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SETTING THE GLOBAL SCENE: A GLOBAL CREDIT CRUNCH?

Remarks by

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It is a genuine pleasure to be in this beautiful city to participate in this conference concerned with "Credit Crunches -- Their Causes and Cures." We in the United States have been challenged with a form of credit crunch over the past year and a half or so. A common definition of a credit crunch is that it is the condition which exists when the demand for credit far outstrips the capacity of the financial system to supply it. That is not the appropriate definition of the phenomenon we face in the United States today. In the United States, the demand, or need, for credit outstrips the willingness of the financial system to lend. I intend to focus mainly on our experience with that problem and what we have done to address it.

Other countries apparently face similar conditions. Otherwise we would not be holding this conference. As the lead-off speaker, I believe it is appropriate for me to offer an overview of the situation around the globe.

Global Overview

In addition to the United States, I understand that other countries, including the United Kingdom, Canada, Australia, and New Zealand have experienced economic problems which are being blamed, in part at least, on a credit crunch. Situations vary, of course, from country to country because of differing institutional policies and conditions. But in all of these cases there are certain common elements.

Economies have either moved into recession or experienced a marked slowing in growth that has been accompanied by either a decline or substantial cutback in the rate of bank credit expansion. Reduced lending caused by an economic slowdown with accompanying shrinkage of demand is not the only underlying condition. We are also experiencing a tightening of the supply of credit which tends to reinforce recessionary trends in the economy.

The tightening of the availability of credit by banks -- and in some cases by other lenders -- has taken several forms, including widening the spread between lending rates and borrowing costs and the imposition of more restrictive terms and conditions under which new loans will be made and existing loans renewed. At least in the United States, it has -- in its most extreme form -- involved banks simply backing away from making new loans at all and being reluctant to renew loans except for the most creditworthy borrowers.

Although the nature and extent of credit crunch conditions vary from country to country, two elements seem to be present in most cases. First, banks in some countries have adopted more restrictive lending standards, in part at least, in order to slow asset growth and help bring capital ratios into line with new international standards. The more important element, however, appears to have been a substantial erosion in asset quality due to a slowdown in general economic activity, to a sharp weakening in certain economic sectors, or to a combination of the two.

Whatever the case, the decline in asset quality tends to undermine capital positions not only creating or adding to difficulties in meeting capital standards, but also threatening an adverse market reaction that would raise the cost of funding. As a consequence, banks have been led to adopt tighter credit standards. Perhaps of greater importance, however, is the impact that the erosion of credit quality has on the willingness of banks to lend. After experiencing substantial losses, banks quite naturally react by tightening their lending standards in order to reduce future losses.

That, then, is the general situation in countries having problems with a credit crunch. The credit crunch in the United States, and possibly other countries, has an additional element to those I have just discussed: that is, bank supervision. I will discuss that issue shortly, but first let me review the sources of past credit crunches and the development of the current situation in the United States.

Definition and Past U.S. Experience

Credit crunches can occur for any of several reasons: First, banks themselves may have difficulty obtaining funds, either because of deposit disintermediation caused by rate ceilings or by lack of depositor confidence. Usury laws may also discourage bank lending by making loans unprofitable during periods of high inflation and high interest rates. At times, concern about the general economy or about individual industries, regions, or economic sectors can also cause banks to curtail

their lending activities. Finally, credit crunches can be created through changes in regulations or supervisory practices regarding bank lending standards or measures of capital adequacy.

Before the mid-1980's, rates that depository institutions in the United States could pay on their deposits were subject to ceilings and many states imposed usury limits on the rates that banks could charge. Since these limits were directed principally at consumers and small depositors, the housing industry was most affected when interest rates rose.

In a sense, the resulting slowdown in construction activity served as a safety valve, releasing pressure on demand and cooling the economy when it began to heat up too much. However, the rate limits could not be sustained during the late 1970's when interest rates increased sharply reflecting mounting inflationary pressures. Reacting to these conditions, the limits were phased out, and many states removed or adjusted their usury ceilings.

Current Experience

Credit crunches caused by concerns for credit quality often develop over several years and involve the interaction of a number of factors. The current slowdown in U.S. bank lending generally evolved along these lines: First, during the 1980's, the country enjoyed a long period of economic growth; indeed, the longest peacetime economic expansion in its history. Although certain sectors, such as energy and agriculture, encountered

particular problems, this favorable environment encouraged some institutions to relax their credit standards. Credit for building commercial real estate projects and for financing corporate takeovers and leveraged buyouts and other ventures was readily available. In part, banks made these loans to book profits from high fees and relatively high interest rates and, in part, because, in the euphoria of good times, they misjudged the degree of risk inherent in the loans.

By the late 1980's, however, economic growth began to slow. Certain commercial real estate markets became depressed, and many heavily indebted borrowers began to default in increasing numbers. The process became somewhat circular as these difficulties translated into higher bank loan losses. Faced with growing loan problems and weakened business prospects for their borrowers, many banks tightened their lending standards.

The slowing economy, by itself, generally reduced the number of borrowers who qualified for loans simply because of the adverse business conditions. While necessary in some cases, tighter lending standards compounded the problems of many borrowers and the already weak real estate markets.

So far this year, a number of large banks have raised significant amounts of new equity to rebuild their capital. Nevertheless, most of them have remained reluctant to finance much new economic growth and have sold assets in order to further

improve their capital ratios. During the period March 1990 to March 1991, the total assets of the 50 largest U.S. bank holding companies remained essentially unchanged. I believe that was a managed outcome related to the need to improve balance sheet values.

Quite obviously, then, it has been an interactive process. Good economic conditions encouraged a relaxation of lending standards beyond prudent limits and that produced bank asset quality problems when the economy subsequently slowed. The banks' problems, in turn, led to restrictive credit standards, which intensified the weakness in the economy.

Effect of Supervision

What I have described to this point is a process being driven by developments in the private sector and by private sector decisions. Let me now discuss the role of bank supervision. The introduction of a new risk-based capital standard, by itself, has been a contributing factor but not a major element in the tightening of bank credit in the United States. Absent the substantial losses from asset quality problems, the capital standards would probably have had little effect on the availability of credit, since the vast majority of U.S. banks already met or exceeded the new standards. The other supervisory factor -- examinations -- has been much more significant.

Along with bankers, bank examiners have seen the effect of weak economic conditions and, in the United States, have witnessed since 1980 the costly failures of more than 1,200 commercial banks with $150 billion of assets, and 900 savings and loans with over $300 billion of assets. Under these circumstances there was a natural tendency for examiners to become more pessimistic and skeptical in their evaluation of loans.

Official supervisory policies did not change, but the interpretation of existing standards and their application by examiners became much more stringent. This supervisory response served to strengthen any reluctance the banks previously had to extend new loans and, in some cases, led to a virtual cessation of new lending to some business sectors by some banks. Unfortunately, loans were sharply restricted even to creditworthy borrowers in many cases.

An example of prior lending standards and subsequent bank responses may help to illustrate the nature of the problem. As you may know, commercial real estate loans -- particularly in certain regions of the United States -- have proved to be a major element in asset quality deterioration. In some extreme cases, the banks financed 100 percent of the land and construction costs plus a cost overrun reserve, plus the interest payments until the project was completed. This questionable practice was justified in the belief that rents and real estate market values would continue to escalate. The structure of these loans, however,

tended to conceal any weakening of the market or of the borrower's condition -- often until the bank was examined or until construction was completed and the borrower could not obtain permanent financing. In many cases, the oversupply of commercial real estate made even loans based on conservative credit underwriting standards susceptible to examiner criticism as real estate values plunged.

When the current market value of the collateral dropped below the loan values, examiners often recommended or required writedowns and forced loans into nonperforming status. In many cases, these actions were appropriate, but they sometimes involved borrowers who were still servicing their loans as scheduled, giving rise to the contradictory definition "performing nonperforming loans" which has become a controversy in itself in the United States. This rigid supervisory response caused many banks to withdraw from the market and to be reluctant to refinance or renegotiate problem loans. That situation is a major element of the current credit crunch.

Policy Actions

Weak bank lending, whether influenced by supervisory actions or not, has been of considerable concern to the Federal Reserve in developing and implementing monetary policy. We believe timid lending has contributed the recent economic recession. Indeed, Chairman Greenspan has repeatedly cited the credit availability problem as "the most critical thing" confronting U.S. monetary policy. As a result, the Fed -- usually in conjunction with

other bank regulatory agencies -- has taken specific actions to reduce the effect of the credit crunch.

Monetary Policy. Monetary policy has been used progressively over the last year. The easing steps began late last summer when it became apparent that the unavailability of credit was contributing to a weakening of the economy. Subsequent easing actions were then prompted by incoming information that the economy was weakening further while inflationary pressures were abating. Concerns about credit availability were a key background element in decisions to take these actions. Since mid-1990, more accommodative open market operations and reductions in the discount rate have helped to lower the federal funds rate by more than two percentage points to about 5-1/2 percent today. In addition, the Federal Reserve reduced reserve requirements on certain deposit accounts from 3 percent to zero, in an effort specifically aimed at stimulating bank lending.

Lower interest rates and reserve requirements have reduced bank funding costs and have also tended to encourage additional lending. Lower rates obviously encourage expansion and increase the volume of loan requests, but they also enable more borrowers to qualify for the loans they want. Importantly, with lower funding costs, banks have also been able to increase their lending margins and their overall profitability. Under those conditions, banks should be more willing to lend to others.

These and other more recent monetary policy efforts appear to have achieved their basic objective. Recent signs indicate that the economy is, once again, beginning to grow. But, these efforts have not completely solved the problem. Monetary policy generally works in a macro sense and at a national market level. Economic conditions, however, vary among geographic regions and business sectors, as do credit crunch conditions. Thus, relying only on monetary policy to solve a credit crunch can lead to distortions and incomplete results. In addition to stimulating demand, we need to deal with the credit crunch in more direct ways.

Supervisory Actions

The additional steps needed are supervisory in nature. However, when the purpose is to stimulate additional lending, such supervisory -- or advisory -- efforts raise sensitive issues. Bank supervisors have the responsibility of ensuring that banks operate prudently in a safe and sound manner. Within the United States, even the term "forbearance," which refers to delaying supervisory actions in the expectation that conditions will improve, has become a discredited concept. Despite the need to end the credit crunch, supervisors should not urge _specific_ institutions to extend loans or encourage the banking industry to lend to specific sectors or regions of the economy. Those are necessarily business decisions of the lenders themselves and should not be dictated by government.

What the supervisor should do is to provide a consistent and responsible level of oversight to the industry and to communicate its policies clearly to the industry and to its own supervisory personnel. In that connection, the Federal Reserve and the other U.S. bank regulatory agencies have in the past year made special efforts to clarify their policies and operating procedures. These measures were not taken to relax the enforcement of capital standards or to overlook problem assets. Indeed, we recognized that some strengthening was needed. We did not want banks to relax conservative standards. Rather, steps were taken to offset the effect of any over-reaction on the part of supervisors that may have contributed to a credit crunch.

During the past year and a half, there has been considerable debate in the United States about whether examiners have, indeed, applied more stringent standards when evaluating loans than they had in prior years. For my part, I have little doubt that examiners have raised their standards and that this change has contributed to the credit crunch. That is also the view of the Fed as a whole and of the U.S. Treasury.

But, regardless of whether examiners have used more stringent standards, most banks have felt they have and, accordingly, have tightened their own standards -- in some cases to an excessive degree. Their continued reluctance to lend has tended to offset the stimulative effects of monetary policy and have led us to undertake exceptional measures to address the problem.

<u>March 1st Announcement</u>. Last March, the U.S. bank regulatory agencies jointly announced a series of steps designed to address the credit crunch. Specifically, the statement encouraged banks to lend to creditworthy borrowers and to work with existing borrowers who are experiencing temporary payment problems. Importantly, it stressed that both lenders and examiners should consider not only the <u>liquidation</u> value of collateral when they evaluate real estate loans, but also cash flows and other factors related to adequate debt service. This was especially critical in regions with depressed economies and thin resale markets.

The statement also urged lenders to disclose more information to the public. Enhanced disclosure, it was felt, would help by differentiating among broad groups of assets with varying degrees of risk. With less information, the investors and depositors may tend to believe the worst.

Finally, the agencies tried to encourage new lending by clarifying certain accounting practices, as well as their policies on growth by institutions that do not meet minimum capital requirements. Regarding the latter, while it is essential that depository institutions take steps to address their deficiencies, it is important that they should not do so by selling high-quality assets or by refusing to lend to sound borrowers. Such actions would in fact would be counterproductive to the goal of improving the asset quality of undercapitalized institutions.

While the interagency announcement was considered helpful, the Federal Reserve recently felt it necessary to take still further action to communicate its views to supervisory personnel by issuance of a guidance statement. This statement stressed that the evaluation of each credit should be based upon all of the fundamentals of the particular credit -- that is, the borrower's current and stabilized cash flow, earnings, and debt service capacity, financial performance, net worth, guarantees, future prospects, and other factors relevant to the borrower's ability to service and retire its debt. That is to say, consider all of the factors, not just the current market value of underlying collateral.

That procedure applies even if segments of the industry to which the borrower belongs are experiencing financial problems. This is an important point especially in the real estate industry, where some borrowers have encountered problems obtaining long-term financing and need the banks to roll over existing loans. In such circumstances, it may well be in the interest of all parties for the bank to extend new financing rather than to foreclose on the property.

Regarding asset concentrations, examiners were cautioned that they should evaluate commercial real estate loans separately from residential real estate loans when residential loan performance is not subject to similar financial risks. Further distinctions may be made within groups of real estate loans on the basis of key factors, such as the existence of firm take-out

commitments for permanent financing or reliable purchase contracts. Institutions with concentrations are expected to have or to develop policies, systems, and controls to monitor and manage their risks. However, some concentrations have been built up over many years, and both bankers and bank supervisors should realize that it will take time to reduce those exposures in an orderly way. Banks should not be forced to sell assets at fire sale prices or without adequate thought. What is critical is that an institution have a plan of action and adequate capital to protect itself while its portfolio is being restructured.

Current Conditions

At present, within the United States, interest rates have declined and economic activity generally seems to be increasing, although at a slow pace. This apparent turning of the corner should have salutary effects on both loan demand and on the banks' willingness to lend. Improved earnings will make potential borrowers more creditworthy and should also stimulate further growth. In large part, though, the credit crunch was brought on by significant asset quality problems of lending institutions that will take time to resolve.

The Federal Reserve has for many years conducted periodic surveys of senior bank lending officers in order to obtain their views on items of interest. During the past year, we have increased somewhat the frequency of these surveys and have focused on the issue of the credit crunch. Recently, the results have been moderately encouraging. Most respondents continue to

cite concerns about general and specific market conditions, but the number of banks indicating they have tightened credit standards since an earlier survey has declined.

Conditions in the Southwest -- one of the most adversely affected regions of the country -- are beginning to improve, while those in the Northeast are still weak. We see little evidence to suggest that credit conditions there have eased. At this time, we are in a delicate situation that we must continue to monitor carefully.

The United States, however, is not the only country encountering weak economic activity. Specific problems in some business sectors, and signs -- or at least the potential -- of some form of credit crunch exists in other countries worldwide. Real estate and securities markets in a number of other countries have declined in recent periods, while corporate bankruptcies have increased. Many banks have been adversely affected by these events and need to rebuild their capital. Some declines in bank lending or slowing in the growth of bank lending may be related to demand, rather than to supply factors, while others are clearly a result of the reluctance of banks to lend. But the effect of a credit crunch on economic growth is a reality and one, as we have seen, which is difficult to resolve.

Conclusion

As I have described it, a credit crunch is a transitional process. It can cause or intensify an economic downturn and may

not be easily resolved through monetary policy actions alone. The current credit crunch in the United States has been an especially worrisome and frustrating matter, although its long-term impact may be limited.

Our experience, however, has reinforced the importance of maintaining a strong banking system and one which consistently follows sound lending standards. Some bankers and bank analysts have argued that banks cannot meet higher capital standards and still offer acceptable returns. The compromised lending standards in the early 1980's were said to be due to a loss of traditional customers and to increased competition from nonbank institutions. Easier standards were necessary, it was said, to obtain fees and higher rates in order to maintain or increase loss reserves to resolve existing problem loans. The "conventional" wisdom was that banks needed to increase their leverage in order to compete.

I have two responses to those "wise" thoughts: First, as a former banker, I must question the wisdom of earning high fees and interest revenues when you only give them back -- and much more -- later in the former of high loss provisions. Second, relatively lower levels of capital for financial institutions do not necessarily provide better returns to investors. Earnings over time will be penalized for earlier errors in asset judgments, and strongly capitalized banks, on the whole, have a better record than marginally capitalized banks. Beyond that, I believe that if banks are required to maintain higher capital and

adhere to more conservative credit standards, they will relieve excessive competitive pressures in the industry and achieve more favorable lending margins. But, in the final analysis, supervisors cannot expect to impose levels of capital which are unacceptable to the market. The trick is to find a prudential level consistent with safety and soundness which is compatible with market expectations for return on investment.

In closing, credit crunches can be caused by a variety of factors, such as government-imposed price controls on financial products and weak financial conditions of banks and other financial intermediaries. They can be cured -- or avoided -- by adhering to sound and stable monetary and supervisory policies and by lenders taking a constructive approach to resolving problems of their customers.

Institutions and investors throughout the world operate more effectively and more confidently when they know the rules and when those rules are firmly applied in a consistent manner. As bank regulators and supervisors, we should not overlook the importance of those fundamentals.

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