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Testimony by

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I am pleased to be here today to discuss, as the Committee requested, the current policies governing examination and supervision of institutions under the Federal Reserve's supervisory jurisdiction. It is clear that the Committee is most concerned with initiatives that the Federal Reserve and other supervisory agencies have taken in response to ongoing concerns regarding credit availability, and that is where I will focus my discussion. In the process, I intend to indicate how the National Examiners' Conference, held in Baltimore on December 16 and 17, furthered the objectives sought in introducing these initiatives.

Chairman Greenspan, in his appearance before the House Ways and Means Committee on December 18, stated that the upturn in U.S. business activity that began earlier in 1991 has faltered. On that as well as earlier occasions he noted that the forces responsible for this development appear, to a considerable extent, to be working through the financial sector, in good part representing a reaction to excesses of the last decade.

In the 1980s, a series of factors combined to promote a boom in the real estate sector, particularly the commercial sector. The boom was sparked by the combination of a shortage of commercial space at the start of the decade, by changes in the tax laws that provided added incentives for investing in real estate, and by long-standing, widely-held expectations that real estate prices would continue to rise over the indefinite future as they generally had in the post World War II period. Further

impetus was provided by appraisers who, influenced by the speculative atmosphere, based their assessments on overly optimistic assumptions about future demands for real estate and the ability of properties to generate sufficient cash flow to service the debt obligations financing them.

Depository institutions also played an important role in the process. Facing intense competition in their operations, all too many decided to lower their real estate lending standards in order to earn attractive fees and high interest returns.

The results of this excessive optimism and failure to adhere to time-tested lending standards are plainly visible. There is a widespread over capacity in our commercial real estate markets. And reflecting this condition, our financial institutions have suffered, and in some cases continue to suffer, heavy losses on their real estate loans.

Asset quality problems, moreover, have not been confined to the real estate sector. A large number of businesses, particularly those that chose to substitute debt for equity, have been encountering difficulties in meeting their debt servicing obligations. And all too many households, encouraged by the availability of ready credit during the 1980s, became over-extended and subsequently have proven unable to meet their debt obligations. The net result of these developments has been that some of our financial institutions have been under considerable strain. Mounting losses in their loan portfolios have weakened their capital positions.

Against this background, it is not surprising that depository institutions -- both those that are experiencing problems and others intent upon avoiding such problems -- decided to become more conservative in setting the terms on which they are prepared to lend and in establishing standards that borrowers must meet to obtain new credit or renew outstanding loans. Given the relatively easy practices and standards in the 1980s, a shift in the direction of more conservative lending was unquestionably an appropriate development. Unfortunately, however, the process has, in some cases, gone too far and in the course of correcting past mistakes produced a counter productive result. What has happened is that some creditworthy borrowers have been finding it difficult, if not impossible, to obtain adequate credit accommodation. Consequently a drag has been placed on the upturn in economic activity.

In the context of these developments, the Federal Reserve has over the past year and a half or so taken a number of steps to reduce interest rates and encourage a general easing in credit markets. Last month's full percentage point cut in the discount rate to 3 1/2 percent, which was accompanied by a further reduction of the federal funds rate, is the latest and perhaps most dramatic of this series of actions.

The Federal Reserve together with other supervisors of depository institutions has also been working to ensure that our supervisory policies and examiner practices are not encouraging overly cautious lending policies at depository institutions. To

that end, the Federal Reserve and other supervisory agencies have introduced a series of initiatives designed to clarify longstanding policies and to make sure that examiners and depository institutions are fully informed as to our policies. In starting a review of these initiatives, it is important that I emphasize that we have endeavored to make sure the guidance issued and policies adopted are fully consistent with prudent credit standards and do not represent a weakening of, or a departure from, past policies and practices. The objective has been to see that these policies are articulated clearly and understood by examiners and the management of institutions they supervise. It has been our hope and expectation that these efforts will work to ensure that examiners utilize prudent and balanced practices and procedures in their activities and that institutions are not deterred in making new loans or renewing existing loans to creditworthy borrowers because of unwarranted concerns about possible examiner criticism.

A brief recounting of the major initiatives that have been taken will help to illustrate this most critical element that is common to all. The joint policy statement adopted by the four depository institution regulatory agencies on March 1 of last year was structured to provide clarification of longstanding agency policies regarding general lending practices as well as the evaluation of real estate collateral. The guidance reiterated the principle that it is altogether appropriate for banks, even those in the process of strengthening their financial

profiles, to meet the legitimate credit needs of creditworthy customers, provided that that is done on a prudent basis. To that end, the guidance indicated that it was appropriate for banks to work with troubled borrowers consistent with safe and sound lending practices. It also made clear that even banks not meeting the minimum capital standards need not stop making sound loans, provided that they have reasonable and effective plans in place to expeditiously restore their capital to adequate levels. The statement also directed that examiners, in evaluating real estate loans, should base their valuation of collateral supporting such loans not solely on the current liquidation value of the property, but should also take into account its stabilized cash flow and income-producing capacity.

The March 1st policy statement also addressed other topics involving loans to borrowers experiencing financial difficulties, such as issues relating to nonaccrual assets and restructured loans and the disclosure of the cash flow provided by nonaccrual assets. In addressing these topics, the agencies sought to set forth guidance that was both prudent from a supervisory perspective and consistent with generally accepted accounting principles.

The Federal Reserve, as well as the other supervisory agencies, went to considerable lengths to ensure that these guidelines were provided to and understood by all our examiners. Officials of each agency held meetings with their examiners to discuss the guidance and answer questions. Officers and managers

were also instructed to use all other opportunities to communicate with examiners and ensure their full understanding of the policies. In early summer, a supplemental statement was issued by the Federal Reserve that reemphasized the points made in the March statement as to the importance of banks refinancing and renewing loans to sound borrowers, provided there was good reason to believe the borrower would be able to service his debt.

Despite our efforts which were paralleled by those of the other agencies, by early fall of this year, reports were still coming to officials in the administration, members of Congress and senior agency officials that some lenders were apparently continuing to adhere to overly restrictive lending policies. These reports also continued to suggest that, in part, banks were following these policies because of concerns that examiners would judge their lending activities on a highly restrictive basis. Accordingly, it was decided that further initiatives should be taken to clarify policies and to inform both examiners and banks of these policies.

Guidance has subsequently been issued that expands on agency policies concerned with reviewing and classifying commercial real estate loans. This guidance, once again, emphasized that examiners should consider factors other than a property's current liquidation price when assessing its value as collateral. It was also stressed that real estate loans on which a borrower has performed in accordance with contract terms should not be criticized or charged off by examiners simply because the

current value of the underlying real estate collateral has declined to an amount less than the current loan balance. Instead, the guidance instructed that a decision to charge-off a loan should be made only when repayment of the loan is in question because of a well-defined weakness in the borrower's ability to continue to service the loan.

The Federal Reserve has also issued guidance for resolving differences between banks and examiners that can arise during an examination. This guidance, which builds on longstanding Federal Reserve practices, indicates that if bankers believe examiners have failed to adhere to the letter or spirit of agency policies, they may, if they are unsuccessful in resolving the matter with an examiner, ask for a review by senior Federal Reserve Bank officials. As a further step, we have also made special review procedures to assure that our policies are understood by examiners and that examiners have complied with these policies in examining the bank. The purpose of this effort is not only to help ensure that examiners carry out their duties in full conformance with our policies but also to reassure supervised institutions of that fact.

In yet another effort to promote banker awareness of our policies, officials of the regulatory agencies have been holding meetings with senior management of major institutions around the country. These meetings provide an opportunity to explain policy initiatives and to obtain ideas and suggestions from bankers as to what might be prudently done to alleviate

credit crunch conditions. Senior agency officials have also participated in a number of regional meetings, sometimes referred to as "town meetings," involving bankers, businessmen and members of Congress. During these meetings, we have listened to the views of bankers and borrowers regarding credit availability issues and concerns, and have explained the rationale for and context of our supervisory policies.

The National Examiners' Conference, recently held in Baltimore also sought to foster achievement of the same basic objectives just described. In particular, the purpose of the Conference was to make sure that senior examiners and their supervisors fully understand the substance and purpose of recent agency initiatives. The Conference offered participants the opportunity to raise questions about the various provisions of guidance that has been issued, and provided a forum for identifying and reconciling differences of views and interpretations that may have existed between examiners and their supervisors and among examiners from the various agencies.

The Conference was organized so that general sessions were concluded on the first day and a portion of the second which provided an overview of the policy statements and other guidance that has been issued by the agencies. The first two hours of the general sessions for the first day were open to the public. On the second day, the Conference mainly consisted of break-out sessions which addressed detailed aspects of the guidance

provided by the agencies and questions that examiners might have on the application of this guidance.

Discussion at the break-out sessions proved to be free flowing, and I believe it accurate to say that participants left the Conference with a clearer and more uniform understanding of agency policies and of procedures and practices that are required to implement these policies.

In conclusion, I would simply stress that the principal message we have tried to convey to our examiners, in our various policy statements and at our Conference in Baltimore, is that they should exercise reasonable balance in their decisions. The current environment is rather hostile for certain bank customers, and obviously many banks and thrifts have suffered and failed at great cost to their insurance funds and the public in general. That situation should not be overlooked; and the likelihood of future problems should not be downplayed.

On the other hand, examiners should not assume routinely that current adverse conditions will continue to prevail forever or that weak or illiquid markets will remain that way indefinitely. Proper balance -- that is the message we have tried to convey to both bank examiners and to bankers in an effort to reduce impediments to lending to sound borrowers while holding true to the principles of sound supervision.