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Bank Trends

Analysis of Emerging Risks In Banking

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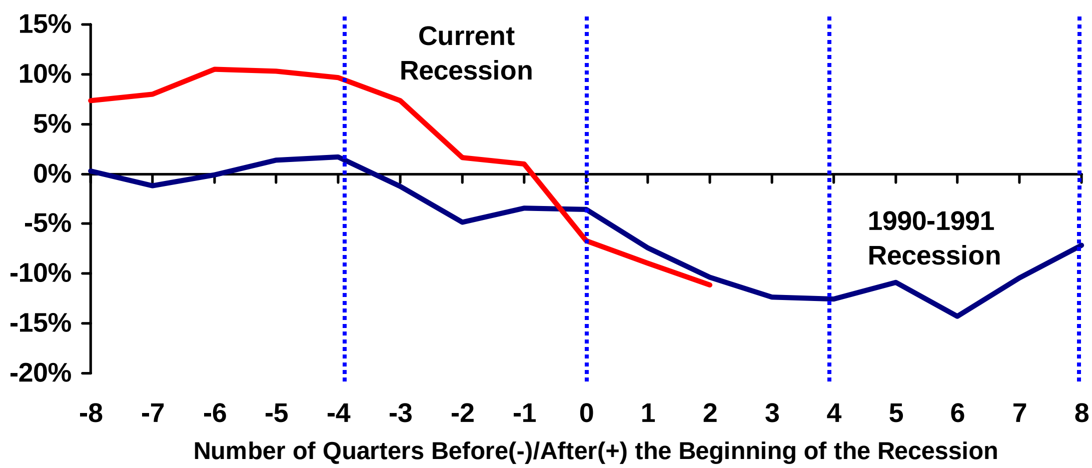
Business Credit in 2001: More Available than in Past Recessions

Commercial and industrial (C&I) lending at commercial banks declined sharply in 2001, raising some concerns about the condition of commercial credit availability during this recession. This study finds that in spite of weaker C&I lending activities, overall commercial credit remains much more available than in other recent recessions. Faced with tighter bank underwriting standards, large borrowers have been able to meet their financing needs in 2001 by tapping the capital markets. Large banking organizations, for their part, can provide access to financing through channels other than bank lending. Data show that smaller commercial borrowers continued to rely on bank credit throughout 2001. Most commercial banks remain well capitalized, which should enable them continue to provide loans to creditworthy borrowers throughout this recession.

Chart 1

C&I Loan Slowdown Paints a Misleading Picture...

Annualized Percent Growth in C&I Loans Held by Domestically Chartered Commercial Banks (Inflation-Adjusted*)



* Inflation adjusted using GDP deflator
Source: Federal Reserve Board H.8 Release (Haver Analytics)

Business Credit in 2001: More Available than in Past Recessions

While C&I Loans Have Shrunk, Total Commercial Credit Continues to Expand

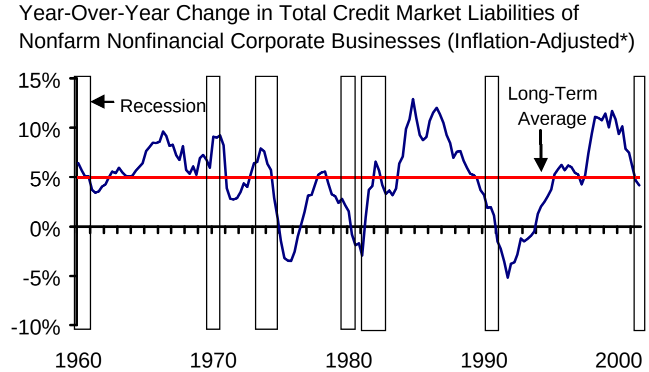
C&I loans held by commercial banks declined sharply in 2001 as the economy entered a recession. Following an annualized 9 percent decline in the third quarter of 2001, outstanding C&I loans fell further by an annualized rate of 11 percent in the fourth quarter.[1] The decline in C&I loans since the first quarter of 2001 has been even more pronounced than in the 1990-91 recession (see Chart 1).

In spite of the decline in bank C&I loans, commercial credit outstanding from all sources (total commercial credit) continued to grow throughout 2001, albeit at a slower rate.[2] This is in contrast to its trend in the last three recessions, during which commercial credit exhibited negative growth in real terms (counting the "double dip" recession of the early 1980s as one episode). For example, total credit market liabilities of nonfarm nonfinancial corporate businesses declined by 1.5 percent in real terms between the first quarter of 1990 and the first quarter of 1991 (see Chart 2).

Growth in total commercial credit slowed in 2001 following three years of rapid credit expansion, during which commercial credit grew by more than 10 percent on average. The slowdown in commercial credit in 2001 partly reflects considerably weaker demand for credit resulting from a sharp curtailment of business investment in

Chart 2

... As Business Credit Availability Remains Much Stronger than in Past Recessions



* Inflation adjusted using GDP deflator

Source: Federal Reserve Board Flow of Funds

plant, equipment and inventories. Throughout 2001, businesses shed $57 billion of nonfarm inventories, which was the largest inventory reduction since 1948. Business investment fell 3.1 percent in 2001, the first contraction since 1991.

The slowdown in commercial credit expansion has been driven primarily by a sharp decline in short-term credit, including bank loans. Commercial paper outstanding fell precipitously throughout the year despite a steady decline in yields. As discount rate spreads between higher and lower-quality commercial paper issues widened, commercial paper outstanding by domestic nonfinancial issuers fell by over 31 percent between the fourth quarter of 2000 and the fourth quarter of 2001.

A decline in short-term credit was to a large degree offset by robust growth in long-term commercial credit throughout 2001. As market interest rates remained highly favorable, corporate bonds outstanding at nonfarm nonfinancial corporate businesses grew by nearly 14 percent during the 12 months ended in the third quarter of 2001. New corporate bond issuance volume for the first nine

[1] Data from Federal Reserve Board H.8 release. The H.8 release provides data on assets and liabilities of commercial banks in the United States. The release is published on a weekly basis.

[2] Commercial credit outstanding from all sources refers to all credit market liabilities of nonfarm nonfinancial corporate businesses including commercial paper, municipal securities, corporate bonds, bank and other loans and mortgages.

months of 2001 was 26.1 percent higher than the volume for the same period in 2000.[3]

The Cost of Capital is Lower Now than in Last Recession

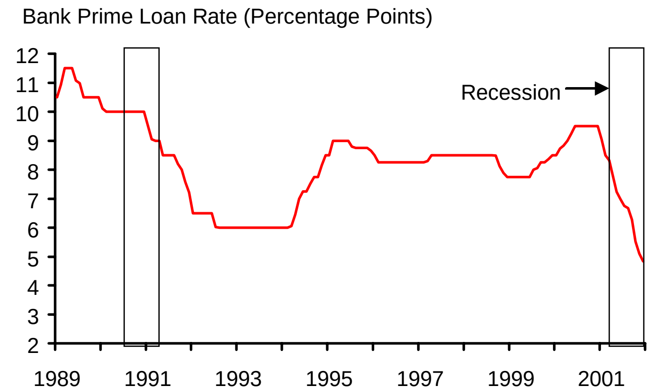
The current credit environment differs significantly from that of the early 1990s in several aspects. One of the most notable differences between the two periods is the market cost of capital. Low inflation allowed the Federal Reserve to respond aggressively to the deteriorating economic environment in 2001.[4] As a result, market interest rates fell much more rapidly in 2001 than in the last recession. This reduced the cost of new capital and allowed many corporate borrowers to refinance debt obligations at a lower rate.

As the Federal Reserve lowered the federal funds rate target eleven times in 2001, the bank prime loan rate fell from 8.3 percent in March 2001 to 4.8 percent in December 2001. By comparison, the prime rate barely moved downward in the 1990-91 recession, falling from 10 percent in July 1990 to 9 percent in March 1991 (see Chart 3).[5]

The long-term cost of capital for investment-grade bonds has also become increasingly more favorable throughout 2001. The average effective yield for investment-grade bonds fell by nearly 105 basis points between December 2000 and December 2001.[6] The average effective yield for high-yield bonds failed to decline throughout most of 2001 as a higher default rate increased the credit risk premium.

Chart 3

The Cost of Capital is Significantly Lower in This Recession than It Was in the 1990-91 Recession



Source: Federal Reserve Board

Large Borrowers Frequently Bypass Banks

Another factor differentiating the current credit environment from that of the early 1990s is greater access to the capital markets, which has enabled many businesses to diversify their sources of credit.[7] As of September 2001, nearly 55 percent of the credit market liabilities of nonfarm nonfinancial corporate businesses were in the form of commercial paper and corporate bonds, up from about 45 percent in 1990. The rising importance of capital market debt instruments in corporate finance may imply that a decline in C&I loans has less of an effect on overall credit availability than in the past, particularly for large borrowers.

Taking advantage of low interest rates, many investment-grade businesses tapped the capital markets throughout 2001 in order to meet financing needs. The volume of new nonconvertible investment-grade bonds in the first nine months of 2001 was up 15.6 percent from the same period a year earlier. Anecdotal evidence shows that many large investment-grade companies replaced short-term credits with long-term bonds throughout 2001.[8] Even the issuers of high-yield bonds were able to tap the market in 2001 although they faced a

[3] The Bond Market Association, *Research Quarterly*, November 2001.

[4] Consumer price inflation, which peaked at 3.7 percent in January 2001, has fallen throughout 2001 as the economy has slowed. By comparison, the inflation rate continued to accelerate in 1990 even as the economy slowed.

[5] However, inflation-adjusted interest rates going into this recession were slightly higher than they were in July 1990. This may have limited the positive effect of low nominal interest rates on loan demand.

[6] Data from Merrill Lynch U.S. Corporate Master Index.

[7] Johan V. Duca, "The Democratization of America's Capital Markets," Federal Reserve Bank of Dallas *Economic and Financial Review*, Second Quarter 2001.

[8] *International Capital Markets*, International Monetary Fund, August 2001.

less favorable market environment following the terrorist attacks. High-yield bond issuance nearly doubled in the first nine months of the year from the same period in 2000.[9]

C&I Loan Growth Has Been Steadier at Small Banks

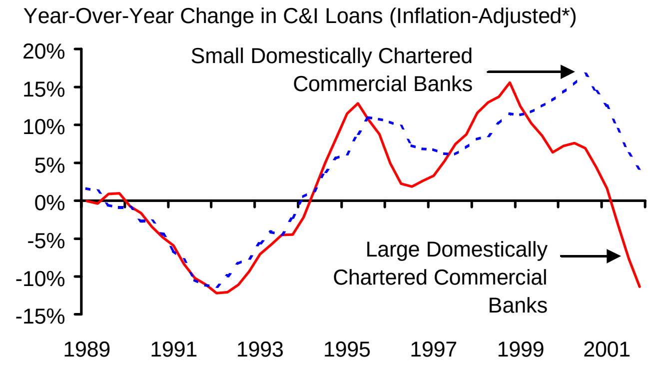
The increasing reliance of large commercial borrowers on the capital markets may also have contributed to diverging trends in C&I loan growth at large and small commercial banks in recent years. Unlike in the early 1990s, C&I loan growth at large banks has also shown greater volatility than that of small banks since the mid-1990s. This development may partly reflect differences in their customers' ability to access the capital markets, and the ability of many large banking organizations to provide financing through channels other than traditional bank lending. In addition, many large banks actively sold their loans in the secondary market in the past two years in order to reduce their credit risk exposure and increase liquidity.[10] This may have reduced the rate of growth in balance sheet C&I loans for large banks.

C&I loan growth at large commercial banks has been on a downward trend since mid-2000. C&I loans held by large commercial banks fell by over 11 percent during the 12-month period ending in the fourth quarter of 2001, continuing a trend of negative growth that began in the second quarter of 2001. This contrasts with the trend in C&I loans among small commercial banks, which continued to grow through the fourth quarter of 2001, albeit at a lower rate (see Chart 4).[11]

In general, small commercial banks tend to provide credit to smaller companies that often have more limited access to the capital markets. The data seem

Chart 4

C&I Loans Held by Large Commercial Banks Have Exhibited Greater Volatility Since the Mid-1990s



* Inflation adjusted using GDP deflator
Source: Federal Reserve Board H.8 Release (Haver Analytics)

to indicate that small businesses continued to rely on bank credit throughout the year to a greater extent than large corporate borrowers. A survey of small businesses by the National Federation of Independent Business shows that the availability of credit for small borrowers did not become significantly more restrictive in 2001.[12]

Tighter Lending Standards Have Helped Slow Loan Growth

One of the contributing factors behind large borrowers' shift away from bank credit in 2001 is likely to have been a recent tightening of lending standards by large commercial banks. A Federal Reserve survey shows that large commercial banks began to tighten lending standards for C&I loans in early-2000.[13] The net percentage of banks that

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9 The Bond Market Association, November 2001.

10 According to the Loan Pricing Corporation, the secondary trading volume for bank loans reached $117.6 billion in 2001, with distressed loans representing about 35 percent of the volume. In comparison, the secondary trading volume in 1991 was $9 billion.

11 Data from the Federal Reserve Board's H.8 release. Data for large commercial banks currently include assets and liabilities of 42 domestically chartered commercial banks, representing approximately 60 percent of the banking industry's total assets. Data for other domestically chartered commercial banks (small banks) are estimated based on weekly samples.

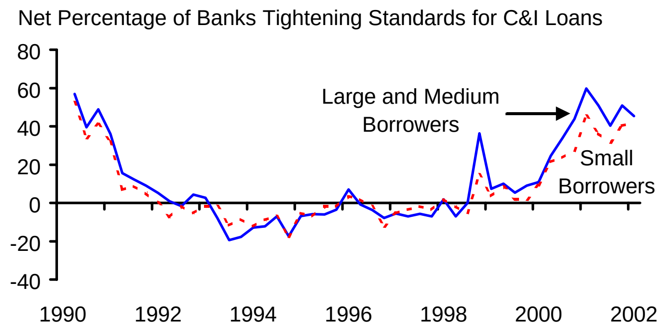
12 *Small Business Economic Trends*, National Federation of Independent Business Educational Foundation, January 2002, p.9. http://www.nfib.com/PDFs/sbet/sbet1-02.pdf

13 *The Senior Loan Officer Opinion Survey on Bank Lending Conditions* surveys about sixty large domestic banks and twenty-four U.S. branches and agencies of foreign banks on a quarterly basis. The question on lending standards for C&I loans was discontinued during the 1983-1989 period and revamped in 1990. See http://www.

reported tighter standards for C&I loans reached over 50 percent by the third quarter of 2001 (see Chart 5). Studies show that a tightening of lending standards usually lead to slower loan growth in subsequent quarters.[14]

Chart 5

Large Commercial Banks Have Tightened Standards for C&I Loans Since Mid-2000



* Federal Reserve Board's Senior Loan Officer Opinion Survey on Bank Lending Practices surveys approximately sixty large domestic banks and twenty-four U.S. branches and agencies of foreign banks.

Source: Federal Reserve Board

The tighter lending standards among large banks appear to be a reaction to deteriorating commercial credit quality. The deterioration in credit quality was particularly notable among large syndicated credits in 2001, leading to a significant increase in problem C&I loans among large banks. Results of the 2001 ***Shared National Credit*** (SNC) review show that adversely rated loans rose 93 percent from year-earlier levels to $193 billion, or 9.4 percent of total SNC commitments. [15]

Among FDIC-insured commercial banks with assets over $10 billion, noncurrent loans as a percentage of total C&I loans increased from 1.54 percent in September 2000 to 2.34 percent in September 2001. By comparison, the noncurrent C&I loan ratio for banks with assets between $100 million and $1 billion fell 4 basis points to 1.43 percent during the same period. The net charge-off rate for C&I loans during the first three quarters of 2001 was twice as high among large banks as for small banks.

Most Banks Are Well Positioned to Lend

Despite the recent tightening of lending standards, the vast majority of FDIC-insured banks currently have the financial wherewithal to expand their loan portfolios in 2002. Most importantly, banking industry is significantly better capitalized in 2001 than it was at the beginning of the last recession. As of September 2001, just one half of one percent of FDIC-insured institutions had a ratio of equity and reserves to assets of less than 6 percent. By comparison, over 10 percent of insured institutions had an equity and reserve to asset ratio of less than 6 percent as of June 1990 when the last recession began.

In the early 1990s, many banks were unable to lend because large losses in commercial real estate loans severely depressed their capital levels just as higher regulatory capital standards were implemented. As a result, C&I loans held by commercial banks fell by 13 percent between 1989 and 1992. Studies have shown that the increased sensitivity of bank lending to capital positions in the early 1990s may have resulted from the higher regulatory capital requirements, leading to an unusually restrictive lending environment.[16] However, given the strong current capital positions of most banks, regulatory capital requirements will have little, if any, effect on the ability of most banks to expand their lending in 2002.

In addition, broad deregulation over the last two decades has eliminated some regulatory constraints that limited credit availability in some of the past

federalreserve.gov/boarddocs/SnLoanSurvey/ for survey questions.

[14] Cara S. Lown, Donald P. Morgan and Sonali Rohatgi, "Listening to Loan Officers: The Impact of Commercial Credit Standards on Lending and Output." Federal Reserve Bank of New York *Economic Policy Reveiew*, 2000.

[15] The annual interagency review encompasses roughly $2.1 trillion in commercial loan syndications, covering credit commitments totaling $20 million or more that are shared between two or more supervised lending institutions.

[16] Frederick T. Furlong, "Capital Regulation and Bank Lending," Federal Reserve Bank of San Francisco *Economic Review* 3, 1992 and Joe Peek and Eric S. Rosengren, "The Capital Crunch in New England," Federal Reserve Bank of Boston *New England Economic Review*, May/June 1992. Peek and Rosengren analyzes the effect of capital positions on deposit growth between first quarter 1990 and first quarter 1991, concluding that institutions with lower capital grew more slowly during the period.

recessions. For instance, in the early 1980s, high interest rates bumped against state usury ceilings and reduced loan supply. At the same time, high market interest rates caused a significant outflow of bank deposits, which were subject to the Regulation Q limits on interest rates. These constraints had a significant effect on small banks' ability to lend. The Credit Restraint Program (CRP) of 1980, which was designed to curtail credit creation, also had a dramatic effect on bank lending.[17] Again, constraints that limited the expansion of credit by all or part of the industry during previous recessions do not appear to be a factor in the current environment.

Conclusion

Although C&I loans held by commercial banks declined in 2001, total commercial credit continued to expand. Adjusted for inflation, growth in total commercial credit during the recession that began in April 2001 has been substantially higher than during any of the past three recessions.

Much of the decline in bank C&I lending during 2001 was concentrated at large banks. Many large borrowers turned to the capital markets to take advantage of declining long-term interest rates while a number of large banking organizations actively participated in arranging capital market financing for their clients. By contrast, smaller companies continued to turn to banks for their borrowing needs and generally reported that credit remained readily available.

Although underwriting surveys indicate that bank lending standards continued to tighten during 2001, there is little evidence of a credit crunch. The overwhelming majority of banks currently report strong capital positions that provide them the means to continue lending to creditworthy borrowers. Moreover, financial deregulation has removed other constraints that have been cited as impediments to credit availability in previous recessions.

About the Author

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[17] The primary purpose of CRP was to limit loan growth, particularly consumer credit. CRP included a voluntary restraint program that limited total annual loan growth to a 6 to 9 percent range and a special deposit requirement for all lenders on increase in consumer credit (other than auto and mortgage loans), as well as changes in marginal reserve requirement on managed liabilities. Although CRP lasted less than four months, it had a dramatic effect on consumer lending. For more information on CRP, see Stacey L. Schreft, "Credit Controls: 1980," Federal Reserve Bank of Richmond *Economic Review*, November / December 1990.