# THE QUANTITY AND QUALITY OF BANK LOANS

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Conference for Examiners
of
The First Federal Deposit Insurance District
Boston, Massachusetts
February 15, 1950

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When Mr. Barlow invited me to appear before you today, I was very pleased to accept because it provides me with an excellent opportunity to learn more about the important work you examiners do. Ever since I joined the staff of the Corporation, I have felt that closer contact with members of the Examination Division and especially its field staff would be most appropriate.

The Division of Research and Statistics devotes quite a lot of time to the collection and tabulation of information with respect to the quantity and quality of bank loans. Some of our most valuable tabulations on the quality of bank loans are obtained from your reports of examination.

As you probably know, not all of the 1949 reports have been completely reviewed. Our tabulations for 1949 are, therefore, not yet complete. On the basis of the information we have, however, the proportion of substandard loans to total loans seems to be increasing in District 1. This is a continuation of the trend that has been operating in recent years.

So far we have tabulated the reports of 248 banks in District 1, somewhat over one-half the total number examined in 1948. These banks had only about two-fifths the total loans held by District 1 banks in 1948, suggesting that some of the larger banks are not included as yet in the tabulations. This exclusion of the larger banks, I hardly need tell you, seriously limits our ability to draw any firm conclusions from the figures. They do show, however, a rather striking increase in the ratio of substandard loans to total loans. For all banks in District 1 the ratio in 1948 was 1.1 percent; for the banks so far tabulated in 1949 it is 1.7 percent.

For all banks throughout the country, our preliminary figures indicate about the same ratio of substandard loans in 1949 as in 1948. That is, about 1.3 percent. It might be presumed that the banks included in the preliminary figures constitute roughly comparable samples for District 1 and the entire nation. In that event, the increasing trend of substandard loans in District 1 is significant. It would agree also with what we know generally about the relatively greater decline in business and employment in District 1 during 1949.

In view of the preliminary nature of the data for 1949, we hesitate to make any detailed analysis of them. For such breakdowns as the distribution of substandard loans by class of bank we must use earlier and complete figures. In 1948, as we can see from the chart, the total value of loans of nonmember banks was only one-fifth as large as total loans in national banks. However, the volume of substandard loans in nonmember banks was two-thirds that of national banks. The ratio of substandard loans to total loans was 2.9 percent in our banks compared with 0.9 percent in national banks and 0.6 percent in State member banks. In other words, our banks in District 1 have about three times the dollar volume of substandard loans per $100 of total loans as national banks, and five times as much as State member banks.

Just what might be responsible for these differences is an open field for conjecture. The fact that our banks are on the average smaller banks is no doubt a factor. It is often thought that smaller banks are more responsive to community needs; the personal equation enters more intimately into their operations. Very likely operators of small banks do not take the precautions necessary to make their loans appear standard, that are taken by larger banks. Looking at it from the supervisory standpoint, it is possible that examiners from the different agencies differ in their application of examination standards. It is no news to you to be told that FDIC examiners are considered "tougher", that their examinations are regarded as more rigorous. That, I fancy, is not because you are necessarily "tough guys", but because the FDIC has, because of its insurance liability, a more immediate concern for the soundness of banks.

We could compare this picture for District 1 with the picture for the nation as a whole and find about the same relative situation. We could examine the data in other districts, by size of bank, or over a period of time to see if there were any clear-cut trends. We like to think that the aggregate statistics can give a good general idea of what is going on in the field of banking. But when we want to find out why a certain development has taken place, or what would be promising or appropriate to do about it, we almost always have to go back to the original examination reports.

I was always amazed how an examiner, who had spent only a few days out of the year in our bank, was able to ferret out and describe the most important developments in its condition. My reading of your examination reports left me with the same impression. It is uncanny the way you put your finger on the sore spots.

The comments on loans were particularly interesting. It was obvious that a good deal of your time was devoted to the note case, and to conferences with bank officials on problem loans. I particularly noticed that comments on the loans listed for special mention almost always included specific recommendations for placing the loan on a sounder basis. But when it came to overdue loans, or classified loans, suggestions for remedial action were often lacking.

Now it is hard, and probably dangerous to generalize, so I want to give you a few examples of what I have in mind. A loan to the Blank Bros.

Radio Company was classified in Group III. The comments included a condensed balance sheet of the radio company and stated that the company might be forced into bankruptcy because of an adverse court decision. Since this company was obviously in trouble, it was hard to see why the loan wasn't classified "Loss" rather than "Doubtful". Perhaps there was some indication as to how this loan might be worked out. Perhaps an income statement would show the company enjoyed good profits but the balance sheet was temporarily weak because of non-recurring court costs and the judgment against the company. I don't know, but I did feel that here was a case where the examiner could perform a real service by exploring possible lines of remedial action right on the spot with officials of the bank.

Next is a case of a substandard loan which is probably typical of many others. This installment loan to Blank Restaurant, Inc. was three payments in arrears and classified as substandard. This loan was originally written several years earlier and had been renewed almost yearly at substantially the same amount. The loan was supported by chattel mortgages and assignment of capital stock in the corporation which controlled the liquor license. Apparently the business was in a good location and could be readily sold to liquidate the loan, but the bank would like to salvage something for other creditors to retain their good will.

I read into this case the fairly common situation of an otherwise good business in the hands of weak or incompetent management. These cases can drag along in times of full employment but are vulnerable to adverse conditions.

In this case the bank was trying to dispose of the loan, had threatened foreclosure, but was understandably reluctant to press foreclosure proceedings.

Perhaps there were ways to strengthen the present management. If the business was basically sound, perhaps management consultants, or an executive with demonstrated ability in this field could be employed on a part-time basis to put this enterprise on its feet.

This bank, with total footings of about $5 million, had eleven restaurant loans amounting to $120,000 classified as substandard. These loans ranged from $2,000 to $22,000 with monthly payments from $100 to $800. Six more loans to eating places totaling $80,000 were listed for special mention. Thus, a total of $200,000 in loans to eating and drinking places was listed in the report of examination; I wonder how many additional loans to this service industry were made by this bank but not written up in the report.

Finally, I noticed an example of a substandard mortgage loan which I hope is an exceptional case. This substantial loan was supported by a first lien on a hotel in a city far removed from the location of the bank. The most interesting feature of this loan was the fact that the underlying property had been reappraised recently to justify a new loan 100 percent larger than the earlier loan on the same property. Three-fourths of the current loan was classified substandard and one-fourth was classified doubtful. In his comments the examiner stated, "The practice of increasing loans on real estate on basis of inflated prices is dangerous". I am sure all will agree that this is a most unhealthy situation. I frankly don't know what could be done in this particular case, but I do know that careful consideration of possible remedial action by the examiner would be most welcome.

Comments on all important classified loans might well contain brief statements showing first, the causes of the current difficulty, and second, possible lines for remedial action. This would help reviewers of examination reports in adding "meat" to the "bare bones" of statistics on classified loans. And I daresay both the bank and the borrower would appreciate your best constructive efforts along these lines.

There is another part of the examination report which I should like to discuss with you. That is Item 10 on page 13 which reads as follows: "If errors were noted in any Call or Earnings and Dividends Report requested and submitted since last examination, were supervisory agencies notified according to instructions and banks advised of corrections?" Your manual or "black book" outlines the procedure to be followed in checking condition and earnings reports.

It is an understatement when I say that this subject is of major importance to us. Far too many errors exist in call reports rendered by the reporting banks, thus causing unnecessary correspondence and work on the part of the respondents as well as on our staff in Washington. A year ago we corresponded with 1,700, or 25 percent of the banks--so far this year we have had to write to banks about 16 percent of the reports submitted as of December 31, 1949. In addition, many adjustments are made in our offices without correspondence. I believe you will all agree with me that this situation is deplorable.

We have attempted to educate the reporting banks during the past 15 years by sending out detailed instructions and by corresponding on the errors which are made. Although some progress has been made, we find it most difficult to obtain correction of errors through letters from Washington. It seems that there are numerous bankers who are not schooled in accounting, and apparently they do not read or digest the instructions and correspondence which are distributed. We realize that people are not infallible.

Some years ago we wrote to a banker concerning errors on his earnings report--the reply was as follows--

"If we have made any errors please correct same or give us instructions as to do so. We want the insurance and are willing to pay for same."

To give you a further idea of the caliber of the respondents let me take a few moments of your time to read a couple of letters on the humorous side.

"The sheets you sent us to be replied to on the back are enclosed, with pencil memoranda of what we think might explain the errors we made, and suffice for amendments.

"The writer has never had much opportunity to learn about accounting, and confesses to be kind of dumb on the subject. In the 47 years in the country banking business the main thing studied was to learn a good note from a bad one, and even this knowledge is not perfectly efficient yet.

"I send you two year-end statements printed. They show the capital accounts after we got through muddling with it, and the trouble with us was we did not know how to put this stuff on your blanks.

"If these penciled notations on the backs of your letter will suffice, please mail the letter back to us and we will write them out in type and sign them.

"If they do not suit, please take a form in each case and fix up what you want us to sign, and mail to us and we will sign it.

"If this would not be acceptable to you, send everything back, and we will take them up to your Atlanta office and ask them to show us how.

"I assure you we regret very much sending these reports in with errors. It is trouble for you that you ought not to have to contend with, and is embarrassing to us. I wish the forms were easy for us, but they are not. This is not your fault at all. It is all ours, and we do most humbly offer you our sincere apologies."

Another banker, to whom we wrote regarding his call report, replied as follows:

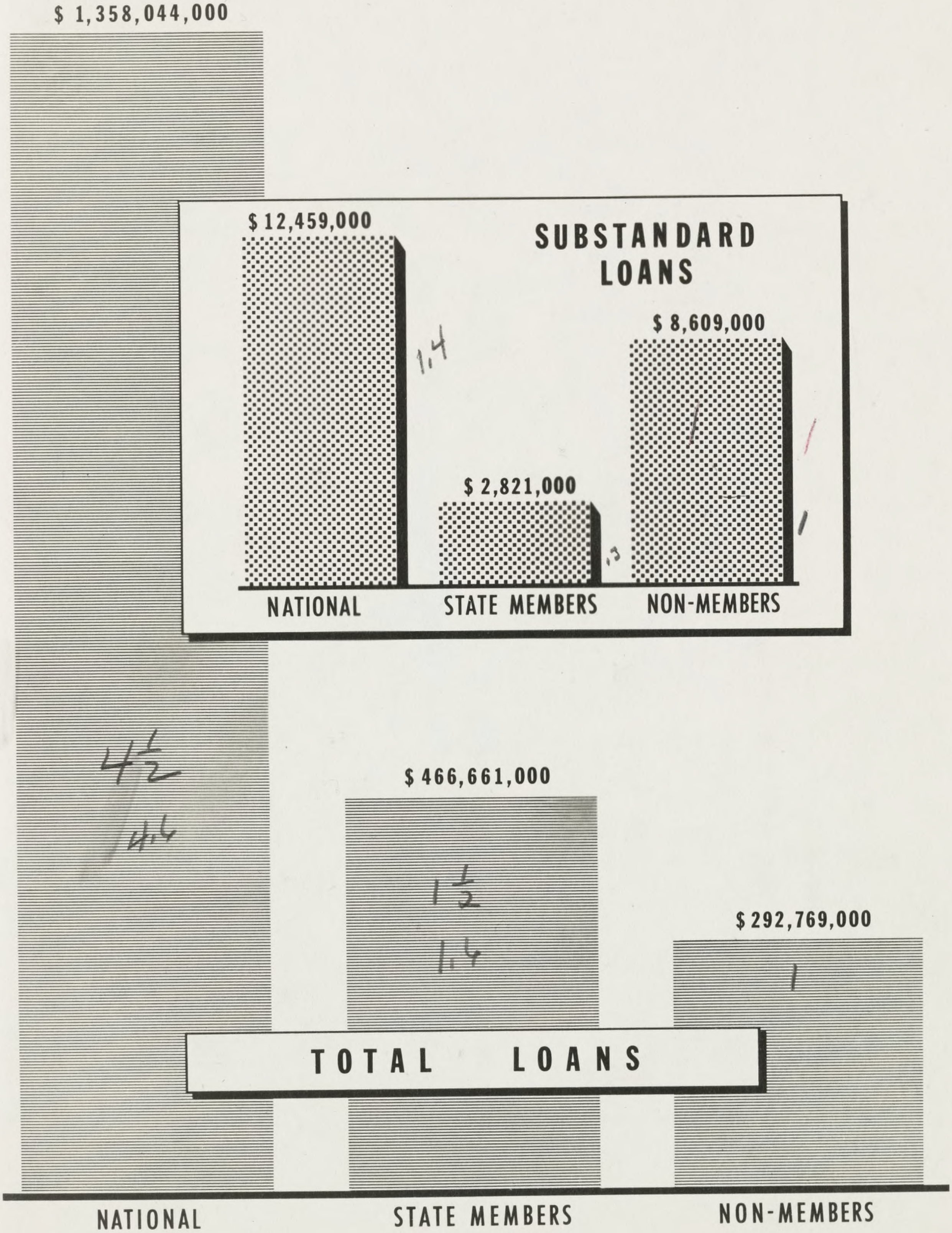
"As requested on the reverse side we reply to your questions. Since you say it is your idea that we have classified our Loans wrongfully, then it would imply that you sitting in a nice 'Air conditioned' building know more about our business than we do here. So may we suggest that if you do not like our classification, then you are welcome to come down and do it yourself to your own satisfaction.

> "We do not have any time, or help to set up any new fangled 'STATISTICAL BUREAU' which is not worth a Tinker's damn to any one. And if that is all you have to do, you had better resign for the Good of the Country and get back on the Farm to raising more Corn and Hogs and then help the poor Starving AMERICAN CITIZENS to have a fair and decent living. Perhaps they might then get enough Lard to grease their Beans and Cabbages."

I might say at this point that the situation is not as serious in the New England States as in some other parts of the country which I might mention.

The solution to this problem rests almost entirely with you men in the field. The Division of Research and Statistics is helpless without your support. We therefore earnestly solicit your cooperation. We ask that you check both the report of condition and the report of earnings and dividends carefully and when errors occur have a thorough discussion with the officer responsible for the preparation of the reports. We have found in numerous instances that Item 10 on page 13 of the examination report indicates that the call reports are correct or are satisfactory when actually discrepancies of a serious nature exist--such as total capital accounts at the end of a calendar year on the earnings report not agreeing with the amount shown for the same date on page 4 of the examination report. Your cooperation will be very much appreciated.

# EXAMINERS APPRAISAL OF LOANS
# INSURED COMMERCIAL BANKS, DISTRICT 1 · 1948

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