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Remarks by

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NEW HORIZONS FOR THE BASIC BUSINESS OF BANKING

I am pleased to attend this year's convention, and to have the opportunity to discuss "new horizons in banking," the general theme of the conference   Certainly there is much that is "new" in banking, if the press coverage on topics such as derivatives, securitization, mutual funds management and the like are any indication But I would remind everyone that the activities often regarded as "new" by casual observers are in fact often merely extensions or different forms of the basic business of banking, which is to measure, price, manage, and accept various forms of risk, especially credit risk   Unfortunately, in the process of focussing on the new, we often lose sight of how important is the old—that is, good old–fashioned lending—and how the old is constantly adjusting to the times   For these reasons, I would like to concentrate my remarks today on new horizons in *lending*, one of the core businesses of *banking*

Competition among banks, and between banks and their nonbank counterparts, has never been greater   We have been seeing for some months now the results of that competition in the form of an easing of the price and nonprice terms of credit for business loans   Spreads over the prime for all sizes of loan have declined since this time last year   Probably a part of this decline is a reaction to the historically high levels of prime relative to the federal funds rate But margins over market costs of funds have contracted and nonprice terms of credit also have eased in the last year or so, including fees, levels of collateralization, and loan covenants   In addition, there is

anecdotal evidence that credit standards have weakened These bankers' anecdotes, of course, are always referring to the competitor down the street But examiners also are saying that some bankers are making loans to borrowers who, in the restrictive years of the early 1990s, would otherwise have been denied credit

I am not in the least suggesting that business credit standards are today inadequate, as they appear to have been (at least in hindsight) during much of the 1980s I have argued previously that the tightening of standards in the recent past was an overreaction—by banks as well as examiners—to the events of the 1980s Perhaps now, in the mid–'90s, we are seeing an adjustment downward to a more balanced set of loan standards This is likely to remain an open question for a while

Nor am I asserting that, now that spreads are narrowing, banks are not getting compensated sufficiently for the risk of lending to businesses Some observers believe this to be the case and say flatly that commercial lending by banks is not profitable in a risk–adjusted sense On this matter judgment should be reserved, especially so long as the overall profitability of banks and the overall capital ratios of the industry continue at their current, comfortable levels But there are enough questions to be raised about industry loan practices to give a central banker and supervisor pause At the same time, there is much that is "new and improved" about industry lending practices and one should balance concerns about possible deficiencies in the lending process with plaudits for the advancements that have been made

One advancement that appears to hold promise is the practice of grading commercial credits More and more banks are grading their loans much like rating agencies provide ratings for corporate bonds. In the past, at most banks, a loan was either a "pass" or a "fail " Now, a number of the larger, better managed institutions assign ratings from, say, 1 through 6 for a bankable loan, with 1 corresponding to a AAA–rated bond and 6 corresponding to, say, a B–rated bond

The rating process appears to be an extremely useful exercise for the loan officers and loan review personnel of the bank In the initial credit granting stage, the rating process often brings greater precision to the decision to approve or deny a loan In addition, by rating the obligor first and then evaluating the proposed facility, the process may help provide insights into loan covenants or other nonprice terms that will allow the credit to become a bankable loan

The ratings are also useful in the credit monitoring process once the loan is placed on the books For example, if the credit review officer determines that a grade 3 loan has deteriorated to grade 4 level, the bank may enter into what is often euphemistically called a "dialogue" with the borrower In some cases, this discussion can be held well before the loan is in danger of becoming a classified asset Also, risk managers, using a rating system, can develop quantitative measures of the credit quality of a bank's portfolio of nonclassified loans, including the average credit quality (or grade) by industry or by geographical sector

The grading process has moved from a procedure that was largely applied to the large, syndicated credits, to a fairly standard practice among the better managed banks for middle–market lending One can guess that it is only a matter of time before loan rating is a common practice for lower middle–market and small business lending, not only for the money center and regional institutions, but for community banks as well

The credit rating process has been improved most recently by the wider usage of credit scoring models in assigning a loan rating to a corporate obligor and loan facility The credit scoring models, which have been common practice in the consumer credit arena for some time, are generally used as inputs into the credit decision process rather than as a substitute for human judgment The ultimate decision as to whether the credit is bankable should, after all, lie with the loan officer and his superiors, not a machine But it is becoming increasingly evident that the rigor of the credit scoring model aids the process, gives the final decision more credibility and, under some circumstances, speeds up the process and reduces cost

Perhaps the most significant implication of the credit rating process is that it permits banks to price loans according to the risk of the obligor This is such a seemingly appealing procedure that I find it curious that the vast majority of banks, including even very large institutions that otherwise grade their credits, have chosen not to vary the price of business credit according to risk Most institutions, having decided that a loan is bankable, will vary the spread according to the size of the credit facility or

perhaps its contractual life But it is rare for a bank to vary the rate charged according to the credit quality of the obligor, especially for middle–market and small business loans

Banks are inviting competitive incursions by offering only one interest rate per facility for borrowers of widely varying risk A single interest rate for credit, or even two or three rates, suggests that some individual borrowers are being overcharged in relation to their riskiness and some are being undercharged Indeed, informed observers say just that the highest quality borrowers are being charged loan rates that are higher than actual loss experience indicates, meanwhile, the riskiest borrowers probably are not being charged sufficiently high rates to cover their significantly higher risk of default and loss in the event of default

If banks continue this practice, sooner or later the best quality customers will decide to seek better loan terms elsewhere This is exactly what happened with the better quality *large* corporate borrowers, who discovered that direct access to bond and commercial paper markets could reduce their borrowing costs below those associated with borrowing from banks The banks' competitive response to this outflow of large corporate customers was to invent the commercial paper facility But one must wonder if banks could have prevented much of the damage by pricing their large corporate credits properly to begin with—i e , to reflect the facts of modern bond markets Specifically, there are more than two dozen price levels or "ticks" inherent in the credit ratings for corporate securities The markets will distinguish, in terms of yield, between

two bonds with similar nonprice terms, if the corporate obligor in one case is rated AA *plus,* and in another case is rated AA *minus* But risk–differentiated pricing was not prevalent in banking when the industry began losing its largest and best quality corporate borrowers, and it is not being used today for the bulk of middle–market and small business lending

Of course, risk–based pricing is a controversial issue, and bankers offer at least three reasons why they do not price differentially for risk First, bankers worry they will lose valued customers if some of them find out that other customers are getting better terms on their loans Also, there is a concern that a higher rate charged to a riskier business will induce that customer to switch banks, causing the original lender to lose the profits that flow from the entire customer relationship In addition, the banking industry apparently is not yet comfortable with the state of the art in measuring and pricing credit risk

These concerns are clearly legitimate, but as technology increasingly facilitates the accurate measurement of risk, we should become more concerned about what happens if banks do *not* price their loans according to risk There should be little doubt that mid–market and small business borrowers are using ever–sharper pencils, or more relevant, sharper PC programs If credit practices are left unchanged, we can expect the experience with the best–quality *large* corporate clients to be repeated with the best–quality *smaller* business clients The best quality customers will seek funds

elsewhere, and banks will be left with ever higher risk borrowers for whom loan rates would then have to be raised in any event to cover the risk

Going beyond the impact on banks' continuing struggle with their competitors, improvements in risk measurement and risk–based pricing can be expected to have several beneficial effects for the general economy   Banks' role in the allocation of scarce resources would be conducted in a more efficient manner, as some businesses with brighter futures and attendant lower risk would find bank credit to be less expensive   Still other companies likely would find that a more critical examination of their prospects would result in more expensive credit—as should be the case for firms with highly uncertain futures

Also, in the long run, more accurate risk–based loan pricing generally should reduce the sometimes disruptive rationing of credit that occurs especially during economic downturns   If banks become more confident of their ability to measure credit risk, then they can begin pricing properly for the higher risk borrowers rather than simply denying credit   Thus, while proper risk–based pricing may cause some high risk borrowers to pay higher loan rates than now, other high risk borrowers will gain access to credit for the first time   For the borrower, credit at a higher rate than other businesses pay may be a more palatable option than no credit at all   So long as banks' risk measurement processes are sound, and so long as banks manage overall loan portfolios properly, including maintenance of adequate loan loss reserves, the general economy benefits from the additional activity of the high risk businesses

Accurate measurement of risk also is a necessary condition for the ultimate development of a market for the securitization of business loans Some bankers may worry that securitization of commercial loans would cause banks to lose their last bastion of competitive advantage over their nonbank rivals But the opposite is more likely to be the case If banks don't develop means to diversify the risk of holding individual, risky business loans, others will Perhaps, bankers should learn from the mistakes of some thrifts, who were slow to embrace securitization of home mortgages, and now find their place at the table occupied by some bankers, who are doing very nicely originating mortgages and selling them into the mortgage–backed securities markets

As was the case in mortgage markets, securitization of business loans likely would cause commercial loans on banks' balance sheets to shrink, but that is not remotely the same thing as saying bank returns on capital would shrink Bankers would continue to profit from processing loan applications, conducting the standardized credit ratings, monitoring loan performance, and working out the particular loans in any given loan pool that do not perform But instead of holding the business loans on their balance sheets, banks would sell them into the pools to be securitized, and would then decide whether to hold the pool securities on their balance sheets instead of the whole loans Also, certain whole loans would continue to be held directly by banks, depending on the risk–return characteristics of the loans The overall effect would be to reduce bank risk, relative to bank earnings, in much the same fashion as, say, the market for consumer credit card receivables In that arena, the individual small or

medium–sized bank may have deemed traditional consumer lending to be too risky But originating credits and pooling them reduces the risk for everyone, and securitization permits smaller institutions to take part in a profitable business practice which otherwise would be off–limits

Granted, many hurdles need to be overcome before commercial loan securitization becomes commonplace, including the development of standardized loan documentation Remember, however, that two decades ago, all home mortgages were nonstandard, there were no mortgage securities markets, nor were there credit card securities It is by no means difficult to envision that a couple of decades from now, markets for business loan securities will be a reality, and bankers will be discussing casually the differences between the markets for conforming business loans versus nonconforming loans Remember, too, that the potential benefits from risk diversification will benefit banker and customer alike, but only those bankers willing to embrace the technological change will share in the benefits

Because it seems so clear that bankers face significant "new horizons" in the lending process, regulatory agencies must be especially careful not to place obstacles in the path of beneficial technological change For example, it would make little sense for bankers to securitize their commercial loans, replace them on their balance sheets with AAA–rated pass–through securities, and then have those securities subject to the same 8 percent capital standard required for ownership of the whole loans With these thoughts in mind, an interagency task force is looking at the

issue of appropriate capital standards for loan securitizations and, in May of this year, the supervisory agencies published for comment various proposals for rationalizing the capital requirements on loan securitizations of all types Much work needs to be done in this arena, and the agencies will have to guard against setting capital standards that are inconsistent with industry "best practice" credit risk management or, worse, that foster uneconomic lending or portfolio decisions by banks

Bankers too must be receptive to the benefits of technological change, and must continue to improve their measurements of credit risk and the associated pricing of that risk Today, I have touched on the profound changes in the business of lending that have occurred in only the last several years One can readily speculate that many more such changes will occur in the not so distant future I have no doubt that bankers will arrive at these new horizons with receptive minds and a willingness to embrace the best of the new ideas The industry will benefit and, I am sure, so will its customers and the general economy