Elizabeth A Duke: Fostering a healthy credit environment

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, at Ohio Bankers Day, Columbus, Ohio, 30 June 2010.

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Good morning. I am happy to be with you here at Ohio Bankers Day, sponsored by the Division of Financial Institutions at the Ohio Department of Commerce. I'm sure you have plenty of topics to discuss during your meeting: commercial real estate, the housing market, regulatory reform, and the state of the local and national economies – to name just some. I plan to focus on a topic that is getting a lot of attention at the Federal Reserve and one that I know is on your minds as well – lending to consumers and businesses.

During the recent financial crisis, the Federal Reserve and other policymakers throughout the government took unprecedented actions to preserve the financial system and the flow of credit to consumers and businesses. Now, even though the crisis is subsiding, the level of credit outstanding continues to decline. So it seems important to ask why, in the face of all that was done to preserve it, is credit still dropping? I have heard some say it is because banks don't want to lend. But I have trouble with that explanation. Banks have to lend to be profitable. A bank that does not want to lend is like an airline that prefers to keep all its planes on the ground. So we shouldn't simply accept that as the reason. We should look deeper to find the causes so we can craft solutions. I believe the answers to this question are numerous and complex. The solutions, therefore, will not be easy, and they will take time.

Given my banking background, I have approached my responsibilities for economic and regulatory policymaking with a keen awareness of the importance of credit to the growth of an economy – most importantly, that there needs to be the right amount of credit. Too much credit leads to underwriting mistakes and mispricing of risks, as well as an overheated economy. Too little credit can choke an economy, as businesses can't find adequate funding for expansion and consumers are unable to borrow against their future income to purchase cars and houses and to invest in education and training. The right amount of credit is a function of the financial system's capacity to lend and potential borrowers' capacity to repay.

To understand where we are now and where we might be headed in the near- and medium-term, I am monitoring four conditions that seem most likely to determine the amount of credit that will support the recovery as we emerge from the recent financial crisis:

- First, the condition of the banking system will certainly influence the capacity for lending.
- Second, the regulatory environment that emerges will impact both the capacity and the confidence of banks to lend to businesses and consumers.
- Third, the financial condition of borrowers will determine their capacity to repay as well as their appetite for adding more debt.
- And finally, the strength of the economy will influence both the willingness to lend and the desire to borrow.

Today, I would like to focus on these four factors.

Condition of the banking system

Let's start with the condition of the banking system. The banking sector continues to recover slowly. Insured commercial banks as a group were modestly profitable during the first quarter, with a 4.8 percent return on equity. Delinquency rates in credit cards and consumer loans began to level off, although at high rates, contributing to slightly lower credit costs. Nonperforming assets, which include foreclosed real estate, repossessed assets, and loans that are not accruing interest, remained high at more than 4 percent of loans, and the net charge-off rate, which represents the actual loan losses recorded, stayed near historic highs – at almost 3 percent of loans.

Credit costs have been so high in this cycle that it is easy to lose track of the other components of bank earnings. But it is actually ongoing earnings strength that gives banks the resiliency to withstand credit cycles and build capital to support additional lending. To separate the impact of credit costs from underlying earnings strength, it is helpful to look at pre-tax, pre-provision net income – that is, earnings before provisions for loan losses. In the first quarter of this year pre-provision net income returned to about pre-crisis levels for the largest 25 banks. The largest banks benefitted in particular from a rebound in trading revenues and improved interest margins. In contrast, for smaller banks, net interest margins and non-interest income remained weaker than they were prior to the crisis, leaving pre-provision net income at smaller banks somewhat lower than it was in 2007.

On the positive side, capital ratios at many banks have improved substantially since the start of the crisis. And strong deposit growth has contributed to steady improvement in bank liquidity. Still, the number of institutions and the total assets represented on the Federal Deposit Insurance Corporation's problem bank list continues to climb as some institutions face serious questions about capital adequacy due to weak loan quality, subpar earnings, and uncertainty about future conditions.

Against this backdrop, lending has fallen significantly. During 2009, total loans held by commercial banks fell by more than $345 billion, or 5 percent. Excluding the effects of an accounting change that resulted in the addition of a significant volume of loans to bank balance sheets as of March 31, loans would have declined for the sixth consecutive quarter in the January–March period. On the same basis, loans continued to contract in April and May at an estimated rate of about 7-3/4 percent.

One way in which Federal Reserve researchers monitor the relationship between bank condition and overall bank lending is by using supervisory ratings to divide the population of banks into strong banks and weak banks and then compare the changes in the aggregate loan portfolios of the two groups. Historically, significant declines in bank lending could be traced almost exclusively to declines in the portfolios of weaker banks. But our researchers have found that something very different is happening this time. In this cycle, reductions in bank lending can be seen at both the strong and weak banks. This indicates that constraints on loan growth are due, at least in part, to factors other than the condition of lending banks.

Regulatory environment

In recent months, when I have spoken to bankers who say they are reluctant to extend new credit or to renew or restructure existing loans, many have cited an uncertain regulatory environment as a primary concern. The current regulatory uncertainty stems from a number of causes, such as the ongoing work on regulatory reform in the Congress and international regulatory standards in Basel. In addition, a number of recent and proposed changes in accounting standards will intersect with the regulatory changes in ways that cannot yet be predicted. While bankers keep an anxious eye on these developments that will shape lending in the future, they are also concerned about the stance of bank examiners in bank examinations right now.

I do not believe it is appropriate or even possible for regulators to urge banks to make loans that are outside their risk tolerance or that would be unsafe or unsound. But we can and should be sure that supervisory policies do not impede the flow of credit to all eligible borrowers. That's why the Federal Reserve and other regulatory agencies have worked so hard during the past few years to ensure that while banks appropriately recognize loan problems they also can continue to make loans that are safe and sound. I'm sure you're aware of what we have done, but I wanted to briefly discuss the lending guidance the Federal Reserve issued in collaboration with the other regulators:

- In November 2008, regulators issued guidance stressing the importance of continuing to make prudent loans to creditworthy customers.[1]
- In October 2009, the agencies issued guidance covering commercial real estate (CRE) loans and workouts.[2]
- And in February of this year, we issued guidance regarding loans to small businesses.[3]

All three pieces of guidance are intended to be accessible and easy to use by both banks and examiners and to provide clarity and consistency about the supervisory treatment of new loans, problem loans, and different loan workout approaches. In particular, the CRE guidance includes a number of examples drawn from common loan situations and specifies classification treatment for alternate scenarios that depend on actions taken by the bank and the borrower. To test my understanding of the specifics and to be sure our intentions were clearly communicated, as we were finalizing the guidance, I sat down with our supervision staff and went through each of the examples just as if we were in a loan closing conference.

Importantly, at the Federal Reserve we have complemented these issuances with training programs for examiners and outreach to the banking industry to underscore the importance of sound lending practices. In January, Federal Reserve staff instituted a Systemwide examiner training initiative that is reaching Federal Reserve and state examiners all across the United States, including approximately 100 examiners from Ohio. In addition, in May more than 1,400 bankers and state bank commissioners from across the country participated in an "Ask the Fed" conference call to discuss CRE-related issues, such as credit workouts and troubled debt restructurings. The session was an effective way of helping clarify the guidance and helped us hear more about concerns people in the industry have.

The Federal Reserve is also working to develop better ways to measure the effectiveness of the lending guidance we have issued. After all, if these sorts of issuances don't work, we need to know that so we can figure out a better way to get our messages across. Before issuing the CRE guidance last year, Federal Reserve staff surveyed examiners to gain a better understanding of the banks' workout practices. That information is serving as a baseline for assessing the impact of the supervisory guidance. We also are asking examiners to capture, where possible, information on troubled debt restructurings and other types of loan workouts and dispositions as part of the ongoing examination process. In addition, we are exploring the feasibility of more-formal statistical approaches for measuring and evaluating the effectiveness of the CRE workout and restructuring policy statement.

Despite all we are doing, I still hear the concern that the pendulum has swung and that examiners are being too strict on banks, a development some say is curtailing loans. I hear this often when I talk to members of the Congress, who say bankers in their district tell them that examiners from all the banking agencies are making it too tough for them to make loans. So I will say the same thing here that I say to people on Capitol Hill – if you believe Federal Reserve examination policies are improperly impeding the flow of credit, we want to know

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[1] For more information, see Board of Governors of the Federal Reserve System (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers", press release, November 12.

[2] For more information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Adopts Policy Statement Supporting Prudent Commercial Real Estate (CRE) Loan Workouts", press release, October 30.

[3] For more information, see Board of Governors of the Federal Reserve System (2010), "Regulators Issue Statement on Lending to Creditworthy Small Businesses", press release, February 5.

about it. I can't stress this enough: We want to know if you believe that our supervisory actions are unnecessarily impeding the flow of credit.

I also want to emphasize that we are focused on lending to creditworthy borrowers. In no way do we want to return to the world where people could buy a house with no money down and no documentation. But where prudent loans can be made, we want to do everything we can to make sure those deals are struck – it's best for the banks, it's best for the borrower, and it's best for our economy as a whole.

So far, I have talked about the two main factors that influence the supply of credit – banks' ability and willingness to lend. But I believe the reduction in credit outstanding is also a result of weaker demand for credit. So let's turn now to the circumstances of potential borrowers.

Financial condition of borrowers

Sometimes when talking about credit, the lines between supply and demand effects get quite blurry. Banks generally talk about the lack of demand from creditworthy customers. But when borrowers think about the availability of credit, they don't divide themselves into creditworthy or not. And borrowers look for the supply of loans on terms that they want. Sticker shock over terms leads them to believe credit is not available.

As the financial crisis unfolded and liquidity dried up, consumers and businesses alike found themselves facing two very different problems. First, many found themselves unable to make payments on existing debt due to reduced income or reduced asset values. In some cases repayment plans had been predicated on earnings, employment, asset sale, or refinancing expectations that suddenly seemed unlikely. The second problem encountered by a number of consumers and businesses was a reduction in their access to credit. Many received notice that their lines of credit had been cut or canceled, or found that changing standards meant they were no longer eligible for credit at all. Those who did still qualify for credit found it to be on much stricter terms and at higher rates than they expected. In some cases, they deemed the terms so onerous that they declined the credit that was offered.

In response to the changes in credit availability as well as in their individual circumstances, businesses and consumers stopped spending and hunkered down. As businesses reduced inventory levels and capital spending during the past few years, they tended to pay down debt and build cash positions, meaning they have less need to borrow. Many consumers are in the same boat – the personal saving rate, for example, is far higher than it was in the years preceding the crisis. In response to questions in the Federal Reserve's survey of senior loan officers, banks have continued to report weaker borrower demand for mortgages and for consumer loans. But demand for business loans may be improving. When asked if they had seen an increase in inquiries about new credit lines or increases in credit lines from potential business borrowers, the percentage of banks reporting increased inquiries rose to 18.2 percent in the April survey from 10.5 percent in the survey taken in October 2009, while the percentage of banks reporting decreased inquiries declined to 16.3 percent in April from 35.1 percent in October.[4]

Consumers

Just looking at the statistics, it is not hard to construct a scenario in which consumer demand for credit remains sluggish for quite a while. During the crisis, household net worth declined about 25 percent from peak to trough.[5] Although some net worth was restored as stock

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4 See http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/fullreport.pdf.

5 See Board of Governors of the Federal Reserve System (2010), Statistical Release Z.1, "Flow of Funds Accounts of the United States: Flows and Outstandings Fourth Quarter 2009" (496 KB PDF) (March 11).

markets recovered, recent retrenchment in those markets demonstrates the volatility that remains. Roughly 20 percent of mortgage borrowers are underwater in their mortgages, leaving them without home equity to tap through sale or borrowing and limiting their ability to sell their houses to move in order to reduce expenses or find employment. At the same time, many face reduced income, as 9.7 percent of the workforce is unemployed and 5-3/4 percent is working only part time while still desiring full-time employment. Although low interest rates on mortgages helped keep mortgage payments relatively low from an historical perspective, households remain quite burdened by debt payments. The household debt service ratio, which represents the share of household after-tax income obligated to debt repayment, peaked near 14 percent in 2007 before dropping off to about 12-1/2 percent recently. Despite its recent decline, this ratio is still above its average of 12 percent over the past 30 years. Much of this recent drop reflects the largest annual decline in aggregate consumer credit outstanding in the nearly 70-year history of the series.

Small business

Data that would indicate underlying borrower demand is much harder to find for small businesses than it is for consumers. Nonetheless, a number of indicators suggest that demand for credit by small businesses is down. Over the past two years, the National Federation of Independent Business (NFIB) monthly economic trends survey has consistently found that the problem reported as being most important by the largest number of small businesses was poor sales. The NFIB survey also shows that, despite a slight improvement in the last couple of months, the percentages of firms planning capital expenditures, increasing inventories, or finding it a good time to expand facilities are still very low by historical standards. These findings suggest that some potential borrowers are likely on the sidelines waiting for a good reason to expand or build inventories.

Despite these indicators of reduced demand, we continue to hear about difficulties experienced by small businesses in obtaining credit. The number of complaints we hear is supported by data from the NFIB's May survey indicating that the percentage of small businesses reporting tighter credit conditions than three months earlier was at levels comparable with its peaks of the early 1990s. Moreover, as reported in the NFIB's 2009 Credit Access Poll, among small businesses that attempted to borrow in 2009, only 50 percent got all or most of the credit they wanted. An earlier NFIB poll found that, during the period from 2003 to 2006, 61 percent of firms attempting to borrow got all of the credit they wanted and another 28 percent got most of the credit they wanted. This suggests that credit conditions for small businesses today remain tight, especially compared with the 2003–2006 period.

Of course, some of the difficulty that small businesses are currently experiencing in obtaining credit reflects their weakened economic condition. Although the May NFIB survey shows an improvement in actual sales, they remain below pre-recession levels. Furthermore, commercial real estate values have declined almost 40 percent during the downturn, and many small businesses rely on real estate as a source of capital or as collateral for other loans. The NFIB reports that as of the end of 2009, 95 percent of small business owners owned personal, commercial, or investment real estate; 21 percent used proceeds from mortgages to finance business activities; and 11 percent used real estate as collateral for loans. It is likely that most small business owners have seen a decline in the value of real estate owned, and many may have at least one property on which they owe more than the property's value.

To better understand what is happening in the area of lending to small businesses, the Federal Reserve System is holding more than 40 meetings across the country to gather information that will help the Fed and others craft responses to the immediate as well as longer-term needs of small businesses. In May, for example, the Federal Reserve Bank of Cleveland hosted five small business roundtable discussions in the region – one each in Columbus, Toledo, Cleveland, Cincinnati, and Pittsburgh – and a workshop on venture capital as part of this series of meetings. These meetings have brought together people with a wide range of backgrounds, including those from banks, community development financial institutions, bank exam teams, federal and local government, and small business trade groups. While most sessions have focused on small businesses in general, others have been more targeted. A meeting in Miami, for example, focused on the needs of Hispanic-owned small businesses.

Earlier this month, Federal Reserve Chairman Bernanke participated in a session in Detroit while I participated in a meeting in Tampa. I find it interesting that the concerns that I heard in Tampa – for instance, with respect to the impact that devalued collateral has had on small business owners' abilities to obtain financing – were also raised with the Chairman in Detroit. Although these two cities have very different economic situations, the impact of the recession has left small businesses in a strikingly similar bind.

These small business forums have given us the opportunity to hear directly from local stakeholders about local market conditions. We are gathering information from these meetings to help us address areas where the flow of credit to small businesses may be hindered. Emerging themes, best practices, and common challenges will be presented at a conference at the Federal Reserve in Washington next month. I look forward to that discussion and learning what government policymakers, nonprofit leaders, and others can do to facilitate the flow of credit to small businesses.

Economic conditions

Ultimately, the most important step policymakers can take to improve credit availability to businesses and households is to achieve a sustainable economic recovery. Over the past two years, the Federal Reserve has acted forcefully on multiple fronts by instituting accommodative monetary policy, expanding existing liquidity programs for depository institutions, and establishing new liquidity facilities to support market functioning.

In light of the improved economic outlook, fewer lenders are tightening loan standards. And business spending for equipment and software continues to improve, which should ultimately lead to more demand for bank credit. As economic activity picks up and importantly, the economic outlook brightens, I would expect both the supply of credit and the demand for credit to improve.

However, a note of caution is in order. Staff at the Federal Reserve has been studying how credit growth typically resumes after an economic downturn. While it is still early in this recovery period,[6] the resumption of credit growth following the recession has lagged that of all other cycles of the past 40 years with the exception of the 1990–91 recession. That cycle, as you will recall, was also accompanied by a banking crisis and was followed by significant regulatory change. Just to give you an idea of how long it could take for credit volumes to recover, adjusting for inflation and measuring the time it took to return to the level of credit at the trough of the cycle in the first quarter of 1991, it took 3 years for consumer credit to return, 4-1/2 years for home mortgages, 5-1/4 years for nonfinancial business credit, and a full 8-3/4 years for commercial real estate.[7] Bearing this in mind, we will continue to study

[6] The Business Cycle Dating Committee of the National Bureau of Economic Research has not estimated when the recession officially ended.

[7] For comparison, the average pattern of inflation-adjusted credit following business-cycle troughs is that consumer credit and commercial mortgage volumes increase from their levels at the trough, and home mortgage volumes and nonfinancial credit take about ½ year and 1 ¼ year, respectively, to return to their levels at the trough. (Note that the business-cycle expansions that we consider here are those that followed the 1970, 1975, 1982, and 2001 troughs. The expansion following the 1980 business-cycle trough is excluded from these average calculations because the 1981–82 recession followed quite quickly after the end of the recession.)

and assess the impact of the various factors at work in determining the total level of credit outstanding.[8]

Conclusion

Credit plays a critical role in our economy. That is why policymakers invested so much money and energy into ensuring the survival of our financial system. There really is no single step that can be taken to quickly unclog all lending markets. Just as the causes for the decline in lending are multifaceted and complex and took time to evolve, the solutions will likely be equally difficult and will take time to fully work. The financial condition of the banking system, the evolving regulatory climate, the financial condition of businesses and consumers, and the path of the economy will all influence supply and demand for credit. We at the Federal Reserve, meanwhile, will continue to do everything we can to encourage a return to a healthy credit environment.

Banks are an important source of credit, providing a way for people to save as well as providing loans to fund everything from college tuition, to business start-ups, to maintaining inventories. Thus, as bankers, you serve a vital role in your communities. The fate of banks is deeply intertwined with that of the cities and regions they serve. Returning to a normal lending environment – whatever that might be in the months and years ahead – will require constant collaboration and communication among policymakers, bankers, regulators, investors, consumers, and businesses. But it will be worth the effort.

I hope I gave you some ideas that will spur some fruitful conversations during your meeting today. I look forward to hearing your questions and your comments.

8 A previous version of this analysis was published as part of the Second Quarter, 2009 CPP Report. See R. Edge and D. Hancock (2009), “U.S. Credit Cycles: Past and Present.” (498 KB PDF) Note, however, that whereas this previous analysis focused on the evolution of credit following business-cycle peaks, staff analysis is now focused on the evolution of credit following business-cycle troughs.