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Testimony of

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of the

United States House of Representatives

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Introductory Remarks

Mr. Chairman, I am pleased to be here this morning to discuss regulatory and other initiatives designed to stimulate bank lending, especially to small businesses, and to comment on recent trends in business lending activity. A review of these issues seems quite appropriate at this time. In recent months, the economy has displayed increasing evidence of underlying strength, accompanied by rising demands for credit by households and businesses. As these trends continue, we believe that initiatives taken in the regulatory arena will help facilitate the lending process for creditworthy small businesses.

I will begin my remarks this morning by reviewing some of the key initiatives that have been taken in the past year and their status, and follow with a look at recent financing trends and the need for additional initiatives.

You also asked for my views on the adequacy of bank Call Report data on small business lending; I will comment on the Call data at the end of my statement and also bring to your attention the survey of small business finances that the Federal Reserve currently has underway. We believe the survey, which is being co-sponsored by the Small Business Administration, will provide important information for assessing credit availability for small businesses.

Recent Supervisory Policy Initiatives

Last spring, the Administration, the Federal Reserve and the other federal banking agencies ("agencies") announced a series of initiatives to reduce regulatory impediments to the availability of credit to small- and medium-sized businesses and farms, other businesses, and individuals. These initiatives were a continuation of ongoing interagency efforts to ensure that examiners evaluate bank lending activities in a consistent, prudent, and balanced manner.

One of the most important initiatives involves a proposal to revise the agencies' requirements for real estate appraisal by certified or licensed appraisers in ways that would reduce costs to banks and their customers. Such appraisals, which relate to a requirement of Title XI of FIRREA, would be required less often under these revised rules. To implement this initiative, rules were issued for comment last year and approved by the Board on March 9th. These rules do three things: (1) they increase the threshold amount for which such appraisals are required from $100,000 to $250,000; (2) they expand the "abundance of caution" exemption for business loans, so that an appraisal would not be required when the value of real estate taken to collateralize a loan is not material to the decision to make the loan; and (3) they exempt from appraisals business loans of less than $1 million, where the principal source of repayment is <u>not</u> the sale of or income from the real estate held as collateral.

Loans secured by real estate are an important source of credit for many small and mid-sized businesses. Thus, eliminating the requirement to obtain an appraisal in the cases just specified should work to their clear advantage by reducing costs. At the same time, such exemptions will not erode the safety and soundness of the lending institutions.

Other actions taken by the agencies to facilitate small business lending include a new policy that permits qualified banks to set aside a portion of their small-business loan portfolios. The selected loans will be evaluated by examiners only on the basis of their performance and not on the level of loan documentation. This change is intended to encourage loans to smaller businesses that banks believe to be creditworthy based, for example, on the borrower's past credit experience or the bank's general knowledge of the customer, but where strict adherence to traditional documentation standards and procedures might make the loan too costly.

The agencies also have issued numerous statements in the past year, the intent of which has been to clarify supervisory policies and reporting requirements. These statements deal with a variety of issues related to the treatment of troubled real estate loans, sales of foreclosed properties, restoration of problem loans to performing status, and the interagency framework for assessing loan quality.

In designing each of these initiatives, the agencies have sought to remove impediments to bank lending that might occur owing to unnecessary costs and supervisory burdens. Thus, as the economy develops momentum and as underlying demands for credit pick up, these actions will help ensure that credit decisions of lenders and borrowers are not unduly discouraged by costly appraisal and documentation procedures or by a misunderstanding of examination policies.

Trends in Business Financing Activity

Ultimately, however, the major determinant of business credit use and availability is not regulations or supervisory policies, but underlying economic and financial forces. In this regard, we are beginning to see evidence that business lending has picked up, including small business lending. Indeed, in recent quarters, incoming data on the economy and credit flows have revealed appreciable underlying strength. Let me briefly review some recent trends that are setting the stage for bank credit growth this year.

Through much of 1993, overall business demands for credit remained quite weak. In the aggregate, nonfinancial businesses largely used internal funds to finance growing outlays for fixed capital and inventories and continued to focus efforts heavily on balance sheet restructuring. When external financing was needed, it was concentrated in capital markets, spurred by continuing declines in bond rates and a strong stock market. Many firms used proceeds from new security offerings to pay down bank loans. Such paydowns were an important factor contributing to the continued weakness in total business loans at banks last year.

The favorable interest rate environment and the restructuring activity of firms have produced a much healthier business sector. Debt service burdens have fallen markedly. Equity cushions seem to have moved to more comfortable levels. Indicators of financial stress, including loan default rates and bankruptcy filings, have dropped well down from peaks of recent years. Banks also have charted marked improvements. Equity capital climbed to nearly 8 percent of assets last year, buoyed by record earnings, and the share of troubled assets on the books of banks dropped to its lowest level since 1986.

As banks have become more assured of their own financial health and that of their customers, their willingness to lend has grown. We observed on Federal Reserve surveys last year a consistent easing of terms and standards on business and consumer loans as the year progressed--a trend that has continued in the new year. The easing appears to have been more substantial for large firms, but respondents also have eased standards for small firms. The reporting banks attributed this easing to the improved economic outlook and their own strong capital positions.

Moreover, although growth of total business loans was held down last year by restructuring activity of big firms, we began to see signs of a pick-up in lending to small firms. The new Call Report data on small business loans provide some evidence of this. I have included in my testimony a set of tables derived from the new Call Reports. These tables show the breakdown of outstanding loans by size of loan and by size of bank, for different categories of business and farm loans. Although the relationship between the size of the credit arrangement that a bank has with a business customer and the size of the customer's assets or sales is not precise, our surveys and examiner experience suggest there is a strong positive correlation. Thus, we feel comfortable in assuming that most of the small loans reported by banks are to small businesses.

More than 6,000 banks indicated on the June Call that "virtually all" of their loans to businesses were less than $100,000 in size. We singled out these banks to see what had happened to their lending last year. We found that, while aggregate business loans were running off last year, this subset of banks maintained and increased their lending to small customers. [These figures are shown in Table 3.]

More generally, in the first two months of this year, growth of business loans at all domestic banks has strengthened. Total commercial and industrial loans increased at an average annual rate of 7.5 percent in January and February. In the latest survey of bank lending officers, respondents indicated that the demand for loans by businesses has firmed, largely reflecting increased needs to finance inventories and investment in plant and equipment.

These signs of a greater willingness to borrow and spend on the part of businesses are quite encouraging. Moreover, banks, which are better capitalized and more liquid than they have been in a long while, appear to be able and willing to meet the rising credit demands. In this environment, I believe that the recent initiatives taken in the supervisory area will help to facilitate new lending, particularly to smaller borrowers.

***Need for Additional Initiatives*?**

You asked my opinion about the need for additional initiatives. In this regard, I view the steps that have recently been taken as an ongoing part of the supervisory process. This process is never complete. Regulators always have to remain vigilant to possibilities for reducing burdens and making the supervisory process more efficient. We must guard against implementing new policies that might unnecessarily impede the lending process. We also must be aware of special situations, such as those resulting from the California earthquake, when there may be a need to ease standards temporarily.

And, while supervision alone can play only a limited role in spurring aggregate lending, there is scope for the Congress and the agencies to work together to foster an environment for banks that will allow them to make sound loans and to compete efficiently in financial markets. Important in this regard are the initiatives now before Congress related to interstate banking and broader powers for banks.

Adequacy of Call Report Data on Small Businesses and Farms

Let me conclude by commenting on the adequacy of data for assessing credit availability to small businesses. In particular, you have asked about the new data we now collect on the Call Reports. The new Call Report data are a good, albeit not perfect, measure of bank lending to small businesses. We believe that their usefulness as an indicator of trends in bank credit flows to small borrowers will increase each year as we collect more observations, and the data will be a valuable supplement to information we gather from other sources.

Our experience with the data reported for the first time in June revealed, as might be expected, a number of reporting problems that needed to be resolved. Consequently, the staffs of the relevant agencies have made a number of changes to the reporting instructions designed to clarify definitions and improve the quality of the reported statistics. The agencies, however, did not see the need to add items to the report or to collect information by size of borrower instead of size of loan for several reasons.

It would be extremely costly for most banks to provide loan data by size of "business" because their records--especially automated records--do not group loans in this way. We recognized that any particular definition of small business that we selected might not be easily available to all reporting institutions nor would it be appropriate for all analytical purposes. Moreover, Call Report data, whether by size of loan or borrower, will not yield a comprehensive enough view to evaluate the adequacy and risks of small business financing. For example, we would need information on items such as: price and nonprice terms of business loans; personal or credit card loans that are used for business purposes; risk characteristics of the borrower and the firm's access to capital; and the cost and availability of credit from nonbank sources.

The Federal Reserve knows that banks play an important role in supplying credit and other financial services to small businesses, and we have a strong commitment to better understanding how the financing needs of these businesses are being met. It is for this reason that we are now undertaking an extensive survey of 6,000 small businesses, including 1,200 minority-owned small businesses. The survey will gather information on characteristics of the business firms and their owners, on their income flows and balance sheets, on their use of financial services and credit sources, and on their recent borrowing experiences. I have with me the questionnaire developed for that survey. I think it is apparent from the size of this document that the information we hope to gain from this survey would be impossible to collect on the Call Report.

Summary Remarks

Finally, let me summarize my remarks this morning by saying that the Federal Reserve recognizes the highly important role that small business firms play in the economy and the need to promote the flow of credit to these firms. We intend to continue to seek ways, consistent with safety and soundness standards, to achieve this objective.

Table 1

BUSINESS LOANS AT U.S. COMMERCIAL BANKS

Amount Outstanding as of June 30, 1993

Original amount of loan or line of credit or commitment (Thousands of dollars)	Asset size of bank (Millions of dollars)					
	<$100	$100 to $300	$300 to $1,000	$1,000 to $5,000	>$5,000	All banks
	Commercial and industrial loans (Billions of dollars)					
$100 or less	21.8	17.7	10.7	9.6	17.6	77.4
Greater than $100 thru $250	3.2	4.5	4.3	5.5	8.6	26.1
Greater than $250 thru $1,000	3.7	7.6	9.0	12.9	22.2	55.4
Greater than $1,000	0.9	4.4	12.2	45.0	213.1	275.6
Total C&I loans	29.6	34.2	36.2	73.0	261.5	434.5
	Loans secured by nonfarm, nonresidential properties (Billions of dollars)					
$100 or less	15.7	14.4	6.8	4.4	5.0	46.2
Greater than $100 thru $250	3.8	5.3	4.4	5.1	7.2	25.8
Greater than $250 thru $1,000	6.4	11.8	11.7	14.2	21.6	65.7
Greater than $1,000	1.3	5.5	12.7	28.8	74.8	123.2
Total nonfarm, nonres. loans	27.2	37.0	35.6	52.5	108.6	260.9

Source: Call Reports

Table 2

BUSINESS LOANS AT U.S. COMMERCIAL BANKS
Percent Distribution as of June 30, 1993

Original amount of loan or line of credit or commitment (Thousands of dollars)	Asset size of bank (Millions of dollars) <$100	$100 to $300	$300 to $1,000	$1,000 to $5,000	>$5,000	All banks
	Commercial and industrial loans (Percent)					
$100 or less	73.7	51.8	29.5	13.2	6.7	17.8
Greater than $100 thru $250	10.8	13.2	11.9	7.5	3.3	6.0
Greater than $250 thru $1,000	12.5	22.2	24.9	17.7	8.5	12.8
Greater than $1,000	3.0	12.8	33.7	61.6	81.5	63.4
Total C&I loans	100	100	100	100	100	100
	Loans secured by nonfarm, nonresidential properties (Percent)					
$100 or less	57.7	38.9	19.1	8.4	4.6	17.7
Greater than $100 thru $250	14.0	14.3	12.4	9.7	6.6	9.9
Greater than $250 thru $1,000	23.5	31.9	32.9	27.0	19.9	25.2
Greater than $1,000	4.8	14.9	35.6	54.9	68.9	47.2
Total nonfarm, nonres. loans	100	100	100	100	100	100

Source: Call Reports

Table 3

GROWTH OF BUSINESS LOANS AT U.S. COMMERCIAL BANKS WITH MOSTLY SMALL LOANS

Year	Type of Loan			
	Total business	Commercial and industrial	Nonfarm, nonresidential real estate	Construction and land development
	Amount outstanding, year-end (Billions of dollars)			
1989	59.5	32.2	21.1	6.2
1990	62.6	33.4	23.1	6.1
1991	63.1	32.0	25.3	5.8
1992	64.9	31.7	27.4	5.8
1993	71.3	33.7	30.7	6.9
	Percent change, December to December			
1989	6.6	3.6	13.3	1.7
1990	5.2	3.7	9.5	−1.3
1991	1.0	−4.1	9.8	−4.7
1992	2.7	−.9	8.1	−.6
1993	9.9	6.2	12.0	20.4
1993 H1 (annual rate)	7.4	4.8	9.8	9.8
H2 (annual rate)	12.0	14.8	13.6	29.4

1. Banks are those that reported on the June 30, 1993, Call Report that virtually all their business loans were in amounts of, or under lines of credit or commitment of, less than $100,000. The number of such banks totaled 6,389. About 300 of these banks are excluded from the above calculations because they were not in operation four years prior to 1993.

Source: Call Reports

Table 4

FARM LOANS AT U.S. COMMERCIAL BANKS
Amount Outstanding as of June 30, 1993

Original amount of loan or line of credit or commitment (Thousands of dollars)	Asset size of bank (Millions of dollars) <\$100	\$100 to \$499	\$500 to \$4,999	>\$5,000	All banks
	Loans secured by farm real estate (Billions of dollars)				
\$100 or less	8.56	3.58	0.79	0.30	13.23
Greater than \$100 thru \$250	1.27	1.00	0.41	0.25	2.93
Greater than \$250 thru \$500	0.59	0.63	0.33	0.26	1.82
Greater than \$500	0.21	0.49	0.64	1.27	2.61
Total	10.64	5.70	2.17	2.08	20.59
	Farm production loans (Billions of dollars)				
\$100 or less	15.89	5.25	1.54	0.70	23.38
Greater than \$100 thru \$250	1.51	0.92	0.54	0.44	3.41
Greater than \$250 thru \$500	0.77	0.61	0.41	0.45	2.25
Greater than \$500	0.41	0.60	1.60	3.73	6.34
Total	18.58	7.38	4.09	5.32	35.38

Source: Call Reports

Table 5

FARM LOANS AT U.S. COMMERCIAL BANKS
Percent Distribution as of June 30, 1993

Original amount of loan or line of credit or commitment (Thousands of dollars)	Asset size of bank (Millions of dollars)				
	<$100	$100 to $499	$500 to $4,999	>$5,000	All banks
	Loans secured by farm real estate (Percent)				
$100 or less	80.5	62.8	36.4	14.4	64.3
Greater than $100 thru $250	11.9	17.5	18.9	12.0	14.2
Greater than $250 thru $500	5.6	11.1	15.2	12.5	8.8
Greater than $500	2.0	8.6	29.5	61.1	12.7
Total	100	100	100	100	100
	Farm production loans (Percent)				
$100 or less	85.6	71.1	37.7	13.2	66.1
Greater than $100 thru $250	8.1	12.5	13.2	8.3	9.6
Greater than $250 thru $500	4.1	8.3	10.0	8.4	6.4
Greater than $500	2.2	8.1	39.1	70.1	17.9
Total	100	100	100	100	100

Source: Call Reports

Table 6

GROWTH OF FARM LOANS AT U.S. COMMERCIAL BANKS WITH MOSTLY SMALL FARM LOANS [1]

Year	Type of Loan: Total farm	Type of Loan: Farm production	Type of Loan: Secured by farm real estate
	Amount outstanding, year-end (Billions of dollars)		
1989	20.5	13.0	7.5
1990	22.2	14.1	8.1
1991	23.8	15.1	8.7
1992	25.1	15.6	9.5
1993	27.4	16.9	10.5
	Percent change, December to December		
1989	7.0	6.3	8.3
1990	8.1	8.2	7.9
1991	7.5	7.5	7.6
1992	5.2	2.8	9.2
1993	9.1	8.4	10.3
1993 H1 (annual rate)	9.6	8.0	12.2
H2 (annual rate)	8.4	8.6	8.0

1. Banks are those that reported on the June 30, 1993, Call Report that virtually all their farm loans were in amounts of, or under lines of credit or commitment of, less than $100,000. The number of such banks totaled 7,903. About 575 of these banks are excluded from the above calculations because they were not in operation four years prior to 1993.

Source: Call Reports