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Statement by

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Committee on Small Business

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Mr. Chairman and members of the Committee. I am pleased to be here this morning to discuss the credit crunch and the availability of credit for small businesses.

The financing of small business enterprises is a central issue in the future growth and vitality of the U.S. economy. Small businesses account for almost two-thirds of the nation's work force. They created 80 percent of the new jobs in the 1980s, a decade in which the U.S. economy created almost 20 million jobs, despite the fact that Fortune 500 firms reduced their employment.

The sources of small business financing are substantially more limited than those of large firms with continuous access to the depth and liquidity of public capital markets. For debt financing, small businesses are generally dependent on financial institutions, primarily commercial banking firms. It is because of the importance of small businesses to the growth of the U.S. economy, especially job growth, that the protracted weakness in business loans at banks is an important public policy concern--one worthy of rigorous analysis and concrete action.

Why have business loans by banks fallen? In our view, there are a number of contributing factors on both the demand side and the supply side of this market.

First, the demand for bank loans typically declines during recessions as economic activity slows, reducing firms' needs for working capital and new plant and equipment. In the recent downturn this has been amplified by a broad-based desire by businesses to reduce their dependence on debt financing. This deleveraging phenomenon, which has been apparent for both businesses and households, followed a decade in which debt financing expanded to historically very high levels. Excess leverage in conjunction with a weak economy reduced the credit worthiness of many firms as well.

Federal Reserve surveys indicate that supply side constraints on the availability of financing may have played a role in reduced business borrowing. They demonstrate that large banks have systematically tightened the terms and standards for granting business loans to customers of all sizes. Of course, some of this tightening was likely justified as an appropriate response to the lax credit standards of the 1980s and the resulting heavy loan losses of the early 1990s. Although no substantial reversal or easing is yet apparent, our surveys indicate that tightening of credit standards has ceased.

An important factor influencing the availability of financing during this period has been the condition of the U.S. banking industry. The debt financing of the 1980s left banks with record nonperforming loans--especially commercial real estate loans--in the early 1990s. These asset quality problems produced large loan losses which reduced the capital base of the U.S. banking industry. In response, the banking industry over the last 2-1/2 years has focused on identifying and working out bad loans, and rebuilding capital and liquidity. In short, the banking industry has been engaged in an intensive process of financial healing--dealing with embedded asset quality problems and rebuilding its financial strength.

This retrenchment process has involved reducing loan growth, investing in government securities, cutting expenses to enhance earnings, retaining a larger portion of these earnings, and issuing new equity to bolster depleted capital bases. While this process may have adversely affected loan growth in the short term, it was a necessary prerequisite to the industry's return to financial strength capable of supporting and sustaining new lending and growth.

It should be noted that, in our view, the Basle risk-based regulatory capital standards appear not to have played a significant role in motivating banks to curtail lending. During this entire retrenchment period, the overwhelming majority of U.S. banks met these minimum standards, most by a very wide margin. Indeed, those banks with capital far above the minimum standards have been responsible for the overwhelming majority of bank investment in government securities. In investing in government securities, it is not likely that these very well capitalized banks were motivated by minimum capital standards. Finally, other financial institutions not subject to Basle risk-based standards, such as credit unions and finance companies, exhibited the same pattern of retrenchment characterized by reduced lending growth and increased investment in government securities. This suggests that neither Basle capital standards nor bank examiners were primarily responsible for these adjustments. Indeed, all financial institutions responded in a similar manner to this economic environment of deleveraging and impaired asset quality regardless of whether they were subject to risk-based capital standards.

The pressure to increase capital beyond the regulatory minimum--in effect to build a notable cushion of capital above the minimums--came from several sources. Faced with uncertain large loan losses, banks themselves raised their assessment of the necessary capital base to sustain future lending; the capital markets demanded higher capital in order for banks to have low-cost access to funds; regulators, and changes in statutes, recognized that a sound capital base is the best protection for the federal safety net and the taxpayer. All concluded that adequate capital is required for banks to be able in the future to sustain lending in both good times and bad.

Finally, it is worth noting that this is a worldwide phenomenon. The retrenchment from the financial imbalance built up in the 1980s has produced stress in financial institutions in Japan, the U.K., Sweden, and Australia to name a few countries. This financial retrenchment has contributed to the economic slowdown in many industrial countries. Both in the United States and the rest of the world, it is quite likely that some banks, some bank lending officers, and some bank examiners may have become overly cautious. Indeed, in the United States, the federal banking agencies, and the previous and current administrations, have attempted to assure that our examiner staffs and examination guidelines do not impede the flow of sound loans to credit-worthy borrowers. These efforts continue.

Where do we stand today? The U.S. banking industry has made impressive progress in improving its financial health. Over the past 4-3/4 years through the third quarter of 1992, U.S. banks have charged off $123 billion in bad loans; yet increased reserves by $5 billion and added $77 billion in equity capital. Moreover, with loan loss allocations declining and after several years of stringent cost controls, 1992 was a record year for bank profitability. Bank capital ratios now are the highest level in more than a quarter of a century. While a segment of the industry remains under stress, the bulk of the U.S. banking industry has made remarkable progress in working through a very difficult economic cycle and emerging with renewed financial strength.

While this retrenchment process has been painful and may have constrained credit availability during the adjustment period, the banking industry now appears to have a strong capital base and ample liquidity to fuel the economic recovery. In addition, the interest rate spreads on small business lending appear attractive relative to alternative bank investments, and the deleveraging process by firms seems to be well advanced, though perhaps not entirely completed.

The recently revised estimate of 4.8 percent GDP growth in the fourth quarter of 1992 confirms that U.S. economic growth accelerated markedly during the second half of last year. This suggests that loan demand should be picking up as well. Thus, both improved supply and demand cyclical factors bode well for the outlook for increased small business lending.

There are signs that business lending at smaller banks--whose customers tend to be smaller firms--may have begun to strengthen. Such increases in small business loans may well be masked in the aggregate data by the extensive restructuring of corporate debt. In recent years, larger businesses with access to the public capital markets have issued record volumes of bonds and stocks and used much of the proceeds to repay short-term debt, including bank loans. More generally, for at least two decades, banks have found it difficult to retain those large business customers who can directly tap U.S. and foreign markets more cheaply. This widely recognized trend has contributed to a decline in business loans as a share of total bank assets. While this trend may well continue, small businesses will remain reliant on banks for their external finance. Thus, the continued importance of banks to small businesses warrants taking a look at those factors that may be constraining credit to small firms that do not have access to public capital markets.

One possible contributing factor may be changes in the nature of bank supervision and regulation in recent years. The 1980s were characterized by a sharp increase in the failure of federally insured financial institutions, both S&Ls and banks. In response, rigorous regulatory statutes were enacted including the S&L reform legislation, FIRREA in 1989, and the FDIC Improvement Act, FDICIA, in 1991.

These statutes produced, directly and indirectly, a substantial increase in regulatory burden on the banking industry. For example, each of the federal banking agencies had to create over 60 separate working groups to write the regulations to implement FDICIA regulations, a process which is still not entirely completed. This process itself likely contributed to subdued loan growth. Banks may have been understandably hesitant to launch major new lending initiatives before knowing the standards and regulations that would apply to these new loans.

While many of these new regulatory requirements have been worthwhile and important and have enhanced safety and soundness, a good many provide less clear-cut benefits that may not justify their cost in terms of increased burden. Higher burdens raise the cost of financial intermediation and can adversely affect the cost and availability of bank credit. Recent research by Fed staff has suggested that the least risky and lowest cost credit extensions to smaller businesses by banks in the 1980s were unsecured relationship lending. If recent statutory and regulatory changes have required additional documentation or collateral on such loans, the quantity of lending to these safer borrowers may have declined, because banks pass through the additional underlying costs or because these borrowers cannot provide the additional documentation or collateral.

Indeed there is every reason to think that recent regulations and statutes have changed the nature of supervision and regulation. The process has become progressively more standardized and mechanical, more dependent on documentation, analytical formulas, and rigid rules as opposed to examiner judgement. This may have disproportionately affected small business lending, which often takes the form of character and cash-flow loans, requiring judgement, and where the bank's return comes from a thorough knowledge and working relationship with the borrower. These loans are heterogeneous in nature, and they may be less amenable to the increasing standardized character of supervision and regulation.

At the same time, the focus on homogeneous, standardized lending products may have encouraged lenders to shift toward areas such as mortgages and consumer loans, which are more easily documented, scored and categorized. To understand the potential bias from this process, one need only to consider the cost and difficulty in documenting--especially for public or examiner scrutiny--the soundness of a character loan for small firms with unaudited financial statements. Compare this to placing funds in standardized mortgages, in mortgage-backed securities, or consumer loans amenable to computerized credit scoring.

Now it is true that a more rigorous supervisory process has many beneficial consequences. But one unintended effect may have been to make small business lending more difficult and costly because such a regulatory process may be in many ways simply inconsistent with the inherent nature of small business lending.

What can be done to ensure the availability of credit for small businesses? First, we need more rigorous insight into the nature of small business finance, and, to this end, the Federal Reserve Board last year initiated a substantial research project to sample the financial behavior of a large number of small business firms. This study will focus on the full range of financing alternatives available to small business, not just bank financing. The objective is to gain a rigorous understanding of the nature, problems and trends in this area. This is a major research project which will take some time to complete, and it underscores the Board of Governors' commitment to this important component of the economy.

As for the near term, we need to ensure that the regulatory process does not impede the flow of credit to small businesses. The suggestions for accomplishing this that have appeared in the public debate include exploring ways to reduce excessive documentation, perhaps by considering small business loans as a portfolio, rather than requiring each individual loan to bear the full regulatory documentation burden--an approach currently employed for consumer loans. Some have also suggested examining whether the FIRREA real estate appraisal requirements have unintentionally imposed an undue burden on business lending, a large portion of which involves real estate collateral. More generally, it is useful to explore ways in which the regulatory process might be tailored to be more congruent with the inherent nature of small business lending, rather than trying to force business lending into a standardized regulatory mold.

To this end, the Treasury Department, the Federal Reserve and the other banking agencies are engaged in a systematic analysis of the possible regulatory impediments to business lending. The objective is to design a set of regulatory actions which will eliminate unwarranted restraints on lending. The scope of the analysis encompasses the full range of issues associated with the regulatory burden on banks and possible problems in the examination process. In addition, we believe it is important to focus explicitly on impediments to small business lending. In attempting to streamline regulatory procedures for such loans, we are all committed to maintaining essential standards of safety and soundness including adequate capital standards. While it is premature to discuss specifics, a detailed set of proposals should be completed in the near future.

A further avenue of attack for this problem, and one that has been proposed in various forms is securitization. Securitization of business loans could measurably increase access to capital for small businesses. Such programs would be most productive for loans other than relationship loans, since the latter are not easily standardized. Because of the heterogeneous nature of small business loans, this will not be easy. More work needs to be done to standardize loan terms and various legal, regulatory and accounting problems need to be resolved before securitization will be feasible.

We at the Board of Governors generally favor efforts, including appropriate legislation, that would encourage securitization. We generally do not favor the establishment of a new government-sponsored enterprise involving business loan securitization because of our concern about adding to the already enormous overhang of contingent government liabilities.

While securitization has the potential to increase credit availability for small businesses, there will still likely remain an important role for banks in small business financing. Securitization is unlikely to be feasible for a basic staple of small business lending--the character loan. These loans are critically dependent on lenders' judgment, their knowledge of the firm, its principals, business and community, and they require an ongoing working relationship between the lender and the borrower. Even if securitization is successful, there are a large number of borrowers whose loans will not lend themselves to securitization. These borrowers are likely to remain dependent on a healthy flow of bank credit.

In summary Mr. Chairman, the outlook for small business finance seems encouraging. Loan demand should be reviving as the economic recovery progresses, and the U.S. banking industry now possesses a strong capital base and ample liquidity to support increased lending. Nonetheless, the weakness in bank business lending and the importance of small businesses to job growth suggest that it would be unwise to remain complacent and rely entirely on improving cyclical conditions to fuel small business loan growth. This is why we are working actively to try to identify and eliminate any unwarranted bank regulatory impediments to business lending. We feel this effort is wholly consistent with the Federal Reserve's fundamental objective of promoting maximum sustainable noninflationary growth in the U.S. economy. Thank you Mr. Chairman.