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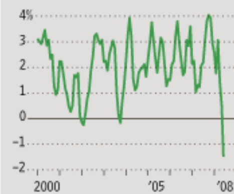
Businesses Feel Pinch Of Tighter Lending

Even Blue Chips Face More Onerous Terms; Individuals Next?

By JUSTIN LAHART
July 21, 2008; Page A3

With the credit crunch on Wall Street entering its second year, a widening array of businesses are finding it tough to get credit. And with mortgage giants Fannie Mae and Freddie Mac roiling credit markets, individuals could soon find it harder to get a loan as well.

One company feeling the strain is Chrysler Financial, the financing arm of the Big Three auto maker that was carved out of the former DaimlerChrysler AG last year. The Chrysler LLC unit has $30 billion of short-term debt due to mature in early August. And bankers, led by J.P. Morgan Chase & Co., are pushing hard to get that debt renewed.



While a deal is likely to get done, people involved in the transaction say the terms could be onerous for Chrysler Financial, pushing up borrowing costs for consumers and auto dealers that depend on it for loans. (Please see related article.)

Banks also are pulling back on the amount of rainy-day money they have been giving out to corporate clients in the form of loans called revolving-credit facilities. Retailers such as Sears Holdings Corp. and Talbots Inc. have struggled to renew revolving-credit facilities with their bankers in recent months. Other companies, including Wal-Mart Stores Inc., AT&T Inc. and American International Group Inc., have had to agree to tougher terms on such credit.

Overall, the value of credit held by banks in the second quarter shrank 1.5% from the first quarter, according to Federal Reserve data. That was the largest three-month contraction since 1948.

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These tight credit conditions are particularly worrisome because the Federal Reserve has responded aggressively since the credit crunch emerged last July. The central bank has cut interest rates seven times by a total of 3.25 percentage points.

Despite those moves, "it's hard to make the case that financial conditions are especially stimulative right now," says UBS economist James O'Sullivan.

Credit-market woes have hammered the housing market and financial companies, but until recently they didn't appear to be hurting the rest of the economy so much. The latest data suggest that might be changing.

Credit is the lifeblood of economic activity. If it continues to be hard to get, despite the Fed's efforts to keep it flowing, that could spell trouble for an economy teetering on the edge of recession.

Investors had started to believe the Fed might be forced to raise interest rates later this year to fight inflation. But with credit tight, that looks less likely now.

The Fed's overnight target rate, at just 2%, is well below the rate of inflation. But that easy-money stance isn't translating into lower borrowing costs for companies and households. Many borrowers haven't seen a drop in the rates they get charged, despite the Fed rate cuts, which began last fall. Chrysler Financial, for instance, is likely to pay more to roll over its $30 billion debt than it did a year ago.

The bear market in stocks also means that companies can't easily tap the equity market for cash.

Much of the decline in outstanding credit has been due to banks sharply reducing the amount of bonds and other debt securities held on their books, but the slowdown is apparent across all forms of lending. The heavy losses banks have taken on mortgage-related securities are forcing them raise cash levels, leading to tighter lending. Because they can't know what other problems might be lurking on their balance sheets, they are being especially cautious.

Payroll-services company Paychex Inc. has been seeing fewer new businesses starting up, which it attributes to the tighter credit climate. On a recent call with investors, Chief Financial Officer John Morphy said that Paychex itself felt the effects of banks' reluctance to lend when it went to open a line of credit.

"We're working with our No. 1 provider lead bank for the last 20 years. You can't believe what we've had to go through to get this," Mr. Morphy said. "And we're in great shape. They want dividend restrictions; they want all kinds of stuff. Now, in the end, we're going to get what we want, but it was a battle."

Fruit-and-vegetable processor Del Monte Foods Co. bought back $50 million of its stock in the second half of last year at an average price of $9.31 a share. At $7.76 a share, the stock is cheaper now, but rather than buy back more of it, the company says it is shoring up its cash holdings instead in order to reassure bond investors of its credit-worthiness.

"The credit market today is very uncertain, to say the least, and the last thing we want to do is in any way affect our credit rating," Del Monte Chief Financial Officer Dave Meyers told investors earlier this month. If Del Monte's credit rating was dropped a single notch, he suggested, the company's borrowing costs could rise by millions.

In a survey of chief financial officers at 468 U.S. companies last month, John Graham, a finance professor at Duke University's Fuqua School of Business, found that companies with low credit ratings, in particular, were seeing significantly higher credit costs and were having a hard time obtaining or renewing bank credit lines. Many companies said they were cutting back or delaying new investment plans, paring hiring plans and initiating cost-cutting programs as a result of tough credit conditions.

"When credit gets tight, money becomes more precious than ever," says Mr. Graham. "If you have it, you're not going to spend it, and if you can't get it, it affects your operations."

That applies to individuals, too. Ron Phipps, who runs Phipps Realty in Warwick, R.I., says banks are making even the most credit-worthy borrowers jump through hoops, asking for reams of documentation before granting a mortgage.

"The approach now is so hyper-risk-sensitive and labor intensive, it's very emotionally taxing," he says. "Somewhere along the way common sense has been replaced by the check-off menu."

David Stevens, who runs the mortgage operation at Long & Foster Real Estate in Fairfax, Va., worked at Freddie Mac from 1999 to 2005. He says that during his time there, the mortgage lender was never as stringent about the quality of mortgages it would accept as it is now.

With banks and other lenders cutting back, Fannie and Freddie have been "the only game in town as far as credit creation is concerned," said Goldman Sachs economist Jan Hatzius. If the mortgage giants, in an effort to raise their cash holdings, curtailed activity in the same way they did in earlier this decade in response too accounting problems, credit conditions could get oppressively tight, Mr. Hatzius says.

--Liz Rappaport contributed to this article.

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