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Why No Business Loan Growth?

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Although the most recent U.S. recession officially ended two-and-a-half years ago, in November 2001, the volume of commercial and industrial (C&I) loans made by U.S. commercial banks has continued to fall. This protracted decline is similar to the pattern that followed the recession of 1990-91, when analysts concluded that borrowers faced a "credit crunch" and Fed officials commented that "financial headwinds" were restraining U.S. economic growth.

The chart plots the year-over-year growth rate of C&I loans during the 36 months before and 36 months after the ends of the 1990-91 and 2001 recessions (data for the 2001 recession are through February 2004). C&I loan volume fell for nearly three years following the end of the 1990-91 recession. Similarly, since November 2001, C&I loan volume has declined at an average annual rate of more than 6 percent.

Are the reasons for the declines in C&I loans following each recession the same? As a whole, U.S. commercial banks came out of the 1990-91 recession in weak condition, characterized by low capital-to-asset ratios, low profit rates, and high ratios of nonperforming loans to total loans. Consequently, banks had relatively little ability to increase loan volume.

U.S. banks were in much better shape at the end of the 2001 recession. Banks averaged a return on assets of 1.13 percent in 2001, as opposed to 0.52 percent in 1991. Average bank capital ratios were also higher at the end of 2001 than at the end of 1991—9.06 versus 6.74 percent—and the average nonperforming loan ratio of U.S. banks was lower at 1.41 percent versus 3.71 percent in 1991. The strength of U.S. banks coming out of the 2001 recession suggests that falling commercial loan volume has not been the result of banks' inability to lend.

In contrast to the previous post-recession experience, when the volumes of all types of bank loans declined, consumer and real estate loans have increased since the end of the 2001 recession. Real estate loan growth was especially rapid in the second half of 2002 and first half of 2003, when long-term interest rates, including mortgage rates, were falling.

Although declining long-term interest rates increased the demand for mortgage loans, they probably contributed to lower demand for business loans. Falling rates encouraged corporations to replace short-term bank loans with long-term debt issued in capital markets. Some evidence for this interpretation is reflected in the difference in C&I loan growth rates for small and large banks. Between November 2001 and February 2004, C&I loans from domestic U.S. banks fell at an average annual rate of 6.2 percent. C&I loan volume of large banks fell at a 11.0 percent rate, however, while small banks—which lend disproportionately to small firms that lack access to capital markets—experienced an average 6.5 percent *increase* in C&I loan volume. Thus, the evidence suggests that a lack of demand, rather than an inability of banks to lend, explains much of the decline in C&I loan volume since 2001. A quarterly survey of senior bank loan officers conducted by the Federal Reserve found that domestic U.S. banks saw an increase in C&I loan demand during the fourth quarter of 2003, the first such increase registered by the survey since early 2000.[1] The absence of constraints on the ability of banks to lend suggests that C&I loan volume will increase if loan demand continues to pick up. ■

[1] Board of Governors of the Federal Reserve System. January 2004 *Senior Loan Officer Opinion Survey on Bank Lending Practices*. http://www.federalreserve.gov/boarddocs/SnLoanSurvey/.

C & I Loans at Commercial Banks