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Testimony by

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Committee on Small Business
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I am pleased to appear before this Committee to discuss the availability of bank credit to small businesses. It is clear that 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. Indeed, the importance of bank credit flows to small business was highlighted by the President's recent announcement of joint actions by all the banking agencies to facilitate such lending.

Given the importance of small businesses to the economy and the clear dependence of such firms on banks, the decline in overall business loans in the 1990s underlines the importance of understanding the difficulties of bank credit availability. Even more importantly, it emphasizes the need to continue 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 the 1990s of 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. This tightening of terms and standards has been clear in our periodic surveys of senior loan officers at large banks since the start of the decade, although this aspect of loan pricing seems to have stabilized in 1992. Evidence from the National Federation of Independent Business is also suggestive. For example, owners of the larger small businesses report greater difficulty obtaining credit than three years ago. The period of credit stringency appears to have lasted longer than in other recent downturns. 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 very profitable, and 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.

The real estate market plays an important role in small business credit, since a significant portion of loans to small businesses involves 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 both the bank's own capital, as well as 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 clearly 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 the prompt corrective action capital rules are unimportant. They reinforced the importance of capital at both banks and in the market. But, Basle and other capital 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 will be encouraged to 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 particularly 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, 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 regulatory 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 March 10, 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. I anticipate that the agencies will shortly promulgate policies that will significantly ease documentation requirements for a portion of loans to small- and medium-sized businesses and farmers by stronger banks and thrifts. While research suggests that loans that likely will be made under this policy will be low risk, the banks that will be permitted to extend such credits are those most able to absorb some additional risk without threat to their safety and soundness and, by the record, are adept at credit underwriting. Loans with limited documentation--often called "character" loans--require 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.

Consideration is also being given to easing formal real estate appraisals for transactions that do not present unusual risk to banks, and for increasing the current \$100,000 exemption level for all loans. 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.

These regulatory actions will be, I hope, quite helpful, but legislative action is still required. The Federal Financial Institutions Examination Council will be making legislative proposals this spring, and I urge the Congress to consider them seriously. But perhaps most important is to learn from the experience of the 1990s. One key lesson surely is that each new, proposed piece of detailed banking legislation has to be evaluated *in advance* to determine what the impacts are likely to be on the health, vigor, and competitiveness of the banking system. It is even more important to consider the potential implications for the vitality and growth of the economy, especially those sectors that create so much of our employment and innovation. These sectors often have few credit alternatives beyond their local banks.