

TESTIMONY OF

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ON

CREDIT AVAILABILITY

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

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Good morning, Mr. Chairman and members of the Committee. We appreciate the opportunity to address the Committee on behalf of the Federal Deposit Insurance Corporation on the timely topic of credit availability.

Our remarks will focus on the so called "credit crunch" debate. Specifically, we will address the condition of real estate markets and real estate lending by banks across the country. We will look at the region receiving the most attention -- New England. We also will review the supervisory policies and practices followed at the FDIC, and will attempt to clear up the misconceptions surrounding the term "performing non-performing loans."

CREDIT CRUNCH

To discuss the subject of a "credit crunch," we first need to know what is meant by this term. We define credit crunch as the general unavailability of credit to creditworthy borrowers, for legitimate and viable purposes. This is in contrast to the term "credit contraction" which is generally defined as a phase in a normal market real estate cycle.

What we see are mixed signals. There may be isolated instances across the country where creditworthy borrowers with viable projects to finance are being denied credit. However, we have not seen any evidence that such credit denials are anything more than isolated instances. That is, we see no signs of a credit crunch in terms of

creditworthy borrowers. We are, however, seeing increasingly clear signs of a credit contraction. Real estate markets are weakening throughout the country, not just in New England. Moreover, we are seeing a downturn in certain types of real estate lending by banks.

Our first quarter data for the commercial banking industry show that the growth rate for construction and land development loans dropped to zero. That is, after years of steady increases, total construction and land development loans remained constant in the first quarter. However, other types of real estate lending continue to show normal growth. Commercial real estate lending continues at a 12 percent annual growth rate. Home mortgage loans and mortgage-backed securities grew at almost the same annualized rate in the first quarter. (See Chart 1). In fact, real estate lending continues to account for an increased portion of overall bank lending. About 40 percent of all bank loans are real estate related. In addition, while total bank assets increased by only 5.1 percent from the first quarter of 1989 to the first quarter of 1990, real estate loans increased by 11.8 percent over the same period.

Greater dependence by banks on real estate lending comes at a time when real estate markets are weakening not just in New England but across many parts of the country. As of year-end 1989 there were 20 states where banks had noncurrent real estate loans that exceeded two percent of total real estate loans. Only three months later, our first quarter data show 28 states where the percentage of noncurrent

real estate loans exceed two percent. More than half of these states have a noncurrent ratio of three percent or higher. (See Chart 2).

The first quarter figures on noncurrent real estate loans indicate that real estate markets are deteriorating in many parts of the country. Under such conditions it is natural that the demand for real estate related loans should decline. A recent report by the Conference Board indicates that "given the current state of the economy ... business demand for bank credit should be expected to be low." The report suggests that any slowdown in debt is perhaps more a reflection rather than a cause of a slowdown in the economy. A survey by the National Federation of Independent Business supports this conclusion by reporting that fewer and fewer small businesses are seeking credit. To quote William Dunkelberg, Chief Economist at the Federation and a Professor of economics at Temple University, "Small businesses are borrowing at low levels, but that's because they don't need it or don't want it."

NEW ENGLAND BANKING ENVIRONMENT

The New England region is undergoing a strong credit contraction as a result of overbuilding and a declining economy. Construction lending in the Boston area declined 13.2 percent in 1989, overdue and nonaccrual real estate loans grew 245.3 percent to 1.9 percent of bank assets, and repossessed real estate leaped by 180.8 percent. A recent American Banker listing of the largest banks (assets over \$500 million) with the highest ratio of noncurrent and nonaccrual real

estate loans as a percentage of capital showed 13 New England institutions among the worst 25. (Of the balance, six were in Texas, three in Arizona, two in Florida and one in New Jersey.)

The regional decline appears to be a market correction caused by several years of a strong economic boom fueled in part by overcapacity in banking. Banking capital expanded significantly with the conversion of a sizable number of institutions from mutual to stock ownership. Concomitant with the capital increase was pressure from shareholders to leverage this capital by lending in order to achieve an acceptable market return.

The boom unfortunately was too often aided by liberalized lending terms and relaxed credit standards. These policies led to high loan demand, primarily in real estate development, which was funded by a combination of high cost purchased funds and consumer funds. The easy, though costly, availability of credit to both established and marginal borrowers led to severe overbuilding and a general overpricing of goods and services throughout the region. This is a common occurrence during boom periods. Other market forces -- such as setbacks in the financial services industry in the aftermath of the 1987 stock market crash, a maturing of the high tech industry, and slowdowns in defense spending -- have caused a substantial slowdown in the region's economy.

Much of the asset quality problems in New England are lodged in the banks which underwent the strongest growth during the boom years.

Many of these banks are among the region's largest. The asset quality problems have caused significant decreases in banking profits and asset valuations. Whether the losses have been recognized voluntarily by the industry or are regulator-induced through the examination process is really not the point. The asset devaluations, with rare exceptions, are proving to be valid and could in fact be understated if the region's economy continues to erode.

In order to maintain compliance with capital requirements, many affected banks have found it necessary to retrench through a shrinkage in size. This is not an uncommon scenario under the circumstances. As a result, there has been a general contraction in the availability of credit funds in these institutions.

Statistics bear this out. Loan volume in New England fell by \$5.8 billion in the first quarter. Of that amount, \$2.4 billion was due to loan sales and charge-offs. Thus, the net contraction in loan volume was \$3.4 billion. This is not an alarming contraction, especially since loan demand also has slackened significantly throughout the region, reducing the overall need for credit. In the face of an economic slowdown, creditworthy borrowers in many instances are unwilling to borrow funds and risk capital.

The New England banking industry has tightened credit standards in a normal reaction to the general downturn in economic conditions, the overhang of properties held by the Resolution Trust Corporation and the rising level of loan problems. These tightened standards are not

new, but a return to the prevalent credit standards in place before the boom years. A number of annual and quarterly financial reports being issued by these banks use the term "back to basics" in the management discussion section of the reports.

A more conservative lending posture has no doubt resulted in many marginal borrowers, particularly real estate developers, finding credit availability curtailed. This may have helped create a general perception of a credit crunch. Some proof of this is from the credit call-in line of the Massachusetts Business Corporation, an association of area lenders formed to help borrowers find credit. In March of this year the Massachusetts Governor's office began publicizing the association's phone number and inquiries increased from about 25 to 100 per week, mostly from borrowers at failed institutions. The number of calls is relatively small considering the economic base of the state.

Even though there is unquestionable weakness in banking conditions in New England, we do not see a repeat of what has occurred in the Southwest. At present, there are 60 problem banks and 14 problem savings associations among the 715 banks and savings associations in our Boston region. This is in line with the national average of problem institutions to total institutions.

BANK LENDING PRACTICES

In our view, banks are to be applauded for tightening lending standards. A recent Washington Post article titled "Credit Crunch

"Threatens Small Business" gives some examples of the kind of borrowers who are experiencing difficulty in obtaining, expanding or renewing credit lines. These include small, troubled and unestablished businesses, companies that are suddenly unprofitable, and "the ones that are shaky." Applying traditional prudent lending standards to this kind of borrower is a sound practice.

Tightening standards does not mean that marginal borrowers are perfunctorily denied loans. It means that bankers are requiring borrowers to provide support for the loans. Bankers are asking for a demonstrated payment record, profitability, owner's equity and collateral. Most of us find it unpleasant to break bad news to someone and bankers are no exception. Placing blame on the examiners or regulators for rejecting loan requests or insisting on better collateral, documentation and other support before advancing funds is one way to mollify an important past and future customer.

We are also hearing that bankers are very concerned about the issue of environmental lender liability and thus take this into account when making credit decisions. We appreciate and support congressional efforts, such as Senator Garn's bill, S. 2319, to limit the liability of both the nonculpable lender and of the FDIC and the RTC. This is an important step to assure that appropriate credit continues to be available.

FDIC SUPERVISORY POLICIES AND PRACTICES

We recognize that some bankers are concerned that vigorous examinations, especially in weak markets like New England, are a

signal to cut back on lending. If this is the signal received, it is a false one. We recently took unprecedented action to dispel any misconceptions or misunderstandings that may exist. The message was delivered at a meeting we requested with the board of directors of the American Bankers Association at its Washington headquarters by Federal Reserve Board Chairman Greenspan, Comptroller of the Currency Clarke and myself. We told the group that we expect bankers to closely scrutinize real estate loans but did not tell bankers to stop making loans. Even where the economy has a slowdown, there are good loans available and those loans should be made. But we are encouraging bankers to carefully screen their loans and pay close attention to market conditions.

"PERFORMING NON-PERFORMING LOANS"

The press has reported that examiners are adversely classifying performing loans. The terminology used is "performing non-performing loans." The term "performing non-performing loans" is a misnomer and is not used officially at the banking agencies. We are even removing the word "nonperforming" from official FDIC literature to alleviate semantic problems.

Instead, the terms "overdue," "nonaccrual," and "adversely classified" are the more common modifiers of troubled debt. Historic definitions of overdue and adversely classified have been developed as part of the examination process. Definitions of nonaccrual loans have been formalized in accounting instructions. A bank is not to accrue interest on (1) any asset which is maintained on a cash basis

because of deterioration in the financial position of the borrower, (2) any asset upon which principal or interest has been in default for a period of 90 days or more unless it is both well secured and in the process of collection, or (3) any asset for which payment in full of interest or principal is not expected. The third definition is important in understanding the agencies' historic handling of loans which are performing but which may not be paid in full.

"Performing non-performing loans" are best described by outlining a typical loan which may fit the category. Assume 100 percent financing of the construction of an income producing property for which no secondary source of repayment is offered. The initial advances provide for the interest payments during the construction period and possibly for a short-term bridge loan after construction is completed. During the life of the loan, it is found that the assumptions used to make the initial appraisal of the property are no longer correct. For instance, rental rates may be lower than expected, operating expenses may be higher than projected, or initial occupancy is lower or slower than anticipated. These or other adverse changes in assumptions mean that a more realistic appraised value of the collateral may be less than the amount of the loan outstanding. In the meantime, the interest reserves included as part of the initial loan are used to keep the loan current or performing. In the absence of a source of payment separate from the project, the full repayment of the principal is unlikely.

Therefore, based on the instructions, this loan would be placed on a nonaccrual status and all payments received would be applied as a

principal reduction. The supervisory response to this type of loan has been constant for a number of years. The loan would be considered to be in a nonaccrual status. The shortfall between the loan amount and the current collateral value, assuming no other source of payment, would be recommended for charge-off and the balance would be listed as having more than ordinary risk.

A loan of this type is speculative in nature. When assumptions used in this type of venture prove to be incorrect, the most prudent course of action is to recognize the losses inherent in the asset. This does not represent a toughening of supervisory standards but the continuation of a traditional supervisory stance.

CONCLUSION

We have no evidence of a credit crunch on either a nationwide or regional basis. However, credit contractions are occurring in areas of economic downturn. Our most recent information shows that noncurrent real estate loans are spreading from Texas and New England to other parts of the country. A credit contraction is the likely result -- but this is after several years of rapid growth, particularly in real estate development. A strong real estate market cycle downturn has resulted in a real devaluation of asset values, which has turned the banking industry cautious. Credit may be difficult to obtain for marginal borrowers. However, there appears to be ample credit sources available to meet legitimate and viable credit needs.

We are in favor of the banking industry tightening lending standards, and returning to basics. However, this tightening does not mean banks should stop making loans. Instead we expect and urge banks to continue making loans to creditworthy borrowers.