

Academic Conference
Stanford University
For Delivery March 5, 1993

Robert T. Parry, President
Fedrl. Rsrve. Bank of S.F.

Banks and Bank Regulation in the Current Economic Environment

- I. The San Francisco Fed is very pleased to co-sponsor this conference on Stabilization Policy with Stanford University, and I want to welcome you all here.
 - A. When I addressed the Fed's Academic Conference in the Fall of 1991, the economic recovery was very much in question, and it looked like a key downside risk was the unusual weakness in bank lending.
 1. The concern then was that the weakness in bank lending was being driven by stiffer bank regulation.
 2. Therefore, bank regulation was thought to be working against monetary policy efforts to stimulate economic activity.
 - B. Since then, the economy has managed a sustained, moderate expansion, which looks as though it will continue.
 1. So it seems that, in general, monetary policy has had the intended effects.
 - C. But there's still a view that many borrowers are shut out of the markets by banks that are reluctant to lend, and that stiffer regulation is the reason why.
 1. For example, last year, banks' profits were, for the most part, strong,
 2. but total bank loans increased by less than half a percent.
 3. At the same time, banks' holdings of government securities soared by almost 18 percent!
 - D. So there's a lot of interest in finding ways to get banks to do more lending,
 1. including giving bank regulatory policy itself countercyclical features.
 - E. In my comments,

1. I'd like to go over some of the factors that have affected bank lending, including regulations.
 2. And then I'll make some observations concerning the debate about bank regulation and economic stabilization.
- II. When we talk about unusual weakness in bank lending, it's important to note that it doesn't cut across all categories of loans.
- A. For example, home mortgage credit at banks continues to expand.
 - B. The areas of bank credit that have been especially weak are commercial real estate loans, construction loans, and commercial and industrial (C&I) loans.
 - C. We don't have to look very far to find developments that explain weak lending in these areas.
 1. The commercial real estate bubble of the 1980s has burst, bringing high vacancy rates, low rents, and high default rates into the 1990s.
 2. And problem construction loans at commercial banks for the U.S. as a whole are running at about 17 percent of total construction loans.
 - a. In California, the figure is over 20 percent.
 3. For C&I loans, the factors that could explain the weakness in lending over the last few years are as long as your arm:
 - a. For one thing, demand was no doubt dampened by the relatively slow pace of the recovery.
 - b. But the weakness in business loans can't be explained by the pace of economic activity alone.
 - (1) For example, innovations like just-in-time inventory management probably have dampened demand for credit.
 - (2) It's also been suggested that businesses have been retrenching from the debt buildup of the 1980s.
 - (3) Furthermore, many firms have shifted away from short-term financing,

including bank loans, and toward bond and equity financing.

(4) And I think we should note that the decline in C&I loans also probably reflects a longer-term trend, where banks are competing with other financial intermediaries and the commercial paper market for C&I loans.

D. These factors suggest that a good part of the weakness in bank lending reflects a variety of adjustments going on more generally in the economy.

1. Now, of course, the effects of these adjustments may be amplified through feedback from the credit sector to the economy.

2. But the developments I've cited don't seem to represent shocks coming from the supply of bank credit itself.

III. It is argued, however, that such shocks have come from changes in bank regulation.

A. This is a possibility I'd like to focus on.

IV. One area of change has been capital regulation.

A. One of the high profile changes, of course, has been the adoption of the Basle risk-based capital standards.

1. The principle behind the standards is sound: More capital should be held against riskier investments.

2. The actual implementation of the principle so far, however, only takes account of default risk.

a. For example, in calculating total risk-adjusted assets, Treasury securities get a weight of zero, and home mortgages a weight of 50 percent, while business loans get a weight of 100 percent.

B. As we heard this morning, there are a number of reasons why this kind of an arrangement seems like a natural for leading banks toward Treasuries and away from certain loans.

1. But the empirical evidence still leaves some puzzles about the effects of the Basle standards.
 - a. For example, the Fed's latest "Monetary Report to the Congress" finds very little to link individual bank's risk-based capital ratios to the growth in their securities.
 - (1) This seems to be consistent with the evidence presented this morning, which shows that banks across the board have increased their share of assets with a zero risk weighting.
 - b. The Report also points out that asset accumulation at credit unions—which aren't subject to the Basle standards—also has been concentrated in government securities.
- V. Other evidence, though, focuses on another important capital ratio that's different from the Basle risk-based standards, and it does suggest that capital regulation has had some impact on lending.
- A. This ratio, the "leverage ratio," is the ratio of the book value of equity to the book value of assets and is not adjusted for risk.
 1. Essentially, it's a supplement to the Basle capital standards, since they currently take into account only default risk.
 - B. Constraints from so-called leverage ratios appear to have been a special problem in New England, where commercial banks took large hits to capital.
 - C. Some banks in other parts of the country also felt constrained by their capital positions in late 1989 and into the 1990s, due in part to recent supervisory pressure to increase capital over and above the required minimums.
 1. In Fed surveys, for example, banks report that capital constraints are at least part of the reason that they've tightened credit standards.
 2. Also, a number of studies find a positive and significant relationship between leverage ratios and bank lending in recent years.

3. And research done at the San Francisco Fed suggests that the effect of the leverage ratio on lending increased in the 1990s,
 - a. which is consistent with the greater emphasis on capital regulation in recent years.
- D. In terms of the current situation, I should mention that capital requirements probably are less constraining, in part because banks have increased capital quite a bit.
 1. The aggregate equity-to-asset ratio rose from around 6.5 percent in late 1990 to 7.5 percent in late 1992, the highest level since the mid-1960s.
 2. This rise has occurred as a result of higher earnings as well as the issuance of new securities.
- VI. Compared with capital regulation, a lot more heat currently is being generated over the issue of so-called "character loans."
 - A. The argument is that examiners are limiting the scope of "character loans"
 1. by requiring more loan documentation,
 2. and by putting more emphasis on borrowers' cash flows.
 - a. One of my favorite stories is about a loan that was criticized because the borrower's cash flow was inadequate, even though it was a reverse mortgage!
 - B. This issue has gotten a lot of attention, and efforts are afoot to give well-capitalized banks more leeway in making character loans to small businesses.
 1. For my own part, I'm not sure how much this will boost lending.
 2. It seems to me that if constraints on character loans were a major factor,
 - a. then we'd expect to see the weakness mainly at smaller banks, which typically make such loans,

b. and not so much at larger banks, with their centralized loan operations.

3. But the fact is, we see weak lending at banks of all sizes.

VII. I do think, though, that regulation has had some effect, and that capital regulation in particular has made some difference to the extension of bank credit.

A. The greater emphasis on capital regulation and controlling overall risk in banking does depart from the past, when forbearance was common.

B. On the margin, the new regulatory orientation could intensify the role of the credit channel in transmitting shocks.

1. This point is at the crux of the public debate over the role of banks in the situation we face now—that is, where many of the negative shocks, such as those I mentioned earlier, seem to have been mainly nonmonetary.

a. Do you ease bank regulation in the face of high problem loan ratios and reduced creditworthiness of some borrowers to make credit more available?

b. Or do you continue to control overall risk in banking and potentially end up reducing credit to segments of the economy?

C. My own view on this debate is that there are some areas where we clearly need to re-evaluate our regulations.

1. A good example would be to drop the leverage ratio once other aspects of risk are built into the risk-based capital standards.

2. And I can also think of some provisions of FDICIA that could make for bad policy.

a. A prime example is the attempt to micro-manage banks by requiring regulators to set operating standards in areas like compensation and information systems.

3. And I don't think the supervisory process should wring all of the risk out of bank lending.

- D. But I do think that there are some very good reasons to stick to our guns on capital requirements.
 - 1. On the theoretical side,
 - a. recent research suggests that an unregulated, uninsured banking system would be subject to qualitatively the same type of discipline that strict adherence to capital standards provides.
 - b. That is, uninsured depositors would require undercapitalized banks to shift their portfolios away from risky assets—like business loans—and toward safe assets.
 - 2. Then there's recent history to remind us of the downside of forbearance.
 - a. I hope we learned a lesson from the 1980s, when the Congress and regulators bent over backwards to keep financially troubled thrifts open:
 - b. The lesson is that regulatory forbearance can be an expensive fiscal policy, and one that leads to an inefficient allocation of resources.
 - c. It's a lesson we shouldn't forget.
- E. In conclusion, my view is that we need to maintain a firm and consistent regulatory posture,
 - 1. and avoid the temptation to make countercyclical adjustments to regulatory policy.

wc 1700