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Economics Group

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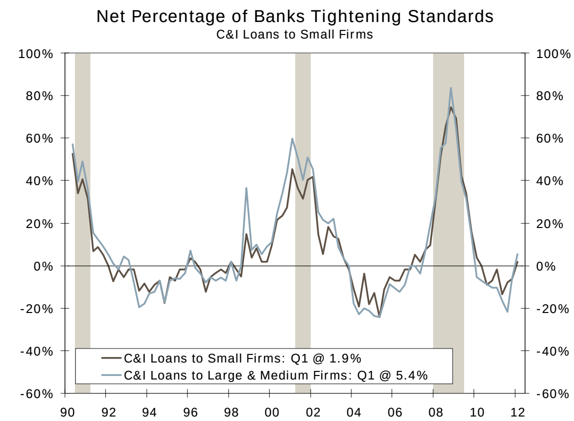
Bank Lending: Fed's Survey Suggests Support for Growth

Loan markets for both business loans and prime residential mortgages are approaching normal functioning as lending standards and demand are stabilizing. Credit markets now support sustained expansion.

Business Lending Standards: Approaching Stability

Current patterns for both lending standards and credit demand appear to be settling into a stable balance typical of an economic expansion, as evidenced by the latest Federal Reserve Senior Loan Officer Opinion Survey. As suggested in the top graph, the net percentage of banks tightening lending standards appears to have settled into a narrow range consistent with little change in these standards. This is a big positive boost to credit markets as stable lending standards provide a degree of certainty to borrowers that they can access credit when needed at terms they can count on meeting.

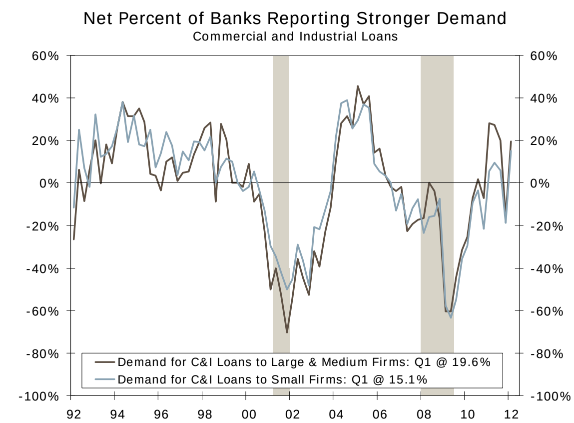
As is also clear in the graph, the sharp increase in credit standards associated with the recession reinforced the depth of the downturn and the weakness of the recovery. Now with standards stabilizing, even if slightly tighter than prior to the recession, a greater degree of certainty exists for borrowers, assuring that the expansion will continue if demand improves—and it is.



Stronger Business Demand and Narrower Spreads

For firms of all sizes, recent evidence from the Fed's survey suggests that demand has improved over the past six months (middle graph). This suggests an improved level of business confidence in the future as firms are willing to step up and borrow funds to meet anticipated future sales.

At the same time, a greater percentage of banks reported narrowing their spreads over the cost of funds on loans to large and middle-market firms. This intimates that lenders are more secure in the credit quality of borrowers and their own future costs of funds. Instead of widening profit margins on lending as demand rises, lenders are willing to lower margins in an attempt to capture market share. Again, this suggests that the economy is receiving support for continued expansion going forward.

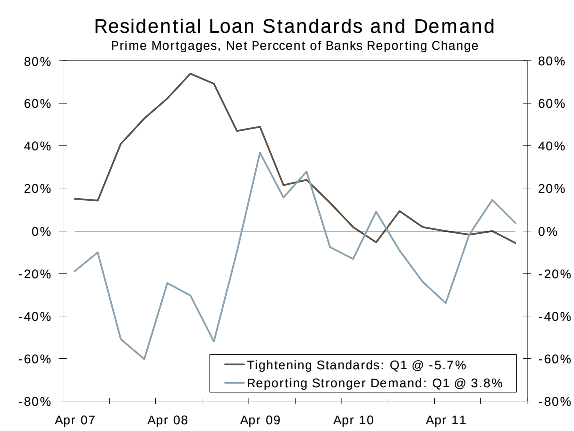


Residential Lending: Demand and Supply Settling into a Balance

One surprising pattern from the Fed's survey is near stabilization between the demand for residential loans and lending standards for prime mortgages (bottom graph). This may be surprising to some, but this pattern suggests that the prime mortgage market is near balance.

Therefore, this would suggest that the challenge in the residential credit market is with nonprime mortgages. While this may appear obvious, the fact that the prime market—which accounts for more than two-thirds of mortgage loans—has settled down suggests that the current level of interest rates, credit standards and demand fundamentals are consistent with improvement in the credit markets.

The fundamental problem then appears to be working out the legacy of the most recent housing boom without promoting the next boom.



Source: Federal Reserve Board and Wells Fargo Securities, LLC

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