Banking Watch
US

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Economic Analysis

US
Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

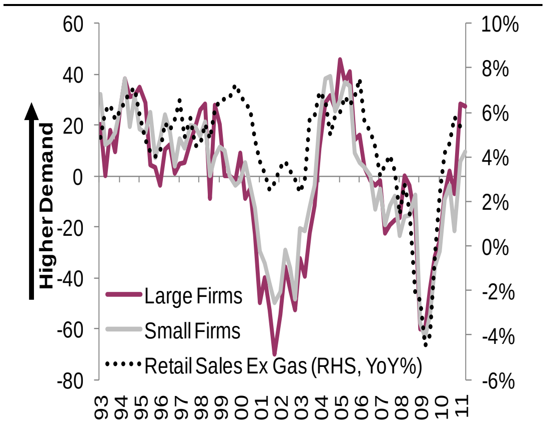
Senior Loan Officer Survey 2011Q2
Residential demand indicators worsen

- Jump in CRE demand expected to be short-lived relative to fundamentals
- Banks continue to hunt for C&I customers, competition grows for clients
- Customers report less uncertain business environment

C&I Credit: Financial firms carry on their robust competition for clients

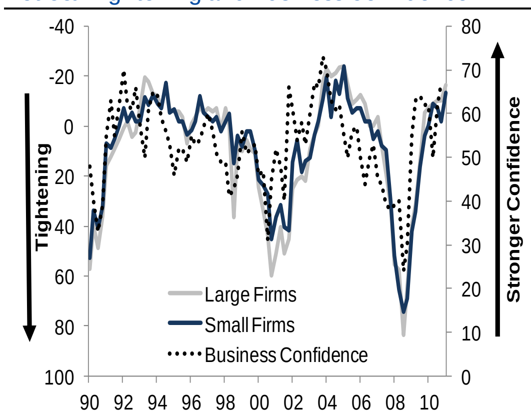
Today's release of the Federal Reserve's Senior Loan Officer Survey (SLOS) reveals that strong competition between financial firms for commercial and industrial (C&I) clients persisted in 2011. Demand for C&I loans increased for both small and large firms. Around one-third of responding institutions reported an increase in liquidity in the secondary market for C&I loans. Similar to the previous survey, a large part of the increased demand for C&I loans stems from a need to conduct mergers and acquisition rather than a reduced interest rate on riskier loans. However, it is notable that the number of banks reporting a less uncertain outlook as a motivation for easing terms increased since the last survey to 45 percent. This survey result is consistent with data on outstanding C&I loans from the Federal Reserve's H8 release, which indicated the first positive YoY growth in C&I loans outstanding since the start of the financial crisis, see our Monthly Banking Watch. The survey also addressed the credit quality of potential business borrowers, which financial firms largely characterized as improving. This is also unsurprising given the rapid recovery of the charge-off on C&I loans at commercial banks over the past few quarters. A new feature of the SLOS regarding C&I lending is coverage of loan covenants and interest rate floors. The survey indicates that a "moderate net fraction" of banks eased loan covenants. A small fraction of banks reduced their usage of interest rate floors. Around one-third of banks reported an increase in inquiries from customers for expanded lines of credit. On the whole, today's survey increases our expectation that the banking system will respond very strongly to an increase in sales and revenue by firms. Financial firms are extremely willing to extend credit to the business sector, but activity faced by commercial and industrial clients remains constrained by weak demand.

Chart 1
C&I Loan Demand and Retail Sales



Source: Federal Reserve and Haver Analytics

Chart 2
Net C&I Tightening and Business Confidence

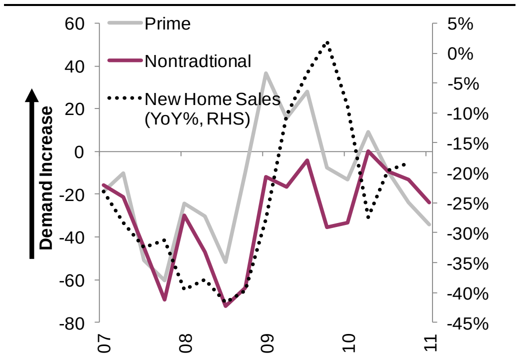


Source: Federal Reserve and The Conference Board

Real estate credit: Residential demand conditions steadily worsening

Demand for residential mortgages continued to decrease, while standards on prime loans remained largely unchanged. This is in stark contrast to the surge in demand for commercial real estate (CRE), which is at its strongest reading since the late 1990s. Our view of the unfolding demand in CRE is that it is the result of opportunistic investment at a time of vulnerability in the market segment rather than an indication of fundamental demand. Conditions in residential lending are suffering from high delinquencies, a lengthy foreclosure process, and diminished consumer interest in purchasing new homes (a largely behavioral response to otherwise favorable affordability factors).

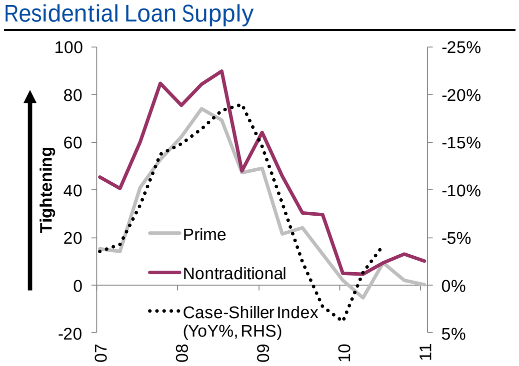
Chart 3
Residential Loan Demand Conditions



Source: Federal Reserve and Haver Analytics

A "moderate net fraction" of banks reported weakness in demand for prime and nontraditional closed-end loans and home equity lines of credit. The survey noted that demand for closed-end loans declined for three consecutive quarters. This underscores the challenge facing residential investment's possible future contribution to GDP growth over 2011 and into 2012. Consumers may continue to shun housing as an investment class until their confidence is restored in stabilized house price indices.

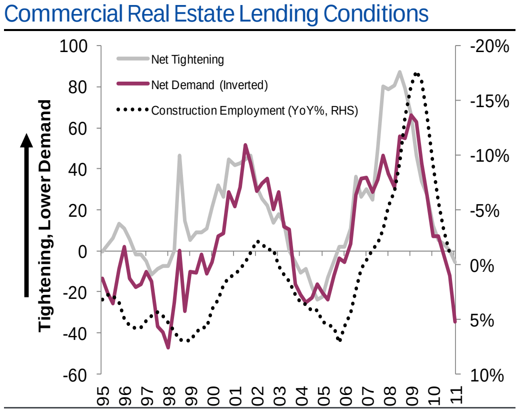
Chart 4
Residential Loan Supply



Source: Federal Reserve and Haver Analytics

Residential loan supply conditions are not changing quickly enough to positively impact demand for housing. Standards on prime residential loans and home equity lines of credit were unchanged since the last survey, while a slight tightening in nontraditional closed-end loans was largely the result of smaller banks. Foreclosures and high delinquencies continue to weigh heavily on the balance sheet of banks, although the level of other real estate owned as a percentage of assets may indicate improvement over the course of the year.

Chart 5
Commercial Real Estate Lending Conditions



Source: Federal Reserve and Haver Analytics

The CRE market currently exhibits elevated (but ameliorating) vacancy rates and a rapid snap-back in returns on CRE investments. This relief rally in returns is signaling gains from opportunistic investment as speculators circle choice CRE projects for long-run gains. We do not expect a commensurate surge in CRE lending as the picture for service employment remains ugly and overcapacity in the CRE market lingers as a threat to any precipitous breakout in lending. Multifamily properties are also performing strongly relative to other CRE.

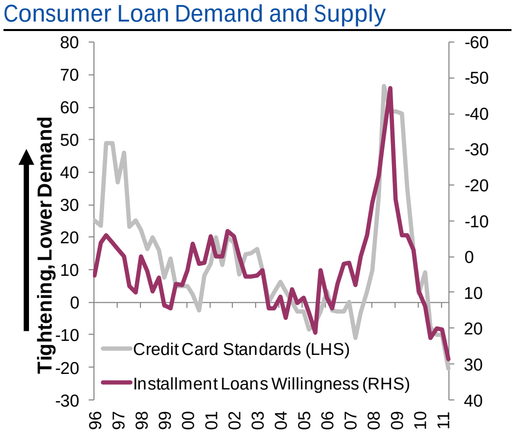
Consumer lending: Fed to keep a closer eye on auto loans

The Federal Reserve unveiled three new indicators for consumer loans in today's survey. The Fed will now monitor credit card, automobile and other consumer loans as separate categories. Although we currently only have one data point, the survey suggests that auto loans are witnessing moderate demand. Credit card and other consumer loan demand were unchanged since the last survey. The Fed noted the relative ease of obtaining an auto loan as a possible area for concern in the previous FOMC minutes. Banks are extremely willing to make consumer installment loans, as evidenced by today's highest reading in the survey since 1994. Around 20 percent of banks reported easing terms on credit card applications over the past quarter, which was the result of large banks' standards and also an improved charge-off for consumer loans.

Bottom line: the survey indicates the future response to growth will vary by segment

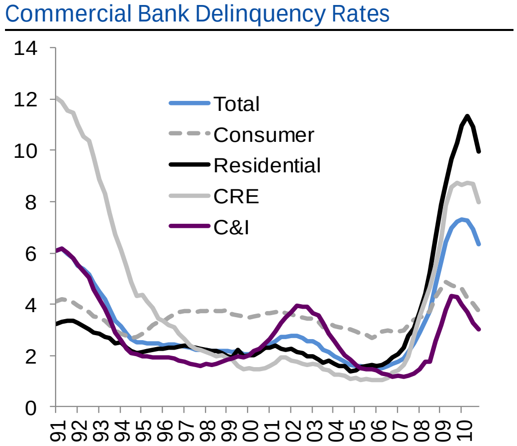
To summarize conditions for lending, C&I is moving as fast as possible given competition and a lack of sales growth in C&I clients. CRE demand improved as a result of a bottoming in fundamental CRE conditions, while residential demand has cemented a worsening trend. Consumer loan demand conditions remain mixed, with auto loans leading other categories. Supply conditions remain tight for real estate, while banks are testing the waters in credit cards and trying to challenge other market participants in C&I lending. Down the road as economic growth continues at a moderate pace, the banking system will respond most quickly to C&I lending and consumer lending, while CRE and residential will not respond as fast.

Chart 6
Consumer Loan Demand and Supply



Source: Federal Reserve and BBVA Research

Chart 7
Commercial Bank Delinquency Rates



Source: Federal Reserve