National Australia Bank

December 2009

US Credit Conditions

Key trends

- The pace of deleveraging in the US economy intensified in Q2 2009, with another fall in household debt balances compounded for the first time by a reduction in business debt outstanding. Higher frequency data suggest this process continued apace in Q3. With the financial system still fragile and lending standards historically tight, system credit growth in the US is likely to be weak for some time yet.

- Private non-financial sector credit fell by 0.1% over the year to Q2 2009, the first annual decline in the history of the series stretching back to the early 1950s and down from growth of 6¾% a year earlier. Household credit continues to deteriorate, though signs that the US housing market is past its nadir should see mortgage balances stabilise in the not too distant future. In contrast the deterioration in consumer and business credit shows few signs of abating, and if anything, looks to be gathering momentum.

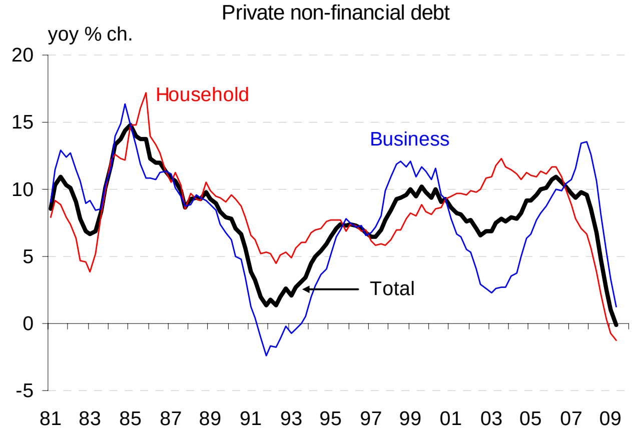
- Lending by commercial banks contracted further through Q3 and into the early part of Q4, portending further declines in the aggregate credit data. Weakness remains most acute in the commercial and industrial space, though has now spread to real estate and consumer lending.

- Data from the Federal Reserve's Senior Loan Officer Opinion Survey show that lending standards continue to tighten across all loan categories, though at the most moderate pace since the onset of the financial crisis in Q3 2007.

- Credit demand remains soft with the notable exception of prime residential loans, where a net 28% of loan officers reported stronger demand for prime residential mortgages in the three months to October, the third consecutive quarter of improved demand.

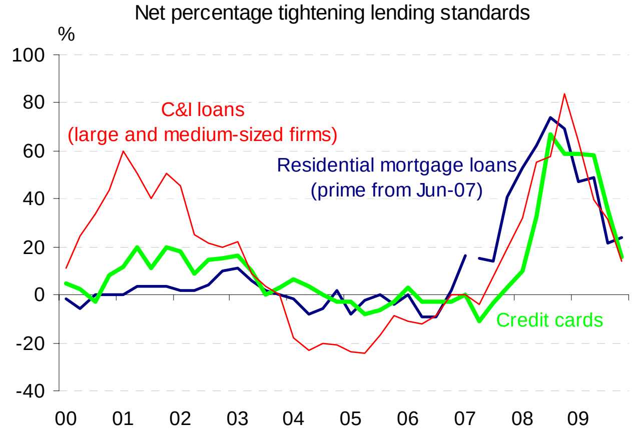
Annual credit growth has turned negative

Private non-financial debt



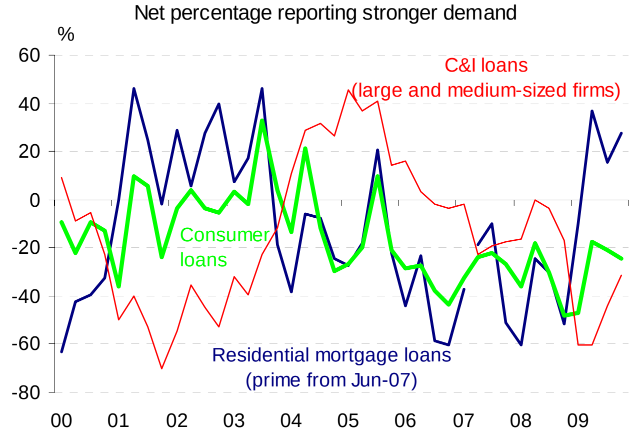
Lending standards continue to tighten

Net percentage tightening lending standards



The main bright spot is the continued improvement in demand for prime mortgages

Net percentage reporting stronger demand



Source: US Federal Reserve (Flow of Funds Accounts and Senior Loan Officer Opinion Survey)

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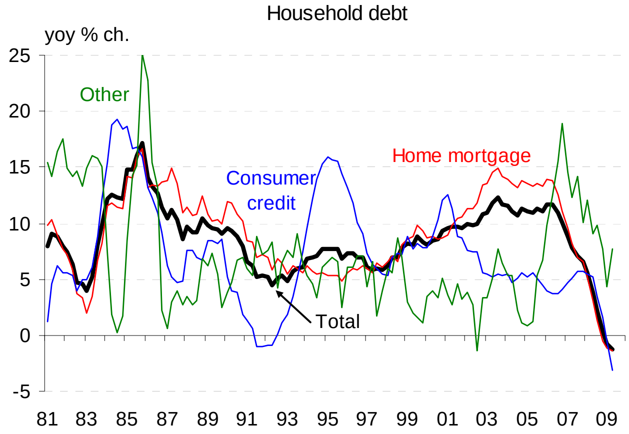
System credit growth

The pace of deleveraging in the US economy intensified in Q2 2009, with another fall in household debt balances compounded for the first time in this cycle by a reduction in business debt outstanding. Higher frequency data on consumer credit and commercial bank assets suggest this process continued apace in Q3. Though there are signs of improved demand for residential mortgages, the financial system remains fragile and lending standards are historically tight. Against this backdrop, system credit growth in the US is likely to be weak for some time yet.

Overall, private non-financial sector debt fell by 0.4% in Q2, the third successive quarterly decline and easily the most significant contraction in the current run. Over the past year private sector credit fell by 0.1%, the first annual decline in the history of the series stretching back to the early 1950s and down from growth of 6¾% a year earlier.

Household debt outstanding fell for the fourth consecutive quarter in Q2 as a combination of tight lending standards, high levels of unemployment and falling asset prices undermined the capacity and incentive for households to take out new debt. Overall household credit fell 0.4% in Q2, down slightly from the pace of decline in Q1. Over the year, credit fell by 1.2%, down from annual growth of 3.8% a year earlier.

Household credit continues to deteriorate

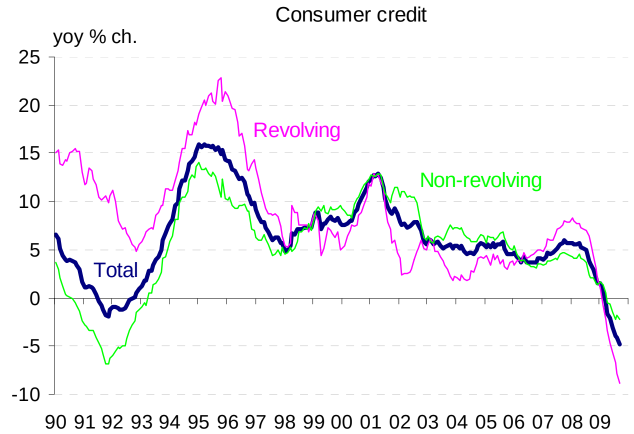


Source: US Federal Reserve (Flow of Funds Accounts)

After stabilising in Q1, home mortgage debt resumed its downward trend, falling a further 0.4% in Q2. Partial data on commercial bank real estate loans suggest that home mortgage debt continued to decline through Q3 and into the early part of Q4. Notwithstanding this, signs that the US housing market is past its nadir – with both prices and construction activity off lows earlier in the year – should see mortgage balances stabilise in the not too distant future.

In contrast, the deterioration in consumer credit has shown few signs of abating, and if anything, looks to be gathering momentum. Consumer credit fell by 1.6% in Q2, the third straight quarter of decline and down significantly from the fall of 0.9% in Q1. Higher frequency (monthly) data on consumer credit continued to deteriorate through to September, falling by 0.6% in the month and 4.8% over the year. Within this, revolving credit (largely credit cards) fell for the twelfth consecutive month in September to be 8.8% lower over the year (compared with annual growth of 5.9% a year earlier). Growth in non-revolving credit, which tends to be more stable over the cycle, fell by 0.3% in September to be 2.3% lower over the year (compared with growth of 2.1% a year earlier).

The deterioration in consumer credit shows few signs of abating



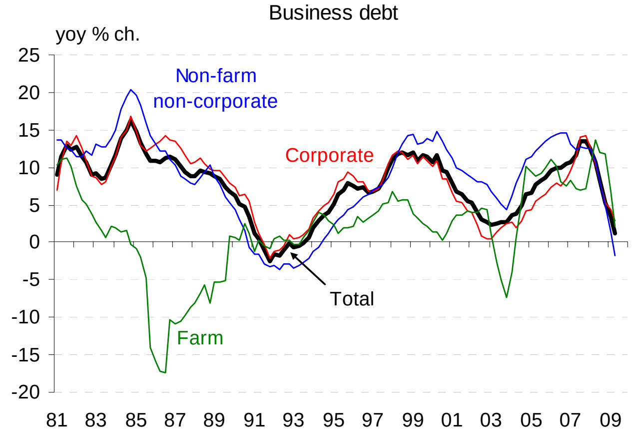
Source: US Federal Reserve (Consumer Credit)

The residual 'other' component of household debt bucked the broader trend, rising by 2.7% in Q2, though this accounts for only a little over 5% of total household credit.

Business debt outstanding fell by 0.5% in Q2, the first contraction since the early 1990s. Over the past year, credit to the business sector expanded by 1.3%, compared with annual growth of 10.7% a year earlier.

Weakness in business lending was once again concentrated in the non-corporate sector, with credit falling by 1.7% in the quarter from rates of growth between 2 and 4% per quarter leading up to the financial crisis. In annual terms, non-corporate business credit fell by 1.5% in September compared with growth of 11% a year earlier. Growth in corporate business lending has also slowed, though at a more moderate pace, growing by 0.3% in Q2 (compared with a rate of 1.7% per quarter a year earlier) to be 2.8% higher over the year (down from 10.5% annual growth in Q2 2008).

Business credit contracted in Q2, for the first time since the early 1990s



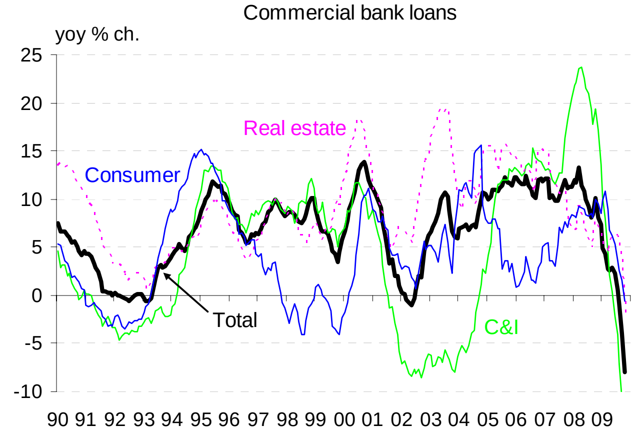
Source: US Federal Reserve (Flow of Funds Accounts)

Commercial banks

The contraction in lending by commercial banks intensified through Q3 and into the early part of Q4, portending further declines in the aggregate credit data. Total credit extended by commercial banks in the US fell by 1% in October, similar to the decline in September and some 5.3% less than at October 2008 (when bank lending was growing at an annual rate of almost 10%).

The deterioration in commercial bank lending is most acute in the commercial and industrial space, where lending has fallen for twelve consecutive months to October. Commercial and industrial lending is now 16.2% lower over the year compared with annual growth of over 19% a year earlier. More ominously, downward momentum in lending continues to build, with the three-month annual rate of growth now running at -25%. A special question in the latest Federal Reserve Senior Loan Officer Opinion Survey found that decreased originations of term loans and decreased draws in revolving credit lines were citied most often as being 'very important' in explaining the decline in commercial and industrial lending this year.

C&I ending by commercial banks has plummeted



Source: US Federal Reserve (Assets and Liabilities of Commercial Banks in the US)

Real estate lending by commercial banks has similarly deteriorated, albeit less dramatically than commercial and industrial loans. Real estate loans have now fallen for five consecutive months (to October) to be 1.8% lower over the past year. Note that this is the first time that annual growth in real estate lending by commercial banks has turned negative since records commenced in the early 1950s. All types of real estate loans – revolving home equity, other residential and commercial – have declined in recent months, though the decline in commercial real estate loans bears the most watching given broader concerns around the commercial property sector in the US. Indeed commercial property lending by commercial banks has now declined in nine of the past ten months, and by increasing magnitudes in each of the last five. While lending standards for new commercial real estate loans continue to tighten, banks appear to be accommodating existing loans. A special question in the latest Senior Loan Officer Opinion Survey found that of the commercial real estate loans on banks' books at the start of 2009 that were scheduled to mature by September 2009, the majority had been extended rather than refinanced or foreclosed.

Commercial bank consumer loans mirror trends in the aggregate consumer credit data, contracting in each of the eight months to October to be 0.7% lower over the year (down from annual growth of 10% in October 2008).

Trends in credit supply and demand

Results from the Federal Reserve's October 2009 Senior Loan Officer Opinion Survey suggest that lending standards continue to tighten across all loan categories, though at the most moderate pace since the onset of the financial crisis in Q3 2007.

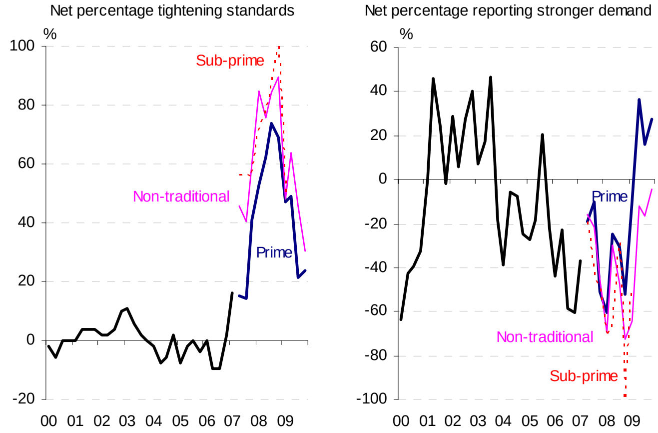
Residential mortgage loans

Lending standards for residential mortgage loans continued to tighten in the three months to October 2009 from what were already historically tight levels. For instance, while the proportion of respondents that tightened lending standards on prime loans fell in this survey, to 24% from around 50% earlier in the year, this is still significant on the heels of twelve consecutive quarters in which lending standards have been progressively tightened. A net 30% tightened lending standards for non-traditional residential loans, though the absence of lenders in this market was perhaps more telling, with only 23 of 54 banks surveyed still originating such loans. Similarly, fewer than four lenders still originate sub-prime loans, and as such, no responses were published.

In contrast, demand for mortgages has clearly turned the corner, with a net 28% of loan officers reporting stronger demand for prime residential mortgages in the three months to October, the third consecutive quarter of improved demand. For those that still originate non-traditional mortgages, only a net 4% reported weaker demand in the three months to October, suggesting that demand at the lower end of the market is close to bottoming.

Credit conditions remain tight for residential mortgage loans, though demand has picked up

Residential mortgage loans



Source: US Federal Reserve (Senior Loan Officer Opinion Survey)

Consumer loans

As with residential mortgages, lending standards for consumer loans continue to tighten from historically tight levels. A net 16% of respondents indicated tighter conditions on credit cards and 17% on other consumer loans, on top of at least two years of progressively tighter lending criteria in both categories. With respect to credit cards, around 30 to 40% of respondents tightened standards by implementing lower credit limits, widening interest rate spreads on outstanding balances, reducing the extent to which cards were granted to customers that did not meet credit scoring thresholds, and increasing minimum credit-scoring thresholds. For other consumer loans, tighter lending standards primarily manifest as increased spreads of loan rates over the cost of funds (reported by 34% of respondents).

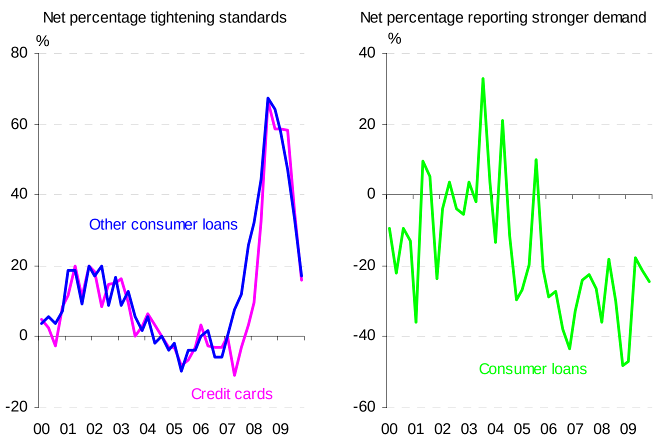
Data on the terms of lending for consumer credit at commercial banks quantify some aspects of the tightening identified in the loan officer survey. For instance, credit card interest rates at commercial banks have actually increased over the past year, to 13.71% in August 2009, from around 12% a year earlier, while interest rates on new car and personal loans are only between ¼ and ½ a percentage point lower than a year ago, despite the monetary easing that has occurred over this period.

Credit conditions in some segments of the market have eased. For instance, interest rates for new car loans at auto finance companies have fallen, to 3.42% in October from 7.09% in Q4 2008. Non-price terms have also eased over this period with the average loan maturity increasing by around 2 months, the average loan-to-valuation ratio increasing by 7ppts to 93%, and the average loan size increasing by almost $8000 to $32,223.

On net, 25% of respondents indicated weaker demand across all types of consumer loans, down slightly from recent surveys, though still indicative of a much more modest pace of deterioration in demand than in the second half of 2008.

Lending standards for consumer loans are still tightening and demand remains soft

Consumer loans



Source: US Federal Reserve (Senior Loan Officer Opinion Survey)

Commercial and industrial loans

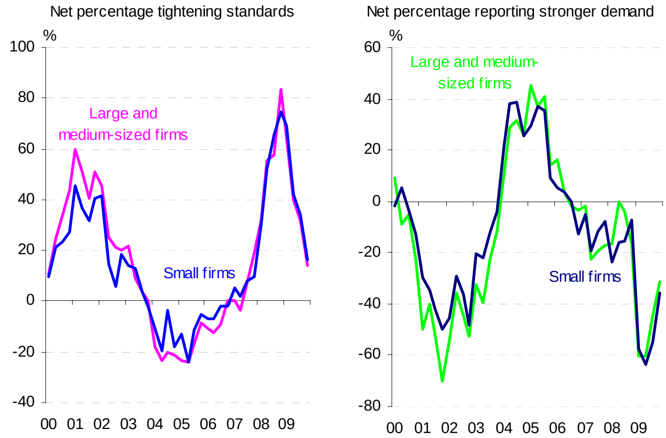
As with other categories, lending for commercial and industrial loans continues to tighten, though at a more moderate pace than in previous surveys. Around 14% of surveyed loan officers at commercial banks reported tighter lending conditions on C&I loans to large and middle-sized firms, compared with 32% last survey and over 80% at the peak in the October 2008 survey. Similarly, 16% reported tighter lending conditions to small firms compared to 34% three months ago and 75% at the peak in late 2008.

Among the various measures employed to tighten credit conditions, increased spreads of loan rates over cost of funds has been the most common (employed by 40% of respondents in the case of large and middle-sized firms and almost 50% in the case of small firms). A significant proportion of banks also reported charging higher premiums on riskier loans (around 40% for firms of all sizes) and having increased the costs of credit lines (just under 40% for firms of all sizes).

Of those that tightened lending standards for C&I loans over the three months to October, most cited a reduced tolerance for risk (cited by 88% of respondents), followed by the less favourable and more uncertain economic outlook (75%) and the worsening of industry-specific problems (68%) and as being important in the decision. Most (97%) continue to report their bank's current or expected capital and liquidity positions as being unimportant in driving tighter credit standards.

Supply and demand conditions for C&I loans remain soft

Commercial and industrial loans



Source: US Federal Reserve (Senior Loan Officer Opinion Survey)

Demand conditions for C&I loans remain difficult, with a net 32% of respondents reporting weaker demand from large and medium-sized firms and 36% for small firms in the three months to October 2009. While up slightly from the July survey, these results need to be interpreted in the context of a very low level of demand following over three years of decline for C&I loans since the July 2006 survey.

Important drivers for the commercial banks that did experience weaker loan demand include reduced customer investment in plant and equipment (reported by 92% of respondents), inventories (84%), accounts receivables (80%) and mergers and acquisitions (62.5%).

Commercial real estate loans

A net 34% of loan officers reported tightening lending standards for commercial real estate, a slight improvement on the approximately 45% of respondents having done so in the previous survey, though once again, following three years of progressive tightening. 42% of respondents reported weaker demand for CRE loans in the three months to October, a 20ppt improvement on the July result, but still weak by any objective measure.

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