TESTIMONY OF

PAUL G. FRITTS
DIRECTOR, DIVISION OF SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

AVAILABILITY OF CREDIT TO SMALL BUSINESSES

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

10:00 A.M.
Wednesday, June 6, 1990
Room 2359A, Rayburn House Office Building

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

Our remarks will focus on the so called "credit crunch" debate. Specifically, we will address the region receiving the most attention - New England. Our testimony 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 driven down-cycle.

What we see are mixed signals. We have no empirical evidence of a credit crunch. If there is one, it is a recent phenomena not reflected in either the banking industries' year-end 1989 or first quarter 1990 Reports of Condition and Income ("call report"). About all we can surmise from year-end 1989 data is that the banking system, in the aggregate, has suffered some capital erosion and has less capacity to lend than previously. However, this dampening effect in itself is not enough to cause a credit crunch or even a significant credit contraction. March 1990 call report figures are undergoing a final edit, but these statistics will not prove or disprove a systemic credit availability problem.

On a nationwide basis, it is reported that a survey of small business conducted by the National Federation of Independent Business found no evidence of a credit crunch and no expectations of a contraction. The Federation's most recent monthly credit survey of 2,500 businesses found that borrowers are having no problems finding credit. We acknowledge that loan volume has dropped in certain sectors and regions, such as real estate in New England and the Southwest, but this a normal economic response to overbuilt markets. 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 declining economic conditions, particularly in the real estate industry. The decline appears to be a normal market correction caused by several years of a strong regional 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 lend 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, a common occurrence during boom periods. Other market forces -- such as severe 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 severe market correction 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 regulator-induced through the examination process is really irrelevant. 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 $7 billion in the first quarter, but $5 billion of that amount was due to loan sales and chargeoffs. Thus, the net contraction in loan volume was $2 billion. This is not an alarming contraction, especially since loan demand also has slackened significantly throughout the region, reducing the overall need for credit. Creditworthy borrowers in many instances, in the face of an economic slowdown, 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 rather than what is in reality a normal credit contraction during a period of economic downturn. Some proof of this is from the credit hotline program established in March of this year by the Massachusetts Governor's office. To date some 200 calls for help in finding credit have been received, which is a relatively small number 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 occurred in the Southwest. There are fewer than 50 problem institutions among the 714 banks and savings associations in our Boston region. This is below the national average of problem institutions to total institutions.

BANK LENDING PRACTICES

In my 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 does mean 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.

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. FDIC Chairman Seidman, Federal Reserve Board Chairman Greenspan and Comptroller of the Currency Clarke met with the Directors of the American Bankers Association. They told the group that we expect bankers to closely scrutinize real estate loans but did not tell bankers to stop making loans. 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. A credit contraction is occurring in the New England region -- but this is after several years of rapid growth, particularly in real estate development. A normal business 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, leading some to the false perception of a credit crunch. 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.