

Originally Processed With FOIA(s):
1999-0277-F

FOIA Number:
S

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Folder ID Number: 40923-012

Folder Title:
Briefing Book - Credit Crunch [3]

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BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

Type: Banking Circular

Subject: Troubled Loan Workouts
and Loans to Borrowers
in Troubled Industries

To: Chief Executive Officers of all National Banks, Deputy
Comptrollers, District Administrators, Directors and all
Examining Personnel

PURPOSE

This issuance provides a summary of supervisory and reporting guidance to help banks deal with troubled borrowers or non-troubled borrowers operating in troubled industries. The issuance addresses: 1) refinancing medium-term commercial real estate loans; 2) loan concentrations; 3) troubled debt restructurings; 4) returning a loan with a partial charge-off to accrual status; 5) recognition of interest income on a cash basis; and, 6) enhanced disclosure of nonaccrual loans. Some of these matters were previously discussed in the joint agency supervisory release of March 1, 1991, which was distributed as Banking Bulletin 91-07.

BACKGROUND

Many national bank customers are experiencing financial difficulties, particularly those involved in industries such as real estate. Periods of economic uncertainty for a major industry provide significant challenges for banks. In commercial real estate markets, overcapacity, declines in value of financed projects, and more cautious lending practices and less availability of financing from traditional non-bank sources (such as insurance companies, pension funds, etc.) have made bank loan portfolios riskier.

In this environment, it is important that bankers understand supervisory and reporting requirements when assessing the options available to them in working with borrowers. Understanding these requirements will help institutions avoid unnecessarily restricting the availability of credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems. The OCC supports banks making loans on sound terms to creditworthy borrowers. Similarly, the OCC supports bankers' efforts to develop a strategy to minimize losses on troubled loans -- which frequently means working with the borrower. It is important that lack of

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understanding or misunderstandings about supervisory policies not adversely affect the availability of credit to sound borrowers or the prudent working out of loans to troubled borrowers.

Loan workouts can take a number of forms: simple renewal or extension of the loan terms; extension of additional credit; formal restructuring of the loan terms with or without concessions; or, in some cases, foreclosure on underlying collateral. Banks should choose the alternative that will maximize the recovery on each troubled loan. This circular presents supervisory considerations regarding these options.

Accurate reporting of troubled loans is also important. Banks' disclosures of troubled loans should enable analysts and other readers of the financial statements to understand fully the effects, both positive and negative, that such loans have on the bank's financial condition and results of operations. This issuance also clarifies certain reporting policies regarding troubled loans.

LOAN WORKOUTS

Refinancing of medium-term commercial real estate loans

Many commercial banks aggressively participated in the 1980's real estate boom by originating a large number of real estate construction and development loans. In today's market, commercial real estate borrowers are having difficulty obtaining planned post-construction refinancing and purchase financing for real estate development projects. In many cases, the usual sources for this financing, such as insurance companies and institutional investors, are currently not available. In other cases, projects that the bank financed are not performing in accordance with original projections. Consequently, banks are frequently faced with the choice of renewing a loan they had not planned to renew, restructuring the loan, or foreclosing on the collateral.

This environment presents significant challenges to banks in maintaining standards of asset quality and diversification. The OCC recognizes that, in many cases, the most effective way for banks to

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minimize their losses on existing loans may be to renew or extend loans beyond the original plan. In other cases it may make sense to restructure the loan terms. As with any commercial credit, these renewals, extensions, or restructurings must be based on sound underwriting standards and must be subject to normal loan classification rules. A bank will not be criticized for continuing to carry such loans as long as the bank has a well conceived and effective workout plan for the borrower, effective internal controls to manage the levels of these loans, has classified the loan in cases where weaknesses exist, and has properly considered these loans when determining the level of the allowance for loan and lease losses.

Concentration of credit

Banks and the OCC have long recognized portfolio diversification as an important element of an overall risk management strategy. Banks have been criticized by the OCC for having excessive concentrations in certain industries. In some cases, concentrations have been the subject of OCC enforcement actions. In recent months, fear of regulatory criticism for adding to, or not reducing, concentration levels has led some banks to hesitate to extend credit to new creditworthy borrowers or to renew existing sound loans.

However, concentration risk is only one consideration in managing the risks associated with troubled borrowers and industries. The OCC recognizes that it may be appropriate for a bank to make additional loans, on prudent terms, in an industry where the bank has a concentration, if it has effective internal systems and controls in place to manage concentration risk. When management believes the renewal, extension, or restructuring of credit is the best way to work out an existing troubled relationship and avoid further losses, the level of loans to a particular industry should not deter management from exercising its best judgment. The OCC will criticize a bank for failing to recognize the reality of a troubled loan but will not criticize a bank that manages a troubled loan using a well conceived and effective workout strategy.

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Troubled debt restructurings (TDRs)

Some banks feel that TDRs implemented in accordance with Statement of Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors For Troubled Debt Restructurings" (FAS 15) will not work in today's environment. Some of these banks believe that FAS 15 requires the lender to grant the borrower a large concession. Others believe the lender must wait a period of time after the restructuring before the loan can be returned to accrual status. Neither belief is always the case.

The OCC believes TDRs can be useful in meeting sound business and reporting objectives. Restructurings should be undertaken in a way that improves the likelihood that the loan will be repaid in full. Regulatory reporting policies and generally accepted accounting principles (GAAP) do not require banks to grant excessive concessions, forgive principal, or take other steps that are not commensurate with the borrower's ability to repay. The only concessions required are those needed to restore the expectation of full collectibility. The amount and size of those concessions depends on the nature of the loan and the financial condition of the borrower.

Regulatory reporting requirements and GAAP do not prevent banks from including contingent payment provisions in the restructured terms. For example, a bank may reduce the interest rate on a troubled loan but require the borrower to pay the bank a percentage of any gain realized if the collateral is sold. Or, the bank may require that the reduced rate will automatically revert to a market rate if the borrower meets certain profit levels. Thus, the bank can recover concessions granted during periods of economic troubles if the borrower's financial condition improves.

It is not always necessary for a bank to wait a period of time after the restructuring before returning a restructured loan to accrual status. Rather, in some situations, the loan can return to accrual status immediately after the restructuring if the return is supported by a well documented credit evaluation of the borrower's financial

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condition and the prospects for full repayment. Examples include

- 1) payment performance immediately prior to the restructuring or
- 2) other significant factors that preclude the need for demonstrated performance.

Payment performance in accordance with the newly restructured terms is one of the most important forms of evidence used to decide whether the borrower can fully meet the restructured terms. The performance to be assessed should not be limited to that occurring after the restructuring. Performance immediately prior to the restructuring should also be considered. Often the level of debt service on a restructured loan is less than the payment the borrower was making before the restructuring. If this is the case, and the borrower is expected to be able to continue this level of performance and fully repay the new contractual amounts due, the loan can immediately return to accrual status.

Other significant factors may constitute a preponderance of evidence that the loan will be repaid in full. Those factors may be sufficient to allow the loan to return immediately to accrual status without demonstrated performance under the restructured terms. Such factors include substantial and reliable new sales, lease or rental contracts, or other important developments that significantly increase the borrower's net cash flow and debt service capacity and strengthen the borrower's commitment to repay. If such factors are not enough to eliminate entirely the need for demonstrated performance, they may reduce the period of performance otherwise considered necessary.

The instructions to the Consolidated Reports of Condition and Income (Call Reports) were amended as of June 30, 1991, to permit the removal of restructurings that are in compliance with their modified terms and yielding a market rate of interest from restructured debt reporting after the year in which the restructuring occurs. In situations where a partial charge-off has been taken before the restructuring, an interest rate concession may still achieve an effective yield that approximates a market rate. This is because FAS 15 requires that the effective yield be computed based on the recorded loan balance instead of the contractual balance. This

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situation is even more frequent in today's environment given recent declines in interest rates.

Because many banks have taken charge-offs on troubled loans, the TDR can, in some cases, use a two-note structure to return one "good" note to accrual status, with the troubled note accounted for separately. The troubled note may represent the lender's contractual claim on the portion of the loan that has been charged-off. For example:

- o Assume that a bank has a \$10 million loan secured by real estate. The loan is on nonaccrual status and \$1 million has been charged off. Cash flows are adequate to service only a \$9 million loan at a market rate of interest. The bank formally restructures the loan by dividing it into two notes. The first is for \$9 million and carries a market rate of interest. The second is for \$1 million (the charged-off portion of the note to which the bank retains a claim) and carries a below market rate of interest. The bank forgives no principal. This restructuring meets the requirements of FAS 15, and assuming that full collection of the \$9 million loan and the borrower's continued performance under the modified terms are expected, that loan can return to accrual status.

The return to accrual status must always be supported by well documented evidence of the borrower's financial condition and the expectation of complete repayment under the revised terms. The restructuring should improve the collectibility of the loan in accordance with a reasonable repayment schedule. The amount of charge-off must be based on a good faith evaluation of collectibility and cannot be calculated simply to achieve a specified rate of interest or avoid future troubled debt disclosures. In every TDR, the bank must make a good faith evaluation of the collectibility of the new contractual principal and interest, maintain the allowance for loan and lease losses at an appropriate level and charge off all identified losses in a timely manner.

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REPORTING CONSIDERATIONS

Returning a loan with a partial charge-off to accrual status

On March 1, 1991, the four federal banking and thrift regulatory agencies jointly issued a statement clarifying certain supervisory and reporting policies. The release also announced the pending issuance of a request for comment on a proposed reporting standard that would permit certain partially charged-off nonaccrual loans to return to accrual status.

The proposal (sometimes called "loan splitting") was published for comment on March 18, 1991, with a 45-day comment period that ended May 2. Most of the comments received indicated concerns that the proposal was not in conformity with GAAP. A number of commenters expressed concern that such differences might diminish the integrity of bank financial reporting. While noting these concerns, the agencies also observed that in some respects where the proposal differed from GAAP, such as the areas of loss recognition and disclosure, the proposal was more conservative than GAAP. As a longstanding practice, however, the agencies have attempted to minimize differences between regulatory reporting requirements and GAAP.

For that reason, the agencies recently announced in the Federal Register that the proposal has been withdrawn. The agencies have agreed to participate in projects underway by the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB) to attempt to resolve issues relating to recognizing income on nonaccrual loans and estimating credit losses on certain loans.

The federal banking agencies have included guidance on certain aspects of the March 1 policy statement in the instructions for the June 30, 1991 Call Report. This issuance reiterates those policies and is intended to encourage depository institutions to continue to work with borrowers who are experiencing difficulties and to avoid restricting the availability of credit to sound borrowers, particularly in areas of the economy that may be experiencing temporary problems.

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Cash-basis interest recognition

For partially charged-off loans where the remaining recorded balance is considered fully collectible, recognition of interest income on a cash basis is an appropriate alternative to "loan splitting" when combined with increased disclosure of the contribution to income that nonaccrual loans provide.

While a loan is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis. This can occur only if the remaining book balance of the loan (i.e., the balance after charge-off of identified losses, if any) is deemed to be fully collectible. The amount of interest income that should be recognized is limited to that which would have been accrued on the asset's remaining book balance at the contractual rate. Any excess over that amount should be recorded as recoveries of amounts previously charged-off until the charge-off is fully recovered.

A bank's determination of the ultimate collectibility of a loan's remaining book balance must be supported by a current, well documented credit evaluation of the borrower's financial condition. Prospects for repayment must also be evaluated, including such factors as the borrower's historical repayment performance and other relevant factors.

Suggested increased nonaccrual disclosure

Many financial statement readers use banks' current nonaccrual loan disclosures as an important barometer of financial condition. Many analysts place heavy emphasis on the levels of nonaccrual loans in projecting future loan losses and earnings. Few banks take the opportunity to show that there are varying degrees of problems in the reported total of nonaccrual loans. Few indicate to the reader that many of these assets provide a contribution to earnings through cash basis interest income and loan loss recoveries.

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In January 1991, the OCC suggested a format in Banking Bulletin 91-05 for voluntary disclosures relating to nonaccrual loans. In addition to the cash-basis interest income recorded on such loans, disclosure can include charge-offs taken and cash payments applied as loan loss recoveries. Banks may also segregate loans that are generating substantial cash flows relative to other nonaccrual loans to help distinguish those loans that are current but are in nonaccrual status due to concerns regarding the borrower's financial condition. The OCC suggested that this increased disclosure also might be extended to other real estate owned so that analysts can see the contribution those assets make to operating income.

Accrual status of partially charged-off loans

There may be circumstances when a partially charged-off loan can return to accrual status without first recovering the partial charge-off. In accordance with the Call Report instructions, this is permitted when the loan has been brought fully current with respect to principal and interest and the bank expects that the full contractual balance of the loan (including any amount charged-off) plus interest will be fully collected under the terms of the loan. (These instructions also provide that certain past due loans may return to accrual status if they are both well secured and in the process of collection.)

Ordinarily, a partial charge-off would indicate that the bank does not expect full repayment of the amounts contractually due and the loan would, therefore, remain on nonaccrual status. If, however, facts have changed since the charge-off was taken such that the full amounts contractually due, including the amounts charged-off, are expected to be collected and the loan is contractually current, the partially charged-off loan could return to accrual status. This determination must be supported by a well documented credit evaluation of the borrower's financial condition and the prospects for full repayment.

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OTHER RELATED OCC RELEASES

The following recent banking and examining issuances contain additional guidance dealing with troubled loan situations and reporting troubled assets:

Banking Bulletin 91-05 -- "Public Disclosure on Nonaccrual Loans"
Banking Bulletin 91-07 -- "Joint Agency Policy Statements"
Banking Bulletin 91-19 -- "Nonaccrual Loan Issues"
Examining Bulletin 91-02 -- "Joint Agency Statements Clarifying
Certain Regulatory Policies"

Questions about this Banking Circular, or any of the issuances listed above, should be directed to the Office of the Chief Accountant at (202) 874-5180.

ORIGINATING OFFICE

Chief National Bank Examiner's Office
Office of the Chief Accountant

Susan F. Krause

Susan F. Krause
Senior Deputy Comptroller for
Bank Supervision Policy

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

July 30, 1991

To: Chief Executive Officers of all National Banks, Deputy
Comptrollers, District Administrators, Directors, and all
Examining Personnel

Today's environment provides unprecedented challenges to banks. At a time when the banking industry is under intense scrutiny for a variety of reasons, the level of troubled loans in the banking system is high. In this environment, it is important that bank managements and bank supervisors maintain a constructive atmosphere for working through the large volume of troubled assets and for continuing to provide credit for sound borrowers in troubled industries.

Attached to this memorandum is Banking Circular 255, "Troubled Loan Workouts and Loans to Borrowers in Troubled Industries." The circular continues the OCC's effort to ensure that its policies are made clear so that neither the continued availability of credit to sound borrowers nor the workout of loans to troubled borrowers is adversely affected by misunderstandings about such policies.

The OCC encourages banks to develop prudent strategies to work with borrowers to maximize the recovery on troubled loans. We recognize that these strategies may sometimes include the renewal, restructuring, or extension of additional credit to borrowers. The OCC supports banks' renewing credits to borrowers pursuant to a well conceived and effective workout strategy. Similarly, the OCC recognizes that it is appropriate for a bank to make additional loans, on prudent terms, in an industry where the bank has an existing concentration if it has effective internal systems and controls in place to manage concentration risk.



Robert L. Clarke
Comptroller of the Currency

Division of Supervision
MEMORANDUM SYSTEM

Classification Number	6314(I&S)
Date	June 17, 1991
Issuing Office	DOS/PP&D
Contact	Robert W. Walsh X6911
☐ Notice	☒ Memorandum

MEMORANDUM TO: Regional Directors

THROUGH: Paul G. Fritts
Executive Director



FROM: John W. Stone
Director

SUBJECT: Refinancing Commercial Real Estate

1. Purpose. To provide guidance to examiners regarding refinancing of medium term commercial real estate loans.

2. Background. Accessible and affordable credit is the life blood of all business, large and small. In a growing economy, banks are needed to supply credit for growth and capital investment. In a soft economy, banks are needed to supply credit to sectors most affected by the downturn. By working closely with sound borrowers on working capital needs, banks perform the critically important function of helping their customers survive temporary difficulties by softening the effect of a slowing economy and absorbing some of the shock of falling sales and property values.

As with all economic downturns, financial institutions recently have seen nonperforming assets increase, leading to the need for higher loan loss reserves. Underscoring the importance of prudent lending practices, many institutions have reviewed and tightened their underwriting standards while others have reduced the pace of lending to shore up their capital position and balance sheets. These actions, combined with a perception that regulators are applying excessively rigorous examination standards, may have created an overly cautious lending environment. In response, the four Federal bank and thrift regulators issued a joint statement in March to clarify certain regulatory policies, eliminate any misunderstandings that may have existed and assure the industry that loans to financially sound borrowers, even those experiencing temporary difficulties, should continue to be made.

One of the issues that has caused some misunderstanding is the regulatory position on loan concentrations. While the benefits of adequate portfolio diversification are well recognized throughout the industry, many institutions were overly attracted to the real estate market because of the potential for high returns and the lack of profitable alternative investment opportunities. Many banks expanded their real estate portfolios at a furious rate during the 1980s. When the inevitable downturn came, these same institutions were left with high levels of real estate loan concentrations and no easy method for reducing those levels.

Compounding the problem is the number of medium term (5 to 7 years) commercial real estate loans made during the 1980s to provide financing after development was completed, the so called "mini-perm" loans. These now are coming due. Developers who have kept their payments current on these loans in many cases have been unable to obtain traditional long-term financing and therefore cannot make the final balloon payment. Instead of foreclosing on these properties, banks have been working with the developers to find permanent financing. When financing cannot be arranged, many banks have renewed the old credits, sometimes with new advances.

3. Policy. Effective supervision combines the skills of problem identification with sound judgment and common sense when devising appropriate corrective action. Examiners should recognize that banks, borrowers and economic sectors experiencing temporary problems may need some flexibility in working through these problems. While sound operating policy dictates that all financial institutions establish and adhere to policies that control concentrations of risk and reduce the volume of problem assets, institutions with effective internal controls to manage and reduce these matters over a reasonable period need not automatically refuse renewal credit to sound borrowers. With this in mind, institutions, whether they have a concentration in real estate loans or not, that choose to refinance a sound mini-perm real estate development loan should not be automatically criticized for doing so. As with any commercial credit, these loans should be analyzed on an individual basis consistent with sound underwriting standards and classified accordingly. In many instances the soundest manner to maximize the economic value of existing assets may be to grant such renewals.

4. Action Required. This memorandum should be distributed to all field and office examination personnel.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SR 91-16 (FIS)

DIVISION OF BANKING
SUPERVISION AND REGULATION

July 16, 1991

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Supplementary Examination Guidelines on Real Estate
Loans and Certain Reporting Issues Pertaining to
Nonaccrual Loans

On March 1, 1991, the Federal bank and thrift regulatory agencies jointly issued a statement clarifying certain supervisory and accounting policies. The statement was issued in response to concerns that some supervisory policies, or depository institutions' misunderstandings about the policies, were inhibiting the extension of loans to sound, creditworthy borrowers. The guidelines and clarifications contained in the March 1st statement establish a framework, consistent with safe and sound banking practices, within which banking organizations can make loans to creditworthy borrowers and work in a constructive and prudent fashion with borrowers experiencing temporary financial difficulties. The statement was based upon the principle that prudent lending practices on the part of banks and timely and effective supervisory actions on the part of regulators should not inhibit banking organizations from playing an active role in financing the needs of creditworthy borrowers.

This letter supplements the contents of the March 1st statement and provides guidance to supervisory and examination personnel regarding certain supervisory policies or practices that may have an impact on credit availability. As was true with the earlier interagency statement, the guidance contained in this letter is consistent with sound banking practices and generally accepted accounting principles.

Supervisory asset assessments

Concerns have been expressed that problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, could lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors. The March 1st statement reiterates that real estate loans should not be assessed solely on the basis of the liquidation value of the

underlying collateral; rather, consideration should also be given to a property's stabilized capacity to generate cash flow to service its debt. Consistent with this principle and longstanding supervisory practice, loans or credits that are adequately protected by the current sound worth and debt-service capacity of the borrower or the underlying collateral generally should not be subject to examiner classification.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamentals of the particular credit, that is, the borrower's (or the collateral's) current and stabilized cash flow, earning and debt service capacity, financial performance, net worth, guarantees, future prospects, and other factors relevant to the borrower's ability to service and retire its debt.

Real estate construction and mini-perm loans

The March 1st guidance states that institutions that have in place effective controls to manage and reduce undue concentrations over time, need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. It is important to emphasize that this principle applies to prudent loan renewals and rollovers, as well as to new extensions of credit that are underwritten in a sound manner.

Many banks have made construction loans that upon completion of the construction phase of the project will require longer-term or take-out financing. In addition, during the 1980s some banks made medium term (up to 7 years to maturity) loans to finance commercial real estate after completion of the construction phase. Many of these construction and so-called "mini-perm" loans are now coming due or will be coming due over the next 12 to 24 months.

Under current conditions, obligors on these loans may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to rollover or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who may not be in a position, at the present time, to obtain long-term financing for the principal. The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and

accounting practices, and that protects the bank and improves its prospects for collecting or recovering on the asset.

Assessment of asset concentrations

The March 1st statement indicates that while the regulatory agencies have not established specific rules on asset concentrations, depository institutions should establish and adhere to policies that control concentration risk. One aspect of such a system of risk control is the definition of asset concentrations. Traditionally, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry often have been included in homogeneous risk groupings when assessing asset concentrations.

In identifying asset concentrations, commercial real estate loans and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not necessarily be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

Institutions with asset concentrations are expected to put in place effective internal policies, systems, and controls to monitor and manage this risk. Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. Banking organizations with a need to reduce asset concentrations are normally expected to develop a plan that is realistic, prudent, and achievable in view of the bank's particular circumstances and market conditions. In situations where concentration levels have been built up over an extended period, it may take time, in some cases several years, to achieve a more balanced and diversified portfolio mix. What is critical is that banking organizations have in place adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan, strong credit policies and loan administration standards to control the risks associated with new loans, and adequate capital to protect the institution while its portfolio is being restructured.

Issues relating to restructured debt
and partially charged-off loans

Working in a prudent manner with borrowers experiencing financial difficulties may involve formally restructuring loans and taking other measures in recognition of the borrowers' condition and repayment prospects. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve a bank's prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements, provide a framework for reporting that, in some cases, may alleviate certain concerns that lenders may have about working in a constructive fashion with borrowers experiencing financial difficulties.

The March 1, 1991 interagency policy statement presented a number of clarifications of supervisory policies regarding issues relating to nonaccrual assets and restructured loans. Three of these clarifications indicated that when certain criteria are met, (i) interest payments on nonaccrual assets can be recognized as income on a cash basis without first recovering any prior partial charge-offs, (ii) nonaccrual assets can be restored to accrual status when subject to formal restructurings in accordance with Financial Accounting Standards Board (FASB) Statement No. 15, and (iii) restructurings that yield a market rate of interest would not have to be included in restructured loan amounts reported in the years subsequent to the year of the restructuring. These clarifications, which are consistent with GAAP, have been fully incorporated into the instructions for the Reports of Condition and Income ("Call Reports") filed by banks and the "Y Reports" filed by bank holding companies, as of June 30, 1991. Additional clarifications on issues relating to the restoration to accrual status of restructured debt and nonaccrual assets with partial charge-offs are set forth below.

Nonaccrual assets subject to FASB Statement No. 15 restructurings. The March 1st policy statement indicated that a loan or other debt instrument that has been formally restructured so as to be reasonably assured of repayment and performance according to its modified terms need not be maintained in nonaccrual status. Furthermore, the interagency policy indicated that in returning the asset to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account.

For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. In so doing, the borrower's restructured terms may require payments that do not exceed the amount and frequency that have been demonstrated by the sustained historical payment performance of the borrower for a reasonable time before the loan

was restructured. In this situation, assuming that the restructured loan is reasonably assured of repayment and performance according to its modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether prior to or subsequent to the date of the restructuring, is a very important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms. In certain circumstances, evidence may exist regarding other characteristics of the borrower that may be sufficient to demonstrate a relative improvement in the borrower's condition and debt service capacity, thereby reducing the degree of reliance on the borrower's performance to date in assessing prospects for future performance and collectibility under the modified terms. For example, substantial and reliable sales, lease or rental contracts obtained by the borrower or other important developments that are expected to significantly increase the borrower's cash flow and debt service capacity and strengthen the borrower's commitment to repay may be sufficient to provide this assurance. In certain circumstances, a preponderance of such evidence, in and of itself, may be sufficient to warrant returning a restructured loan to accrual status, provided the loan under its restructured terms is reasonably assured of performance and full collectibility.

It is imperative that the reasons for the restoration of restructured debt to accrual status be documented. Such actions should be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This documentation will be subject to review by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways which improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule.¹ When restructuring loans, regulatory reporting requirements and GAAP do not require banking organizations to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay, in order to use the reporting treatment specified in FASB Statement No. 15. Furthermore, regulatory reporting requirements and GAAP do not preclude institutions from including in the restructured terms prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions involved in

¹ When a restructured loan is not reasonably assured of repayment and performance under its modified terms in accordance with a reasonable repayment schedule, the loan may not be restored to accrual status.

the restructuring should the borrower's condition substantially improve.

Treatment of Nonaccrual Loans with Partial Charge-offs.

Questions have been raised regarding whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must first be fully recovered before a loan can be restored to accrual status. GAAP and regulatory reporting requirements do not explicitly address this issue.

In accordance with the Call Report instructions, restoration to accrual status is permitted when (a) the loan has been brought fully current with respect to principal and interest and (b) the bank expects that the full contractual balance of the loan (including any amounts charged-off) plus interest will be fully collectible under the terms of the loan.² Thus, in determining whether a partially charged-off loan that has been brought fully current can be returned to accrual status, it is important to determine whether the bank expects to receive the full amount of principal and interest called for by the loan's terms.

When a loan has been brought fully current with respect to contractual principal and interest, and the borrower's financial condition and prospects for repayment have improved so that the full amount of contractual principal (including any amounts charged-off) and interest is expected to be repaid, the loan may be restored to accrual status without having to first recover the charge-off. On the other hand, this treatment would not be appropriate when the charge-off is indicative of continuing doubt regarding the collectibility of principal or interest. Since the criteria for nonaccrual status include the requirement that loans or other assets be placed in nonaccrual status when repayment in full of principal or interest is not expected, such nonaccrual loans could not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be documented. Such actions should be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including

² The instructions for the Call Reports and "Y Reports" discuss the criteria for restoration to accrual status in the glossary entries for "nonaccrual status." This guidance also permits restoration to accrual status for nonaccrual assets that are both well secured and in the process of collection. In addition, this guidance permits restoration to accrual status, when certain criteria are met, for formally restructured debt and acquired nonaccrual assets.

any amounts charged-off) and interest. This documentation will be subject to review by examiners.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FASB Statement No. 15 so that it meets the criteria for restoration to accrual status presented in the previous section (that addresses restructured loans). Under GAAP, when a charge-off was taken prior to the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.



Richard Spillenkothen
Deputy Associate Director



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SR 91-18 (FIS)

DIVISION OF BANKING
SUPERVISION AND REGULATION

September 23, 1991

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Classification Guidelines For An Asset When A
Substantial Portion Has Been Charged Off

In some cases, institutions with loans to financially troubled borrowers have charged off substantial portions of these credits. Questions have been raised regarding the appropriate supervisory treatment of the remaining recorded balance of these loans. This examination guidance is intended to clarify existing supervisory practices regarding the classification of partially charged-off loans.

Consistent with long standing supervisory practice, the evaluation of each extension of credit should be based upon the fundamentals of the particular credit. That is, the evaluation of each credit should be based upon the borrower's (or the collateral's) current and stabilized cash flow, earning and debt service capacity, financial performance, net worth, guarantees, future prospects, and other factors relevant to the borrower's ability to service and retire its debt.

Based upon consideration of all of the above relevant financial factors, this evaluation may indicate that a credit has well-defined weaknesses which jeopardize repayment in full, but that a portion of the loan may be reasonably assured of repayment. When an institution has taken a charge-off in a sufficient amount so that the remaining recorded balance of the loan is being serviced (based upon reliable sources of cash flow) and is reasonably assured of repayment, this remaining recorded balance would generally be classified no more severely than substandard.¹ Consistent with long standing classification guidelines, a substandard classification of the remaining recorded balance would only be appropriate when well-defined weaknesses continue to be present in the credit. For example,

1

The accrual/nonaccrual status of the loan must continue to be determined in accordance with the glossary to the current Call Report instructions. Thus, while these partially charged-off loans may qualify for nonaccrual treatment, cash basis recognition of income will be appropriate when the criteria specified in the Call Report guidance are met.

when the remaining recorded balance of an asset is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be classified.

This approach would generally be appropriate when an institution maintains sufficient controls over its lending function and maintains adequate current documentation to support the credit analysis of the loan. This classification approach could not be utilized for loans for which the loss exposure cannot be reasonably determined, e.g., loans collateralized by properties subject to environmental hazards. This approach would also not be justified when sources of repayment are considered unreliable.

Extensions of credit that have not been subject to partial charge-offs should continue to be classified in accordance with existing supervisory guidelines.

A handwritten signature in dark ink, appearing to read 'R. Spillenkothen', with a stylized flourish at the end.

Richard Spillenkothen
Deputy Associate Director



Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

Jonathan L. Fiechter
Deputy Director

Washington Operations

MEMORANDUM TO THE REGIONAL DIRECTORS

FROM: *JLF* Jonathan L. Fiechter
Deputy Director
for Washington Operations

DATE: July 11, 1991

SUBJECT: Refinancing Commercial Real Estate Loans

This memorandum describes the Office of Thrift Supervision's policy on the refinancing of commercial real estate loans. Please distribute it to appropriate field staff.

Background

Accessible and affordable credit is crucial to all businesses, large and small. In a growing economy, depository institutions -- banks and savings associations -- are needed to supply credit for growth and capital investment. In a "soft" economy, institutions are needed to supply credit to sectors affected by the downturn. By working closely with sound borrowers on working capital needs, banks and savings associations help their customers survive temporary difficulties.

As with all economic downturns, financial institutions recently have seen nonperforming assets increase, which has led to a need for higher loan loss reserves. To ensure prudent lending practices, many institutions have reviewed and tightened their underwriting standards, while others have reduced the pace of lending to shore up their capital positions and balance sheets. These actions, combined with a perception that regulators are applying excessively rigorous examination standards, may have created an overly cautious lending environment. In response, the four Federal bank and thrift regulators issued a joint statement in March to clarify certain regulatory policies, address any misunderstandings that may have existed and assure the industry that loans to financially sound borrowers, even those that experience temporary difficulties, should continue to be made (within the constraints of statutory limitations on nonresidential lending for savings associations and growth limitations on undercapitalized thrifts).

One of the issues that has caused some misunderstanding is the regulatory position on loan concentrations. While the benefits of adequate portfolio diversification are well recognized, many

institutions were overly attracted to the commercial real estate market because of the potential for high returns and the lack of profitable alternative investment opportunities. When the inevitable downturn came, these same institutions were left with high levels of commercial real estate loan concentrations and no easy method for reducing those levels.

Compounding the problem is the number of medium term (5 to 7 years) commercial real estate loans made during the 1980s to provide financing after development was completed, the so-called "mini-perm" loans. These are now coming due. Developers who have kept their payments current on these loans in many cases have been unable to obtain traditional long-term financing and, therefore, cannot make the final balloon payment. Instead of foreclosing on these properties, institutions have worked with developers to find permanent financing. When financing cannot be arranged, many institutions have renewed the old credits, sometimes with new advances.

General Policy

Savings associations should be encouraged to work with sound borrowers so that credit availability is not inappropriately reduced. Examiners should recognize that associations, borrowers and economic sectors that experience temporary problems may need some flexibility to work through these problems. While all financial institutions should control concentrations of risk and reduce the volume of problem assets, institutions with effective internal controls to manage and reduce these assets over a reasonable period of time need not automatically refuse to renew credit to sound borrowers.

It is important to keep in mind that maintaining current levels of loan concentration may not be a problem where sound borrowers are involved. Problems do arise, however, from poor internal controls, inadequate loan underwriting standards, and insufficient diversification. But it is also important to avoid turning a performing loan into a troubled loan by declining to renew it.

With this in mind, institutions that choose to refinance sound commercial real estate loans should not be automatically criticized for doing so. This includes "mini-perm" loans. As with any asset, these loans should be analyzed on an individual basis consistent with sound underwriting standards and classified accordingly. In many instances, the soundest manner to maximize the economic value of existing assets may be to grant renewals. Extensions of new advances should also be undertaken where it is deemed prudent and where it is likely to maximize the recovery of funds lent. Such extensions of new funds, however, must comport with the statutory limitations on nonresidential lending and loans to one borrower.

Savings associations may also undertake troubled debt restructurings (TDRs) to address borrowers' financial difficulties, in accordance with Statement No. 15 of Financial Accounting Standards. In a TDR, an association grants concessions to a borrower who experiences financial difficulties. A TDR may involve a modification of the terms of the loan, such as a reduction in interest rates, reduction in principal, or extension of payment dates. Examiners should not automatically classify TDRs; they should review them based on the general guidance used in our asset classification policy.

cc: T. Ryan
J. Downey
J. Robinson

TREASURY NEWS



Department of the Treasury

Washington, D.C.

Telephone 566-2041

AS PREPARED FOR DELIVERY
EMBARGOED UNTIL 1:00 PM (EST)

Remarks by
Nicholas F. Brady
Secretary of the Treasury
before the
National Examiners Meeting
Baltimore, Maryland
December 16, 1991

Thank you, Bob (Clarke). It is a pleasure to join you today.

In the two days of meetings here in Baltimore, we have the opportunity to examine the concerns many have expressed that bank regulation is constraining the economic recovery.

As bank regulators, what you do and what you don't do affect the economy directly. If America's banks are the engines for growth in this country, then you are at once the throttle and the governor. On the one hand, your decisions and examinations can choke expansion. On the other, you can foster the injection of fuel that will lead to solid economic growth. What makes your chosen line of work a profession -- as opposed to only an occupation -- is the task of finding the right mix.

But first let us confront a popular perception -- that regulators caused the recession and are responsible for what happened to the economy. Yes or No?

Were examiners responsible for the accumulation of huge amounts of third world debt in our largest banks? Were examiners responsible for the now unbelievable over-building in the real estate market, particularly commercial real estate? Were examiners responsible for the changes in the tax laws and interest rates during the 1980's? Were examiners responsible for Iraq's invasion of Kuwait and its all-consuming effect on Americans' purchasing patterns? The answer obviously is NO!

NB-1584

The question then becomes "How has the regulatory profession reacted to the problems now facing the banking industry and the economy as a whole?"

Some say you have relegated your professional judgment to formulas and arithmetic -- no insight, no judgment -- just formulas and arithmetic. My message to you is that you must fight this perception. You are professionals. You have a trade that relies on judgment. Formulas out to the third decimal point won't cure our problems. What I ask, what the President asks, is that you carry out your responsibilities, conditioned by the statistics but enriched by your experience.

Now, we face a problem particular to the banking industry but critically affecting the economy as a whole. The regulatory profession must be sure -- as sure as they can be -- that they are not contributing to the problem. Instead, we all must work to be part of the solution. And that is the important task of this meeting -- to discuss what can be done that addresses and solves.

No one would disagree that our economy is in the vice-like grip of a credit crunch. There has been a reduction in the amount of credit available to finance the needs of businesses and consumers--centered in the country's commercial banks. Loan losses have gone up and economic activity has gone down. The result is a market in which some people are unable to borrow and some bankers are afraid to lend.

How did this happen? There are many reasons. But, certainly, over-building in the real estate market was a major cause. Just look at the commercial real estate market. There has been a four-fold increase in office building vacancy rates in 11 years -- from five percent in 1980 to about 20 percent today.

From the point of view of individual Americans, they, too, are affected. Roughly 40 percent of Americans' net worth is in their homes. During the 1970s and most of the 1980s, existing homes and land appreciated in value, especially in the Northeast and the West. In the last year, some existing home values have declined, notably in the hard-hit regions of the Northeast and California. The values have not fallen as dramatically as they rose, but in most Americans' experience, this is something they never expected.

This has affected all of us. But most importantly, it is conditioning the way Americans think about their future. So you can see we are at the center of the storm.

Now we need a firm, unified effort to address the credit crunch. Firm--because only unrelenting effort will wipe the problem out. Unified--because individually we can make decisions, but together we can make change.

I am reminded of the three masons who were building the Cathedral of Notre Dame in Chartres, France, in the 13th century. An onlooker asked the first man what he was doing, and he replied: "It's not hard to see, I'm putting one brick on top of another." The second was asked what he was doing. He replied: "Just take a look, I am building a wall." When the third was asked, he thought for a moment and replied: "I am building a great cathedral."

In a real sense we have such a mission. Our banking system is central to all that we do in this country and all that we aspire to by way of a standard of living.

The Administration, Congress, banks and regulators are responsible for strengthening our economy. Together, we all have a role to play.

The Administration's responsibility is to recommend and implement sound economic and financial policies. It is our task to spur economic growth and create the jobs all Americans want and deserve. We must produce a sound budget that stops wasteful spending, encourages investment, promotes exports, and cuts government bureaucracy. In the budget process, the principal of fairness is at the forefront. We all know that there is nothing more unfair than someone without a job.

I assure you President Bush is working hard toward that end. The President is not satisfied with the status quo, and he will announce additional measures to generate the long-term economic growth that will promote new businesses and, most importantly, new jobs.

Congress also has a responsibility. Theirs is to act in a thoughtful and reasonable way on legislation that will encourage non-inflationary, robust economic growth and a strong, competitive financial system.

I certainly don't need to repeat to this group the long-term needs of our financial system. You know today's banks are hurting, and the pain is being passed on to businesses and consumers alike. Our banks must be current with the American

people's requirements, the needs of the market. They must be strong enough to access the private capital needed to protect taxpayers and depositors alike. Banks must be able to stand toe-to-toe with financial competitors at home and abroad. That's why President Bush introduced legislation early this year to modernize and strengthen the banks and return the financial system to a sound footing.

Today, badly needed reform legislation is still waiting for action on Capitol Hill. It is unattended Congressional business -- critical legislation. If we do not want to hang a bullseye on the public's pocketbook, reform is necessary and the time is now.

For the banks, there is a different set of responsibilities in solving the credit crunch. First, one must question what is added by blaming others when good loans are turned down. There's no banker in the country who wants to tell a friend from the local PTA or Rotary -- a long-time bank customer -- that a loan is being refused. It only adds to the fingerpointing that we are trying to avoid.

Banks have lost an important part of their franchise in recent years due to outdated laws and regulation. Some have commented that large sums of money have been siphoned off by the bond funds and that banks have followed this trend by eschewing loans for the purchase of Treasury Bonds. But banks did not build their franchises by just providing a vault for safety deposit boxes. They succeeded by taking bankable risks, providing a safe place for family and business savings, and by using those savings to make loans. Whatever happened to the "character loan" that built this country? Let me ask you: If a bank made such a loan and time was needed to provide repayment, would you, the examiner, give the borrower the "the benefit of the doubt?"

Judgment and experience are the key to bank regulation. Though you didn't create the problem, you are part of it now, and you carry a very heavy responsibility to be a part of the solution. By making your examination standards clear to bankers and using professional judgment, you can inspire confidence among those who now shy away from providing credit.

Let me draw a distinction -- which may sound semantic but is not. The difference between bank regulation on the one hand and bank supervision on the other:

The term "bank regulation" conveys to me a black book approach where every step in the process is subject to rigid, legalistic mandates -- or worse, strict mathematics.

On the other hand, "bank supervision" conveys to me an approach that relies on judgment, experience, common sense, and vision -- not, of course, to the exclusion of rigorous analysis. As I told a group similar to this back in April, "bank examination is an art -- not a science."

If the distinction I'm drawing is relevant to current circumstances, as I believe it is, my principal call to you today is to remember you are supervisors and not regulators.

I am sure you hear what we hear about loan officers who feel, as a first order of business, they must answer to their examiners before their officers and boards of directors. That's wrong, and if the banking industry is operating in that manner, something is awry.

If bankers think the regulation process is a mystery, it must be more clear. If they think it is unpredictable, the process must be defined.

To help create a sound environment for bank lending, regulators must make qualitative decisions based on quantitative information. Decisions that: 1) make sense, 2) are implemented properly and consistently, and 3) are current with the needs of today's financial system. If we do this, we can help take the mystery out of bank regulation. That is how we can solve the credit crunch.

But the credit crunch will not end soon if Congress continues to send mixed signals. They most of all must give regulators a clear view of how they think the problem should be addressed and then join a national consensus to allow the experts in the field to do their job.

Today, there is a view that the situation is improving. That's good. In fact, the Fed's most recent Senior Loan Officer Survey indicated we are moving in the right direction.

But there is more work to do. The guidelines and policy statements established by your agencies represent a collective effort to communicate and standardize examination policies. These are regulations that were put forward by the heads of your agencies here today, along with the most senior career policy makers and bank examiners.

I should also make it clear that these guidelines represent policies that should be applied consistently over the long term. The guidelines are not a quick-fix that will swing the other direction in a couple of months. These are solid, lasting guidelines that will improve the system.

We need continued input from you -- the front-line professionals with the experience necessary to make the regulation process work. We need your advice. What is working, and what is not. What can be improved? What can be done to help bolster the efficiency and effectiveness of bank supervision nationwide? You have the ideas and the discipline to ensure that consistent standards are communicated.

In the search for sound solutions to the credit crunch problem, your sense of professionalism is critical. We look forward to working with you to provide a secure economic future for the United States. With your help we will succeed.

Thank you and good luck.

TREASURY NEWS



Department of the Treasury

Washington, D.C.

Telephone 566-2041

PREPARED FOR DELIVERY
EMBARGOED UNTIL 2:45 P.M. (EST)

Remarks by
John E. Robson
Deputy Secretary of the Treasury
before the
National Examiners Meeting
Baltimore, Maryland
December 16, 1991

It is a pleasure for me to be here with you today. I have looked forward to this opportunity to visit with you.

Just two days ago, I returned from a trip to the Russian Republic and the newly independent Baltic nations -- places where they do not yet have commercial banking systems, let alone any regulation of financial institutions. We were there to advise these fragile emerging free markets as they set up their financial systems from scratch. Our mission made me reflect on the purposes of bank supervision and the role of bank examiners - issues directly relevant to this conference.

You have already heard today about the current economic situation, the importance of bank credit to economic growth, the credit problems we are experiencing, observations from the real estate industry vantage, and some thoughts on where you fit into the picture and can help address these difficult problems. I don't want to replough all of that ground. But I would like to add some perspectives of my own.

I will readily confess that my perspectives on the roles of regulation and regulators -- and their interaction with the industries they regulate -- are directly influenced by my personal experiences as the former head of a Federal regulatory agency, and as chief executive of a Federally regulated corporation. So I come at these issues pretty much as you do -- as a trench fighter and not from the ivory tower.

One perspective is that we at the policy level and you in the field are trying to do the same job-- the job of furthering economic growth while at the same time protecting the public.

The President and Treasury try to take actions, or persuade Congress to take actions, that will stimulate economic growth without creating undue risk to the public, such as inflation, excessive budget deficits from overspending, and tax schemes that have short term appeal but inflict long-term harm.

And you, too, promote economic growth by helping to assure that the United States has a strong, responsive system of banks and financial institutions -- for they are primary engines of economic growth -- and at the same time protect the public -- that is, the taxpayer in our federally insured deposit system, depositors, and the consumer.

Besides that, our tasks have other things in common. They are both imprecise and require judgment and balance in their implementation. And another thing -- if events turn out so it looks like an earlier decision was wrong -- even if we used good judgment at the time -- we will be heavily criticized. Believe me, we understand that part of the job.

It is because we share these economic growth responsibilities that senior Treasury officials have worked so closely with your four agencies to find responsible ways to address the credit crunch.

We're concerned about lending institutions not making or renewing loans to businesses and individuals who need them. I'm not talking about the go-go lending of the 80's. I'm talking about the kind of loans a banker described in a recent meeting with the President when he said, "We just aren't making loans that we could make."

Why aren't they making those loans? And who is hurt?

It's not hurting great big corporations. They don't go to the banks for loans. It's little guys and people who run small and medium sized businesses who have no place to turn for credit except banks. It's potential homebuyers who are hurt because homebuilders can't get credit.

Sometimes it's bigger enterprises, like real estate developers forced to liquidate property at distressed prices in distressed markets. All this has a multiplier effect -- hurting the economy, jobs and standards of living for lots of ordinary people.

Anyone who analyzes it carefully knows that the credit crunch has multiple causes. Yes some still allege that the sole cause of the credit crunch is the financial institution examiners. I just don't believe that.

But I do believe that supervisory policies and practices have contributed to timidity and a lack of confidence in the lending environment and therefore to the credit crunch. So the leadership of your agencies and Treasury have tried to make sure that overregulation of financial institutions is not contributing to the lack of credit and dampening economic growth.

To accomplish this, and create an appropriate balance between our (and I emphasize our) dual responsibilities of advancing economic growth and protecting the public, your agencies have provided comprehensive regulatory guidance to the examiner corps over the past year. You are quite familiar with the content of this guidance and you are here in Baltimore to discuss it further with your colleagues. So I won't review it in detail now. But I will make a few observations.

First, and extremely important, is that these regulatory changes and clarifications are intended to be permanent improvements in the supervisory process. They are not here just for today's problems and gone tomorrow. They are expected to provide sound guidance for examiners in good times and bad.

Second, be assured that this guidance wasn't cooked up in some back room at Treasury. It is the product of the career professionals of your agencies to which Treasury contributed what it could along the way.

Next, at least to this former federal regulator and businessman, the regulatory guidance you have received seems to represent pretty straightforward commonsense ideas that simply need equally commonsense application in the field.

What I mean, for example, is that it makes sense for bank examiners to encourage lenders to work with borrowers experiencing temporary problems, not to make it unreasonably difficult to do.

It also makes sense for examiners to take a balanced approach to real estate loans. Why rigidly condemn or criticize the renewal of even troubled real estate loans if the only alternative is foreclosure, total loss, and additional burdens on already distressed markets.

And it makes sense for examiners not to assume doomsday scenarios in evaluating loans. Our troubled economy will turn around and so will troubled credits. There has to be a time line and some assumptions of normality applied. That's particularly true for real estate appraisals and loan evaluation. That's not dangerous forbearance. That's common sense and responsible regulation.

Now let's talk for a minute about the requirements in the guidance you have received for certifications by examiners and their supervisors concerning application of the standards in examinations and their discussion with the heads of the examined institutions, and also about the revised appeals process.

We know there have been complaints and objections from the field supervisory corps on these matters. You may not agree with me, but let me try to give you my perspective.

The new appeals process allows examined institutions to appeal outside the chain of examination if they believe that the regulatory standards or guidance have been misapplied. Why? Because there are continuing complaints about such misapplication coupled with expressions of fear or futility if an examination decision can only be appealed to or through the same examiner who made the decision.

I'm not suggesting that these complaints and perceptions by banks and borrowers are all valid. No doubt the examiner decisions complained of are by and large reasonable. But you need to be sensitive to the fact that it takes very few unreasonable examiner decisions -- only a small number of "horror stories" -- to sap confidence in a fragile lending environment. So we have tried to address these concerns of bankers and borrowers in a way that does not undermine the integrity of the supervisory process. That is what your agencies have in mind.

I should point out that a parallel appeals process exists for every government agency and official -- including Secretary Brady and me -- in the form of the inspector general. Such an appeals system is also common in private businesses. And let me emphasize that this is not a system to allow "parking tickets" to be fixed without appropriate involvement and input from the cop on the beat who wrote the ticket. You'll be able to justify your actions and give your side of the story.

As for the certifications by examiners and supervisors concerning application of the supervisory standards, we hear that some consider these to be insults to their professionalism. Perhaps some of you do. But the technique of compliance certification is widely used as a quality control measure by regulators and in the private sector.

For example, talk to the Federal Aviation Administration inspectors about the certifications they make in the course of their examinations. And I can tell you that at the pharmaceutical company I once headed, our PhD scientists certified to the compliance of each of their experiments with Federal standards. Why? Simply to make darn sure that when there is something important to be done, it gets done -- like tying a string around your finger when there is something you absolutely do not want to forget.

Let me make a final point. There is nothing in the regulatory guidance you have been given or the instructions concerning its application that requires you to compromise your principles or do something foolish or dangerous.

You have a tough job. We want you to carry it out in a way that promotes economic growth and protects the public. You will be praised for appropriate vigilance. But you need to have the confidence to use your own common sense and good judgment and the courage to give the benefit of the doubt -- even if it might ultimately turn out to be a misjudgment.

Do not fall prey to the so-called "mixed messages" such as the gross injustice done to Bob Clarke or the misguided mark-everything-to-market approach of the GAO. You are doing vitally important work. You are important forces in the struggle for sustained economic growth. If you do your jobs with balance and common sense, if you carry out fully in the field the letter and spirit of the guidance your agencies have issued, I can assure you that you will have the full backing of your supervisors and the Treasury -- even if every decision doesn't turn out right. You are entitled to that.

We look forward to continuing to work with you as colleagues in the financial system and partners in the advancement of economic growth and the protection of the public.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Embargoed Until Release
October 30, 1991
9:00 am

The Honorable John E. Robson
Deputy Secretary of the Treasury
Before the Committee on Small Business
United States Senate

October 30, 1991

Mr. Chairman, members of the Committee, I am pleased to appear before you today to address issues relating to the availability of bank credit.

Today, I would like to describe the steps the Administration has taken, with the collaboration and cooperation of the bank and thrift regulatory agencies -- the Federal Reserve Board, the FDIC, the Comptroller of the Currency and the Office of Thrift Supervision, to address the regulatory aspects of this credit crunch. Also, I would like to discuss how the passage of the President's growth initiatives and comprehensive banking reform could contribute to a healthier economy and stronger, more competitive banks which can better handle future periods of tight credit.

Factors Contributing to the Credit Crunch

During the last year there has been considerable discussion about the so-called "credit crunch" and its impact on the economy.

Let me say first, that despite some assertions in the media that the credit crunch is illusory, we believe that a real credit crunch exists for certain types of borrowers and in certain regions of the country and that it is having a negative effect on the economic recovery. By "credit crunch" I mean that loans which could reasonably and responsibly be made are not available. These are loans that in normal times would be made -- not go-go credits -- and loans which could be extended under traditional standards. A banker in a recent meeting we had put it succinctly when he said, "We are not making loans that we could make". So we do not concur in the thesis that the current credit situation is simply a matter of weak demand for loans. This problem has a supply side.

The credit crunch has multiple causes which I will discuss in more detail, but which I will enumerate on here to indicate its complexity. These causes include:

- The recession, which has sapped consumer, business and banker confidence;
- Lender caution induced by the savings and loan catastrophe;
- Lenders' effort to build capital to meet international standards and satisfy stock market and credit agency concern about financial institution capital levels;
- Severe overbuilding in the real estate sector, especially commercial real estate;
- Reduced lending and tougher collateral requirements caused by the perception that borrowers have easier access to bankruptcy protection;
- Bank management uncertainty about what future structure and laws will govern the industry;
- Increased risk aversity, due to greater exposure to liability on the part of bank directors and officers and various professionals such as appraisers and accountants; and
- The influence of bank regulatory policy and examiner overreaction.

Let me also add that we are, as is the Committee, aware of the severe consequences a credit crunch has on small and medium businesses which do not have access to the capital markets and must rely primarily on bank credit for growth, expansion, and in some cases, survival.

Recession

From roughly July of 1990 until mid-year 1991, our country experienced a recession -- a recession somewhat less severe than average, but a very real one nevertheless. This declining level of economic activity, combined with the uncertainty resulting from fighting in the Persian Gulf War, negatively impacted consumer and business confidence. During recessions, people buy less, so demands for credit soften. Likewise, real estate markets have experienced increasing vacancy rates and falling rents. Commercial banks have seen a rise in non-performing assets and the need for greater loan loss reserves -- while at the same time they are working to raise capital.

Recognizing these trends, the Federal Reserve Board lowered short-term interest rates and reduced the reserves that banks are required to maintain on deposit at the Federal Reserve. While

these steps were helpful, it is my view that the Federal Reserve actions came too slowly. Money supply, as measured by M2, is still growing well below the rate set by the Federal Reserve's own target ranges.

The Commerce Department reported yesterday that real GNP rose at an annual rate of 2.4 percent in the third quarter, so that while not robust, the economy has moved out of recession. These are macroeconomic statistics and we realize that there are regions and economic sectors which are struggling.

Regulation's Impact on the Supply of Credit

Many businesses and borrowers have reported a significantly more stringent bank regulatory approach. It must be said first that this approach was in substantial measure due to the banking agencies' application of prudent regulation in more severe economic conditions, where the creditworthiness of borrowers and the values of collateral had in fact deteriorated, necessitating larger loan loss reserves. Praise, not criticism, should be given to the bank regulators for vigilance in difficult economic conditions. No one wants to return to the dangerous regulatory laxity that marked the savings and loan collapse.

However, it is this same savings and loan collapse that many believe has generated an overcorrection -- or some would call overzealousness -- in the application of regulatory policy. Nearly every day, an examiner can turn on CSPAN or read in the local newspaper about a Congressional Committee attacking a regulator for being too lax -- rarely, if ever, for being too strict. Thus, the nearly 7,000 examiners in the field are subjected to a "mixed message." This mixed message makes the job of achieving our goal -- balanced, common sense regulation -- especially difficult. This hearing is an important step in examining how to achieve a more direct and balanced message from both the legislative and the executive branches of government.

Likewise, prompt confirmation of Bob Clarke and Alan Greenspan, as well as the President's nominees to the Board of Governors of the Federal Reserve, would reduce uncertainty about the direction of regulatory policy.

There are banks, borrowers, and economic sectors experiencing temporary difficulties which need flexibility to work through their problems, and, regulatory judgment should and can be quite responsibly exercised in these situations.

In these areas of appropriate regulatory judgment the perception has been created among banks and businesses that examiners are inflexible and overly harsh. This perception has contributed to create an atmosphere of risk-aversity,

apprehension and hesitation among lenders, and has resulted in the constraint of bank credit even to sound borrowers.

Lender's Contribution to the Credit Crunch

Bankers too have become more cautious. This is due in part to the perceived increase in regulatory scrutiny. But, bankers have on their own, tightened loan standards in response to their bad experiences with the loan loss lessons of the last decade: farm credit, third world debt, real estate, and highly leveraged transactions. These previous difficulties have increased the risk aversity of many loan officers.

It is also reported to us that bank directors, concerned about increased personal liability due to the provisions contained in FIRREA and the 1990 Crime Control Act, have instructed officers to be ultra-conservative in their lending. Wall Street stock analysts consider real estate "high risk lending" and thus, publicly traded banking companies are attempting to please analysts and boost their stock prices by rapidly reducing their real estate exposure. Banks hurt by loan losses in real estate may limit new lending to even credit worthy small businesses, as they attempt to shrink loan portfolios in order to build capital reserves.

The result is a banking system that is not functioning properly and that has retreated from its role as a taker of reasonable risks to fuel the establishment of new enterprises and the expansion of economic activity. It is my opinion that it is a poorer America where the old fashioned character loan is no longer available.

The Credit Crunch and Small Business

The impact of this credit crunch on small business, like the rest of the country, has not been uniform. New England continues to report more problems than elsewhere.

The National Federation of Independent Business (NFIB) quarterly publishes a survey of 2,000 small businesses. In both the March and July 1991 surveys, those small businesses who regularly borrow did not cite a material difficulty in obtaining credit. The study did note that there was a weak demand for short-term loans, particularly in light of earnings performance.

Credit availability for small business in the second quarter was unchanged from what it has been over the last year. However, borrowing frequency held at comparatively low levels and we continue to hear anecdotal evidence of small business not getting credit. One percent of those polled by the NFIB reported credit

easier to obtain in the last three months compared to the prior three; 12 percent reported it harder to get. These numbers indicated that credit has been more difficult to obtain in the last quarter than it has been historically, but not more so than in the three prior recessions.

One area we have followed closely is residential housing. Many single family home builders have pointed to a dramatic decrease in credit available for new construction -- even in areas where there is identifiable demand for new starts. These borrowers could be victims of both overly cautious bankers and regulators, and also of a failure to distinguish properly among credit requests for commercial real estate in overbuilt markets and needed residential real estate credit. Another area of difficulty are those small businesses attempting to borrow and operate in regions of the country where there have been a large number of local banks in financial difficulty, such as New England or here in the Washington, D.C. metropolitan area.

Improving the Climate for Lending

Since the summer of 1990, President Bush and other Administration officials have been meeting with bankers, businesses, and the regulators to identify specific steps that could be taken to improve the climate for lending. These meetings led to regulatory policy changes and clarifications that were released in March, July, and October of 1991. Each of these steps is aimed at achieving balance and common sense in the application of regulatory policy, and raising the level of confidence in the lending environment. These changes are permanent changes to improve bank regulation. They are not simply quick-fix changes which will be abandoned when the credit crunch is over.

Some of these policy changes provided specific guidelines for the handling of troubled real estate loans, methods for working with troubled borrowers and improving the banker-examiner relationship. Specific changes and clarifications include:

- Directives that bankers should work constructively with borrowers experiencing temporary difficulties and facilitate the orderly restructuring of credits;
- Prudent refinancing of economically sound commercial real estate loans;
- Improved verification by regulatory supervisors that recent policy changes and clarifications are appropriately applied in each examination;
- Enhancements in the process for appeals of alleged

misapplication of regulatory standards;

- Harmonization of the treatment of preferred stock in U.S. capital standards with other signatory countries under the Basle capital accord;
- Appropriate application of valuation standards especially in real estate credits so as to avoid a liquidation approach to valuation;
- Improved guidance in the appraisal process and steps to reduce excessive appraisal costs for lenders; and
- Legislative action to make permanent a recent EPA proposed regulation to limit lender liability for environmental cleanup of loan collateral properties, and to address related issues.

Long-Term Solutions to Future Credit Crunches

Addressing the credit crunch is a battle which must be waged in the short term to accelerate and sustain the economic recovery. To encourage long term economic growth, Congress should act immediately to pass the President's initiatives for economic growth which were submitted in our 1992 budget request but on which Congress had yet to act. Our program would:

- Reduce the capital gains tax rate to promote jobs and business formation;
- Enhance personal savings through an expanded Individual Retirement Account (IRA) and the Family Savings Account;
- Make permanent the Research and Experimentation tax credit;
- Increase federal investment in science, technology and infrastructure;
- And keep the pay-as-you-go system in the budget process to ensure that any new spending must be offset by decreased spending elsewhere in the budget. This restraint on federal spending must be kept in place to contain the deficit.

Next, in order to ensure that our country has a competitive and strong financial services industry, the Congress should pass the President's comprehensive banking reform measures. As Treasury Secretary Brady said on March 18, 1991, "the state of banking in the U.S. leaves taxpayers overexposed, consumers and

business underserved, and the industry increasingly uncompetitive.

Comprehensive reform is essential because strong banks and financial service firms are a key to the economic health of our country. Strong banks will keep credit available in good times and bad, fueling economic growth and new jobs. Competitive, well capitalized financial institutions are a sure way to avoid future credit crunches. If you want stronger banks, banks that will return to the business of lending money to sound customers for sound projects, work with your colleagues to pass this package.

Conclusion

Mr. Chairman, in the past, I have served as the head of a federal regulatory agency and as the chief executive officer of a company operating in a regulated industry. Thus, I believe that I can speak with some perspective on the dynamics of the regulatory process and what it takes to achieve the desired result.

It takes constant and consistent communication of the policies and procedures that one wants followed in order to achieve balanced and consistent regulation. Regulation should be consistent in boom times as well as times of economic hardship. We need the help of you and your colleagues, Mr. Chairman, to accomplish our mutual goal of safe and sound banks and available credit for America's entrepreneurs and businesses.

I would now be pleased to respond to the Committee's questions.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

The Honorable John E. Robson

Deputy Secretary of the

U. S. Department of the Treasury

Before the Committee on Small Business

U. S. House of Representatives

March 5, 1991

Mr. Chairman, members of the Committee, I am pleased to appear before you today to address issues relating to the availability of bank credit.

During the last several months there has been considerable discussion about the credit crunch and its impact on the economy. As we all know, accessible, affordable bank credit is important to all businesses, large and small. And a safe and financially strong banking system is the best assurance for the availability of credit.

Mr. Chairman, you and the Committee are to be commended for your work during the last Congress in researching the factors that promote a sound, financially strong and competitive banking system. Your Task Force report on "The International Competitiveness of U.S. Financial Institutions" was very helpful to us in the preparation of the analysis and recommendations contained in our study, "Modernizing the Financial System," on

which Secretary Brady testified before the House Banking Committee last week.

Strong, competitive institutions are necessary for the banking system to play the critically important role as a "shock absorber" in our economy. When the economic needs of industry expand, the banks are there to provide the credit necessary for growth and capital investment. And, when the economy contracts, our banks are needed to patiently work with borrowers on their working capital needs and to absorb some of the shock from falling sales and property values.

Today, I would like to give some opening comments and then my colleagues representing the four bank and thrift regulatory agencies -- the Federal Reserve, the FDIC, the Comptroller of the Currency, and the Office of Thrift Supervision -- (the "Regulatory Agencies") will discuss more fully the specific recommendations and proposals. My comments are in the spirit of the Treasury's role in this effort. We served as a "catalyst" in working with the Regulatory Agencies who actually developed the united set of recommendations and are now acting to implement them promptly and effectively.

Factors Contributing to the Credit Crunch

For the last several months our country has experienced a declining economy and our citizens have been preoccupied with our service men and women in the Persian Gulf. This has had a deleterious effect on consumer confidence and has negatively impacted many borrowing decisions including home and automobile sales and corporate capital expenditure plans. Thus, demands for credit have fallen. Likewise, with a softening economy, real estate markets are experiencing increasing vacancy rates and falling rents. Commercial banks, as in all downturns, have seen a rise in non-performing assets and the need for greater loan loss reserves -- while at the same time they are working diligently to raise capital to meet international standards.

Recognizing these trends, the Federal Reserve has responded by moving to lower short-term interest rates and reduce the reserves that banks are required to maintain on deposit at the Federal Reserve. These steps are meant to address both credit demand by lowering rates and credit supply by freeing up reserves that banks can then lend to sound borrowers.

Regulation's Impact on the Supply of Credit

However, even before the invasion of Kuwait, businesses and banks perceived a more stringent regulatory approach. It

must be said first that this approach was in substantial measure due to the application of prudent regulation in more severe economic conditions, where the creditworthiness of borrowers and the values of real estate and loans had in fact deteriorated, necessitating larger loan loss reserves. Praise, not criticism, should be given to the bank regulators for vigilance in difficult economic conditions. No one wants a return to the dangerous laxity that marked the savings and loan collapse.

However, the application of prudent regulation also requires balance, common sense, and a recognition that banks, borrowers, and economic sectors experiencing temporary difficulties may need some flexibility to work through their problems -- and that regulatory judgment should and can be quite responsibly exercised in those situations.

It is in these areas of permissible and appropriate regulatory judgment where the perception has been created among banks and businesses that examiners are inflexible and overly harsh. This perception -- right or wrong -- began to create an atmosphere of risk-adversity, apprehension and hesitation among lenders, and has resulted in the constraint of bank credit even to sound borrowers. This undesirable atmosphere appears to have been created in a number of areas of the country and seems to be largely traceable to the examiners' overly pessimistic and rigid

application of regulatory guidelines in areas where supervisory latitude exists and judgment can be properly employed.

For example, in the past, examiners reviewed appraisal information and also looked to the income generating capability of a real property in order to determine adequate reserves. However, regulators and bankers have recently reported a trend toward using only worst case, liquidation-type of valuations. Another instance might be the case where an examiner has instructed bank management to make a significant reduction in a loan concentration over a short period of time. Under that circumstance, many bankers will cease making or renewing any loans -- even sound ones -- in that concentration area.

Certainly, it was not the intention of the Regulatory Agencies to create a repressive lending climate. However, these perceptions are not facilitating the proper atmosphere to encourage bankers to work with borrowers experiencing problems and to avoid shutting off credit to sound borrowers, especially those in sectors of the economy experiencing temporary problems. And, commendably, in their statement released last Friday, the Regulatory Agencies stated that they "do not want the availability of credit for sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings of them."

Improving the Credit Climate

Following President Bush's State of the Union Address urging "sound banks to make sound loans," Secretary Brady suggested to the leadership of the Regulatory Agencies that they get their heads together and sort through the many recommendations from the Regulatory Agencies themselves, the business community and the bankers to address these issues.

On Friday, March 1, 1991, the Agencies announced a package of proposals to address the credit crunch. The package is the result of several weeks of work to determine what existing supervisory and examination policies and guidelines should be reassessed and clarified.

The proposals address a number of the areas of concern raised by both the regulatory community and the private sector. This includes guidance on the use of appraisals by examiners and other valuation issues -- especially in troubled real estate markets; broader disclosure to inform the investment community as to the true earning power of loans which have been technically placed in the non-performing assets category; continued prudent lending by institutions operating under a capital plan or with a loan concentration; clarification on the disclosure of credits in Highly Leveraged Transactions (HLTs); and, the need for clear and effective communication between bankers and their regulators.

Furthermore, the Regulatory Agencies will continue to review their supervisory practices to determine what other policies may require modification.

These Proposals are not "Forbearance"

It is important to properly characterize the actions undertaken by the Regulatory Agencies last week and to address the concerns expressed by some that this is a kind of improper and risky forbearance. Such concerns have no foundation in fact. In no part of this package of recommendations from the Regulatory Agencies is there any -- I repeat -- any proposal to create fictitious capital, permit accounting practices not in accord with generally accepted accounting standards, or otherwise encourage "toying" with the books. This package encourages the application of common sense and judgment in supervisory actions and promotes lending to sound borrowers. To condone an approach of discredited forbearance would not be in keeping with the reforms implemented under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) or that we are now asking the Congress to consider as a part of our recommendations to modernize the financial services industry. Furthermore, it would ignore the disciplines of the market place and protect institutions which operate in an unsafe and unsound manner. That is not the case here.

Importance of Communication

Mr. Chairman, in the past, I have served as head of a federal regulatory agency and as chief executive officer of a company operating in a regulated industry. Thus, I believe I can speak with some perspective on the dynamics of the regulatory process. In order to achieve policy goals it takes clear communication and a great deal of management effort to achieve the desired policy objective.

I cannot emphasize enough that the encouragement of prudent lending activities rests on the shared confidence and understanding among both examiners and those whom they regulate. The guidance released last Friday must be clearly communicated to the more than 6,700 field examiners and to the financial institutions, and implemented in an even-handed, common sense manner. I am pleased that each Regulatory Agency has committed to make a special effort in disseminating these initiatives.

These steps alone will not end the credit crunch. However, they should have a very positive impact on the regulatory environment -- giving greater confidence to lenders that extending credit to sound borrowers will not result in regulatory retribution -- giving greater assurance to examiners that their exercise of appropriate judgment, balance and recognition of economic reality will not result in criticism from

their superiors -- and giving greater confidence to borrowers to come forward in the expectation that sound projects will be funded. So, it is my hope that when combined with steps already taken by the Federal Reserve to lower interest rates and reduce bank reserve requirements, these efforts will result in greater credit availability to sound borrowers.

I would be pleased to respond to the Committee's questions.

Key Credit Crunch Questions

1. What caused the credit crunch? What are some of the factors that cause the credit crunch to persist?

Answer:

The credit crunch has multiple causes which include:

- The recession, which has sapped consumer, business and banker confidence;
 - Interest rates that did not drop quickly enough;
 - Lender caution induced by the savings and loan catastrophe;
 - Lenders' effort to build capital to meet international standards and satisfy stock market and credit agency concern about financial institution capital levels;
 - Severe overbuilding in the real estate sector, especially commercial real estate;
 - Reduced lending and tougher collateral requirements caused by the perception that borrowers have easier access to bankruptcy protection;
 - Bank management uncertainty about what future structure and laws will govern the industry;
 - Increased risk aversity, due to greater exposure to liability on the part of bank directors and officers and various professionals such as appraisers and accountants; and
 - Bank regulatory policy and examiner overreaction.
 - Uncertainty caused by lack of action from Capitol Hill. Bank regulators such as Alan Greenspan not confirmed or Bob Clarke rejected for being too lax when Congress was blaming him for the credit crunch.
 - Lack of Congressional action on the President's growth package.
2. Do the bank regulators have a deliberate policy to reduce bank concentrations in real estate loans and a formula to determine what amount of real estate assets a bank should have?

Answer:

No, the bank and thrift regulators do not have a strict ratio test that they apply to financial institutions in an attempt to reduce

concentrations of real estate loans. Further, bankers and regulators recognize the benefits of adequate portfolio diversification.

Regulators encourage banks and thrifts that have systems in place to monitor asset concentrations, to work with troubled borrowers and make new loans. Automatically refusing to renew existing creditworthy real estate loans or to make sound, new loans may reduce concentrations, but it may also reduce portfolio quality.

3. Do the bank regulators force bankers to classify loans where the borrower is making payments on the loan, but the property value has been marked down by a new appraisal? (the so-called "performing non-performing loan")

Answer:

No, just because a property securing a loan has fallen in appraised value does not mean that the examiners will force a bank to write down the loan's value.

The banker and the examiner will look at the property's ability to generate current cash flow to service the debt, the past track record of the borrower, and the long term value of the property over the term of the loan to determine what, if any, loan loss reserves should be created by the bank.

4. Shouldn't banks be able to work with troubled real estate borrowers over the long term, instead of pursuing policies to foreclose and write off loans?

Answer:

Yes, that is the current policy of the regulatory agencies. Bankers are encouraged to work with troubled borrowers. Specific guidelines have been issued to urge bankers to use GAAP accounting rules to formally restructure weak credits, thus improving the banks' chances for collection. Guidelines were also issued stating that bankers can refinance medium term real estate credits, often extended for construction purposes (so-called mini-perms), without fear of automatic regulatory criticism.

5. What are banks doing outside the influence of the regulators to contribute to the credit crunch?

Answer:

Bankers have simply become more cautious and conservative in their lending. Bankers have tightened loan standards on their own, in many cases, in response to their bad experiences with the loan loss lessons of the last decade: farm credit, third world debt, real estate, and highly leveraged transactions. These previous difficulties have increased the risk aversity of many loan officers.

Bank directors, concerned about increased personal liability due to the provisions contained in FIRREA and the 1990 Crime Control Act, have instructed officers to be ultra-conservative in their lending. Wall Street stock analysts consider real estate "high risk lending" and thus, publicly traded banking companies are attempting to please analysts and boost their stock prices by rapidly reducing their real estate exposure. Banks hurt by loan losses in real estate may limit new lending to even credit worthy small businesses, as they attempt to shrink loan portfolios in order to build capital reserves.

The result is a banking system that is not functioning properly and that has retreated from its role as a taker of reasonable risks to fuel the establishment of new enterprises and the expansion of economic activity.

6. How are the Bank For International Standards (BIS) Capital Standards (commonly referred to as the Basle Agreement) contributing to the credit crunch?

Answer:

Many cite the BIS capital standards as the primary reason for banks increasing pressure to build capital. The reality is that 96 percent of all U. S. banks, including 48 of the top 50 banks, currently comply with the capital standards. However, banks are building capital for several other reasons. First, increased pressure by bank stock analysts. Second, banks' own uncertainty about the future and possible consolidation in the industry. Third, during the recent economic downturn, banks redirecting their assets from loans to consumers, to investments in government securities. This fundamental shift, by definition, increases capital.

Moreover, these capital standards have been phased in since 1986. These required capital levels are no surprise. Bankers have known they were coming and have prepared for them.