FRBSF Weekly Letter

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Financial Constraints and Bank Credit

Loan growth at commercial banks slowed markedly in the second half of 1990 and remained weak through the first part of this year. To a large extent, the dropoff in lending is explained by the responses of banks and their customers to contracting output, rising unemployment, and plummeting consumer and business confidence.

A much more controversial explanation focuses on the financial condition of commercial banks and its impact on the availability of credit and on the performance of the economy. The argument is that poor loan quality, capital constraints, and a stricter regulatory environment have reduced the willingness of banks to lend. This has raised the concern that the tightening of credit conditions by banks is more than just a symptom of a slack economy, and that it could impede the recovery from the recent economic contraction.

This *Letter* examines how the financial condition of banks has affected their lending. The *Letter* also looks into how other credit intermediaries have adjusted to offset the effects of slower bank loan growth.

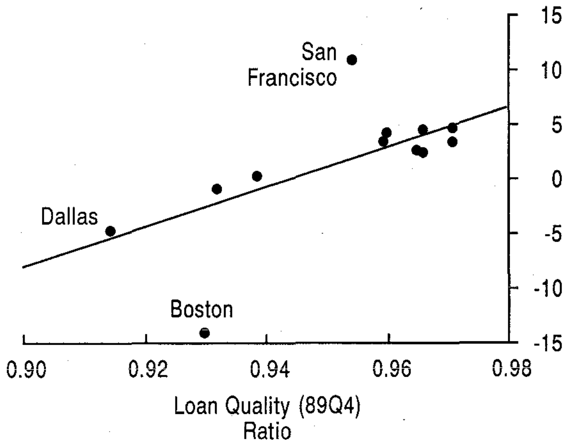
Tighter credit and economic conditions

Surveys on bank lending practices conducted by the Federal Reserve and regularly reported on by the financial press indicate that many commercial banks tightened credit standards from late 1989 through the beginning of this year. According to these surveys, the tightening of credit standards has been more prevalent for businesses than for households.

Banks give several reasons for adopting a tougher stance on lending. The primary reasons are a poor economic outlook and industry-specific problems. These factors normally would be expected to affect bank lending and so do not suggest anything unusual. However, the other reasons banks give for tighter credit standards are related to banks' own financial condition, namely, the volume of problem loans and capital constraints. These considerations do suggest that the restriction of loans by banks may not be just a reaction to the underlying health of the economy.

A look at the relationship between loan growth and loan quality for each of the twelve Federal Reserve Districts is a useful starting point to examine the effects of the financial condition of banks on their lending. Chart 1 plots the growth in total loans and leases at commercial banks in 1990 against the overall quality of loans for banks at the end of 1989. Loan quality is measured as the ratio of performing loans to total loans. The loan growth rates and the performing loan ratios are weighted averages for each District. The chart suggests that bank loan growth last year was positively related to the quality of the loan portfolios. Other factors, however, also affected loan growth in 1990. In the case of the Boston District, the extreme weakness in bank lending probably reflects the severity of the overall economic problems in the New England states, which had the country's largest percent decline in employment last year. In the case of the San Francisco District, on the other hand, direct acquisition of thrift institutions by commercial banks helped boost the overall loan figures for banks in the West.

Chart 1
Loan Quality vs. Loan Growth
By Federal Reserve District



A more formal test analyzes not only the growth rates in loans at individual banks in 1990 and the quality of loan portfolios, but also capital-to-asset ratios at the end of 1989 and employment growth rates in 1990 in each bank's region. The analysis shows that all three factors—the capital-to-asset ratio, the quality of a bank's loan portfolio, and regional employment growth—had a positive and significant effect on its lending. This would appear to support the survey evidence that the financial condition of banks and the condition of the economy affected their lending decisions.

It's important to note that the financial condition of a bank and the economic environment in which it operates may not be factors that are easy to isolate. For example, it is likely that regional differences in economic growth and industry-specific problems prior to 1990 affected both the quality of a bank's loan portfolio and the bank's views on the prospects for extending additional credit. Still, based on the evidence, we cannot rule out that there was more to sluggish bank loan growth last year than just a weak economy.

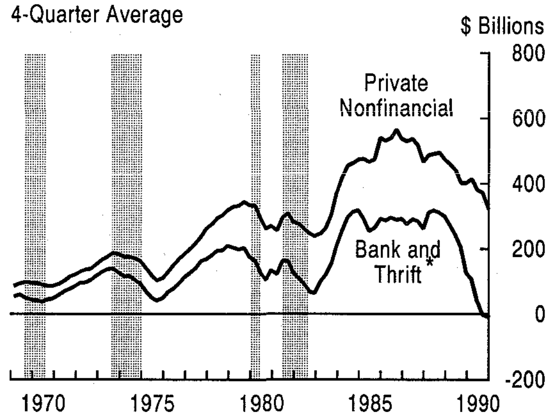
More nondepository intermediation

Some have argued that reduced bank lending will prolong the recession and stall the recovery. For example, if firms want to expand, they'll face problems getting loans from banks to finance their plans. This is a situation that would seem to be made even worse by the contraction of the thrift industry. Overall, financial assets (excluding Treasury securities) at thrifts fell by almost $120 billion last year.

But the situation may not be all that bleak if we consider not only bank and thrift lending, but other means of financial intermediation as well. Chart 2 shows that net intermediation (excluding Treasury securities) by banks and thrifts combined was nil in 1990. On the other hand, the chart also shows that the decline in the net flow of market funds to the private, nonfinancial sector was much less than the drop-off in bank and thrift intermediation. In the chart, the net flow of market funds includes the net issuance of corporate equities and of credit market instruments.

The widening of the gap between the lines in Chart 2 represents a shift to new channels of intermediation that help offset the effects of reduced bank lending. Among nondepository intermediaries, the combined net flow of funds from life insurance companies, pension funds, finance companies, and mutual funds jumped by about $97 billion in 1990 compared with 1989. The decline in intermediation by depositories also was offset by the acquisition of failed thrifts' assets by the Resolution Trust Corporation (RTC)—acquisitions that were funded in large part by Treasury debt. In effect, through the RTC the federal government acts as a financial intermediary, replacing federally insured deposits at thrifts with federally guaranteed Treasury securities.

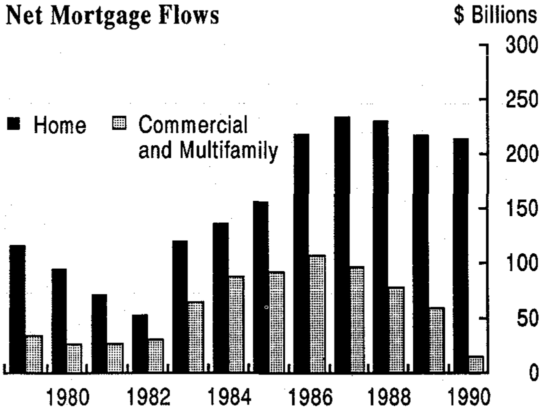
Chart 2
Net Credit Market Funds
4-Quarter Average



*Excludes Treasury securities.

Even with these changes in the channels of intermediation, credit flows to certain sectors of the economy were weak. Of particular note is the commercial real estate and development industry. As Chart 3 illustrates, combined mortgage flows to commercial and multifamily real estate last year were low not only relative to recent years, but also relative to the recession years of the early 1980s. This contrasts sharply with what has happened to net funds flowing to home mortgages. The difference may be due in part to the increasing volume of mortgage credit going through federally sponsored mortgage pools last year. These consist of pass-through securities collateralized by home mortgages and guaranteed by federally sponsored agencies. These secondary market instruments have helped to fill some of the gap in home mortgage financing left by the contraction of thrift industry. However, it is likely that the paltry flow of funds to commercial and multifamily real estate is due more to the depressed condition of these sectors, as reflected in the high vacancy rates in many parts of the country, than to unusually restrictive supply constraints.

Chart 3
Net Mortgage Flows



Adjustments to leverage

In addition to a shift in the channels of intermediation, nonfinancial corporations sharply curtailed the retirement of equity last year, thus reducing their demand for debt financing from banks and other market sources. In 1990 the net retirement of equity by nonfinancial corporations totaled about $63 billion, roughly half the value of net retirements in 1989. Even among noncorporate businesses, owners withdrew far less equity in 1990 than in 1989. This represented an increase in the reliance of these businesses on nonmarket financing, and, thus, is not reflected in the figures plotted in Chart 2.

These developments, along with the higher profile of nondepository institutions, should have helped to mute most of the adverse effects from the decline in bank and thrift intermediation on the economy as a whole. For corporations, for example, net funds raised in the market (the sum of net debt and equity) in 1990 was not much different from the level for 1989. In the case of households, the drop in net market borrowing last year was more or less in line with the slower growth in personal disposable income and movements in market interest rates.

Conclusion

Survey results and other evidence suggest that to a large extent sluggish bank loan growth observed over the past several quarters reflects a poor overall economic environment as well as problems specific to particular industries. At the same time, the financial conditions of commercial banks also appears to have contributed to tighter credit standards and to slower bank loan growth. The negative effects of the slower commercial bank growth along with those associated with the contraction of the thrift industry, however, have been dampened by shifts in intermediation patterns and other adjustments by borrowers.

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