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Testimony by

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Mr. Chairman and members of the Committee, I am pleased to have this opportunity to discuss the Federal Reserve's supervision of bank lending on commercial real estate and the international coordination of supervisory efforts, in general. As requested, I will also provide an assessment of commercial real estate markets around the country and describe steps we have taken to alert examiners about potential risks.

In brief, conditions within the U.S. banking system generally appear to be improving and, for some institutions, improving in significant ways. This progress flows from a number of sources, including a general stabilizing of commercial real estate markets, albeit at a relatively depressed level in all too many cases. Nevertheless, problem real estate credits remain a principal concern to major bank lenders throughout the country and also, of course, to the supervisory agencies. It is important to learn from past events, and steps are being taken by both banks and the agencies to prevent the recurrence of problems of the scope we have experienced in recent years.

Importance of Commercial Real Estate Lending

While always important to U.S. commercial banks, real estate lending became even more critical to the industry during the past decade, as all loans secured by real estate increased from 14.5 percent of total commercial bank assets at the end of

1980 to nearly one-quarter of the industry's assets at the end of last year. Currently, loans secured by real estate represent the largest asset class held by banks today and at $850 billion exceed the volume of commercial and industrial loans by more than $330 billion. In absolute terms, real estate loans have accounted for more than one-half of the industry's loan growth since 1980.

This growth in real estate lending includes substantial increases in home mortgages as well as commercial real estate loans, but it is the latter, of course, that has mainly presented the problems to the banking industry. Commercial real estate lending has also been the fastest growing real estate segment, with loans outstanding nearly quadrupling during the 1980s. This lending, combined with that provided by thrift institutions, fueled a dramatic expansion in commercial real estate building nationwide that has left markets in most cities around the country significantly overbuilt.

To understand conditions today, it is helpful to consider views commonly held during much of the 1980s when most of the excess construction occurred. Over that period, contractors and lenders alike seemed to believe that nearly all real estate projects would prove profitable, and for a long period of time. That view was supported by experiences in which properties were generally worth more by the time they were completed than all the costs included in their construction. Even banks that held problem REIT loans in the mid-1970s had seen those problems largely disappear with rising inflation rates that gave real estate values a boost. Although inflation rates had declined since then, many developers and lenders still felt that real estate values would continue to increase.

These expectations, as well as favorable tax treatment accorded by 1982 legislation and the general ebullience of the economy encouraged many builders to expand their activities. At the same time, thrifts looking for added revenues to offset other problems, banks experiencing a loss of customers to other lenders and to the open market, and foreign banks seeking to expand their presence in the United States, all decided to lend aggressively in the real estate sector.

A principal result of this intense competition was that many institutions liberalized their terms of lending. In particular, they became more willing to finance land acquisition and construction projects and also to provide so-called "mini-perm" loans to carry projects several years beyond construction. That financing allowed developers and other real estate borrowers to undertake projects without the permanent take-out financing traditionally provided by long-term investors. During their first few years of operation the projects were to become fully, or at least mostly, leased and permanent financing obtained. Clearly, though, as commercial real estate markets deteriorated in the face of excessive capacity, many properties failed to lease up and relatively few long-term lenders have stepped forward. Thus, banks have been unable to extricate themselves from many of these credits.

As the Committee knows, the resulting exposure from mini-perms and from other commercial real estate lending has placed substantial stress on the banking industry, has been a main contributor to the failure of a number of large banking institutions, and has led to the merger or acquisition of others. At the end of March, 1992, U.S. commercial banks held more than $26 billion of nonperforming commercial real estate loans and another $21 billion of foreclosed commercial properties. These high levels remain despite the large charge-offs the industry has taken in recent years. The main positive note is that the increase in problem real estate loans has slowed sharply from the explosive pace of 1990 and, even including foreclosed assets, has virtually stopped since the middle of last year.

Supervisory Procedures for Real Estate Credits

With that background, I would like to discuss the Federal Reserve's procedures for reviewing real estate loans and assessing the lending activities of state member banks. These procedures are contained in our Commercial Bank Examination Manual and in other supplementary documents that provide guidance on the supervision of real estate lending that the Federal Reserve has followed for many years.

An assessment of real estate lending activities rests heavily on the payment performance of each borrower, the value of the collateral supporting individual loans, and a review of the bank's own operating policies and procedures. Examiners also determine whether the bank has complied with applicable laws and regulations and whether its portfolio is consistent with general principles of diversity. Where weaknesses are found, examiners are instructed to ensure that corrective measures are adopted.

Lending policies are reviewed to see that they are well documented and complete and that they cover relevant aspects of a sound lending activity. Examiners also consider whether, for example, they define the geographic limits within which the bank will lend, the types of properties acceptable to the bank, the required internal authorizations, the type and frequency of information to be required from the borrower and the appraiser, maximum acceptable exposures, and standards for documentation. In addition to determining whether the policies and stated procedures are adequate, our examiners also undertake to confirm that the policies are being followed by reviewing loan portfolios and credit files.

Traditionally, in assessing individual loans and loan portfolios, examiners have been advised to consider the borrower's fundamental ability to meet his or her obligations and not place undue reliance on the collateral value of a loan. Therefore, if the collateral's value declines but other factors remain sound, a loan is not automatically classified or criticized. The wisdom of that approach has been demonstrated by recent experience, as the value of many commercial real estate properties declined below previously appraised values. Nevertheless, when a credit does become troubled and the borrower is unable to meet an obligation, the role of the collateral increases in importance. It is critical, therefore, that banks have sound appraisal policies and standards in place.

There are a number of ways to estimate a property's value that are accepted by appraisers, bankers, and the regulatory agencies. They typically consider a variety of factors including historical cost less appropriate depreciation, current market comparisons, and the capitalized value of revenues that the property is reasonably expected to provide. When appraisals are considered to be out-of-date or otherwise deficient, examiners replace inaccurate or outdated assumptions and generally follow procedures similar to those used in the appraisals. Since commercial real estate loans of banks are often on relatively new properties, examiners generally consider estimated stabilized income streams when making their assessments. They also look for indications of troubled loans such as rent concessions, declining market prices, or payment problems. Consideration is also given to the unique characteristics of real estate properties, which can be either beneficial or harmful to their underlying value.

Following their review, examiners assign a specific rating to each problem loan. Those rated **substandard** are likely to produce losses to the lender, unless deficiencies are corrected. **Doubtful** loans are those for which collection in full is highly questionable and improbable, while assets rated loss are considered uncollectible and not appropriate to report as bankable assets. In addition to assigning ratings, examiners should attempt to determine what amount of a loan should properly be charged off or reserved and then classify the remainder, as appropriate.

Not yet mentioned are other possible supervisory standards for real estate lending that have been recently proposed as a result of requirements of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Earlier this month the Board issued for public comment its proposal regarding Section 304 of FDICIA, a section that requires the agencies to adopt uniform regulations prescribing standards for real estate lending. If adopted, the proposal would reimpose a concept of regulatory maximum loan-to-value (LTV) ratios for real estate lending that was repealed for national banks by Congress in the early 1980s.

Tentatively, the ratios would serve as guidelines for a variety of different types of real estate loans. Under one alternative method, lenders would individually establish LTV ratio limits within or below a range of supervisory limits prescribed in uniform regulations and subject to supervisory review. The low end of the range would be considered as a benchmark ratio for that category of loan. Institutions would be able to select a higher maximum ratio (within the specified range) on the basis of demonstrated expertise in that particular type of lending and other factors. Under the second alternative, the agencies would prescribe maximum LTV ratio standards in their regulations that institutions could not exceed.

There are a number of proposed exemptions to these standards, such as for loans guaranteed or insured by the U.S. government, and there is a provision allowing for a limited amount of nonconforming loans. The agencies are also considering exemptions for loans to organizations or projects promoting the economic rehabilitation and development of low-income areas. The final details of the standard will depend upon the comments received and any further agency reviews. Uniform regulations are required to be adopted by March, 1993.

In hindsight, more stringent standards and more vigorous supervision may have helped to prevent many of the problems we have seen. Examiners did not insist on conservative practices as much as they should have. But in boom times, it is hard to argue with success.

It is important to emphasize, in this connection, that examiners do not dictate that bankers extend or not extend credit in specific cases. That responsibility properly belongs to the banker. The examiner, rather, should review procedures for safety and soundness and help to ensure that the bank's financial statements reasonably reflect the condition of the bank. Provided bank policies and procedures are reasonable, appraisals appear sound, and the credit is performing as agreed, it is difficult and inappropriate for examiners to criticize loans or to override the banker's judgement about the outlook for future market conditions.

However, as asset quality deteriorates and it becomes clear that conditions have changed and that management's strategy has not worked as planned, the bank's activities may begin to threaten the safety net. At that point, the examiner and other supervisors obviously have a more important voice in the approach management takes in resolving its problems and more forcefully impose their views. Corrective measures required of the bank may take a number of forms, including capital plans, restrictions on lending, and the development of stronger credit standards. If necessary, supervisory demands can be backed by cease and desist orders and can involve the removal of key officers and directors and, ultimately, seizure of the bank.

Recent initiatives

Concerns about excessive tightening of credit standards by many banks and the inability of apparently creditworthy borrowers to obtain or renew bank financing in the wake of examiner criticisms of commercial real estate credits led the agencies to undertake an extensive review of their examination practices throughout much of last year. In recognition that banks had shifted markedly in their willingness to lend, the agencies undertook special efforts to coordinate and clarify their supervisory policies.

Much of the reduced willingness to lend was understandable given weak economic conditions, the level of excess capacity in commercial real estate markets, and the asset quality problems of many banks. Moreover, some strengthening of credit standards was needed in much of the industry, and those changes would necessarily affect the lending policies of many banks. Nevertheless, the agencies felt that banks might be tightening unduly because of concerns about supervisory actions. We wanted to ensure that banks did not misunderstand our supervisory policies or believe that examiners would automatically criticize all new loans to troubled industries or borrowers.

Accordingly, building on earlier initiatives, in March, 1991 the agencies issued a joint statement to address this matter. That statement sought to encourage banks to lend to sound borrowers and to work constructively with borrowers experiencing temporary financial difficulties, provided they did so in a manner consistent with safe and sound banking practices. The statement also indicated that failing to loan to sound borrowers can frustrate bank efforts to improve the quality and diversity of their loan portfolios. Under-capitalized institutions and those with real estate or other asset concentrations were expected to submit plans to improve their positions, but they could continue sound lending activities provided the lending was consistent with programs that addressed their underlying problems.

At other times during the year, and particularly in early November, the agencies expanded on that March statement and issued further guidance regarding the review and classification of commercial real estate loans. The intent was to ensure that examiners reviewed loans in a consistent, prudent, and balanced fashion. This second statement emphasized that evaluation of real estate loans should be based not only on the liquidation value of collateral, but also on a review of the borrower's willingness and ability to repay and on the income-producing capacity of the properties.

Finally, in December, in order to assure that these policies were properly understood by examiners and to promote uniformity, the agencies held a joint meeting in Baltimore of senior examiners from throughout the country in one more effort to achieve the objectives just described. Once again, the principal message was to convey the importance of balance. Examiners were not to overlook problems, but neither were they to assume that weak or illiquid markets would remain that way indefinitely when they evaluated commercial real estate credits.

I would stress that the regulatory agencies took great care to indicate that these initiatives did not represent an exercise in forbearance. Indeed, they were compatible with the long-standing supervisory procedures described earlier.

International coordination

The Committee also asked about efforts to coordinate bank supervision on an international basis, so I will offer a few remarks on that topic. As you know, the Basel Committee on Banking Supervision was established as a permanent body by the governors of the Bank for International Settlements to provide a forum for exchanging views and information on bank supervisory matters. It is currently chaired by President Corrigan of the Federal Reserve Bank of New York.

Regular meetings of the Committee include a tour de table, during which representatives from all countries comment on areas of concern. When appropriate, topics would include commercial real estate markets and overall bank exposure to that market in countries experiencing a problem with commercial real estate. During these meetings, there is also ample opportunity for an informal exchange of views, experiences and problems, and for open and frank discussions.

In the vast majority of cases, credit problems in the commercial real estate industry tend to be uniquely national in nature, but where they are not, informal conversations are held with other regulators. This is particularly true when foreign branches and subsidiaries of U.S. banks have significant exposures in foreign markets that are experiencing problems in a particular sector such as commercial real estate. One example would be the situation several years ago in Australia where commercial real estate problems in that country had a major effect on the asset quality of several U.S. bank holding companies with a banking presence in Australia.

From time to time, a major cross-border problem will arise, the most recent and most serious being the credit and liquidity problems of Olympia and York Developments Ltd. In that particular situation, there were extensive and informal discussions with central banks and supervisory authorities in the United Kingdom and Canada, as well as with major creditor banks in the United States. Finally, there was a discussion at the April meeting of the G-10 central bank governors at the Bank for International Settlements. This meeting occurred just after the initial intensive press coverage of the Olympia and York situation. Chairman Greenspan and Secretary Brady were kept appraised of major developments as they occurred.

Assessment of U.S. Real Estate Markets

As noted in my opening comments, the worst seems to be behind us in terms of declining commercial real estate markets in most sections of the country, but only because the decline has stopped or at least slowed markedly. There remains little real improvement to be seen in any major market nationwide, and conditions in Southern California continue to be a concern. Basically, the volume of excess real estate capacity will take years for the nation to absorb and for the banking industry to overcome. That said, the industry's performance during recent quarters offers encouragement that banks will generate sufficient revenues to resolve their problems more quickly than many have believed.

Although the initial and, hopefully, worst revaluation phase appears over, further write-downs undoubtedly lie ahead. Metropolitan office vacancy rates, which reflect both downtown and suburban experiences, remain around 19 percent nationwide, about where they have been for several years. Some communities, such as Dallas, Ft. Lauderdale, and Stamford, have vacancy rates exceeding 25 percent. Such conditions will continue to place pressure on commercial real estate values and dampen earnings of some banks for at least the near future.

Olympia and York

One of the largest and most recent commercial real estate problems involves the Olympia and York (O&Y) group, which has substantial properties in Canada, the United States, and the United Kingdom. As the Committee may know, in late May, the company sought bankruptcy protection in the British courts for Canary Wharf, following similar filings earlier in the month for its Canadian companies. O&Y's U.S. companies have not sought bankruptcy, and the parent has stated publicly that it has not planned any filings for them.

The bulk of O&Y loans appears to be financed primarily by foreign banks, insurance companies, and public debt holders. Although some U.S. banks--a half dozen or so--also have sizable claims on O&Y, their exposures constitute a relatively small share of overall O&Y debt and do not appear to be unmanagable or to pose a threat to the lending institutions. Loans to Canary Wharf, in turn, are a small portion of U.S. bank claims on O&Y.

Although O&Y is not a major problem in itself for any U.S. bank, the conditions that produced problems for the company continue to depress real estate markets and are made worse by the weakness of this exceptionally large developer. That broader issue, which is the principal focus of these hearings, is the more serious concern.

Recent Examiner Advice

As indicated, examiners have received a significant amount of guidance from the agencies during the past year or so about the assessment of commercial real estate loans and about conditions in that market. In addition, their recent personal experiences evaluating these loans have sensitized them to the risks in this area, not only in the United States, but also in other countries where real estate values have declined.

Beyond statements already described, the Federal Reserve has through various Federal Reserve System meetings discussed risks in other aspects of the economy and bank lending. These discussions occur at meetings of members of the Board and Reserve Bank Presidents, at various conferences and seminars of senior examiners and other supervisory officials, during weekly conference calls involving the heads of supervision at the Board and at each Reserve Bank, and through other internal activities.

The Federal Financial Institutions Examination Council also provides a forum for discussing supervisory issues and developing advisories or policy statements for bankers and bank examiners on an interagency basis. One statement issued early this year dealt with investment practices of banks, especially those involving instruments whose values were exceptionally sensitive to changing interest rates. In short, this statement defines such "high risk" instruments and requires depository institutions that hold them to be able to demonstrate clearly that they serve to reduce the overall exposure of their investments to market rate changes.

Conclusion

In closing, the outlook for domestic commercial real estate markets and for most of its major bank lenders is more encouraging now than it was a year ago. The excess capacity in the commercial sector of the market, however, will take years to absorb. While both the industry and the bank supervisory agencies must learn from this experience, from a regulatory perspective, solutions may be difficult to find.

FDICIA contains numerous provisions that urge bankers to take greater care, including those involving prompt corrective action, and regulators have had more responsibilities handed to them. Requirements such as annual examinations should help supervisors to identify problems earlier and hold down the FDIC's costs. We must be careful, however, in turning constantly to barriers, prohibitions, and controls when something goes wrong. Too many restrictions will unduly restrain risk-taking and curtail economic growth. We cannot have examiners making decisions that are the responsibility of bankers in our private enterprise system.

While many changes were needed, the Congress should consider the more fundamental causes of the problems and not address merely the unwanted symptoms we see. Times have changed, and banking laws need to change, too. U.S. banks must have the legal authority to manage their businesses efficiently and pursue opportunities that arise. Without the ability to branch interstate and to expand into related financial businesses, I fear that many U.S. banks will continue to operate under profit pressures, a situation not conducive to a healthy banking system.