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March 13, 1993

Remarks by

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before the

Annual Convention of the
Independent Bankers Association of America

San Diego, California

March 13, 1993

I appreciate the opportunity to address this annual meeting of the IBAA. Let me begin by briefly reviewing the major trends in our economy today. I will then discuss a related issue, the ways in which regulatory burdens on banks could be eased to foster the lending to small firms that is essential for healthy and sustained economic growth.

We are now roughly two years into the economic expansion that began in the spring of 1991, and is one of the weakest on record. This anemic performance reflected an unusual confluence of structural impediments to growth: heavy debt burdens for both households and businesses, overbuilding in commercial real estate, a substantial cutback in defense spending, and a tightening of loan terms by banks and other intermediaries.

Although these factors continue to weigh on the economy, their damping influence on activity began to subside around the middle of last year. Real gross domestic product (GDP) increased at about a 3-1/2 percent annual rate in the third quarter of last year and then advanced at nearly a 5 percent pace during the fourth quarter. Much of the impetus for stronger economic growth came from the consumer sector, after a period of cautious spending during which many households focused on paying down debts and shoring up balance sheets. The greater willingness to spend likely reflects the improvement that has been achieved recently in household balance sheets.

At the same time, businesses stepped-up their pace of capital spending. Real outlays for office and computing equipment soared, as firms continued to install the more powerful and cost-effective machines that have become available. Demand for other, more traditional types of equipment also picked up. Much of the wherewithal to finance these expenditures was provided by the marked increases in profits and cash flow over the past year.

On balance, the data in hand for the first two months of 1993 suggest that the economic expansion has continued, but at a slower pace than in the fourth quarter. The most positive news has been the continued firming of labor demand. Over January and February, the unemployment rate fell another 0.3 percentage point, dropping to 7 percent. In addition, the increase in payrolls in February was the largest in four years. However, the February report almost surely overstates the improvement in the labor market, given the still somewhat elevated level of new claims for unemployment insurance. Moreover, the other data for early 1993 are mixed. The growth in retail sales has slowed since year-end, and purchases of motor vehicles declined in February. In addition, most indicators of single-family housing activity just after year-end were disappointing, though anecdotal reports indicate that falling mortgage rates have invigorated this sector in recent weeks.

The news on inflation has been favorable. Excluding the often volatile prices for food and energy, the 3.3 percent rise in the consumer price index last year was the smallest in two decades. Although the CPI moved up considerably in January, underlying inflation pressures likely remain subdued, especially in light of the extraordinary gains in productivity. Indeed, the explosive bond-market rally in recent weeks would suggest that market participants are increasingly optimistic about the longer term inflation outlook.

Although broadly speaking, the recent economic indicators are encouraging, one should not readily conclude that we have clear sailing ahead. As I indicated in my Congressional testimonies over the past six weeks, the headwinds facing the economy have slackened somewhat, but they have not yet disappeared. This is still, in some respects, a tentative expansion, and the possibility of further setbacks, albeit temporary, cannot be dismissed out of hand.

For one, we are continuing to work through a major downsizing of military spending. Ultimately, the defense cutbacks will benefit the U.S. economy by freeing up resources to augment the nation's stock of physical and human capital. However, in the short run, lower defense spending depresses economic activity--as is obvious here in Southern California.

Another impediment is the slump in commercial real estate which, as you know, has accounted for a large share of the recent asset quality problems of financial institutions. Prices for such property have fallen precipitously in most markets. And, given the continued high vacancy rates and the sluggish demand for space, prices are likely to remain soft, inhibiting any recovery in commercial construction spending this year and possibly next year as well.

In addition, a number of our major trading partners have experienced slow economic growth or recession, hampering our export performance. In both Germany and Japan, real output fell for part of 1992, and growth for the year as a whole was substantially less than in 1991. Many other countries in continental Europe have recorded only weak growth, and the United Kingdom has yet to emerge from prolonged recession. The resulting adverse spillovers for the U.S. economy can be expected to persist for some time.

Here at home, the availability of bank credit remains a major concern. While weak demand certainly explains much of the weak loan growth at banks and other intermediaries, the supply of such credit clearly has tightened in recent years. To a large degree, this tightening reflects a return to more prudent lending practices. However, increased regulation likely has played

a role as well, with the most noticeable effect on the supply of credit to small firms

Any assessment of the outlook for the economy as a whole--especially employment--has to focus on the health of our small business sector--including its ability to obtain finance

Historically, not only have banks--especially smaller banks--had the special expertise to tailor terms to meet the needs of small borrowers, but their franchise has relied on--as it still does today--their special accumulated knowledge about the individual customer. The capital markets specialize in more standard credit contracts and hence--especially with the recent difficulties of life insurance companies and the reduced availability of private placements--smaller businesses do not have the luxury of tapping very many nonbank sources of credit. Even if they could, their scale of borrowing would result in prohibitive costs, given the high fixed costs of public and private capital market issues. According to a 1988-89 Federal Reserve survey, the median *total* outstanding loan balance at banks for a small business was only \$25,000, only 10 percent of loans outstanding exceeded \$300,000.

Given the importance of small businesses to the economy and the clear dependence of such firms on banks, the decline in business loans in the 1990s underlines the importance of understanding the difficulties of bank credit

availability. Even more importantly, it highlights the need to do whatever is possible to remove those sources of restriction that do not imperil the safety and soundness of the banking system.

Assessing the true nature of small business bank credit availability is especially complicated, in part because it seems clear that a substantial share of the decline in total business loans at banks reflects significant balance sheet restructuring by large firms. Many larger businesses have taken advantage of the decline in interest rates and the increase in stock prices to refinance their bank loans.

The declines in business loans associated with balance sheet restructuring by the larger firms were superimposed on a secular downtrend in business credit flows by banks to large firms that have been increasingly relying on nonbank finance. And overlaying the interest rate and stock market induced repayment of bank loans by large firms, and their secular shift to nonbank credit, has been a normal cyclical decline in the demand for credit during the recession and modest recovery.

However, I do not believe that cycles, trends, and refinancing are the sole explanations for the decline in business loans. There *has* been a substantial tightening of lending terms and standards and it *has* affected small businesses. Evidence from the National Federation of

Independent Business' Survey is suggestive. For example, owners of small businesses with more than 40 employees report greater difficulty obtaining credit than three years ago. And, small business credit problems have been very intense in some regions of the United States. Clearly, New England has borne a disproportionately large burden.

The sources of tighter credit availability are not hard to find. A significant part of our current problems reflects a too expansive credit policy throughout most of the 1980s. Large numbers of lenders mistakenly perceived that financing real estate was not only very profitable, but also virtually risk-free because of the near certainty of continued real estate inflation. But inflation in real estate not only ended, it was in many cases reversed, exposing the lax underwriting standards that had evolved.

The resulting acceleration of nonperforming loans, and associated reserving and write-offs, not only cut sharply into capital--causing many banks to fail and others to be greatly weakened--it also shook the confidence of lending officers and management. Indeed, despite the low rate of depository institution failures so far in 1993 we should not forget that the past several years have seen many more depository institution failures than all the other years since World War II combined. The almost inevitable result of these traumatic experiences has been that bank lending policies have gone through a period of exaggeratedly high

underwriting standards--the same error as in the 1980s, but in the opposite direction. While there appears to have been no further tightening in recent months, the effect on banks of excess optimism in real estate in the 1980s is not, I am afraid, as yet behind us.

Commercial real estate prices have not stabilized enough to allow most banks to feel confident that they know what collateral is really worth. Thus, a kind of traditional bank liquidity--a sense that real estate collateral could be liquidated expeditiously within a known price range--has not yet returned to bank balance sheets. While improving significantly from the dark period of 1989-91, we do not yet have the turnover and transactions required to instill adequate confidence in most bankers about either their existing or new loans secured by commercial property.

As each of you well know, a significant portion of loans to small businesses involve some real estate collateral. And, even though banks often do not look to that real estate as the intended source of repayment, I am still concerned that a real estate market that has not found its feet, is retarding the availability of small business credit. This impact is both direct--in evaluating particular loans--and indirect--by coloring bankers' sense of general confidence.

As significant as the real estate contraction has been on bankers' attitudes, it is not the sole source of trauma. The lax underwriting standards adopted by many banks in the 1980s contributed to large losses and write-offs--write-offs of almost \$125 billion since 1988. Surviving banks have not only covered such losses by earnings and capital issues, but have increased their own minimum capital standards. This increase in internal standards has resulted in part from their own review of "policy," but in many cases it is the direct result of market demands. Both capital-issuing banks and those without ready access to capital markets also improved capital ratios by growing less rapidly or even shrinking. All of this, I suggest, is not an unexpected reaction to difficult problems. Indeed, I would argue that it is not surprising that underwriting standards have been reviewed and tightened.

Banks' own desire to rebuild a strong capital base has played an important role in constraining the supply of bank loans. Research at the Fed appears to have begun to pick up the importance of internal capital targets. In saying this, I do not mean to imply that either Basle or FDICIA capital rules are unimportant. They reinforced the importance of capital at both banks and in the market. But, Basle and FDICIA standards imposed on a less traumatized banking system would have been viewed by few

observers as a major constraint on banks' ability to make loans

Indeed, the Federal Reserve Board supports both the Basle standards and the prompt corrective action zones of FDICIA. The behavior of the 1980s--and the associated losses--would surely not have occurred to the same extent without a deposit insurance system that permitted banks and thrifts to take major risks on a slender capital base with only minimal market response. Political concerns apparently made it impossible to lower directly the per account level of deposit insurance. Hence, making the moral hazard of deposit insurance moot through higher capital standards was the most attractive option available. With larger amounts of stockholders' capital at risk, banks we must assume will adopt more careful and efficient loan policies. Moreover, simulating market responses, as is intended in the progressively restrictive prompt corrective action zones, is helpful. In the absence of deposit insurance, markets would impose reduced dividends, a lower pace of expansion, and other increasingly severe actions on firms becoming financially distressed.

Parenthetically, so far as we can tell, the risk weights in the Basle standards have not played a significant role in disrupting credit flows generally, or to small businesses in particular. To be sure, the intention of the risk weights was to make the capital charge reflect

differences in credit risk, and to induce banks at the margin to hold more liquidity in their portfolios. Thus, if the weighting system had not caused banks to lean somewhat more toward securities, it would have had to be counted as a failure. Nonetheless, the weights were not designed to cause a large shift from loans to securities. And there is simply no real evidence that the weights have been a significant factor causing the observed substantial shift in bank credit from loans to government or mortgage-backed securities. In addition, the banks that have accounted for most of the increased holdings of Treasury securities are those with the highest capital ratios, where the zero weight could not have been relevant to their decision. Indeed, financial institutions not subject to risk-based capital or FDICIA, such as credit unions, have also shifted strongly away from loans and toward securities in the 1990s. In short, other factors--lower credit demands, balance sheet restructuring, and tightened loan standards--are better explanations of portfolio shifts than the Basle risk weights.

But Basle and prompt corrective action were not the only external forces supplementing banks and the markets' responses to the residue of the 1980s. Examiners have been widely and severely criticized for permitting banks to have made such bad credit decisions. That many examiners would respond by becoming unusually sensitive to credit

granting procedures and--as professionals--reluctant to respond to pleas for more flexibility cannot come as a surprise. At last reading the laws of human nature have not been repealed. This tendency to respond in an overly cautious way is doubly unfortunate, because if there were ever a time that bankers would be careful without examiner oversight it has been the early 1990s.

The other critical external force contributing to reduced credit availability at small businesses is recent banking legislation--FIRREA and FDICIA. In understandable reaction to the huge taxpayer costs of the failure of S&Ls and the need to establish a taxpayer's backup to the FDIC--a backup, I note, which has not been used--the Congress felt it necessary to place severe restrictions on insured depository institutions. As I indicated a moment ago, the Board supports the capital and prompt corrective action provisions of FDICIA. But, the scale and sheer detail of other portions of recent legislation have, I believe, played an important role in constraining small business credit flows.

The scale has resulted in a drum beat of mandated regulatory announcements and--perhaps worse--anticipated actions. All have diverted management resources, increased burdens and costs, and created uncertainties that could only make bankers more reluctant to take risks. As I have indicated over the past year, I have been particularly

concerned about provisions that require regulations to specify operational, managerial, asset, and earnings standards and minimums, as well as detailed auditing requirements--especially management reports and certification by auditors. In addition to cost and burden, such micromanagement has a chilling effect on bank lending attitudes, imparting a high degree of management uncertainty while the implementing rules are developed, debated, and adopted. It is not unreasonable that banks expect the worst in rule changes before they are promulgated.

Aside from the general impacts on bankers' attitudes and risk-taking, two regulatory factors have particularly constrained small business credit availability at banks. The first, I am sure, was unintended. The real estate appraisal requirements of FIRREA were designed mainly to eliminate excesses in development and commercial real estate loans. However, as you know, most small business loans involve some real estate collateral, even if the purpose of the loan is not to purchase or refinance real estate, and the bank does not look to the real estate as the source of the repayment. Nonetheless, FIRREA requires banks either to increase their risk by foregoing real estate collateral on such loans, or to impose significant costs and delays on the credit granting process by requiring certified appraisals on the real estate collateral. Either way the

willingness and ability of banks to make such loans is reduced, and in some cases may have been eliminated

The second development that has affected small business credit availability at banks is the huge increase in the amount of paperwork resulting from heightened risk aversion by examiners and the attitudes induced by the banking legislation. Our research, and the conventional wisdom in banking, support the view that the least risky small business loans of the 1980s often had no collateral at all. Despite this evidence to the contrary, many bankers now perceive that full documentation and collateral on such loans are necessary in order to minimize the possibility that examiners will classify them. As a result, the cost of lower risk loans to small business has risen by the imposition of documentation and collateral requirements or-- if the necessary documentation and collateral are not available--such loans are not being made. In either event, the economy suffers.

Nonetheless, as I review the current banking situation, I find reasons for optimism, but not complacency. While not yet totally stabilized, some degree of firmness is occurring in some commercial real estate markets. Our surveys and other information indicate that banks' attitudes toward loans and risk-taking are improving. Notwithstanding the almost \$125 billion of loans that have been charged off over the last five years, loan loss reserves are \$5 billion

higher Earnings were at record levels in 1992, and banks have been extremely successful in raising new equity. Indeed, equity capital in the industry has risen by almost \$80 billion over the last five years, the resulting bank capital ratios are at their highest levels in a quarter of a century. On balance, while a segment of the industry still is under stress, the banking industry as a whole has made remarkable progress in working through severe portfolio problems during a difficult economic cycle. With an improving economy, I am hopeful that the signs of some business loan growth this winter will become more evident this spring. Banks are patently in a strong position to meet such demand.

But the issues are too important to leave to chance. There are steps we can and should take. As the President announced on Wednesday, the banking agencies are working on ways--within the parameters of FDICIA and FIRREA--to modify their policies and regulations in order to encourage more small business credit availability. While all the details have not yet been developed, we plan to exempt from appraisal requirements the real estate collateral for smaller loans that are not for the purpose of acquiring or refinancing real estate, and where the lender is not relying on the real estate collateral as a source of repayment of the loan, we anticipate that this provision will provide relief mainly to small- and medium-size businesses. Consideration

is also being given to raising the exemption level for appraisals above the current \$100,000 for all loans, since there is little evidence that modest size commercial real estate loans present unusual risk to banks. We also plan to promulgate policies that will permit well-rated and adequately or better capitalized banks to make some loans to small- and medium-sized businesses and farmers, on the basis not just of documentation and/or collateral, but solely on the bank management's knowledge and evaluation of the borrower. This type of loan, as I have noted, requires the special expertise that is the hallmark of the bank lending process and, I believe, is one of the special ingredients that fuels small business--and hence economic--expansion. Outside of the permitted "basket" of such loans, I am hopeful that policies will be adopted suggesting additional loans by these strong banks, as well as loans by other banks, will not be criticized for small or occasional documentation shortfalls, nor will special mention loans be treated as classified. In addition, the agencies have a long list of technical modifications in process, including revisions to other real estate owned, in substance foreclosures, and partially charged-off accounting and reporting rules, as well as efforts to attempt to reduce examination duplication by function and agency. Finally, each agency will attempt--where necessary--to streamline its examiner appeal and complaint process.

To wrap up, the past several years have been difficult ones, and the economy is still adjusting to structural imbalances that have built up over recent decades. However, I believe that these painful adjustments have laid the foundation for better performance of our economy over the longer term. The small business sector is crucial to job formation and strong growth. We need to, and can, take actions which ensure the flow of bank credit to smaller firms, while simultaneously protecting the safety and soundness of the banking system. We at the Federal Reserve intend to continue fostering the economic expansion in the near term, while promoting a financial environment conducive to sustainable growth over the long haul. Fiscal policy, in turn, must take the necessary actions to reduce the structural deficit. Enhanced living standards for the American people for years to come is on the horizon, if we succeed.