Bank Lending Standards

Banks face a delicate trade-off in making loans. On the one hand, if they lend only to undeniably safe and secure creditors, then lending, profits, and perhaps economic growth will suffer. If they relax their standards and lend to a broader spectrum of creditors, then defaults may increase, threatening profits from the other side. Furthermore, what is appropriate at the depths of a recession may differ from what's best during a strong recovery.

One measure of how banks are responding to the challenge comes from a recently released report on bank lending standards. The Federal Deposit Insurance Corporation surveyed examiners of 2,000 banks on loan underwriting practices. Most banks reported no change in lending standards; of those that did note changes, nearly twice as many tightened as eased. The number of banks that raised their standards roughly corresponds to the number reporting above-average risk on new loans. When characterizing the risk of their entire portfolio (including old loans), most banks again noted average or below-average risk. Some states had more than the usual number of banks reporting above-average risk, notably California (38%), Louisiana (25%), and New York (24%).

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Bank Lending Standards (cont.)

Reserve's Senior Loan Officer Survey. For the broad category of business loans, banks reported almost no change in lending standards over the last three months, with a slight bias toward tightening.

Commercial real estate loans, which include construction and land development loans and loans secured by nonfarm, nonresidential land, can be risky because such projects typically do not produce an immediate return for the borrower. Banks mitigate this risk by modifying the terms of the loan contract, but some practices that have led to problems in the past remain common. Of these, the most prevalent is banks' failure to check the quality of alternative repayment sources. This concern, which showed up most often in New England, may be the source of the slight tightening in standards for a minority of commercial real estate loans.

The consumer lending side follows a broadly similar pattern, with most banks reporting little or no change in standards. About 10% of the respondent banks expressed concern over collateral quality and repayment ability, but this seems not to have filtered down into major changes in behavior. Standards for credit card loans are tightening, however, with more than a quarter of reporting banks raising standards, some considerably.