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Remarks of
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One of the most disturbing elements of the current subpar recovery has been the extraordinary debilitation of our financial intermediation process, in general, and the seeming moribund bank loan market in particular. This is especially distressing because banks are the major, and, in many areas, almost the sole marginal suppliers of credit to small and medium sized businesses. Smaller firms are the core of entrepreneurial effort in the American economy and historically have been a key source of innovation and a major force for job creation.

Hence, it is essential that the bank loan markets be restored to a semblance of vigor if adequate financing of overall economic growth is to reemerge. The variety of forces that make up what we have been calling the credit crunch is not the only reason for the disappointing performance of the economy. There are many other significant factors affecting the economic outlook. But the state of bank loan markets certainly is a key element, and it is this, as well as some related banking issues, I should like to address tonight.

Part of the so-called credit crunch problem reflects deep-seated economic forces which government policy can only tangentially affect. Part is a reflection of the interaction of bank lending policies with those economic forces that government policies can impact somewhat. Finally, part reflects the

statutory framework under which banking labors and to which supervision and regulation must adhere. Here, of course, government generally has full control.

Doubtless, by far the greatest source of stagnant loan markets is weak demand. Both businesses and households have been actively shedding debt perceived as excessive in recent years. In the 1980s, large expected future increases in real estate prices encouraged heavy debt accumulation to finance property investments. Debt was also incurred in anticipation of continuing large increases in cash flow and income--increases that could not be sustained without rising inflation. When price increases failed to materialize, indeed, when asset prices especially for commercial real estate fell, debt became burdensome. Households and businesses accordingly embarked upon debt reduction strategies unprecedented in recent decades. Large repayments of bank loans, in part financed by heavy issuance of equity and long-term debt in the capital markets, have kept net bank loan demand in check. This process of debt shedding and balance-sheet repair is likely to persist until both businesses and households have restored their debt burdens to more comfortable levels.

To be sure, loan demand and economic activity could strengthen well before balance sheets are fully restored. It is the rate of improvement that matters. If, as balance sheets

become more comfortable, businesses and households decide to reduce their excess debt more slowly, cash flows will be diverted to purchases of goods and services, and gross and net debt issuance will rise. Easier monetary policy has facilitated this process as lowered interest rates have decreased interest burdens.

But monetary policy can only peripherally alter the perceived needs of businesses and households to strengthen balance sheets. We can encourage spreading the adjustment over a longer period and reduce the short-term impact on economic activity and loan demand, but it is difficult to alter the total size of the balance-sheet adjustments the private sector sees as necessary.

Although tepid loan demand accounts for most of the unimpressive trends in bank loans, supply factors have surely played a role as well, and lending restraint has doubtless been a factor in the weak economic environment. The decline in prices of commercial real estate held as collateral for a significant segment of bank assets induced a surge of nonperforming loans, undermining bank capital positions and threatening the franchise value of the banks. It is no wonder that, having been badly burned, lending officers retrenched rapidly. The Federal Reserve survey of senior loan officers reported that a marked tightening

of lending terms and standards on business and commercial real estate loans had begun by the second quarter of 1990.

As a consequence, a number of marginal loan applicants were turned down, who five or ten years ago would have been readily offered credit. Considering the volume of sour loans that was granted in the earlier years, arguably, this has been an unavoidable and beneficial development. However, an impressive number of worthy applicants has been rejected as banks pressed to rein in asset growth to preserve capital positions eroded by loan losses. When real estate loans became a black mark against bank credit ratings such loans were reduced, not only by write-offs but by pressing solvent borrowers to repay because they were the only ones who could. That sounds more like fear than sound banking practice.

Bankers also complain that we supervisors have so tightened examination standards that they have been forced to tighten loan underwriting standards inordinately. While I have no doubt that the complaints are somewhat exaggerated, it is hard not to suspect that there is some validity in the accusations. Human nature being what it is, it is entirely understandable and credible that examiners have become tougher in evaluating loans as the consequences of earlier lax lending standards became apparent.

A similar trend has obviously emerged as well in recent years in the legislation underlying bank supervision. The tendency to micro-manage is particularly disturbing. The Federal Deposit Insurance Corporation Improvement Act, for example, by requiring standards to limit risk in interbank credit exposures, could disrupt interbank markets and long standing banking relationships. The same legislation also imposes further restrictions on bank directors and has increased their potential liabilities. These changes, coupled with earlier laws, may add to the difficulties banks are already experiencing in attracting qualified people. Recent legislation also imposes a large number of record keeping requirements in areas such as branch closings, auditing, small business loans, and truth in savings. In addition, it requires the agencies to impose operational standards for internal controls, interest rate exposure, asset growth, compensation of banking employees, and minimum earnings and market-to-book ratios. Guidelines are also required for loan documentation and credit underwriting. Some recent legislative initiatives have endeavored to reverse some of this micro-management and we can only hope that the new Administration and the Congress will see fit to ease some of these restrictions, which are raising bank costs and discouraging lending.

Moreover, recent legislation has emphasized avoiding possible losses at banks. This is understandable, in light of

the potential for taxpayer funds being needed to bolster deposit insurance, but it has discouraged healthy as well as unhealthy risk-taking in lending decisions. The most recent thrust of legislation, and the associated supervision, has virtually eliminated the so-called character loan that had so dominated lending practices of a large number of banks to individuals and small business. If regulations require that all loans be based solely on collateral or always documented by full accounting detail, an important part of the credit granting process that calls for the banker's special expertise will be lost, to the detriment of the economy.

What then is the role of government policy in addressing the so-called credit crunch? For the longer term we need to look at the appropriate structure of regulation. Indeed, in recent years in each of the areas addressed by requirements for additional regulation, one can find many examples of abysmally poor bank management, or of regulatory judgments and decisions that should not have been made. Thus, one can understand that while the Congress was deciding to provide substantial taxpayer funding to the Federal Deposit Insurance Corporation, there was an inclination to take all necessary steps to see that these poor management practices would never recur. However, the collection of micro-management regulations that finally emerged last year in the FDICIA represents, as I

indicated in earlier presentations, an overreaction that imposes significant cost by absorbing real resources and removing desirable flexibility at our nation's banks.

On the bank supervisory front, we are going to have to find a reasonable balance between discouraging excessively risky loans and allowing some leeway for taking legitimate chances on lending opportunities. After we find this balance we are going to need to maintain it over the business cycle, an even more difficult task. We need to make certain that our examination standards remain cautious when loan demand is expanding at a speculative rate and do not become overly conservative at the other end of the cycle. This is not an easy activity. When a society is propelling asset values higher, it is very difficult to argue with bank management that the loans they are making may not be very well covered by collateral. And when collateral prices may be falling owing to forced liquidations of property, supervisors must keep their eyes on longer-term underlying values.

Another reason for tight lending practices according to some has been the added cost of making loans imposed by the Basle accord on capital standards. Some observers have argued that banks have accumulated a large volume of Treasury and agency securities in the last couple of years precisely because of their

low risk weights in those standards and not, as I argued a moment ago, largely in reaction to extremely weak demand for bank credit.

The timing of the introduction of the Basle accord, coinciding as it did with the onset of an economic slowdown, makes it difficult to disentangle the effects of slack loan demand from those of the new risk weights on changes in the composition of banks' interest-bearing assets. The implementation of risk-weighted capital requirements probably has had some balance sheet implications. Indeed, it was intended to, since it was designed to strengthen banking systems around the world by lining up capital requirements with relative credit risk in a much more sensible way than the previous rule. The old standard, for example, assigned the same amount of capital to a commercial real estate loan as to a Treasury bill.

To say the new risk weights have had some effect is one thing; it is quite another, however, to argue that they have caused the substantial increase in banks' holdings of Treasuries and agencies relative to loans over the last couple of years of weak economic growth. Rather, as I previously indicated, the decisions of borrowers to restructure balance sheets by paying down short-term debt has played a major role. Some evidence in support of the importance of the demand side explanation can be found in the fact that it has been those banks that have the

higher risk-based capital ratios that have been the largest purchasers of Treasuries. This finding is consistent with surveys of banks indicating that the major reason they have purchased Treasuries over this period has been their high relative profitability in an environment of weak loan demand and not their low risk-weights. It is also consistent with the behavior of credit unions, which also have been accumulating government securities even though they are not subject to the Basle capital standards.

The shift toward securities has also given rise to concerns that it has materially increased banks' exposure to interest rate risk (and it has also fueled demands for mark-to-market accounting procedures). It is probably true that greater interest rate risks have developed of late because securities tend to have longer maturities than bank loans. Nonetheless, one has to be careful not to exaggerate the degree of maturity mismatching. We see little shift toward longer maturities in banks' securities portfolios, and we know that government and agency securities listed as over five years in maturity generally are mortgage-backed issues whose effective maturities are considerably shorter than their stated maturities.

As regulators, we view both credit and interest rate risks as matters of concern. Indeed, we have released for comment a proposal for explicitly accounting for interest rate

risk in assessing capital adequacy. In the meantime, a critical protection against interest rate risk, and risk generally, is adequate levels of equity capital. In this connection, it is important to note that banks have substantially improved their equity capital positions over the very period during which their interest exposure likely has increased. Minimum leverage ratios imposed by supervisors have limited the extent to which banks can avoid capital constraints by shifting balance sheets toward low risk-weighted assets that might involve substantial interest rate risk. Many bankers, however, have pointed to this leverage ratio as a factor in the credit crunch, and while the evidence on that issue is mixed, we hope that new more customized techniques to adjust capital standards for interest rate risk will enable a significant reduction in, or the elimination of, the leverage ratio itself.

The large volume of securities that banks now hold as a result of these developments is one reason to suppose them ready to lend once loan demand picks up. Banks historically have used holdings of liquid securities accumulated during periods of slack loan growth to help finance accelerating credit needs once the recovery takes hold. We do not see the capital standards as standing in the way as this expansion unfolds.

Not only are banks more liquid, they are also more profitable, which gives an even stronger base from which to begin easing credit availability. Profitability has risen for a number of reasons. Banks' cost cutting efforts of the past few years are having a positive effect. A notable widening of interest margins has resulted from several factors including tighter lending terms, lower short-term interest rates, and an unusually steep yield curve. In addition, fee income is up and capital gains that have accompanied falling interest rates also have made a large contribution. This improvement in bank profitability came at a fairly crucial juncture, as it facilitated the repairing of banks' own balance sheets, putting them in a much better position to increase lending going forward.

Impressive profits, a much more receptive market for issuing new stock, and, for many banks, reduced dividends, have contributed to substantial gains in bank capital. Since the beginning of 1991, for example, the 50 largest bank holding companies alone have issued more than \$14 billion of common and preferred stock. The industry's equity is now at 7.23 percent of total assets, the highest ratio since 1966. About 98 percent of loans are at banks that meet the minimum risk-based capital standard that becomes effective at year-end, and 60 percent are at banks that meet the statutory definition for being well capitalized. In our surveys, the vast majority of banks tell us

they are no longer tightening credit terms and standards; a few have eased standards, particularly for smaller firms.

Although recent developments are supportive of the ability of the banking system to finance a continuation of the recovery, the future can be full of surprises. More banks will fail, perhaps some sizable ones. As we all know, the period after December 19th will bring an acceleration in the number of bank failures owing to new standards established by legislation. More generally, developments in the commercial real estate market and the future path of interest rates obviously will be very important here, and they cannot be predicted with any certainty. Nevertheless, I think that the views I am offering tonight on the state of the banking system are more supportable than those of some whose outlook is highly pessimistic. For example, one hears forecasts of substantial future losses in the banking system and of still-greater numbers and costs of bank failures, and claims that the commercial banking system is heading the way of the thrifts. These outcomes are not supported by the evidence we see. Forecasts such as these generally value loan portfolios on a liquidation basis and seem to couple that approach with excessively gloomy views of current and likely future market values.

In judging the soundness of our banking system, the crucial concept of market value requires definition. Owing to

market imperfections, the value of an illiquid asset depends on the time frame over which it can be sold. Such an asset priced for immediate sale or liquidation is presumably of lesser "value" than one that can be converted to cash over a one- or three-year period.

Adopting mark-to-market accounting to value all commercial bank assets tends to overlook the essential nature of commercial banking. Investment banks, which hold assets for rapid resale, and fund their investments on a day-to-day basis, properly should mark their portfolios to liquidating market values. But commercial banks choose to create and hold illiquid assets. This is the competitive reason for banks' existence and their special expertise. It is how they add value to the economy. As a consequence, bank loans are commonly tailored to meet customers' individual needs, reflect claims on borrowers that typically are not well known, and require specific analysis for a proper evaluation. Banks often have special and unique relationships with their borrowers that permit them to analyze and value a given loan differently than would someone else. As a result, loans--which comprise roughly 60 percent of a typical bank's balance sheet--generally do not fit easily into standard packages that are easily priced. It was in fact precisely recognition of the highly illiquid nature of bank loans that

provided the original justification for the Federal Reserve's discount window.

Applying liquidating values to instruments not meant to be liquidated prior to maturity is a misapplication of accounting principles. Those principles are supposed to measure the success or failure of particular business strategies. The commercial bank's primary business strategy is to make illiquid loans. The lack of any real headway in developing a cash market for commercial loans and the absence of a futures market for such instruments is explained by the uniqueness of any particular commercial loan.

In the absence of clear external market valuations, banks have traditionally established valuation reserves to reduce reported loan values by the amount of expected loss. These reserves are established by each bank based upon its own experiences, an assessment of current and prospective conditions, and a judgment of the general collectibility and risk-exposure of its loans. Such reserves, in effect, simulate the appropriate market valuation for loans, that is, at maturity. To be sure, reserve levels are constantly under adjustment to ensure net book values are moving into line with this concept of market value. In the current environment, it seems likely that provisioning, while presumably on a downtrend, will remain distinctly positive for the foreseeable future.

The stock market provides its own comprehensive assessment of the value of a bank's business. While the market's opinion can change quickly, it is useful to consider. In recent periods market valuations have generally been firm. Stock prices of the 50 largest banking companies, for example, reached their recent low-points about two years ago, when the group was selling at an average price near 90 percent of book value. Today, stock markets place a value on these companies at nearly one and one-half times the amount that their financial statements show, although a few are valued at about 75 percent of book value. Obviously, market participants are aware of the value of loans as they appear on the books of a bank and form judgments about their ultimate contribution to the market value of the bank itself.

Finally, although many problems remain before one can conclude that our banking system has fully weathered the storm of recent years, it certainly appears in sufficiently reasonable shape to assist in the financing of a sustained expansion in economic activity. But it would be a mistake not to recognize that the remnants of past mistakes will continue to plague the financial system and the economy for some time.

Fortunately, the credit crunch, which has been so debilitating to the economic performance in this country over the past two to three years, has shown no evidence of worsening in recent months and may finally be retreating. At least this is

the implication of some stirring in the loan markets in recent weeks. But elements will remain to restrain economic growth if we do not remove unnecessary regulatory burdens from our banking system. Not only must we counter the pendulum's swing to excessive regulation but we must look to expanding the capabilities of banking by allowing interstate branching and securities powers. This will foster restoration of bank loan markets so crucially important not only to the nation's financial system but to its economy overall.