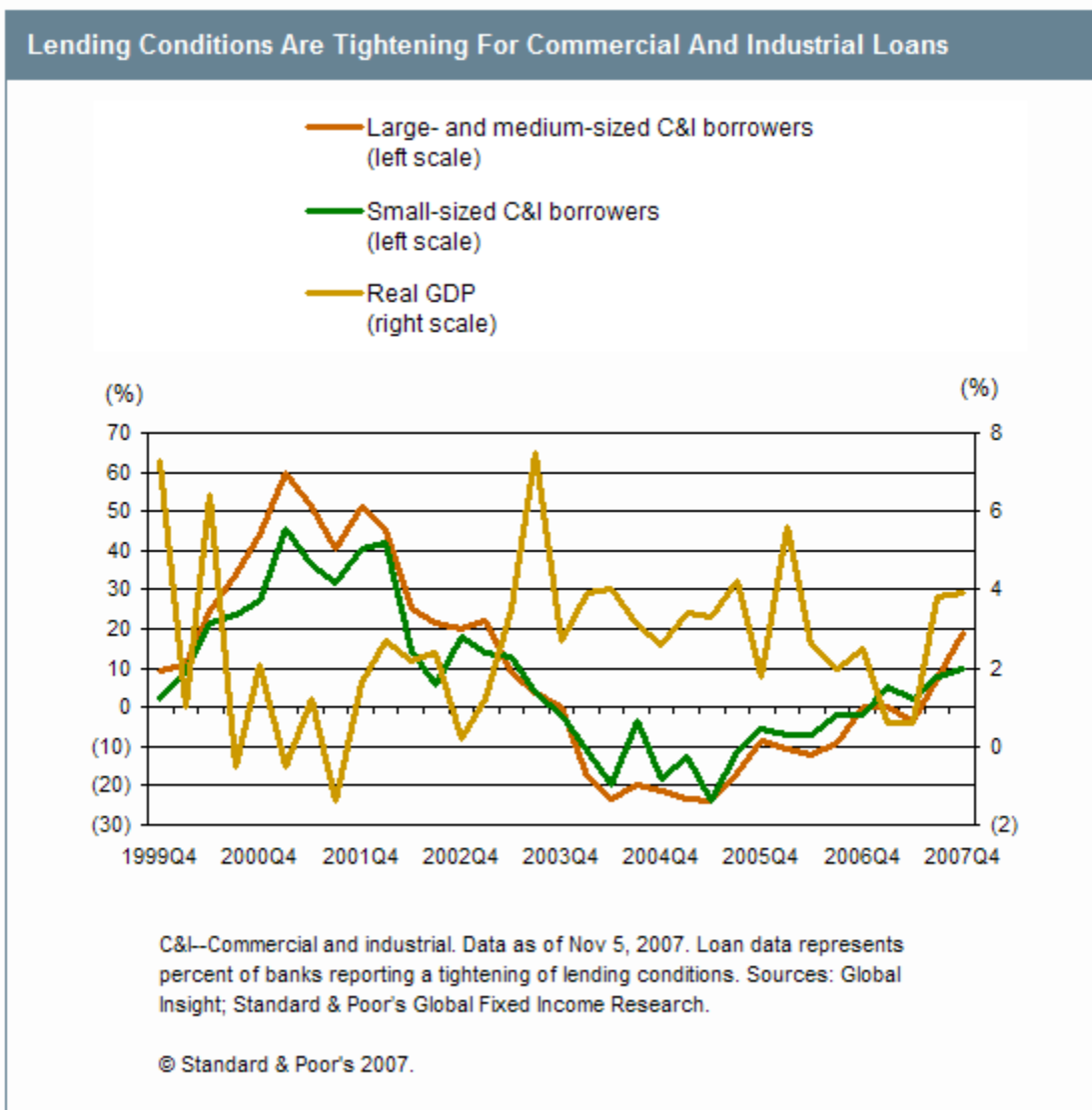


Chart 2

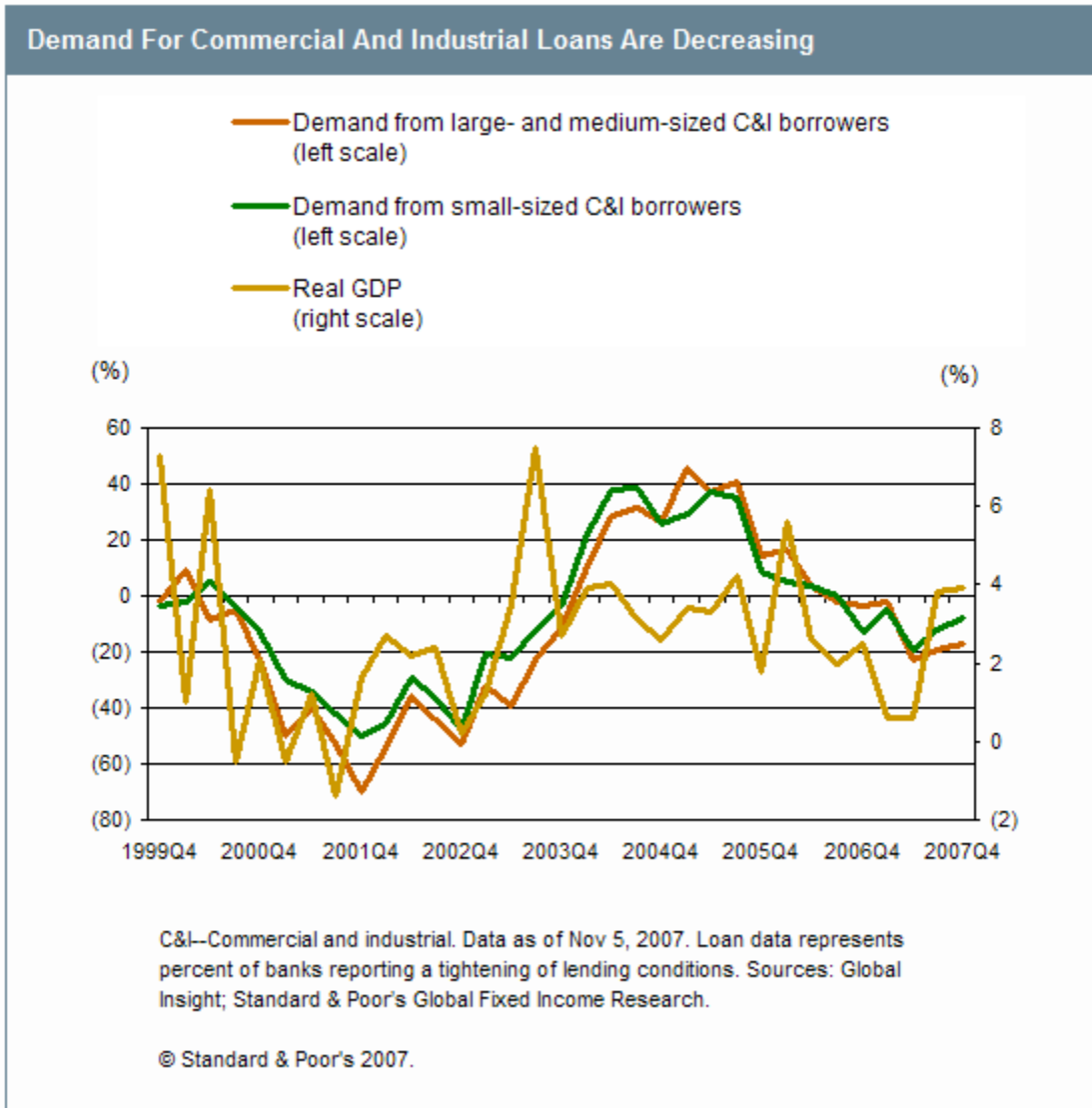
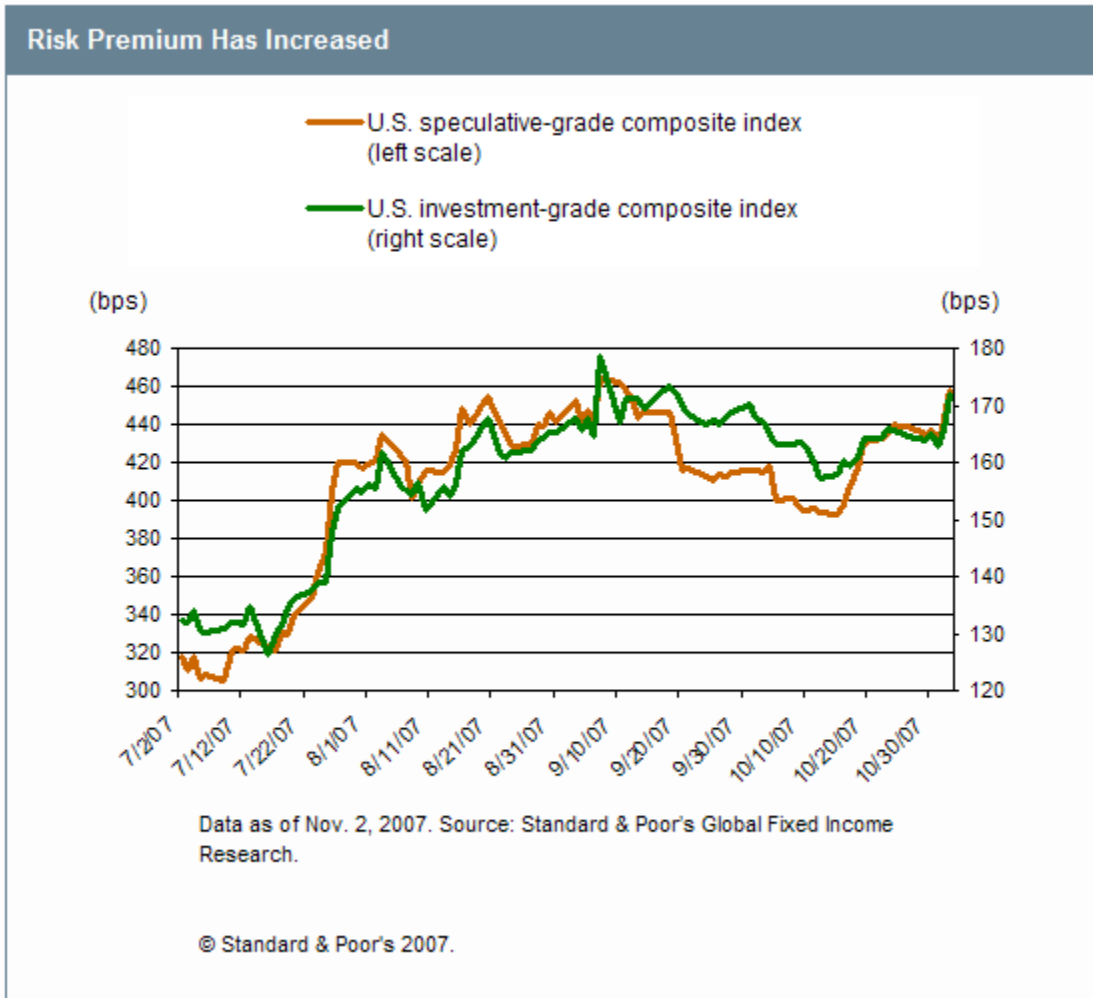


Chart 3



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