

For Release on Delivery

Approximately 12:00 noon  
Eastern Standard Time,  
Friday, March 19, 1965)

LENDING STANDARDS AND THE QUALITY OF CREDIT

Remarks of C. Canby Balderston,  
Vice Chairman,  
Board of Governors of the Federal Reserve System,  
Before the ABA Monetary Conference,  
in Princeton, New Jersey,  
on Friday, March 19, 1965

(Governor J. Dewey Daane delivered  
this speech for Governor Balderston  
in his absence.)

LENDING STANDARDS AND THE QUALITY OF CREDIT

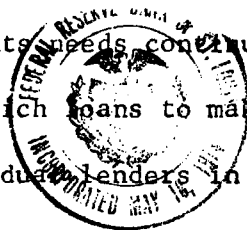
I shall not discuss the volume of total debt except to observe: first, that private debt has been increasing much faster than public debt; and second, that, despite the nearly sixfold expansion of private debt since the end of World War II, its current ratio to GNP is still below comparable ratios reached in 1912, 1922 and 1929.

Nor shall I discuss the mixture of private debt except to remark that between 1945 and 1964, consumer debt increased 13 times and residential mortgage debt nearly 11 times. In short, these types rose about twice as fast as all forms of private debt taken together.

Finally, I shall not argue whether lending, to be sound, requires that the borrower possess adequate equity in the collateral. Experimentation with signature loans, credit cards, and the financing of travel without down payments makes one wary of being dogmatic about the degree of risk involved in lending even where the equity is thin or nonexistent.

Rather I shall turn to the perennial concern of lenders with measurement of the overall quality of the credit they are advancing. Scattered failures of banks and other financial institutions as well as other evidence of unsound financial practices cannot help but be disquieting when viewed against the broader backdrop of continuing reports that loan standards are lower. While the ultimate indicators of doubtful credit quality--loan losses, delinquencies, and foreclosures--have remained relatively small, their rise during a period of general economic expansion suggests that the quality of credit arrangements needs continuing and careful attention.

Decisions as to which loans to make and on what terms are, of course, the responsibility of individual lenders in an essentially free economy like



LIBRARY

ours. Within the broad loan standards established by statute and by supervisory authorities, the individual lender is in a better position to judge the credit standing of his borrowers than governmental authorities; he is also frequently able to make a more realistic appraisal of loan collateral. Reasoning from this truism, many economists argue that the determination of lending standards should be left wholly to the competitive interplay of market forces. As they see it, unfettered competition among lenders will operate to insure an optimum allocation of loan funds among borrowers, and the risk of loss will provide an effective discipline on lender judgments. They argue that lenders who are foolish will be forced out of business, and their misfortunes will serve in turn to impress other lenders with the wisdom of prudent financial management.

This doctrine is admittedly appealing. At times, however, the cost of these lessons of experience affects not only the marginal few assumed by the doctrine, but many other lenders and borrowers as well. They, like Government officials, are subject to waves of optimism and pessimism. For these reasons, it gives one pause to hear lenders reporting now that loan standards are being relaxed, precisely because of the intensity of competition among different types of lending institutions.

Unfortunately, United States financial history is replete with episodes in which aggressive lender competition during periods of economic expansion led to euphoric judgments about underlying collateral values and about the long-term ability of borrowers to pay debt-service charges. Inevitably these earlier periods of overexuberance culminated in moments of truth in which asset values were generally adjusted downward. On some

of these occasions the shift in credit climate itself triggered a corollary decline in economic activity; on others, economic activity turned down first, but then initiated an adjustment in the credit climate which further aggravated the economic decline. Much of the concern expressed in financial circles about present tendencies in credit standards undoubtedly reflects the propensity to reason by analogy from this past.

Of course these past episodes appear today as extremes that occurred at times when the financial system did not possess its present underlying structural strength. Nonetheless, this earlier history is a useful reminder of the perverse impact which cyclical downturns can exert on credit arrangements, not only those of a marginal character but also many credits previously thought to be of unquestioned quality.

This persistent and proper concern poses two logical questions: first, how can one measure the extent to which credit quality has in fact been changing; and second, how does one ascertain the point at which any broad trend toward greater liberality in loan characteristics is becoming unsound? These questions are, of course, fundamental to lenders. They are also important to the Federal Reserve. Close attention to lending standards at individual banks is crucial to successful exercise of the Federal Reserve supervisory responsibility. Also, in the implementation of general monetary policy, domestic economic activity is more vulnerable to contraction when the underlying credit structure is weak.

Unfortunately, changing trends in credit quality are difficult to measure. In theory, one might conclude that it is deteriorating if an increasing volume of loans is being made on which there is a noticeable risk of borrower default and ultimate loss to the lender. But in practice

lender risk has many dimensions that are difficult to quantify. For example, one key consideration in judging the quality of a loan portfolio is the economic climate likely to prevail during the period when the loans are outstanding.

Statistics on loan delinquencies, foreclosures, and losses are ultimate measures of lender risk--after the fact. Moreover, they show only a small part of the total credit iceberg. By themselves they tell us little about the chances that other loans outstanding may also get into trouble. To obtain an idea of the relative quality of other credits, two types of additional information would be needed. First, would be statistics showing the prevailing characteristics of representative loans actually being made currently; second, would be quality bench marks against which current statistics could be judged. While such bench marks would necessarily have to stem from past experience, they would also need to reflect the changing structure and stability of the economy. Ideally, good historical bench marks would make it possible--assuming continuance of relatively stable economic growth--to estimate the increased delinquency and loss experience likely to flow from any general lowering of present standards.

Practical development of these two types of information is a tall order indeed. Current data on changes in average loan terms--such as the contract rate, loan-value ratio, and maturity--are not complete measures of the relative riskiness of new loans being made. Full documentation of the prevailing quality of new loans would need to show whether any liberalization of terms had been balanced either by an improvement in the quality of borrowers and collateral, or by higher interest returns. Moreover, any judgment of total portfolio quality for individual lenders would need to

consider whether such lenders were balancing new loans of greater risk with new high quality assets.

The particular information on loan characteristics which would need to be collected would, of course, vary according to the type of credit in question. Thus, information on the income, employment status, other liabilities, and assets of borrowers would be particularly important in the analysis of consumer credit; whereas data on the location and structure, as well as the price and income prospects of different types of properties would be more important in the analysis of mortgage credit. Statistical sampling for such series would also have to make some allowance for geographic differences, since the averaging of regional loan standards into overall national series might tend to obscure important local divergences.

A substantial amount of current information is already being collected, both publicly and privately, as to the terms and other risk characteristics of different types of credit. In fact, a number of useful analytical studies have been made, or are underway. The National Bureau of Economic Research, in particular, has taken the lead. However, most of the available statistics on loan terms and characteristics are collected as separate series for each characteristic and are presented in the form of national or regional averages. This does not permit systematic analysis of relationships within the matrix of loan characteristics, nor does it permit meaningful correlation of their changes with loss experience.

The second need to be met, namely the lack of quality bench marks, is no less a challenge. Of course most lenders have general rules-of-thumb which they use in practice to identify loans that are of questionable soundness.

But these customary rules are not typically based on any systematic quantitative analysis of past experience. Moreover, those that are rooted in the past often relate to considerably earlier periods of history, like the 1920's and 1930's when institutional arrangements were substantially different from what they are today. Much of our present uneasiness about credit quality seems to stem from the fact that today's lenders--many of whom have been active only since World War II--believe they can justifiably allow current standards to fall below the old rules-of-thumb. But as yet they have no new, sufficiently tested bench marks to indicate when the risk of loss on today's more liberal loan characteristics overbalances the need to venture.

To me, one of the most intriguing experiments in this field is a pilot survey recently initiated by the staff of the Federal Reserve Board in cooperation with those who extend consumer credit. This pilot project gets data from a selected group of banks, listing the key terms and borrower characteristics of individual consumer loans. Data are being collected for a sample of new consumer loans made on a given day or days each month, as well as for old loans closed out, loans written off, and applications rejected on the same days. Loan characteristics surveyed include contract terms--such as rate, maturity, and downpayment; security pledged; and data bearing on the credit worthiness of the borrower. The latter include borrower income, employment, other debt obligations, bank deposits, and years of residence at the present and previous address.

When the characteristics of new loans are compared with those for old loans being closed out, one can see whether or not lending standards are being liberalized. Moreover, data on loans written off should in time

permit some correlation of such characteristics with loss experiences.

Ultimately the Board hopes to expand this survey to a representative national sample, but so far the project is being used only to test methodology. The sample is as yet too small to produce statistically significant results. The data already collected do suggest, however, that a shift in a single loan and borrower characteristic, such as an increase in the number of loans with maturities over 36 months, gives a very incomplete picture of changing credit quality because of offsetting changes in other quality elements.

Absent more public or private surveys of this type in other credit sectors, our general measures of credit quality will remain fragmentary, and will force continued reliance on the impressionistic judgments of lenders and bank examiners. It has been said that, barring collusion, no lender ever knowingly makes a bad loan; it just becomes bad afterward. The chief culprit responsible for turning good loans to bad in the past has, of course, been general economic deflation. To a considerable extent recent relaxation of lending standards clearly reflects the view that our economy has become less vulnerable to deflation. Success in achieving an active rate of future economic growth without serious depression will obviously be of prime importance in determining the ultimate quality of the credit now being extended.

In conclusion, many lenders seem to me to be taking a more prudent look at the risks attaching to the credit extensions they are being pressed to make because of the current growth in savings. All the while continued good business has been aiding those who so desired to improve their portfolio quality. In closing with a note of optimism, I am not assuming that all



the real estate, accounts receivable, and consumer loans now being made will in fact be paid off. I am merely expressing gratification that I sense a lively awareness of the need for balance and proper proportion between risk and the desire for yield. But only the future holds the answer as to whether this balance is, in fact, being maintained.