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Remarks of

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I am pleased to have the opportunity to talk with you today. Although there are a number of things we could talk about, I thought I would focus on the questions surrounding the alleged "credit crunch."

The availability of credit, and in particular, credit for small businesses, is a topic of considerable interest to the Federal Reserve. Bank loans have been essentially flat for the past two years, and there has been a substantial decline in the share of total credit that comes through the banking sector. This trend is troublesome. Many have cited this decline as an indication that there is a "credit crunch." To most of us the term "credit crunch" conveys the sense that creditworthy borrowers find it unusually difficult, if not impossible, to obtain credit at reasonable cost. In the past, credit crunches have typically been associated with periods of high interest rates, monetary restraint and disintermediation. But today we are more likely to hear of tight credit standards, risk-based capital requirements, and overly cautious regulators as the underlying causes.

To shed light on whether there is indeed a credit crunch, and whether policy prescriptions are needed, we need to disentangle the various supply and demand factors that have interacted to produce the recent weakness in bank lending.

My remarks today will focus on the three factors that I think are the most important. The first is the demand for credit by businesses and households; the second is private lenders' efforts to rebuild balance sheets and strengthen capital; the third is bank regulation--both risk-based capital requirements and the examination process. These factors are clearly interrelated, but it may be helpful to distinguish among them because each has different policy implications.

Let me begin by noting that a number of positive signs have begun to emerge in the banking sector. Bank lending, after declining through last summer, turned up a bit in the fall, although we have yet to see sustained growth in business lending. Bank capital positions are stronger than they have been for many years, boosted by record bank profits and new capital. From a liquidity standpoint, banks appear to be in a good position to increase lending given the substantial amount of government securities that they hold. We should see more strength in bank lending, and in other types of credit, as economic activity continues to pick up.

With that background, let me turn now to the credit crunch and the demand for bank loans and credit more generally. I believe that weak demand for credit goes a long way toward explaining the slow growth of bank loans and broader measures of debt in the 1990's. Growth in credit demand has been blunted by the relatively slow pace of the recovery. Many factors have contributed to the weakness of the recovery--cuts in defense spending following the end of the cold war, the restructuring of many large U.S. firms in response to increased global competition, and large declines in commercial real estate values following the overbuilding of the 1980s. In short, coming out of the decade of the 1980's there are substantial structural impediments to growth and it will take time for the economy to work off these imbalances. I would cite commercial real estate as an area that is likely to recuperate slowly.

The other factor limiting the demand for credit generally has been the substantial effort of businesses and households to reduce the debt burdens that they accumulated in the 1980s. By 1990 household debt service obligations amounted to more than 18 percent of disposable personal income, 2 percentage points above their previous historical high in 1980. Similarly, gross interest payments by corporations amounted to almost 40 percent of cash flow in 1990--another record. In part these heavy debt burdens reflected high interest rates, but they also resulted from large increases in debt to fund mergers and support higher real estate prices in the 1980s. When real estate prices stabilized and, in some cases, declined, many firms and households found themselves with higher levels of leverage than they had intended. Then, in addition, for firms, weak sales and slower growth in asset prices increased exposure to heavy debt payments.

Over the past two years, both firms and households have sought to reduce their debt burdens. Their efforts have been helped by the large decline in interest rates over this period. Large firms have issued new lower-interest bonds and equity in record amounts, and in many cases the proceeds have been used to repay bank loans. These repayments probably were a major factor slowing business loan growth last year. Indeed, a review of prospectuses by a U.S. investment bank revealed that debt and equity issues, having as their primary purpose the retirement of bank debt, were considerably in excess of the decline in business loans at banks in 1992.

Households have used low-yield assets, such as bank deposits, to pay down high-interest debts--contributing, incidentally, to the weakness in the monetary aggregates. Although household debt burdens in terms of disposable income remain fairly high by historical standards, they have declined somewhat recently. Moreover, the recent growth in consumption spending and indicators of consumer sentiment suggest that households may be more comfortable with current debt levels.

Turning to the other side of the supply-demand equation, it also appears that tighter supply conditions have contributed to the weakness in bank credit. Spreads between bank loan rates and money market rates increased by a percentage point or more in 1990 and 1991, and they have remained elevated since. In addition, banks appear to have imposed tighter non-price terms on loans and tougher underwriting standards. The results of the Board's quarterly survey of senior loan officers at large banks suggest that non-price terms on commercial and industrial loans tightened appreciably in 1990 and 1991. The tightening of terms included reducing the sizes of credit lines, increasing commitment fees, requiring more collateral, and increasing the use of loan covenants. For the same period, the senior loan officers also reported that they tightened the standards for approving loan applications. However, since late 1991 or early 1992, the senior loan officers have reported little change in either terms or standards for commercial and industrial lending.

In a traditional crunch, the bank lending mechanism breaks down--either because of disintermediation or, as in 1980, because of direct controls on the quantity of lending. In the most recent recession and recovery, there was no dramatic or obvious breakdown, but rather a persistent, but hard to locate, slowdown. The flow of credit from other sources has also slowed. For example, while bank consumer installment lending fell by about 6-1/2 percent between 1990 and last fall, finance company consumer installment lending fell by nearly twice as much. Installment credit from all other sources was also down. Similarly, business loan growth at banks has been weak, but so has business loan growth at finance companies. This general weakness in short-term credit suggests that overall credit demand has been weak. Or if suppliers of credit have tightened, the retrenchment has not been limited to banks.

It is not hard to think of reasons why lenders might have chosen to tighten underwriting standards. First, one would expect lenders to be more careful simply because of the state of the macroeconomy, and the consequent declines in collateral values. Second, many lenders--and not just banks, but also thrifts, finance companies, and insurance companies--have sustained large losses as a result of over-aggressive lending in the 1980's. Given the very high levels of delinquencies and charge-offs in recent years, it would be astonishing if these institutions did not alter their practices and procedures to avoid similar losses in the future. This natural reaction to increased loan losses may have been reinforced by regulatory pressures.

What role have banking regulations and capital requirements played? With regard to capital requirements, I do not believe that the Basle risk-based standards have been a major constraint on bank activity. The evidence simply does not support this view. First, for most banks the standards have not been binding constraints, or even particularly close to binding. In December of 1990, presumably when the "capital crunch" was in full swing, more than 95 percent of U.S. banks already met the fully phased-in standards. Moreover, about two thirds of bank assets were held by banks that both met the capital standards and were highly rated by their examiners.

The Basle standards, while perhaps contributing, are not the most important factor motivating banks to increase their capital ratios. Indeed, the banks' own experiences with large loan losses and portfolio problems likely have prompted many to reassess their appropriate levels of capital. Moreover, banks recognize that there are substantial market incentives for having higher capital. In late 1990 and early 1991, some money center banks had to pay spreads of more than 5 percentage points over Treasuries to issue subordinated debt. At the same time, the top 50 banking institutions' stock was selling at an average discount to book value of 15 percent. Clearly, financial markets believed that these institutions were poorly capitalized. More recently, the improved capital positions of the largest banks have contributed to the reduction in spreads on their subordinated debt to less than 2 percent over Treasuries, and the stock prices of the 50 largest banks are now more than 70 percent above book value.

Risk-based capital standards would be expected to encourage some banks to cut back on higher-risk loans and purchase more government securities. Indeed, the fraction of bank portfolios invested in government securities has increased sharply. But by historical standards securities are still a modest fraction of bank assets. Granted times are different, but securities were more than half of bank credit in the late 1950s. Even as late as the mid-1970s banks had about 30 percent of their portfolios invested in securities--much as they do today.

In any case, the increase in securities holdings does not appear to be the result of the risk-based capital standards. Some evidence for this claim comes from observing the behavior of institutions not constrained by capital standards. For example, consider banks with the strongest capitalization, say banks in the well-capitalized zone under FDICIA that are also in the top 1 or 2 bank rating categories. These banks cannot credibly be said to be constrained by the risk-based standards. As one would expect, these institutions are the ones with the most rapid asset growth, yet the bulk of that growth is coming from increased holdings of government securities.

In addition, credit unions also tend to be quite well capitalized, and indeed are not subject to the risk-based capital standards. Nonetheless, loans by credit unions decreased from 66 percent of assets to 53 percent over the past few years, while the share of government and agency securities has doubled. These shifts are somewhat larger than for banks, occurring at about the same time--and they cannot be attributed to risk-based capital standards.

Evidently, the increase in bank securities investments by well-capitalized banks and credit unions is the result of other factors. I have already pointed to weak credit demand and the tightening of underwriting standards in response to increased loan losses as possible explanations. In addition, the steepness of the yield curve may increase the appeal of some government securities. As an aside, however, it is worth noting that securities profits have not contributed as much as one might have thought to bank profits. In 1992 bank profits on securities were less than 15 percent of total profits.

Should we conclude from all of this that the risk-based capital standards have had no effect? I hope not. One of the goals of the risk-based capital standards was to reduce the bias toward risky investments caused by government deposit insurance and a single capital standard. This important objective contributes to the safety and soundness of the banking system and reduces exposure to taxpayers.

Thus far I have focused almost exclusively on capital standards. What about other aspects of the regulatory process? We have heard that banks are skittish about making loans that might be viewed as risky by the examiners or that cannot be documented adequately. The fact that banks have raised lending standards and tightened credit terms in the past few years cannot be disputed.

I suspect that this increased caution has received additional impetus from the supervisory process. Examiners have become acutely aware of the impact that asset quality can have on individual institutions and on the banking system. Although the Fed and other agencies have sought to discourage examiners from overreacting to past problems, it is natural human instinct to be more circumspect. And if bankers expect regulators to be more critical, they are likely to be more conservative in their decision-making and record-keeping. One product of this process has been an increased trend toward greater documentation which increases the cost of loans. Recently enacted laws, including FDICIA, have added to this trend. The merits of this legislation can be debated, but it appears to have encouraged banks and examiners to err on the side of caution in the lending process.

These tighter standards, whether prompted by bank or regulator concerns or new laws, impose a cost on all borrowers but may be especially burdensome for smaller businesses. For example, many small business loans are collateralized by real estate. Any loan with real estate collateral over $100,000 must contain an appraisal by a licensed or certified appraiser. This requirement was singled out by respondents in the Fed's survey of senior loan officers at large banks as a specific regulation that especially hurt small businesses.

The Federal Reserve and other regulatory agencies have been working to identify statutory or regulatory requirements that may have disproportionately affected small businesses and were not essential to sound banking. As you may be aware, the President announced last week the preliminary results of this interagency effort. The details of the intended regulatory changes remain to be worked out. This interagency effort reflects the longstanding interest of the Federal Reserve in reducing the regulatory burden on healthy banks and encouraging lending to creditworthy small and medium-sized businesses.

I believe that two of the announced changes are particularly important. First, in order to reduce the documentation burden on small loans, the agencies will allow strong and well-managed banks and thrifts to carry a portfolio of creditworthy small and medium-sized business loans with minimal documentation requirements. The size of individual loans included in this portfolio will be limited, as will the overall size of the portfolio. Second, the agencies have agreed to attempt to ease the rules requiring appraisals where this can be done without affecting the safety and soundness of the credit decision. This includes a reassessment of the loan size threshold for formal appraisals. I believe that these changes should help increase the flow of credit to small and medium-sized businesses.

In sum, considerable attention is being directed to the question of availability. I think that to explain the weakness in credit growth over the past two or three years, however, we need not look much beyond the state of the economy and efforts by both borrowers and lenders to rebuild balance sheets and redress imbalances of the previous decade. I would attribute far less importance to the imposition of risk-based capital standards, which for the vast majority of institutions were not constraining. Other aspects of the supervisory process are more difficult to disentangle. Concerns of examiners likely have reinforced those of banks, contributing to tougher lending standards. Although we have been careful to discourage overzealous regulation, scrutiny of financial institutions by the public, the Congress, and the agencies has likely created an environment more conducive to tighter standards and documentation requirements. The changes announced by the President show that the supervisory agencies are aware of these difficulties.

What about the future? I expect lenders will pursue more cautious policies than we saw in the preceding decade, but that their willingness to lend will increase as the economy improves, regulatory costs are reduced, and imbalances are worked off. I think we are seeing some evidence of progress at banks and among businesses and households.

Finally, I would stress the important role that small businesses play in our economy. Although the Federal Reserve and other agencies are acting to reduce the costs of small business loans, we need to learn much more about the diverse credit needs of this sector. In order to improve our understanding in this area, the Federal Reserve will be conducting a survey this year of small businesses and will ask about the full range of their credit sources, not just banks. This survey should provide useful insights into potential bottlenecks in the flow of credit to small businesses. Such insights can assist in the development of appropriate policy prescriptions.

Thank you.