

RESEARCH LIBRARY  
Please on delivery  
10:30 A.M. EDT  
Federal Reserve Bank  
June 6, 1990  
of St. Louis

Statement by

John P. LaWare

Member, Board of Governors of the Federal Reserve System

before the

Committee on Small Business

U.S. House of Representatives

June 6, 1990

I am pleased to be here on behalf of the Board of Governors to discuss credit availability to small businesses. The Board recognizes the important role played by small firms and commercial enterprises in providing jobs and fostering economic growth. We also recognize the responsibilities of commercial banks as major suppliers of credit to the business sector and, in particular, to many small businesses that lack the diversified funding sources of larger ones. One of the Federal Reserve's principal objectives in its capacity as a bank supervisory agency is to promote a sound, competitive, and innovative banking system--a system that can effectively provide credit and other important banking services within the context of a strong and stable economy.

In my remarks today I would first like to review what the relevant data suggest about the availability of credit in the economy. Then, I will address the supervisory role and objectives of the Federal Reserve and briefly discuss concerns that the supervisory or examination process, itself, may be contributing to reduced credit for certain sectors or regions of the country. At the outset, I would point out that a slowdown in lending in certain markets seems entirely warranted given current economic conditions and the need for some lenders to strengthen

underwriting standards in light of higher levels of loan losses.

#### General availability of credit

Historically, commercial banks have played a key role in financing economic growth, and obviously, they still do. In this regard, there has been much concern of late about the availability of bank credit, especially for particular sectors and regions. As I will discuss in a moment, there are clearly pockets of slowing business activity which are affecting both large and small firms. In response, banks have tightened terms and cut back lending in those sectors. The effects are most dramatic for commercial real estate and merger-related types of transactions, and it seems likely that activity in both of these areas is being affected to some extent.

Tighter terms also are evident in lending to small- and medium-sized businesses. Still, there is little evidence of a widespread over-reaction to changing conditions--an over-reaction that could materially worsen the situation for these firms. Bank credit growth has slowed in recent months, but on-balance, it appears that the economy's credit needs are being met.

Let me review the evidence more closely.

Aggregate statistics show that the flow of credit through banks to businesses and households slowed during the first five months of this year from the pace in 1989. Weak real

estate markets, especially in the construction and commercial areas, have contributed to this decline. The softness reflects a combination of factors related to overbuilding, high prices in some areas, a perceived slowing of the economy, and to specific market conditions. In some overbuilt areas--notably New England and the southwest--mortgage credit quality has deteriorated markedly as reflected in high delinquency rates and rising loan charge-offs.

In this environment, banks should be taking a more cautious approach, and recent surveys indicate that they are. Most commonly, banks have strengthened their lending criteria, for example, by lowering their maximum loan to value ratios on construction loans, requiring more collateral, and imposing stricter covenants on loans. Many also have curtailed lending on income-producing properties; about 80 percent of the respondents to a recent Federal Reserve survey of senior lending officers indicated that they had tightened lending for commercial office buildings.

In contrast to commercial real estate lending, banks do not appear to have pulled back from the single family housing market. While slowing some in response to higher interest rates, the growth of residential mortgage credit seems to have been reasonably maintained. Existing home sales this year are not much changed from last year's average, and spreads between home mortgage rates and other market rates such as those on government bonds are currently

narrow by historical standards, despite the contraction in residential lending at thrifts. The development of the mortgage-backed securities market has undoubtedly eased much of the pressure we might otherwise have felt in this market because of the problems of the thrifts by making it possible for other investors to readily fill the void.

In other areas, the most notable cutbacks have been in lending either to finance mergers and acquisitions or to defend against them. This decline reflects greater caution on the part of lenders as well as a reassessment by corporations of the benefits of restructuring in view of the problems in certain sectors and the recent difficulties of some highly leveraged borrowers. I view that slowdown as appropriate in these circumstances.

Other business lending--that is, lending unrelated to real estate or mergers--also has slowed since year-end. However, our survey suggests that this decline is related mostly to reduced credit demands, presumably caused by a slower economy. Those banks that indicated they were taking steps to tighten credit most often cited as reasons their concerns about the general economy or the prospects for particular industries, followed by concerns with the quality of their loan portfolios. Regulatory pressures also were mentioned, but less frequently.

A recent survey of small businesses conducted by the National Federation of Independent Businesses found less borrowing by small firms, but supported the view that during

the first quarter these firms had no unusual difficulty obtaining the credit they sought. Complaints about credit stringency in the NFIB survey remain well below the number registered during 1980-81. These results seem broadly consistent with our own survey, in which most banks reported "somewhat" rather than "much" tighter lending terms.

There are some notable exceptions to this picture. In New England, commercial bank loans fell in the first quarter by more than 1.0 percent, after adjusting for loan sales and charge-offs. This decline followed an extended period of rapid growth and lends credence to the many anecdotal stories of credit restraint in that area.

On balance, aggregate measures of credit flows, while slowing, do not show evidence of a significant change in credit availability. We recognize, however, that to the extent terms and conditions of lending have changed, they would be expected to show through to aggregate measures of credit flows with a lag. The Federal Reserve, of course, will continue to monitor the credit markets carefully.

### Supervisory role

It is important to point out here that the tightening of credit standards that has occurred so far is appropriate from the point of view of macroeconomic stability, as well as from a supervisory perspective, if the purpose is to correct for past deficiencies or to accommodate a slower, more sustainable pace of economic

growth. Nevertheless, some have argued that the activities of bank examiners have contributed to a tightening of credit. The Federal Reserve would, of course, be concerned if the examination process resulted in an unwarranted decline in lending to creditworthy borrowers or for projects that are economically or financially sound. To address that point, I would now like to discuss briefly the Federal Reserve's supervisory activities and objectives.

The Federal Reserve has long had the view that frequent on-site examinations based on an evaluation of asset quality are central to a strong supervisory process. That approach is founded on the knowledge that credit losses have almost always been the principal cause of commercial bank failures. Accordingly, a key function of the examiners is to evaluate credits and ensure that assets are reflected in the financial statements of the banks at appropriate values. Without performing that review, examiners cannot evaluate the underlying adequacy of a bank's capital or the real profitability and solvency of its business. Such a review is also necessary to identify problems in a timely fashion and to encourage appropriate corrective actions before the problems reach a more serious stage.

When evaluating credits, examiners consider the adequacy of a borrower's cashflow, the value of any collateral, the existence of guarantees, and a variety of other factors, importantly including changes in market conditions. They review credit files containing appraisals

and customer financial statements and make judgments about the nature of any expected loss. Much depends on the skill of the examiner, the information available to the bank, and the procedures used to evaluate market conditions. Loans that involve specific weaknesses or deficiencies that could jeopardize repayment or loans that involve the distinct possibility of loss are subject to examiner criticism. Such loans would generally include those that are based upon cashflow projections or collateral values not supported by current market conditions.

Examiners also evaluate loan administration and underwriting standards and internal risk control systems of the banks. Our experience suggests that these standards and controls have declined at some institutions, or at least have not kept pace with the rising risks associated with certain lending activities. One of the goals of supervision is to encourage such institutions to take appropriate steps to strengthen their internal procedures. In the context of commercial lending, such steps might include requiring higher levels of borrower net worth, obtaining additional collateral or guarantees, applying more intense scrutiny to the creditworthiness of prospective borrowers, and placing greater emphasis on the adequacy of the borrower's net income and cashflow.

In carrying out their responsibilities, examiners do not attempt to allocate credit or tell bankers not to lend. That is not an examiner's role, nor is it the role of



the regulatory agencies. Bankers, themselves, must determine what loans to make in recognition of their responsibilities to operate prudently while meeting legitimate credit needs of their communities.

Regulatory reviews should not cause bankers to stop lending to creditworthy borrowers or to refuse to work in a constructive fashion with borrowers who are attempting to strengthen their financial positions. Banks should frequently reassess their lending and credit review procedures, especially when economic conditions change, to ensure that their lending decisions are sound. They must also, however, work with their customers to resolve problems and to permit new and emerging companies to grow. That is in their own long-term interest and that of their communities.

During recent months, the media have carried numerous stories about problems that small to medium-sized businesses have had lately in getting or renewing their loans. Some companies have reported that they were required to provide more collateral than they had to in the past or were turned away altogether. Others have claimed that their banks dishonored prior commitments to lend, leaving construction projects unfinished.

While such cases no-doubt exist, as a former banker, I do not believe that bankers normally deny loans to customers that they believe are creditworthy. It is certainly not good banking to do so. Most banks simply

spend too much time and money building customer relationships to do that. Rather, as our survey evidence confirms, banks have tightened credit standards in view of softening real estate markets, a less favorable economic outlook for certain sectors, increased business risks and, in some cases, rising levels of problem loans and loan losses. Undoubtedly, concerns about potential regulatory actions, or perceptions about the impact of examinations on other institutions, also have played a role in fostering a more cautious attitude toward extending credit in certain situations. Nevertheless, as I have suggested, I believe that strengthened lending standards are a reasonable and appropriate response to the economic and business conditions facing many banking organizations.

While the Federal Reserve has not changed its examination standards, examiners must apply these standards, using their own experiences and skills, in the current environment. We must recognize that an examiner's assessment of loans involves a measure of judgment and that this judgment may sometimes differ from that of bank management. Nevertheless, bankers and examiners have the common objective of ensuring that problem credits are identified and that underwriting and lending standards are prudent. Banks are subject to losses; that goes with lending funds. They have the responsibility, though, to use their funds wisely in order to serve their communities

appropriately, protect the safety of customer deposits, and minimize undue risks to the deposit insurance system.

Current problems in real estate markets may be traced in part to earlier trends in credit flows. Until recently, real estate in most parts of the country has enjoyed strong growth and strong support from commercial banks. In the past four years, for example, commercial bank lending secured by nonfarm/nonresidential properties (in large part commercial office buildings) increased 123 percent and total real estate loans virtually doubled. By comparison, total bank loans grew by only 34 percent, and bank assets by less than that.

This increased real estate lending, combined with the lending activities of the savings and loans, has led to excessive office capacity in many markets throughout the country. In 1980, for example, downtown office vacancy rates in major cities averaged less than 4 percent nationwide. Currently, the average is more than 16 percent. In parts of the northeast and southwest vacancy rates are much higher than that. Many banks which previously financed only the construction phase now find themselves providing medium-term financing after construction is completed because long-term investors cannot be found.

We should also recognize that a number of institutions need to strengthen their capital positions. That includes some banks in New England, where examinations have revealed large losses and other asset problems. Faced

with a generally weak market for issuing new securities, banks there and elsewhere have decided to meet their capital requirements at least partly by curtailing new lending and selling assets.

Although reduced lending may disproportionately affect small firms with no resort to money markets or businesses without a proven credit history, it is important that regulators continue to maintain and enforce their standards, including minimum capital requirements. The thrift situation demonstrates all too vividly the adverse consequences that can flow from institutions assuming significant risks without an adequate commitment of owner or shareholder resources. Only well-managed and well-capitalized institutions will be in position to weather market cycles and meet the long-term credit needs of their customers. Ultimately, we serve neither the banks nor the taxpayers if we fail to identify problems on a timely basis or permit undercapitalized banks to grow.

#### Conclusion

In closing, I would stress that the Federal Reserve is mindful of concerns about the availability of credit and has been watching for evidence that would validate these concerns. Lending terms have tightened in selected areas or for certain types of borrowers but, as yet, we continue to see little indication of a process that

is out of proportion with changes in underlying business conditions.

In our examination and regulation of banks we are working to avoid actions that would prevent creditworthy borrowers from receiving loans. At the same time, we have a responsibility to foster prudent lending policies and adequate capital bases in order to promote stability in financial markets and to protect the taxpayer, whose credit ultimately backs insured deposits. Only in that context can we be certain of the continued vitality of our banking organizations, whose lending activities are essential to the further advance of the economy.