

Banks and Real Estate: Regulating the Unholy Alliance

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Banking and real estate have always had an uneasy relationship. It was not until early this century that national banks were even permitted to extend loans collateralized by real estate. To this day, national banks, bank holding companies, and many state-chartered banks are prohibited from owning real estate directly, except when obtained through foreclosure or if used for bank premises.¹ In addition, savings and loan institutions generally have had authority to make commercial real estate loans and to invest in real estate directly for only a little more than a decade.

The uneasy attitude toward bank involvement in real estate lending is not difficult to understand. Real estate lending has played a significant role in several of the major episodes of banking difficulties in the postwar era: in particular, in the mid 1970s through bank-established "real estate investment trusts" or REITs; in the mid 1980s among banks and savings and loans in the Southwest; and more recently among banks in the Northeast and (thus far to a lesser extent) in California.

This paper will attempt to answer four key questions that the most recent real estate troubles have provoked. First, could the problems that banks in particular have suffered have been prevented or significantly minimized in any way by reasonably prudent regulation in advance? Second, did regulators actually make the problems worse once they

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¹ As of 1990, some 27 states permitted their banks to make some direct investments in real estate, but generally subject to some percentage of capital, assets, or deposits.

were discovered? Third, what changes in regulatory policy toward bank involvement in real estate activities would best prevent real estate downturns from causing troubles in the banking industry in the future? And finally, how should those changes be phased in, to ease the transition out of the current difficulties?

The paper focuses principally on lending for commercial real estate, not because residential real estate lending is unimportant—to the contrary, it has been and continues to be larger in volume than commercial real estate lending—but instead because most of the real-estate-related problems that banks have experienced have been concentrated in commercial projects. In addition, the discussion concentrates heavily on *bank* lending for commercial real estate, although virtually all of the analysis and policy recommendations apply with equal force to such lending by savings and loans.

In brief, the long-run recommendations are centered on the well-known observation that commercial real estate activity and values appear to be heavily influenced by the availability of financing, or liquidity. When times are good and money is available, lenders lend and builders build. But because of the long lags between the times loans are made and projects finished, both developers and banks will eventually overexpand, leading to excess capacity and thus creating the conditions for a subsequent contraction.

A central objective for bank regulation (and for policymaking generally) is to construct a statutory and regulatory environment that minimizes the amplitude of this inherent “boom and bust” cycle in commercial real estate. During the up side of the cycle this means that, at a minimum, lenders should be held to prudent loan-to-value requirements, such as those recently proposed by federal bank regulators. Some have suggested that statutory or regulatory ceilings also be imposed on the portions of a lender’s assets that can be invested in commercial real estate lending (mortgages as well as construction and development loans). This study recommends incentives to encourage banks not to concentrate so heavily in commercial real estate, rather than the imposition of arbitrary limits on participation.

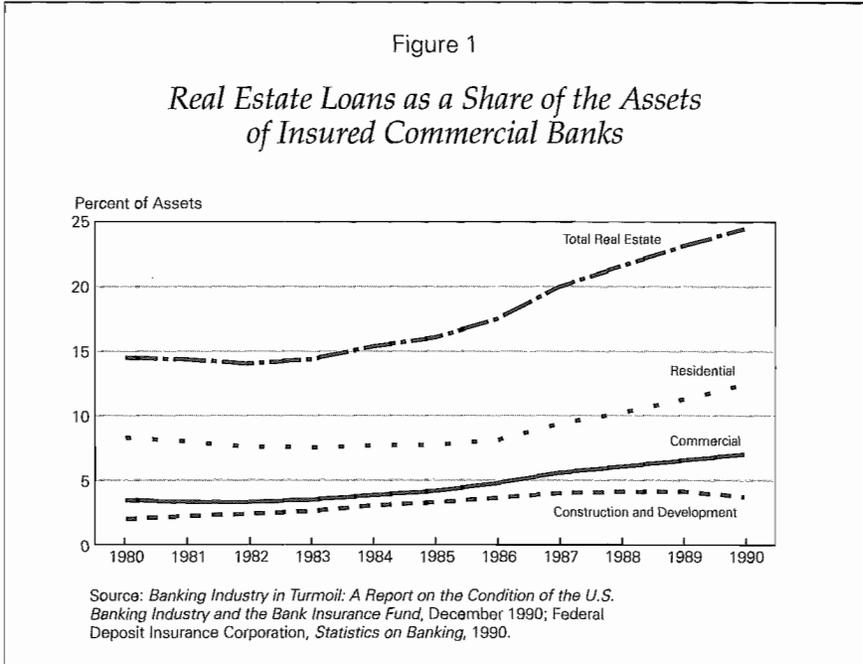
Ultimately, the best protection against excessive risk-taking in commercial real estate or any other bank activity is a regulatory system that imposes effective discipline generally. The “early intervention” capital-based requirements of the 1991 banking reform legislation are a step in the right direction, but more can and should be done to introduce market discipline, with respect to larger banks in particular. Toward this end, all banks with assets over \$1 billion should be required to satisfy some portion of their Tier 2 capital standard with subordinated debt, which would provide a stable source of market discipline against excessive concentration in high-risk real estate lending. Smaller banks could be penalized in a different way for excessive concentration,

preferably with lower supervisory ratings and thus higher deposit insurance premia, or alternatively through supplemental capital requirements.

The more difficult regulatory questions arise when asset values "turn south," posing the critical issue of whether the policies desirable for the long run should be relaxed in any way in the short run. Critics of recent bank regulatory policies argue that they should, pointing to what they believe has been the contractionary effect of those policies. The discussion that follows accepts the premise of the critics, that bank regulation does appear to have worsened the 1990-91 downturn and inhibited the recovery, but it does not agree with their conclusion that bank regulation should necessarily be weakened. Instead, the contractionary effects induced by recent bank regulatory policies mean that the two traditional macroeconomic policy tools—monetary and fiscal—need to work that much harder to achieve the desired stimulative impact. Thus, at this writing, a strong case continues for further monetary easing and possibly even some short-run fiscal stimulus, provided that any fiscal package contain concrete measures to reduce the high-employment or structural federal deficit in the long run.

This study nevertheless will recommend three ways in which bank regulation might be changed to minimize the contractionary effects that have been the focus of the critics' attack and yet be consistent with desirable long-run regulatory objectives. First, and admittedly most difficult to alter given their internationally negotiated character, the risk-based bank capital standards should be reworked to remove much of their current bias against banks' making loans. At the very least, a waiver procedure could be established to permit individual countries to narrow the risk-weighting differential between government securities and conventional loans, provided the overall level of capital required of banks is not reduced. In this way the actual 4 percent and 8 percent capital standards for Tier 1 and Tier 2 capital would not be reduced or even delayed. Second, regulators should abandon the policy of requiring banks to establish loss reserves on so-called "performing nonperforming loans," those loans where the borrower continues to make payments but, in the opinion of the regulators, the short-run liquidation value of the collateral has fallen below the face amount of the loan. Instead, banks should be required to establish reserves on loans only when they become nonperforming, not when they are expected to be in that status. Third, once loans become nonperforming, regulators should be discouraged from using liquidation values to establish reserve levels, but instead should base their reserving decisions on conservative, but realistic, estimates of the present discounted value of the real estate collateral.

Some may interpret any or all of these recommendations as a "relaxation" of current standards, but all three can be justified with



appeals to simple common sense. Moreover, to do otherwise in the name of regulatory purity can actually be self-defeating, encouraging a spiral downward in real estate values and bank capital that can only further weaken many of the loans banks already have on their books. Put another way, these changes are designed to be permanent features of the regulatory landscape that nevertheless take account of inevitable cyclical fluctuations in the macroeconomy. *Bank regulatory policy itself should not be cyclical.*

Finally, key to any economic recovery is the growth of residential construction. It is therefore critical that bank regulatory policies not discourage the financing of residential construction by banks and thrift institutions.

Banks and Real Estate Lending: Some Factual Background

As other papers in this volume document, commercial banks became substantially more involved in real estate lending during the 1980s. Figure 1 illustrates, however, that the major upturn did not really

begin until the middle of the decade, and then it did not really accelerate until the end of the decade. At the end of the first quarter of 1992, banks had \$854 billion in real estate loans on their books, representing one-quarter of their assets and 43 percent of their total loans.

Figure 2 charts real estate lending for banks of different sizes by major loan category—construction and development, nonfarm, nonresidential mortgages (commercial mortgages), and residential mortgages (one- to four-family). The figures illustrate that banks of all sizes became more active real estate lenders during the past several years, although some distinctions are notable. In contrast to their larger brethren, the smallest banks (those with assets below \$300 million) did not significantly increase their lending for construction and development, and thus did not have to cut it back significantly at the end of the decade, as did the larger banks.

It is not difficult to explain why larger banks were increasingly attracted to real estate—and especially commercial real estate lending—during the past decade. These institutions suffered a loss of their prime commercial and industrial loan customers, who found cheaper finance in the securities markets, but they did not suffer a loss in deposits. Accordingly, many large banks chased various forms of higher-risk lending, largely for commercial real estate but also for highly leveraged corporate transactions.²

More puzzling, however, is the fact that even banks that had never loaned money to the large companies that deserted banks for the securities markets during the 1980s plunged more heavily into commercial real estate lending. As will be argued below, this was likely a reflection of the herd mentality that gripped many investors, foreign and domestic, bank and nonbank, in the 1980s. At the same time, it is noteworthy that the very smallest banks (those below \$300 million in assets), which would have been least affected by the “securitization” of commercial lending in the 1980s, moved less aggressively into commercial real estate lending than the medium-sized and larger banks.

Meanwhile, the rise in the share of all bank assets devoted to less risky residential real estate mortgages can be attributed largely to two factors. Among other things, the 1986 Tax Reform Act gradually phased out deductions for consumer installment debt and thus encouraged consumers to replace what were once straight consumer loans with home equity loans, which are included in the data for residential real estate lending shown in Figure 2. In addition, in the latter part of the decade, bank regulators from the major industrialized countries agreed upon new capital standards (the so-called “Basle Accord”) that gave banks incentives to originate and hold residential mortgages, by requir-

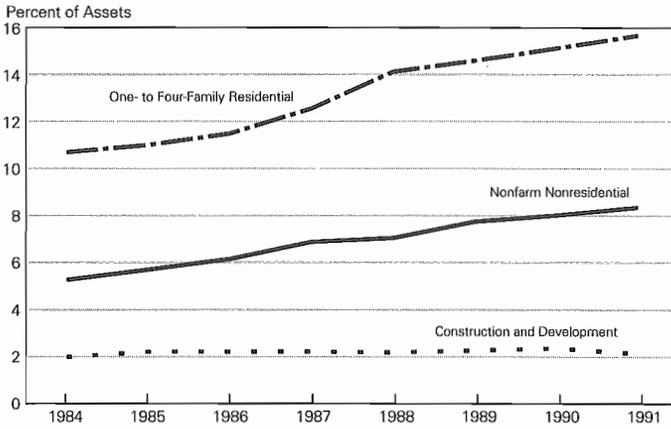
² This phenomenon is addressed in some detail in Litan (1991).

Figure 2

Real Estate Loans as a Share of Average Consolidated Bank Assets

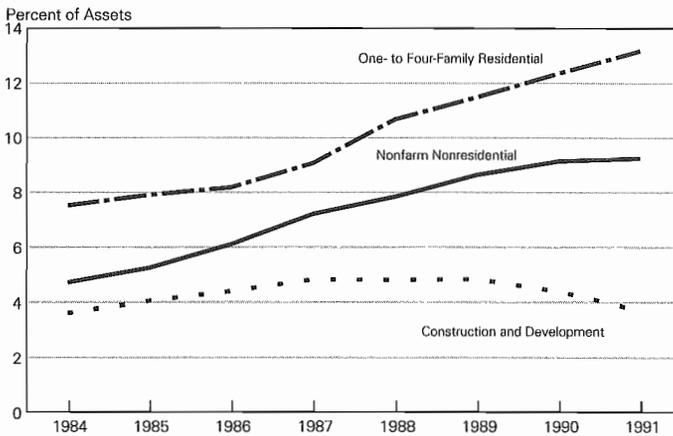
2a.

Banks with Assets below \$300 Million



2b.

Banks with Assets of \$300 Million to \$5 Billion



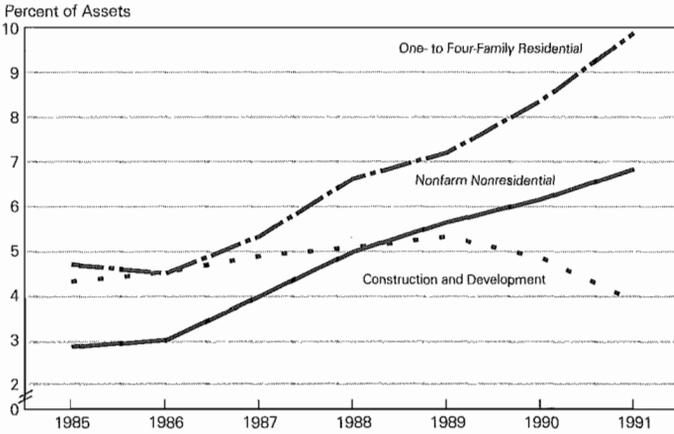
Source: Federal Reserve Bulletin, July 1992.

Figure 2
continued

Real Estate Loans as a Share of Average Consolidated Bank Assets

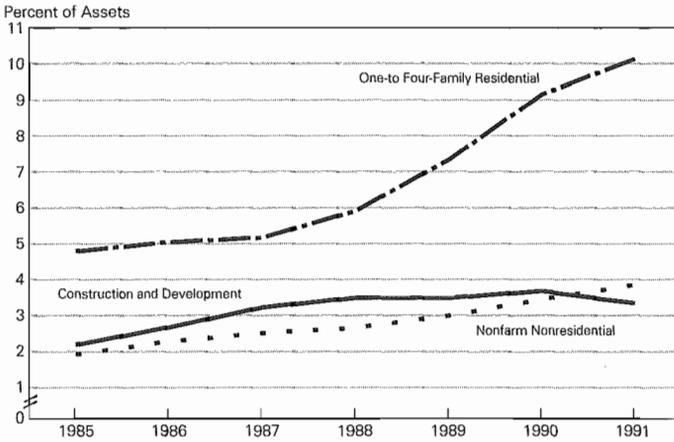
2c.

Banks with Assets over \$5 Billion
excluding the Ten Largest Banks



2d.

The Ten Largest Banks



Source: *Federal Reserve Bulletin*, July 1992.

Table 1
 Percentage of Bank Commercial Real Estate Loans in Nonaccrual Status, First Quarter 1991 vs. First Quarter 1992

| Asset Size | Construction and Development Loans | | Commercial Mortgages | | All Loans | |
|------------------------------|------------------------------------|--------|----------------------|--------|-----------|--------|
| | 1991:1 | 1992:1 | 1991:1 | 1992:1 | 1991:1 | 1992:1 |
| All Banks | 11.9 | 14.8 | 5.5 | 5.9 | 3.2 | 3.0 |
| Less than \$100 Million | 2.8 | 3.2 | 2.1 | 2.5 | 1.8 | 1.6 |
| \$100 Million to \$1 Billion | 5.2 | 5.8 | 2.6 | 3.4 | 2.1 | 2.1 |
| \$1 Billion to \$10 Billion | 11.1 | 12.2 | 5.3 | 5.5 | 3.1 | 2.8 |
| Over \$10 Billion | 16.7 | 22.4 | 10.0 | 10.5 | 4.2 | 4.0 |

Source: Federal Deposit Insurance Corporation, Division of Research and Statistics. *The FDIC Quarterly Banking Profile*. First Quarter 1991, p. 3; and First Quarter 1992, p. 3.

ing them to back each dollar so invested with only half the capital required for conventional loans. Although the standards did not become effective until 1991, the fact that they were announced in 1988 would have given banks incentives to build up their residential mortgage portfolios in advance.

It is now well known, of course, that in the 1990s banks have paid a heavy price for their plunge into commercial real estate during the preceding decade. As shown in Table 1, by the first quarter of 1992, nearly 15 percent of all construction and development loans made by U.S. banks were in nonaccrual status, while almost 6 percent of all banks' commercial mortgage loans were in a similar condition. Both numbers were several multiples of the nonaccrual percentages for bank loans generally, and both were higher in the first quarter of 1992 than in the same period the prior year, while bank loans generally were improving in quality. In addition, the largest banks reported the highest percentages of commercial real estate loans in nonaccrual status, consistent with the observation just made that these institutions suffered the greatest shock to their traditional lending business in the 1980s and thus took the greatest risks in an effort to compensate.

Thus far, banks' losses in commercial real estate have not exceeded their losses from LDC debt, either in absolute or relative terms. For example, from 1987 through 1991, the top 50 U.S. banks wrote off \$26 billion, or approximately one-quarter of their LDC debt. In contrast, between 1989 and 1991 (the years covering the recent commercial real estate crisis) all U.S. banks wrote off \$18 billion, or only about 5 percent, of their commercial real estate loans (Lipin 1992). But it is far too soon to close the books on the comparison. A Goldman Sachs study reported in mid 1992 that \$93 billion in bank loans for commercial real estate had still to be "repriced"—or less euphemistically, written down—in order to reflect a projected average deterioration of 30 percent in the value of the

underlying real estate.³ If, quite conservatively, the write-downs average 20 percent, then the banking industry as a whole is looking at total additional losses of almost \$19 billion, a sum roughly equal to the entire earnings of the banking industry in 1991 (approximately \$18 billion).

Bank Real Estate Lending: The Role of Public Policy

Banks clearly took a roller coaster ride in their commercial real estate investments during the 1980s and have only themselves to blame for their mistakes. Nevertheless, public policy helped in various ways to build the roller coaster.

The role played by changes in tax policy is well known. The 1981 Economic Recovery Tax Act helped launch a wave of development activity by granting generous depreciation allowances and other incentives for commercial real estate development. But then the Tax Reform Act of 1986 pulled the plug on the market by abruptly taking those incentives away. The changes in tax policy are reflected in the statistics: between 1981 and 1985, the nominal value of commercial construction put in place almost doubled, rising from \$40 billion to \$76 billion; it was virtually flat thereafter until mid 1990, when it began to plummet on account of the recession.⁴

Bank regulatory policy followed a similar roller coaster pattern. As part of the Garn-St Germain Act of 1982, Congress removed various statutory restrictions on permissible loan-to-value ratios governing the real estate lending of national banks, which previously ranged from 66.7 percent for unimproved land to 90 percent for improved structures.⁵ In their place, Congress issued only broad instructions to the Comptroller of the Currency to regulate real estate loans in a manner consistent with the "safety and soundness" principles it applied to all bank lending. A gradual relaxation of lending standards throughout much of the banking system followed.

For example, at the beginning of the decade the typical bank did not finance unimproved land; when it financed construction it did so only when a developer had a commitment for "takeout" financing in hand; and commercial mortgages were provided only where developers put up at least 30 percent of the money. By the end of the decade, land loans

³ Brueggman (1992). The study also indicated that at that time thrift institutions and insurance companies faced repricing on \$92 billion of commercial mortgages.

⁴ Data are from the *Economic Report of the President, 1992*, pp. 354-55. For a thorough treatment of the role played by tax policy changes, see the paper by James Poterba in this volume.

⁵ The previous law also specified loan-to-value limits and maturities for residential mortgage loans of 80 to 90 percent.

were common, construction loans often were provided without advance takeout commitments, and many developers put up as little as 10 percent equity. In some cases, banks put up all the money (Brimmer 1992; Downs 1992). In this respect, banks followed the thrifts, which were allowed into commercial real estate finance for the first time only at the beginning of the 1980s (with the passage of the Depository Institutions Deregulation and Monetary Control Act in 1980 and the Garn-St Germain Act in 1982). Liberal commercial real estate lending by many thrifts helped lead to the overbuilding in many markets that later came to haunt the commercial banks and the developers they funded.

The roller coaster in bank and thrift regulatory policy changed direction at the very end of the 1980s in two ways. First, lending by thrifts for both commercial real estate and residential construction was significantly cut back in August 1989 in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). This was not done directly, but instead was the effective result of provisions that forced thrifts to limit loans to one borrower to no more than 15 percent of capital (the standard applicable to banks), down sharply from the previous 100 percent of capital limit. As a practical matter, this change had its greatest impact on commercial real estate loans, which tended to be the largest loans in thrift portfolios. In addition, FIRREA mandated a long overdue increase in thrift capital ratios that had the effect of constraining the growth of capital-weak institutions.

Second, shortly after FIRREA became law, bank regulators became more rigorous in their valuation of loans collateralized with real estate and then of commercial loans generally. The change in attitude appears to have surfaced first with the Comptroller's examination of Bank of New England, which had a large portion (38 percent) of its loan portfolio tied up in real estate, primarily in the Northeast where real estate values had begun to drop. As a result of the exam, Bank of New England was required to make substantial additions to its reserves in the fourth quarter of 1989 and even greater additions the following year (culminating in the bank's failure in January 1991).

The regulatory posture became more formal and general in early 1990, mandating a more conservative approach toward establishing reserves for future loan losses and in particular requiring banks and their examiners to place greater emphasis on the market value of the underlying collateral, as an indicator of the likelihood of future default. For commercial real estate loans in particular, the Comptroller issued new instructions that noted, among other things, that "[m]ortgaged premises can be considered foreclosed, *in substance*, regardless of whether formal foreclosure has taken place . . . when the debtor has little to no equity in the collateral, sources of repayment depend on the operation or sale of the collateral, and the debtor has abandoned control of the collateral" (emphasis added). The new guidelines further ob-

served that while "in some cases" the debtor may continue to retain control of the collateral, as a practical matter control may be deemed abandoned "because of financial weakness or [poor] economic prospects."⁶

In effect, this language gave examiners the authority to require banks to establish reserves against loans on which borrowers were current in their payments but where the market value of the underlying real estate collateral had fallen so low as to wipe out any equity the borrower may once have had in the project. In fact, examiners had this authority before, since the *Comptroller's Handbook* had previously counseled that mortgage loans were unsound if "the amount of the loan is large relative to the fair value of the property" or if the "ability of the obligor to pay is questionable" (Section 213.1, p. 2). In this connection, the *Handbook* had also observed that real estate values could be determined by looking to the recent prices on comparable real estate or by capitalizing income that the property was expected to generate. All of this preexisting language gave examiners ample flexibility to force banks to establish reserves on what have since been labeled "in substance foreclosures." Nevertheless, by adding specific instructions to this effect, the new guidelines issued in early 1990 appeared to dictate that approach, rather than allowing banks to avoid reserving until borrowers actually began missing their loan payments.⁷ It appears that the other federal bank regulatory agencies—the Federal Deposit Insurance Corporation and the Federal Reserve—adopted the Comptroller's new policy at roughly the same time.

The widely understood rationale for the tough regulatory stance toward the valuation of bank real estate loans was a desire to make provision in advance for the increased likelihood that in a depressed real estate market, borrowers would simply "hand the keys" to their property to the bank rather than continue to make loan payments, even if they had the financial resources to make those payments independent of the collateral. Such behavior apparently was common in the Southwest in the mid 1980s, when plunging oil prices caused an economic downturn in that regional economy. Regulators simply wanted to apply that experience to New England and any other part of the country where it seemed likely to be repeated. A critical question, to be addressed

⁶ Taken from the *Comptroller's Handbook for National Bank Examiners* (March 1990), Section 213.1, p. 2.

⁷ Much has been made of the fact that the Comptroller's new policy urged examiners to value property based on "discounted cash flow" techniques. It is true that the new instructions specifically described discounted cash flow as an alternative real estate valuation technique, but no major conceptual difference exists between discounted cash flow and the "capitalization of income" approach that was previously identified as a method of valuation.

below, is whether in attempting to anticipate future loan losses, regulators helped make them worse.

Bank Real Estate Problems: Could They Have Been Avoided?

It is easy in retrospect to claim that regulators could have done a better job of preventing banks from taking the real estate roller coaster. At a minimum, if both bank and thrift regulators had retained in the form of regulation the loan-to-value ratios that were previously part of the bank statutory environment, both types of depository institutions would not have so freely increased their exposures to commercial real estate. The same would be true, of course, if Congress had never repealed the loan-to-value guidelines as part of Garn-St Germain.

A case can also be made that real estate concentration limits would have helped, although as will be argued below, less arbitrary ways can be found to curtail excessive real estate lending risks. In fact, even Garn-St Germain constrained federally chartered thrifts in their commercial real estate lending, although the "limit" was quite high—40 percent of assets, or more than four times the average level of the typical bank during the 1980s. No such concentration limit was set for commercial banks. Clearly, in retrospect, had both sets of institutions been subjected to significantly lower limits—say, on the order of 10 percent—commercial real estate construction would not have gone as far overboard as it did. Moreover, a 10 percent concentration limit would have constrained fewer than 10 percent of the banks.⁸

But just because different regulatory policies could have prevented overlending by banks for commercial real estate, overall bank *safety* would not necessarily have been enhanced. After all, if banks and thrifts had not made commercial real estate loans that later turned sour, they still would have had to find some other investments for the deposits they had collected. Since by making these loans in the first place these institutions had displayed an appetite for risk-taking, would they not simply have found other, perhaps even riskier, ways to gamble—for example, by extending even riskier commercial and consumer loans, engaging more heavily in trading activities (government securities and foreign exchange), or taking on more interest rate risk? Or, if their risk-taking opportunities in commercial real estate lending had been truly diminished, would they have pursued their other banking activities more prudently?

⁸ This calculation is based on data from *Bank Source*, a data base service of W.C. Ferguson & Co., for the years 1986 to 1990.

To oversimplify, the answers to these questions turn on which view of the commercial real estate lending phenomenon most accurately describes the behavior of lending institutions during the 1980s. The "moral hazard" view suggests that risk-taking was concentrated among institutions that were poorly capitalized or perhaps even economically insolvent, or those institutions that, in principle, would have had the most to gain from the "heads I win, tails the FDIC/FSLIC loses" gambles that are created by federal deposit insurance. If this view is correct, then tighter loan-to-value criteria or lending concentration limits for commercial real estate lending would have helped contain the overbuilding of commercial properties, but would not have stopped the lending institutions from taking other, potentially even riskier gambles.

An alternative view would suggest that it was a "herd" or "lemming" mentality that drove banks and thrifts into such heavy involvement in commercial real estate lending. That is, once some lenders saw how profitable such lending was for other lenders, they quickly hopped on the bandwagon, hoping either that the real estate boom would last forever or, more likely, that at least their borrowers would be the last good ones before the crash came. Moreover, what made commercial real estate lending so easy is that lenders did not have to go out chasing deals. The 1981 tax act gave developers strong incentives to cook up deals, which then came to the banks, and all the banks had to do was decide whether to take them. If the "lemming" view of bank and thrift lending for commercial real estate is correct, then presumably tighter loan-to-value ratios and/or concentration limits not only would have constrained risk-taking in commercial real estate, but also would have enhanced the overall safety of the banking system.

Which of these two views is most accurate? For thrift institutions, several pieces of evidence tilt toward the moral hazard explanation. First, between 1982 and 1985, or the three years following the enactment of Garn-St Germain, the thrift industry as a whole increased its investments in commercial mortgages from \$44 billion to \$98 billion, or from 6.4 percent of its assets to 9.2 percent. It was during this period that much of the asset gambling in the industry took place and quite clearly commercial mortgages were the chosen vehicle for this risk-taking, since the share of residential mortgages in thrift portfolios dropped sharply, from about 73 percent of assets to less than 60 percent (Hendershott and Kane 1992). Significantly, the thrifts that grew most rapidly—and thus were likely to have had the thinnest capital-to-asset ratios (assuming they were positive)—had higher proportions of their assets invested in commercial mortgages, suggesting that these institutions were deliberately taking risks at the expense of the deposit insurer (White 1991, pp. 102–103).

Second, between 1985 and 1988, thrifts that were insolvent according to generally accepted accounting principles (GAAP) consistently had

higher proportions of their assets invested in commercial mortgages; the same pattern was true for direct investments (Barth, Bartholomew, and Bradley 1989). In some quarters, this pattern has been interpreted as evidence that commercial mortgage investments "caused" the insolvencies. The more accurate interpretation may be that institutions that were GAAP-insolvent throughout this period abused the deposit insurance system, taking ever larger risks while they remained open, and that their vehicle of choice was commercial real estate. Indeed, GAAP-insolvent thrifts increased the share of assets devoted to commercial real estate mortgages between 1985 and 1986 from 12.7 percent to 17.2 percent, a trend consistent with this explanation.

Moral hazard behavior also helped drive some of our largest banks—namely those that had suffered significant losses on LDC debt—toward commercial real estate lending (Litan 1991, pp. 28–29). But that surely cannot explain why, as was shown in Figure 2, banks in all size groups increased the concentration of their portfolios in such investments. Nor can it explain why so many *nonbank* financial institutions, such as life insurance companies and pension funds, also became more active lenders for real estate (although primarily for the less risky takeout financing). The "lemming" hypothesis appears to be more consistent with these actions than moral hazard.

To investigate this issue further, this study analyzed banks of different capital strengths during the period from 1986 to 1989, the years when banks sharply increased their investments in commercial real estate loans, to see if the weaker banks displayed any greater tendency to increase their asset concentrations in construction and development and commercial mortgage loans. Banks were segregated for this purpose into "small" and "large" banks, or those with less and more than \$1 billion in assets, respectively.

Table 2 shows the results for the larger banks in two capital-to-asset categories, above 6 percent and between 3 percent and 6 percent; too few banks of this size had capital ratios below 3 percent to provide meaningful results. The contents of the table can best be described with an example. The first line of the table lists, for all banks with capital ratios above 6 percent in 1986, the shares of their assets invested in loans for construction and development, commercial mortgages, and residential mortgages in the years from 1986 to 1989. For this group of banks, the best-capitalized institutions, the shares invested in all three types of real estate rose during the period. The same pattern was repeated for banks with capital ratios above 6 percent in 1987 and in 1988.

The critical question is whether banks that were less well capitalized, those with capital ratios between 3 and 6 percent, displayed any *greater* tendency to invest in commercial real estate loans, the behavior one would expect if moral hazard incentives were driving much of the investment in this area. The answer appears to be "no": the shares of

Table 2
Percentage of Bank Assets Vested in Real Estate in the Years 1986 to 1989
Banks with Assets Greater than \$1 Billion, Grouped by Equity-to-Asset Ratio

| Year-End | Equity-Asset Ratio | Construction and Development Loans | | | | Commercial Mortgages | | | | Residential Mortgages | | | |
|----------|--------------------|------------------------------------|------|------|------|----------------------|------|------|------|-----------------------|------|------|------|
| | | 1986 | 1987 | 1988 | 1989 | 1986 | 1987 | 1988 | 1989 | 1986 | 1987 | 1988 | 1989 |
| 1986 | >6% | 6.9 | 7.7 | 8.1 | 8.0 | 7.2 | 8.6 | 9.5 | 10.3 | 11.8 | 13.0 | 13.8 | 14.7 |
| | 3%-6% | 6.3 | 6.9 | 6.7 | 6.6 | 4.9 | 5.8 | 6.2 | 6.8 | 7.1 | 8.4 | 10.0 | 12.4 |
| 1987 | >6% | 6.6 | 6.9 | 7.1 | 7.1 | 8.0 | 9.7 | 10.4 | 11.2 | 11.3 | 16.2 | 17.1 | 17.6 |
| | 3%-6% | 6.2 | 7.1 | 7.4 | 7.4 | 5.1 | 6.7 | 7.2 | 7.7 | 8.9 | 11.7 | 13.2 | 15.4 |
| 1988 | >6% | 6.4 | 7.0 | 7.5 | 7.4 | 7.8 | 9.9 | 10.7 | 11.4 | 12.6 | 17.9 | 19.2 | 20.0 |
| | 3%-6% | 5.8 | 6.4 | 6.9 | 6.8 | 4.6 | 5.6 | 6.5 | 7.0 | 7.3 | 9.5 | 10.8 | 12.6 |

Source: W.C. Ferguson & Company, *Bank Source*.

assets invested by these banks in commercial real estate loans also rose over the period, but not noticeably faster than among the better capitalized banks.

Table 3 provides the same statistics for banks with less than \$1 billion in assets, with one key difference: for this group of banks, it was possible to include banks with significantly lower capital ratios, between zero and 3 percent, where one would expect to find more evidence of moral hazard behavior. This table, too, shows no strong evidence of

Table 3
Percentage of Bank Assets Vested in Real Estate in the Years 1986 to 1989
Banks with Assets Less than \$1 Billion, Grouped by Equity-to-Asset Ratio

| Year-End | Equity-Asset Ratio | Construction and Development Loans | | | | Commercial Mortgages | | | | Residential Mortgages | | | |
|----------|--------------------|------------------------------------|------|------|------|----------------------|------|------|------|-----------------------|------|------|------|
| | | 1986 | 1987 | 1988 | 1989 | 1986 | 1987 | 1988 | 1989 | 1986 | 1987 | 1988 | 1989 |
| 1986 | >6% | 4.3 | 4.5 | 4.6 | 4.8 | 12.0 | 13.1 | 13.7 | 14.2 | 20.8 | 22.6 | 23.6 | 24.5 |
| | 3%-6% | 7.7 | 7.2 | 6.9 | 6.8 | 13.9 | 15.5 | 15.4 | 16.3 | 16.6 | 18.8 | 20.2 | 21.4 |
| | 1.5%-3% | 7.0 | 5.6 | 5.2 | 4.5 | 12.5 | 11.3 | 12.7 | 13.3 | 11.3 | 12.8 | 12.1 | 13.1 |
| | 0-1.5% | 17.9 | 18.6 | 13.8 | 5.9 | 8.8 | 15.5 | 17.6 | 17.6 | 14.0 | 14.7 | 18.2 | 19.6 |
| 1987 | >6% | 4.1 | 4.7 | 5.0 | 5.1 | 11.9 | 13.0 | 13.6 | 14.2 | 21.2 | 27.3 | 28.3 | 29.1 |
| | 3%-6% | 7.9 | 7.4 | 6.2 | 5.9 | 13.3 | 15.2 | 15.8 | 16.4 | 16.7 | 20.4 | 22.6 | 25.2 |
| | 1.5%-3% | 9.0 | 8.3 | 7.0 | 5.2 | 12.9 | 17.5 | 13.3 | 12.5 | 13.7 | 16.6 | 17.6 | 26.6 |
| | 0-1.5% | 8.3 | 5.2 | 4.2 | 3.2 | 14.8 | 15.0 | 15.7 | 13.0 | 16.5 | 22.8 | 31.8 | 32.6 |
| 1988 | >6% | 4.0 | 4.6 | 5.0 | 5.1 | 11.9 | 12.9 | 13.7 | 14.3 | 21.5 | 27.6 | 28.7 | 29.4 |
| | 3%-6% | 6.8 | 7.0 | 6.9 | 6.2 | 12.2 | 14.2 | 14.8 | 15.4 | 16.6 | 20.6 | 22.4 | 24.8 |
| | 1.5%-3% | 5.3 | 5.8 | 3.4 | 4.1 | 11.1 | 13.1 | 12.9 | 14.4 | 15.2 | 18.8 | 19.0 | 22.0 |
| | 0-1.5% | 9.6 | 9.4 | 7.1 | 3.9 | 9.5 | 12.6 | 14.5 | 12.4 | 12.1 | 16.5 | 18.4 | 19.8 |

Source: W.C. Ferguson & Company, *Bank Source*.

such behavior. Indeed, the weakest banks (those with capital-to-asset ratios below 3 percent) actually decreased the shares of their investments devoted to commercial real estate by the end of the period, although this result is strongly affected by "survivorship bias," since a large fraction of the banks in this category eventually failed.⁹

The fact that moral hazard behavior was not as evident in the banking industry as it was among thrifts should not be surprising. After all, during the mid 1980s, the thrifts that were gambling were actually *insolvent*. In contrast, while the capital ratios of many banks were weak—especially those of the larger banks that had engaged heavily in LDC debt lending—they were not *negative*. Thus the incentives for risk-taking, while present, were not as strong as those that confronted insolvent thrifts. At the same time, however, moral hazard incentives probably played some role in the tendency of a number of weak larger banks to engage more heavily in commercial real estate lending in the latter part of the decade.

In sum, to the extent that commercial real estate lending increased among thrifts and banks during the 1980s on account of moral hazard, it is unlikely that a tougher regulatory policy toward real estate lending would have improved overall bank and thrift safety, although it clearly would have resulted in fewer real estate problems. That does not mean, however, that such a policy would have been totally ineffective. Lemming behavior also appears to have played a significant role in the willingness of so many lending institutions to increase the shares of their asset portfolios invested in commercial real estate loans. A more restrictive regulatory policy toward real estate lending would have constrained the lemmings from following each other over the cliff.

How then could the moral hazard dangers have been prevented? With respect to thrifts, the answer is easy: insolvent institutions should have been shut down, and if the money for that job would not have been made available (as it was not), then at the very least those institutions should not have been permitted to grow. With respect to banks, it would have been desirable to have had in place something like the capital-based early intervention system of many years ago, so that a number of the weakly capitalized banks would have been constrained from bidding for high-cost deposits and placing the proceeds in risky investments. However, as will be argued below, enhanced regulatory discipline could and should have been supplemented by *non-destabilizing* market discipline, in the form of a mandatory subordinated debt

⁹ The overwhelming proportion of banks with less than \$1 billion in assets actually had assets below \$500 million. Of the banks with capital ratios below 3 percent, approximately one-half failed during the period from 1987 to 1989. See Barth, Brumbaugh and Litan (1992, p. 102).

requirement for larger institutions. Such a requirement would have limited the growth of some of the weaker large banks and thus inhibited their risk-taking.

Did Regulators and Congress Make the Problem Worse?

As already noted, regulatory and statutory policy related to bank and thrift financing of real estate turned sharply more restrictive at the very end of the 1980s. A growing chorus of policymakers—some in attendance at this conference—believe that regulators overreacted, creating a vicious downward cycle in real estate prices and in economic activity generally.

The stylized argument, in summary, goes something like this. By requiring banks to establish substantial reserves against currently performing loans where the market value of the collateral may have fallen below the loan amount, regulators induced a significant erosion in the capital bases of many banks, initially in the Northeast but more recently in other parts of the country. All this occurred at a time when regulators were also paying much greater attention to compliance with capital standards, initially as a result of the Basle Accord and later on account of the 1991 banking legislation. Accordingly, it is said that banks became much more reluctant to lend, not only for new real estate projects—which was appropriate, given the overbuilding in the market—but also to roll over the mini-perm and bullet loans they had previously extended. This reluctance to lend, in turn, allegedly drove real estate prices down further, which caused second and third rounds of write-downs on commercial real estate lending. At the risk of stating the obvious, the critics do not quarrel with the fact that real estate prices initially may have fallen, but with the regulatory policy driven in large part by the market's valuation (or estimates thereof, based on discounted cash flow models).

If this was the only alleged effect of the tighter regulatory policy toward commercial real estate, the critics would find few sympathetic ears beyond those on the heads of real estate developers and lending officers in the financial institutions that had extended money to them. But the alleged damage is considerably worse: it is suggested that the capital erosion induced by the market-based valuation of real estate, coinciding as it did with tougher capital enforcement generally, caused banks to contract their overall lending to other sectors of the economy, thus worsening the economic downturn that began in New England at the end of the 1980s and elsewhere in 1990. In short, the so-called "credit crunch" is said to be directly attributable to a combination of the

Table 4
Portfolio Composition of Insured Commercial Banks
Percentage of Total Assets

| Asset | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 4/92 |
|-------------|------|------|------|------|------|------|------|------|
| Loans | | | | | | | | |
| C&I | 22.0 | 20.8 | 19.9 | 19.4 | 19.1 | 18.5 | 17.3 | 17.7 |
| Consumer | 10.9 | 11.2 | 11.1 | 11.3 | 11.4 | 11.2 | 10.8 | 10.5 |
| Real Estate | 15.7 | 16.7 | 18.7 | 20.6 | 22.2 | 23.5 | 24.4 | 25.1 |
| Securities | 15.5 | 16.1 | 16.7 | 16.8 | 16.7 | 17.2 | 18.7 | 19.8 |

Source: *Federal Reserve Bulletin*, July 1992.

regulators' policies toward real estate lending in particular and the structure and enforcement of capital standards generally.

The evidence is clear that banks have become more reluctant to lend since 1989. Table 4 shows that the share of banking assets devoted to securities investments (principally U.S. government bonds) increased by 3 percentage points between 1989 and April 1992. Indeed, the Federal Reserve reported in July 1992 that, for the first time in 27 years, total bank holdings of Treasury securities (\$607 billion) had surpassed total bank commercial and industrial loans (\$599 billion). The peculiar structure of the new capital standards—namely, the risk-weighting of assets that assigns a zero weight and therefore no capital requirement for U.S. government securities, as opposed to conventional loans—has only worsened this problem.¹⁰

In addition, strong evidence suggests that banks have purposefully curtailed their asset growth, in an effort not only to conform with capital standards but also to provide a margin of comfort in excess of those standards. It takes only a brief look at banks' real estate problems to understand why. As of the first quarter of 1992, 4.6 percent of all real estate loans made by all U.S. banks were in "noncurrent" status (past due by at least 90 days or otherwise in nonaccrual status); since real estate loans represent one-quarter of all bank assets, the real estate nonaccruals represent an estimated 1.2 percent of all bank assets. If, in a reasonable worst case, one-half of the value of the nonaccruals must be charged off, then the "hit" to bank capital ratios from problems in real estate lending alone is about 0.6 percentage points. For banks in New England, where almost 8 percent of all real estate loans were in

¹⁰ A number of Federal Reserve officials, including the Chairman of the Federal Reserve Board himself, have stated that the "leverage ratio" was becoming more binding for many banks than the risk-based standards and that, therefore, the regulators were giving strong consideration to phasing out the leverage standard. Ironically, however, it is the Basle risk-weighted standards that have given banks especially strong incentives to invest in government securities.

nonaccrual status in the first quarter of 1992, the effects would be twice as large, or over 1 percent of assets. In New York, where real estate nonaccruals were over 16 percent of all real estate loans, the impact is potentially four times as high, or more than 2 percent of assets.¹¹

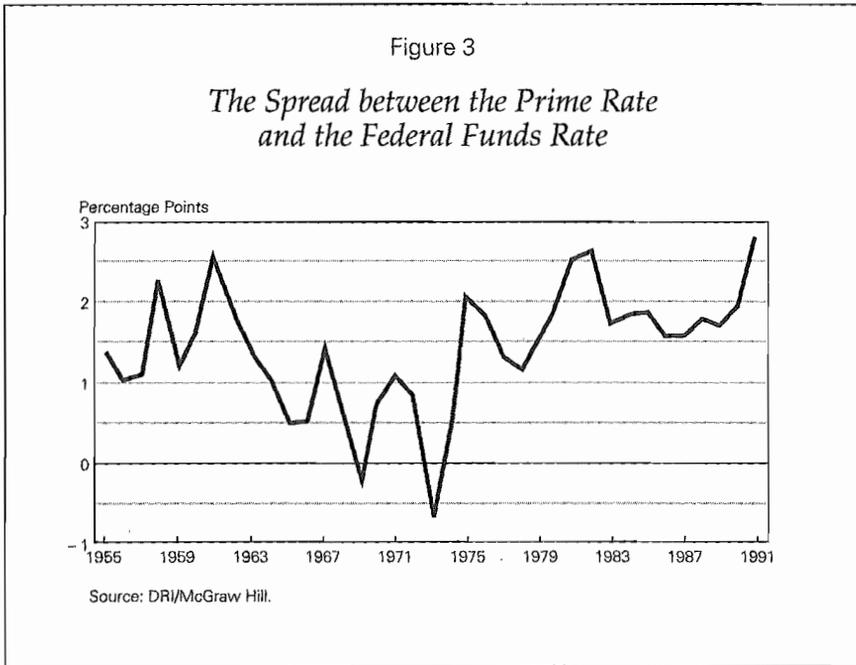
Given that the minimum bank leverage ratio is 4 percent, and that banks have losses on other loans as well, it is little wonder that the potential losses on real estate loans have driven banks to shrink their assets—principally by letting their high-cost deposits “run off.” For example, total bank assets grew at an annual rate of just 2.8 percent between December 1989 and April 1992, or less than half the 5.9 percent growth rate between 1983 and 1989. The sluggish growth of bank assets during the past several years is consistent, of course, with the concomitant slow growth in the monetary aggregates. It also reinforces the significance of the slowdown in the growth of bank lending.

There are two views, of course, about the source of this slowdown. Most banks, and quite a few economists, have claimed that bank assets and loans have not been growing because of a lack of demand for credit. After all, the economy has been extremely weak and both businesses and consumers have been overextended, so understandably businesses have not been eager to borrow from banks, at any price. Indeed, a recent survey by the National Federation of Independent Business reports loan demand at an all-time low among companies with 100 employees or less (Saddler 1992).

On the other hand, when customers fail to show up at a bank, that does not automatically mean that demand is absent: it only means that demand is weak *at the price suppliers are offering*. In the case of the banking industry, while it is true that the absolute level of the prime rate has fallen, it has not fallen as rapidly as the cost of funds. For example, by one measure, the difference between the prime rate and the rate on fed funds, the “spread” on bank commercial and industrial loans rose to an historic high in 1991 (Figure 3). And the spread does not include the other costs of obtaining a bank loan these days, especially the costs entailed in providing more collateral.

The higher costs in turn may be—and probably are—misperceived by many borrowers, who may believe that they are so high that they do not even bother applying for loans (the counterpart of “discouraged workers”). Too many anecdotes to be ignored, coming from smaller businesses as well as some bankers, suggest that precisely such factors have been at work, especially in the Northeast where bank capital has been hit especially hard by the real estate downturn. Perhaps the most persuasive of such anecdotal evidence occurred in May 1992, after the

¹¹ Data in this paragraph are taken from *The FDIC Quarterly Banking Profile*, First Quarter, 1992.



Bank of Boston announced and publicly advertised the fact that it was making up to \$3 billion available for commercial loans. According to a bank official, the response was literally overwhelming: over 5,000 loan applications were filed in short order, and while many were not meritorious, by August 1992 the bank had agreed to provide \$1 billion in new financing to this pool of customers. The fact that other banks in the New England area do not appear to have been as aggressive as the Bank of Boston suggests that the credit crunch in that region is very real—and that it is driven by supply, rather than demand.

Critics of the supply-driven “credit crunch” hypothesis may respond by pointing to the commercial paper market, where the most creditworthy companies that do not rely on banks for credit have curtailed their borrowing. For example, after growing at an annual rate of 21 percent between the end of 1987 and the end of 1990, commercial paper issued by nonfinancial corporations actually fell by almost 10 percent in 1991. Clearly, if the most creditworthy borrowers in the United States have cut down on their borrowing, that would suggest that cries of a credit crunch are overblown and that any drop in borrowing must be demand-driven instead.

This argument now appears less convincing, in light of the disap-

pointing pace of the economic recovery and the continued spate of anecdotes about the unwillingness of banks to lend to creditworthy borrowers. For another thing, nonfinancial companies have resumed their borrowing through the commercial paper market in 1992, causing the total outstanding to increase at an annual rate of almost 20 percent in the first quarter. In contrast, during the same period, total commercial and industrial lending by commercial banks fell at an annual rate of 7.5 percent, suggesting that smaller businesses were indeed having more difficulty finding credit than larger borrowers. In any event, the most creditworthy borrowers, who can access the commercial paper market, account for only a small proportion of total employment in the economy. In 1991, for example, the Fortune 500 companies employed only a little more than 10 percent of all nonfarm workers, down from about 20 percent in the early 1970s (Hale 1992).

Moreover, the fact that corporate borrowers have reduced their commercial paper borrowings does not necessarily prove that *less* creditworthy borrowers who must rely on banks have not been discouraged from seeking bank loans by an actual or perceived unwillingness of banks to lend. What may be going on is a vicious cycle, whereby smaller companies that both supply and consume the products and services that are produced and delivered by larger companies have been hurt by the unavailability of bank financing; the larger corporate customers in turn need to borrow less because they are producing or delivering less; but all this does not mean that a credit crunch has not existed for smaller companies, especially those in hard-hit regions like New England.

The aggregate data confirm that banks have become less important providers of credit, relative to other financial institutions. Between 1989 and 1991, total credit market funds advanced by all private financial institutions fell from \$536 billion to \$337 billion, a 37 percent drop. Over the same period, the funds supplied by commercial banks fell even more, by 53 percent (from \$177 billion to \$83 billion). In contrast, insurance and pension funds actually increased their supply of funds by the small margin of 2 percent (\$198 billion to \$203 billion).¹² In short, a shift of credit flows has most likely occurred among borrowers, from the smaller businesses that customarily rely on banks to individuals and to larger corporations that borrow from other financial intermediaries.

Still another possible criticism of the credit crunch hypothesis, at least as it relates to New England where bank capital ratios have been reduced the most in recent years, is drawn from the experience in Texas. In the mid 1980s, banks in that state experienced a similar negative shock to their capital positions. Yet as one study has shown, economic activity there has not been correlated with the lagged values of lending

¹² Data are taken from the *Federal Reserve Bulletin*, August 1992, p. A41.

by banks in the state, suggesting that banking difficulties have not had noticeable negative real consequences (Gunther and Robinson 1991). It would be a mistake, however, to draw too much from this experience. As the authors point out, the most likely explanation of why the drop in lending by Texas banks had no perceptible effect on subsequent economic activity was that Texas-based customers who wanted credit could find it *elsewhere*, from bank and nonbank lenders based *outside* the state. In the current circumstance, bank lending has been curtailed *throughout the country*, not just in New England, suggesting that customers in New England and elsewhere would have had a tougher time finding credit than Texas-based borrowers did in the mid 1980s. While certainly not as intense as it was during the Great Depression, when thousands of banks failed and thereby interrupted the bank intermediation process for many borrowers (Bernanke 1983), the recent contraction of bank lending appears to have had some of the same effects.

In short, it appears that the tougher regulatory policy stance toward the depository industry *has* worsened the recession and inhibited the recovery, although this writer is not prepared to say by how much. Probably we will never know. *Whether the more stringent regulatory policy was wrong* is an entirely different and more complicated matter. As will be discussed in the concluding section, the answer—looking both backward and forward to the transition ahead—depends very much on one's faith in the likelihood that appropriately stimulative macroeconomic policies would have been (and will be) implemented to offset the contractionary effects of bank regulatory policies that, with a couple of exceptions, are basically in the long-term interest of promoting a safe and sound banking system.

Regulation of Bank Real Estate Activities: The Long-Run Agenda

In comparison to the first two questions, the third question—namely, the appropriate long-run strategy for regulation of bank real estate lending—is an easy one to answer, and one whose broad contours already have been suggested. The answer comes in two parts, one addressed to real estate lending directly, and the other to bank lending and other activities generally.

With respect to real estate lending, it is simply common sense that banks be held to loan-to-value ratios, requirements that were part of the statutory framework until 1982. If it is true that such requirements would have limited the severity of the overbuilding of commercial real estate in the 1980s, as is argued above, then it follows directly that such requirements represent sound long-run policy for the 1990s and beyond.

At this writing, the four federal banking and thrift regulators have

just proposed re-implementation of loan-to-value ratios that, on balance, are modestly more restrictive than those in place prior to 1982. Specifically, the proposal would require loan-to-value ratios at the low end for raw land (in the 50 to 60 percent range, below the 66.7 percent limit in the 1982 standards), and at the high end (an 80 to 95 percent range) for mortgages on residential real estate. The agencies issued their proposal in response to the 1991 banking reform legislation, which directed the agencies to adopt uniform real estate lending standards by September 19, 1992, to be effective by March 19, 1993. To allow for a transition, the proposed rules would permit lending institutions to extend loans not conforming to these restrictions in an aggregate amount of up to 15 percent of the institution's capital. This proposal seems eminently reasonable as a long-run objective.

Some analysts have suggested going even further by imposing a concentration requirement on banks; for example, limiting the proportion of a bank's assets that can be invested in real estate (or individual categories of real estate) loans. While there is little doubt that banks that concentrate excessively in real estate lending may be prone to greater risk, this writer would be reluctant to support any arbitrary asset concentration limit, and would prefer to rely on an incentive-based approach.

Larger banks—specifically those with more than \$1 billion in assets, which are likely to have access to the subordinated debt market—should be required to meet some portion of their Tier 2 capital requirement by subordinated (uninsured) debt. Unlike pure equity capital, which banks can manipulate depending on the levels of loan loss reserves they establish, subordinated debt outstanding is a hard and definite number. Holders of subordinated debt also cannot "run" because they are not entitled to a return of their proceeds until the debt matures, unlike investors in certificates of deposit who can demand an immediate return of their funds, albeit with a small penalty. It is for this reason that this author has always been skeptical of proposals that would cut back the level of deposit insurance, especially with respect to the larger banks that, despite the 1991 banking reform legislation, will always be deemed "too big to fail" (or more precisely, "too big to let uninsured depositors take a loss").¹³

In any event, banks that cannot sell subordinated debt to the markets will not be able to grow, and thus will be constrained from investing more heavily in high-risk assets. And one reason the markets

¹³ Since the enactment of the 1991 reform legislation, which makes it more difficult for regulators to pay off uninsured depositors, the FDIC has increased the proportion of failures that it has resolved by not protecting uninsured deposits. The banks that have been subjected to this treatment are smaller institutions, however, none larger than \$1 billion in assets, to my knowledge.

may not purchase a bank's subordinated debt is that investors may be uncomfortable with the levels of its asset concentrations, given its equity capital. In short, it would be preferable to let sophisticated investors influence a bank's asset concentration levels rather than have portfolio decisions made by regulators, or worse, by legislators.¹⁴

For smaller banks that do not have effective access to the subordinated debt market, excessive concentration in commercial real estate lending could be restricted in either of two ways without imposing an arbitrary ceiling. One approach would be to give banks that cross a certain concentration threshold for high-risk assets a lower supervisory rating, unless such concentrations were offset with additional capital. High-risk assets would include not just commercial real estate, but also LDC loans, loans for highly leveraged transactions, and arguably credit card loans, which historically have had high charge-off rates. Since the FDIC's new risk-based insurance system will be pegged, in part, to banks' supervisory ratings, this approach would have the effect of charging banks higher deposit insurance premia if they concentrate their investments excessively in high-risk assets. Alternatively, regulators could directly require banks that cross certain concentration thresholds to raise additional capital. Under either approach, the requisite concentration criteria would be somewhat arbitrary, but they would not act as flat limits, which could hamper otherwise useful lending by institutions with expertise in a field and in locations where such financing is in heavy demand. An incentive-based approach would be preferable, one that would encourage banks that want to concentrate in higher-risk activities to have more capital backing them.

Finally, any long-run regulatory agenda must have clear rules for loan valuation. This subject will be treated in the following section.

Managing the Transition

While it may be useful to know the direction in which we should be headed in the long run, bankers and regulators must continue to live in the short run, and unfortunately it will be painful. A number of analysts have suggested that real estate prices have hit bottom in key markets, but many banks are far from out of the woods, on their problem

¹⁴ I am fully aware that even the most sophisticated investors can fail to forecast future bank difficulties, as Richard Randall has documented (1989). Nevertheless, not only do regulators fail to anticipate all bank problems but in recent years they also have often engaged in forbearance, allowing banks to grow more rapidly than their weakened financial conditions would otherwise permit, and which the market itself would not permit. In short, while investors may not be able to anticipate all asset quality problems, once those problems have been recognized, they can discipline weakened institutions more effectively than regulators can.

commercial real estate loans in particular. Moreover, it now seems to be conventional wisdom that in many areas of the country where commercial real estate markets have been especially hard hit in the last several years—New England, much of the Northeast, and California—the excess capacity now on the market may not be absorbed for several more years.¹⁵ Indeed, even that forecast may be optimistic. The commercial vacancy rate in Houston exceeded 20 percent in the spring of 1992, more than five years after the collapse of the real estate market there.¹⁶

More broadly, the economy continues to recover from the 1990–91 recession at a very sluggish pace. Since hitting bottom in the first quarter of 1991, GDP has grown at an annual rate of less than 2 percent, a pace clearly insufficient to absorb new workers coming into the labor force. As a result, the unemployment rate at this writing (7.7 percent) stands more than 1 full percentage point above the level of the first quarter of 1991 (6.5 percent), when the recession supposedly “ended” (the last quarter when GDP actually fell).

Meanwhile, the financial system appears unwilling or unable to encourage a faster recovery. In particular, despite apparent efforts by the Federal Reserve to expand the money supply, the growth of M2 and M3 has been at the floor of the Fed’s target ranges for more than two years now, surely in part because of banks’ unwillingness to make loans and to bid for deposits, both in an effort to build capital ratios.¹⁷ Even so, short-term interest rates have dropped steeply, but with little apparent stimulative effect. In the vernacular used by many economists, the Fed seems to be pushing on a string. It may be the case, of course, that the full effects of the most recent easing of rates (generated during the summer of 1992) will not show up until early 1993. Nevertheless, rates have been coming down for over 18 months at this writing, and yet annual GDP growth has continued to be disappointing and slower than the rate expected by most economic forecasters.

Against this background of slow growth, a growing chorus has been urging that bank regulators relax both their capital standards and their loan valuation methods in order to help jump-start the economy by encouraging bank lending, to smaller businesses in particular. Advo-

¹⁵ See, for example, the views of David Shulman of Salomon Brothers, quoted in Quint (1992).

¹⁶ See “Still Flat On Its Back,” *The Economist*, May 16, 1992, p. 103. The article reported the vacancy rate for downtown Los Angeles to be even higher, at 25.2 percent. Other major cities—including Chicago, Boston, and New York—also reported vacancy rates in the 20 percent range.

¹⁷ In particular, the Fed’s target range for the growth of M2 in 1991 and 1992 has been 2.5 percent to 6.5 percent, but in actuality, M2 grew by only 3 percent in 1991 and was advancing at a 3.5 percent pace through April 1992. Similarly, the target range for M3 growth was 1 to 5 percent in both 1991 and 1992, yet M3 grew by only 1.4 percent in 1991 and through April was climbing at an annual rate of just 0.7 percent in 1992.

cates of this position point to the limited effectiveness of easier monetary policy as well as to political and economic reasons why additional fiscal stimulus would not be appropriate. That leaves the relaxation of bank regulatory policy as perhaps the only other tool of macroeconomic stimulus left. It is little wonder, therefore, that economic officials in the Bush Administration have been pushing such an approach as the Presidential election nears.

As will be discussed shortly, a number of the criticisms that have been advanced with respect to loan valuation have merit, independent of short-run concerns about the pace of the recovery. However, this writer remains skeptical of proposals to relax or delay the effectiveness of the capital standards, which took a number of years to negotiate internationally and which are important to deter abuses of the moral hazard incentives built into deposit insurance. Indeed, the United States has about as much moral authority to urge the rest of the world to relax or defer the implementation of bank capital standards—after witnessing the highest rates of bank and thrift failures in the world—as we have to urge the rest of the world to run larger budget deficits (where we have also been “pioneers”).

But all this does not mean policymakers are helpless. It simply means that the traditional tools of macroeconomic policy must be used more aggressively than otherwise, not only to offset the contractionary effect of the much needed return to capital-based discipline, but also to stimulate the recovery. For example, the reluctance of banks to bid for deposits or to lend them out has dramatically reduced the ability of the Fed to encourage economic activity by stimulating new lending through the traditional multiplier process. Instead, easier money now seems to “work” principally by lowering the interest costs of borrowers and thereby freeing up income for other purposes. But this effect, which is akin to a tax cut, has been offset by weakness elsewhere in the economy, especially in nonresidential fixed investment (which fell by more than 7 percent in 1991) and state and federal government purchases (which dropped 1.5 percent in 1991).

At this writing, short-term interest rates have fallen sharply, to the 3 percent range. Since evidence continues that banks are curtailing their lending, the Fed should continue easing. Given the larger spread between effective lending rates to small to medium-sized businesses and market interest rates, the Fed must push market rates down further than they otherwise would in order to achieve a given degree of stimulus. At one time, the main argument against further easing was that investors would view it as inflationary and bid up long rates, counteracting the effect of the intended stimulus. But the weak economy has put a lid on inflation, so this standard objection to monetary easing should not apply.

Others nevertheless may worry that even lower rates would help drive down the exchange value of the dollar, which already has been so

battered that central banks have intervened to keep it from falling further. Nothing is wrong, however, with an even lower dollar, which would help boost exports. The critical question is whether further easing would provoke a speculative run on the dollar, thus laying the groundwork for a subsequent, self-defeating increase in interest rates. Such claims are doubtful; the bogeyman of the "dollar strike" has been raised for several years running, with no evidence that such a strike is imminent. Indeed, both short and long rates have had no trouble falling even while the dollar has been falling (precisely what should be expected as rates fall).

All this does not mean, however, that policymakers should be content to rely on monetary easing alone to speed the recovery. The limited effectiveness of lower interest rates thus far suggests a need for a macroeconomic insurance policy, and specifically for some short-run fiscal stimulus. My own preference would be for the federal government to provide, for up to two years, another \$30 billion or so—roughly 0.5 percent of GDP—to the states and localities (distributed on the basis of population) to help finance infrastructure spending and to minimize the need for contractionary tax increases by these governments to close their budget shortfalls. Any fiscal stimulus should be strictly temporary and coupled with concrete deficit-reducing measures designed to take effect automatically in the "out years" (say, beginning in 1994). This writer's personal preferences for deficit reduction include further cuts in defense expenditures and tax increases on energy, but the policy mix is not as important as getting the structural deficit down in the long run in order to bolster the nation's anemic savings rate. Moreover, unless any temporary fiscal easing is coupled with clear and definite deficit-reducing measures in the long run, policymakers run a significant risk that investors will bid up long-term interest rates, fearing that the short-run increases in the deficit represent harbingers of worse things to come.

At this writing, the prospects for a fiscal stimulus package like the one just outlined are somewhat remote. Thus, for those who remain skeptical that further monetary easing will prove beneficial, the temptation is great to turn back to easing bank regulatory policies as the only macroeconomic policy tool left. Again, for reasons already mentioned, it would not be wise to ease bank capital standards for this purpose. Several policy changes could have some of the stimulative effects the critics of recent bank regulatory policy so desire, without at the same time significantly compromising the prudent regulatory objectives of safety and soundness. Put another way, a number of regulatory changes that take account of expected cyclical difficulties are nevertheless desirable as permanent features of the bank regulatory landscape; they are not advanced with the objective of making bank regulatory policy itself an instrument of countercyclical macroeconomic policy.

First, the risk-weighting system of the current capital standards should be revamped; as already discussed, it provides an unduly strong incentive for banks to invest in government securities, which have a zero risk weight versus the 100 percent that applies to conventional business and consumer loans. Ideally, much of the risk-weighting system of the Basle Accord would be scrapped; the risk weights are highly arbitrary, they lump together a basket of conventional loans with widely different risks, and they fail to take account of portfolio, liquidity, and interest rate risks, which may be more important than the asset-specific risks the standards attempt to recognize. The only significant feature of the Basle standards that represents a real advance is the inclusion of off-balance-sheet risks in the capital scheme.

It is, of course, politically unrealistic even to attempt a major reworking of the Basle standards, which could require several more years of negotiation. Instead, the United States might ask its G-10 partners who agreed to the standards for a waiver procedure, whereby individual countries would have the freedom to change the risk weights so long as the changes do not significantly affect the overall total of bank capital being required. Thus, such a waiver could allow the U.S. regulators to narrow the current risk-weighting differential between the capital required for government securities and the capital required for conventional loans—say, by raising the risk weight on government securities to 30 percent, while lowering it on certain loans (standard consumer and commercial) to 80 percent. Note that such a procedure would not represent a weakening of the capital standards, but instead a realignment that would reduce current disincentives banks now have to make loans. To be sure, changing the risk weights would have no effects on the investment decisions of those banks whose capital is constrained by the leverage ratio (unweighted capital to assets), but most banks are not constrained in that fashion and thus would have stronger incentives to make loans if their loans were not so heavily “taxed” by the current risk weights.

Second, regulators should discontinue the practice of requiring banks to establish reserves on performing loans *before* they become nonperforming, solely on the basis of valuations of the market values of the underlying collateral. It is true that once real estate values begin to fall, the risk of nonpayment rises, but attempting to anticipate that risk with arbitrary reserving decisions can become a self-fulfilling prophecy, causing bank capital and thus lending to shrink; this in turn can negatively affect real estate values.¹⁸ In such an environment of limited credit and only a few liquidation-induced transactions, the market prices on “comparable sales” certainly are not representative of the long-run

¹⁸ For a persuasive discussion of this effect, see Downs (1991).

values of many properties. When regulators nevertheless automatically mark down performing loans based on such comparable values, they are injecting their own judgment—not necessarily that of the thinly traded market—about the likelihood of default. A more objective policy that requires additional reserves only once a loan truly becomes nonperforming would be preferable.

Of course, by now any alteration of the “performing nonperforming loan” rules would do little to help New England: the horse is already out of the barn. But the revision could be of some use in minimizing any further deterioration in banking markets like California, where significant real estate problems have surfaced.

Nevertheless, of far greater potential importance are the standards for valuation—and thus for establishing reserves—on loans that have become nonperforming and where real estate serves as collateral. The U.S. Department of the Treasury and other bank regulators instructed their examiners in December 1991 to use prudent but realistic assessments of the long-run economic values of these properties, based on present discounted values of the projected revenues that they should earn. As anyone who is familiar with such projection techniques knows, even minor changes in key assumptions—notably the discount rate, vacancy rates, rent inflation levels—can have dramatic effects on the outcome. The examiners in the field should be instructed to take the long view when doing these projections (or reviewing those made by the banks), but also should be firmly instructed *not* to use liquidation values in setting reserves on nonperforming loans.

Critics of such a suggestion, of course, may point to the failure of banks and their regulators to insist on larger reserves for LDC debt at a much earlier time, based on the depressed market values for such loans. That failure, in turn, allowed many of the larger banks to grow more rapidly than was prudent and to devote their incremental deposits to such high-risk assets as commercial real estate loans. Would a refusal to base reserving decisions on real estate loans not lead to a similar problem?

In brief, the answer is no, for a couple of reasons. No one is questioning the need for reserves on nonperforming real estate loans; the critical issue is whether prices on thinly traded properties should be the basis for those decisions. For real estate, which is inherently a longer-term investment, they should not. Even the market prices of LDC debt and its high-risk successor, junk bonds, have recovered substantially from their lows of several years earlier, indicating how short-term liquidation prices can provide misleading signals regarding long-term valuation.

In essence, bank regulators recognized this tendency by not requiring banks to reserve earlier and in substantial ways for LDC debt, even after the loans became nonperforming. It now appears to be

conventional wisdom in some quarters that this forbearance “worked,” because all of the larger banks that were heavily extended to the LDCs, with the exception of Continental Illinois, seem to have recovered from their brush with disaster. However, the policy had its drawbacks as well, since it was not accompanied by regulatory measures designed to limit the growth of these capital-weak institutions. The absence of such regulations allowed many of the banks to gamble by investing in commercial real estate, which may yet prove to be an even bigger financial headache.

This is not a recommendation that regulators pursue the same valuation and regulatory policies with respect to commercial real estate as was done for LDC debt. First, such loans that are nonperforming should have reserves, but those reserves should not be based on liquidation values. Second, a subordinated debt requirement will ensure that the largest institutions at least will not be able to grow unless and until the market believes that their problem loans are under control, or the banks have been sufficiently recapitalized. But by not using liquidation values as a basis for reserving—which the market itself almost certainly does not use—regulators would avoid imposing an excessive degree of stringency on all depositories with significant commercial real estate exposures.

Finally, given the existing glut of commercial space, absolutely no justification can be presented for exempting new commercial real estate loans from the loan-to-value ratios recently proposed by the bank regulators. But special concern is warranted for residential construction loans, since residential housing investment traditionally has been critical to economic recovery from recession. Although gross residential investment accounts for only about 4 to 5 percent of GDP, during the recovery phases of recent recessions the *growth* in such investment has accounted for a much larger fraction of the growth in output: 22 percent from 1975 to 1977 (the first two years after the 1973–75 recession) and 19 percent from 1982 to 1984 (the first two years following the 1980–82 recession). At this writing, however, the growth of residential construction has been very weak. Regulators should therefore allow reduced risk-weightings on construction loans for residences that have been pre-sold, while putting the required loan-to-value ratio near or at the top of the proposed range of 65 to 80 percent.

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Discussion

*Robert R. Glauber**

In his comprehensive review of the real estate lending activities of banks during the 1980s, Robert Litan analyzes whether regulatory action, and bank reaction to it, have exacerbated the current economic downturn by restricting bank lending. In short, has there been a credit crunch? Litan's answer is a grudging "yes." Litan also proposes a number of regulatory changes in the treatment of real estate, which he believes could have reduced the excess of bank lending in the 1980s and for that and other reasons should be adopted. It is on these two issues in Litan's paper that these comments will be focused.

Credit Crunch

There is little question but that banks have curtailed lending activities since 1989. Litan cites numbers on the sluggish growth of bank assets since 1989, as well as the marked increase in the relative level of securities holdings. At issue is whether the slowdown in the growth of assets and loans has been driven mainly by a lack of demand for credit from creditworthy borrowers, or mainly by a reduction in the willingness of banks to lend to creditworthy borrowers at reasonable prices. The regulators can be blamed only if the pressure comes mainly from the supply side.

Litan admits that the evidence is ambiguous at best, but appears to come down on the side of supply restrictions, due at least in part to regulatory pressure. His evidence is mainly anecdotal. What hard

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evidence is available strikes me as very much on the other side; that is, that most of the reduction in loan growth is due to an easing of demand, as would be expected in a recession. While regional differences exist and, in New England particularly, bank reluctance probably explains somewhat more of the lending slowdown, it is hard to accept this as the explanation nationwide.

A principal reason for being skeptical of the argument that banks are responsible for the lending slowdown is that other nonbank, unregulated sources of short-term business lending have shown reductions in growth and even absolute declines in 1991. Finance company lending, a major source of funds to small business, after growing at a 12.6 percent annual rate during the period from 1988 to 1990, grew only 0.8 percent in 1991.¹ Funds raised by nonfinancial businesses through commercial paper actually *contracted* by 15.7 percent in 1991, after growing at a 16.6 percent annual rate over the previous three years. While commercial paper is generally not available to smaller businesses, which rely principally on bank loans, the contraction in this source is indicative of general reductions in the demand for funds throughout the economy.

Another piece of striking evidence against a credit crunch comes from surveys of small businesses, the principal victims of any bank-driven credit restrictions. The April 1992 survey by the National Federation of Independent Business, based on questionnaires completed by over 2,000 of its member firms, states unequivocally: "Financing difficulties were named by just 4% as the most important problem. Nope, no CREDIT CRUNCH" (capitalization in original). (For what it is worth, regulation and taxes tied for first at 23 percent.) For completeness, it is worth noting that this indicator has been in the 5 to 7 percent range nationally over the past two years and 7 to 11 percent in New England. By comparison, in the 1980-82 period, when most observers would agree there really was a credit crunch, the index rose to 36 percent.

In the end it is hard to read a definitive answer to the credit crunch question from the data. Obviously no one would seriously argue that the cause is wholly demand or supply-side forces. But the data strike me as hardly compatible with the conclusion that the systematic refusal of banks to lend to creditworthy customers pervasively caused the slowdown in loan growth.

¹ These figures and those in the rest of this paragraph are derived from the Federal Reserve Board's *Flow of Funds Accounts*, Fourth Quarter, 1991.

Regulatory Changes

Litan's most interesting regulatory proposals are to reintroduce explicit loan-to-value ratios for real estate lending, to require large banks to issue subordinated debt as part of their capital, to develop standards that would focus on long-term value rather than liquidation value in appraising real estate collateral, and to reduce the current bias in the risk-based capital standards in favor of government securities and against commercial and industrial loans.

The proposals for subordinated debt and the use of long-term valuation in appraisals are eminently sensible, in my view. Any attempt to reintroduce market discipline—as would happen with subordinated debt—should be encouraged in an industry where deposit insurance has removed much of it. But I would not be too optimistic about the disciplinary effect of subordinated debt. With insured deposits still available to a bank, it will most likely simply turn to the government's balance sheet through brokered deposits when its own balance sheet becomes so weak that the cost of subordinated debt rises unacceptably. This is in fact what Citicorp did in mid 1991. Nevertheless, subordinated debt provides a market "early warning system" and should be encouraged.

While generally in sympathy with most of the remaining regulatory changes Litan proposes, I view a reinstatement of explicit loan-to-value ratios for real estate lending as both wrong policy on its own and a reflection of a misguided direction in regulatory structure. First, it is worth noting that, while the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) mandates that the regulators adopt real estate lending guidelines and standards, it in no way requires that they promulgate explicit loan-to-value restrictions.

The fundamental issue raised by these proposals is whether the banking regulatory structure should further evolve in the direction of a centrally orchestrated system of detailed restrictions on banks, a system that would increasingly replace the presently functioning, diverse structure of standards developed by the banks themselves. Banks face complex lending decisions and develop complex, varied control systems to avoid exposing shareholders to inordinate risks. These systems by and large are sensible and effective, although their effectiveness is perhaps limited by a failure of the banks to always apply the systems consistently. I am skeptical that a centrally developed structure created by the regulators will be superior.

It likely will be argued in rebuttal that the proposed loan-to-value system is but one simple addition to the banks' own self-regulatory structures. But it is almost certain that the regulators will find it necessary to further elaborate the simple list of loan-to-value ratios in order to deal with complicated specific cases: for example, construction loans with recourse; loans subject to sale within one, two, or three

months; loans collateralized by specific kinds of real estate, like timberlands. Indeed, Litan in his paper would make a regulatory exemption to the capital standards for construction loans on pre-sold homes. I fear this path inevitably leads to the evolution of a mountain of regulations, slow to respond to innovations in the marketplace and potentially stifling of bank vitality and creativity.

Moreover, the danger exists that regulatory standards designed to constrain bank real estate risk will in fact have the opposite effect. What are developed as upper limits on aggressive lending can easily metamorphose into safe harbor protections. If, for example, 70 percent is the prescribed limit on commercial real estate construction loans, a loan at 65 percent of value is difficult for the regulators to challenge even if other aspects of the loan make it unduly risky.

Real estate lending was the bank problem of the mid and late 1980s across the board, as Litan demonstrates. But one can be pretty certain the next major banking crisis will not be caused by real estate (even if banks ever do start making real estate loans again). This obsessive attention to real estate lending has much the image of fighting the last war. The next crisis will come from another direction—energy loans, agriculture loans, swaps, or somewhere else. And after that horse is out of the barn, if we follow this trend to microregulation, we will have another rule book of detailed restrictions dealing with the most recent problem assets.

Finally, harking back to a question Litan posed in his paper, would loan-to-value ratios have significantly contributed to avoiding the bank real estate problems of the 1980s? If the real estate excesses had simply been the consequence of pervasively poor loan underwriting, perhaps loan-to-value ratios could have played an important, beneficial role, although I have concerns that the cure might be worse than the disease. But clearly the real estate problems of the eighties were much more the consequence of a rapid asset inflation, followed by an equally rapid asset deflation. (55 Water Street, New York, one of the “jewels” in Olympia & York’s U.S. crown, is today worth perhaps 30 percent of its peak value.) How well would loan-to-value ratios operate to hold back the flood in such an economic environment? Surely, at least at levels that would still permit a healthy level of lending activity, loan-to-value ratios could not effectively protect against asset inflation. Loans made as prices were rising would meet the standards at the time they were made. And without some dynamic, mark-to-market process in the implementation of the standards, loan-to-value ratios are unlikely to operate as an effective impediment to the excesses Litan has documented.² Such

² Such a dynamic application of loan-to-value ratios would in fact engender the same kind of “performing nonperforming” loans that Litan rejects as a regulatory category.

restrictions might work to prevent poor evaluation of specific assets, but they cannot be very effective in a world of boom and (unforeseen) bust in real estate prices.

What is a reasonable alternative to the reimposition of loan-to-value ratios? Certainly a strong sense exists that bank regulation did not work in the eighties and that something different is needed. That is the view of Congress implicit in FDICIA. But Congress, with at least some wisdom, did not require microregulations such as loan-to-value ratios. An alternative road to more intrusive regulation would be to have regulators promulgate a set of standards, which could be used as a template by examiners in evaluating the institutions' own policies and their implementation. Regulatory standards would focus more on an institution's policies rather than on the specifics of its loans. This would surely require more judgment by examiners than the checklist approach toward which we are evolving, but it would also reduce the risk that the regulators will increasingly stifle the creativity and vitality of the banking system.

Ultimately, the path to revitalizing the banking industry lies not in more restrictive regulations to prevent bank mistakes, but in reducing the needless restrictions that limit the range of profitable opportunities open to banks. Banks have the almost unlimited ability to raise funds from the markets (using as necessary the government's guarantee), but confront limited opportunities to put this money to work profitably at acceptable risk levels. This "excess capacity" leads inevitably to banks seeking out riskier investment opportunities. Litan seems to agree with this diagnosis.

What is surely needed is the removal of the outdated restrictions that constrain where banks can conduct their activities and what types of securities activities they can engage in. Congress would have served the public interest far better if it had accepted the Bush Administration's proposals to repeal the interstate banking restrictions of the McFadden Act and the securities activity restrictions of the Glass-Steagall Act, instead of mandating the plethora of microregulatory initiatives in FDICIA as it was passed.

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Discussion

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Since I agree with a great deal of what Robert Litan says, I shall not analyze his paper in detail. Rather, I shall emphasize the areas where I disagree or where I think his ideas can be supplemented.

I believe his historical analysis is correct. The tremendous increase in bank lending for construction and development and on commercial property was primarily the result of animal spirits—lemming-like behavior. Losses would have been reduced through proper regulatory actions.

The amazing aspect of banks' rapid loan expansion is that it took place after 1985, when the large losses suffered by savings and loan institutions on such loans already were well recognized. Clearly, many bankers thought they were being cautious and making only sound loans. They were aware of dangers but failed to forecast them accurately. What they did not recognize was the great institutional bias in real estate financing toward extreme cyclical behavior.

The High Cyclical Risks in Real Estate Lending

The high risks inherent in construction, development, and commercial loans are well known. In every year's surveys of loan losses, they show up as one of the top risk categories. But the losses are multiplied many times in a recession. Numerous factors can explain real estate's amplified booms and busts.

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1. The period between the time when a loan is made and the time when it is paid off is much longer in real estate than in most other fields. Values depend on future, not current, supply and demand.
2. Because properties are large, durable, and expensive, their ownership normally requires an outside source of funds. As a result, the availability and cost of financing play a major role in determining property values. When the amount of money made available by lenders expands or contracts, prices move up or down. This occurs even if construction or user costs remain constant.
3. Collateral values are based on appraisals that are notoriously poor. Appraisals reflect primarily what has happened in the market in the past. When sales have been dominated by a herd mentality, appraisals use the resulting high prices as the basis for current valuations. Any shifts in expectations cause wide variations in future values and prices.
4. While construction and development loans are made for a considerably shorter period, their dangers are even greater. In most cases, current cash flows are low or nonexistent. Interest payments are pre-funded. No one knows what prices can be achieved until the buildings or lots are completed. During the construction period, supply can expand far too fast, as competitors rush to fill the previously observed demand.
5. The risks in real estate financing are extremely hard to quantify. In normal periods, they are underestimated. The distributions, as in many financial situations, tend to be highly skewed. Extreme losses occur, but infrequently enough to be forgotten in normal times. The risk distributions shift often as a result of expectations, interest changes, or large movements in supply and demand.

Given the large risks, their skewed distributions, and the difficulties in quantifying them, I agree that special regulatory attention should be paid to real estate lending. The difficulty arises in devising the most efficient regulatory rules.

The objectives of regulating real estate, as with other lending, are:

1. To decrease the likelihood that banks will endanger their future by an overconcentration in excessively risky loans.
2. To decrease the tendency of banks to make their loans pro-cyclically. Overexpansions of lending are expensive both for banks and for the economy. They lead first to excess and then to too little investment.
3. To allow a more efficient correction of past errors. Regulations should give banks the incentives and the time to choose the best

way out of a bad situation. Banks are often better off recasting loans rather than foreclosing. Debtors may be willing to add some funds. They may be able to manage and market the property more profitably. However, banks must be certain that they get their fair share of any cash flow. Since the debtor usually has little or no equity, problems of moral hazard are great. If a bank has to foreclose, it should not be forced to liquidate in an untimely manner.

Regulatory Relaxation

A second theme of the Litan paper is whether or not regulatory relaxation is a proper tool of antirecessionary policy. As regulators realize only too well, the demand for regulatory relaxation appears in all recessions. The shift of bank assets toward securities rather than loans also is a regular cyclical phenomenon. It certainly reflects a shift in demand for loans. It probably also reflects a reestimation by lenders of the risks and profitability of certain types of loans.

It is also clear that regulatory relaxation or forbearance can be dangerous. We know that the Federal Home Loan Bank Board, the Administration, and the Congress thought that forbearance made sense for savings and loans from 1980 to 1984. Regulations were relaxed by the introduction of regulatory accounting principles, the reduction of net worth requirements, and an increase in lending powers. The relaxation turned out to be disastrous.

Suggestions as to regulatory forbearance include both lower loss reserves and a delay in liquidating assets. It is assumed that delaying the liquidation of foreclosed properties will help the asset holder as well as the market and the economy. In contrast, many economists have argued—incorrectly, I believe—that the Federal Deposit Insurance Corporation and the Resolution Trust Corporation have been too slow in closing institutions and selling their assets. They claim that the costs of holding assets far exceed any gains that could be obtained through a delay in liquidation.

In considering this topic, one should recall one of the earliest studies of the problem—John Lintner's study of the results of the performance of Massachusetts savings banks in the Great Depression (Lintner 1948). His results have been used as another argument against forbearance. He found that book losses became larger after the worst of the Depression was over. The longer loans were held, the greater the losses. What remains ambiguous is whether losses would have been greater or smaller if they had tried to liquidate earlier. Obviously, those operating at the time thought they were taking the more profitable

action by delaying foreclosures and sales, even though they were later criticized for doing so.

Possible Forbearance Now

Litan, in contrast, argues that forbearance in general should not be adopted at the present time. But he does suggest that additional reserves should not be imposed against performing loans; that loan reserves should not be based on current or liquidation values; and that special provisions should be made for housing construction loans.

The need for such relaxations arises from the assumption that current market prices are incorrect. It is argued that the market overreacts. It fails to judge cyclical forces correctly. A lack of liquidity artificially curtails demand. As a result, both banks and the economy will gain if regulators do not penalize banks for not foreclosing or for not selling real estate owned. Not requiring larger reserves will increase bank capital and add to available credit. Holding properties off the market will help maintain prices.

As in all issues of regulatory relaxation, the question arises as to how best to solve a particular problem. Examiners require additional reserves because the situation has changed. The risks to the bank, its depositors, and the insurance fund have gone up. Is altering required loss reserves or delaying liquidation a better way to act so as to minimize additional costs?

The use of the term "performing nonperforming loans" seems to point to a contradictory and illogical policy. How can a performing loan be nonperforming? The situation might be clearer if we spoke of loans that are currently performing but whose risks have increased sufficiently to make an additional loss reserve requirement logical.

One obvious source of future problems with performing loans is found in construction and development advances, where interest has been pre-funded or where it is probable that the amounts available for current payments will not suffice to complete a project. Requiring action now will reduce future losses.

In other cases, it may be clear that a loan based primarily on the available collateral holds greater risks because the value of that collateral has dropped. Whether or not action is necessary may depend on a reanalysis of the underlying credit as well as negotiations with the debtor. The fact that loans are performing does not mean that reserves should not be held against them.

What about the idea that examiners finding nonperforming loans should not base their reserve requirements on liquidation values, but instead should use "realistic assessments of the long-run economic values of these properties, based on present discounted values of the

projected revenues that they should earn''? As a corollary, it would seem that a similar rule should be applied to real estate owned. Why should properties be liquidated at less than their values?

In attempting to follow such advice, bankers and examiners must determine whether appraisals that show the present value of future income greater than current market prices are correct. Anyone who has used many appraisals must be extremely dubious about using appraised valuations to replace those of the market. Such caution will be reinforced by reading a 1992 paper by Hendershott and Kane, which shows how far off appraisals were in recent years from values based on more realistic assumptions.

Appraisals, by their nature, can tell only what past market values have been. Even such judgments become dubious if the number of recent comparable sales is small or if many adjustments are needed to arrive at comparability. Discount (or capitalization) rates used by appraisers merely reflect the relationships between past values and future projected income. When people try to substitute discount rates other than those found in the market, they assume that their knowledge is better than that of those who are actively trading. Why should this be true? To be more accurate, the substitute values must be based on a clearer vision of future income or expenses, or of what prices would be in the current market if it were not subject to liquidation pressures.

Anyone trying to find equilibrium values for reserve or liquidity decisions would perhaps be better off using the appraisal concept of replacement cost. It would make clear the hazardous assumptions necessary in attempting to measure equilibrium values. The problems are similar to those in the use of discounted cash flow procedures.

To arrive at values through this method, we must find the current replacement cost of a property. This amount must be reduced by the loss in value due to physical or functional depreciation as well as the present value of the losses from excess vacancies and reduced rents between now and the time equilibrium is reached. Needed are projections of current costs and how they will change; the point when equilibrium will be reached; the real depreciation at that time (what the level of rents and expenses will be); how far below equilibrium income will be in the interim; plus proper discount rates for the lost income.

The main advantage of the replacement cost technique is that it is based on the more easily estimated current costs and income plus a discount rate. It still requires projections of the point when equilibrium will be reached and of income between now and then.

With respect to the view that reduced risk-weighting should be allowed on construction and development loans, I believe this also is not too logical. The determination of risk should be as accurate as possible and then should be maintained. In the past, construction and development loans have used various forms of credit enhancement from

specialists to reduce the risks to banks. Since banks have often failed in estimating the risks of such loans, this appears to be a logical division of functions. If bank regulations are altered, it becomes harder for others to perform such functions. All may be better off if the regulations are maintained.

Rather than try to make ad hoc regulatory adjustments to the cycle, as envisaged by such proposals, I believe we would be better off revising the regulations so that they include proper cyclical relationships in their basic structure.

The Long-Run Agenda

In addition to his discussion of the past and the present, Litan suggest several policies for the future. He believes that the new, stricter maximum loan-to-value ratios proposed by the regulators are sensible. He would require large banks to borrow on subordinate debt if they want to expand their assets. The objective is to require the market's scrutiny and approval of the bank's operations when it wants to grow.

For smaller banks, he would measure their concentration in a broad class of riskier loans, of which real estate loans would be a major element. If this seemed excessive, he would require either a lower examination rating, and therefore greater scrutiny and higher insurance premiums, or a higher required capital-asset ratio.

While requiring subordinated debt in order to bring about some outside scrutiny makes sense, I do not see it as a strong tool to halt the undue expansion of real estate loans. They can grow and have grown as a result of a shift in lending within a static total. They can expand even though a bank would not need to borrow additional capital.

The second proposal, to penalize but not prohibit an undue concentration of loans, seems sensible and should be applied to all banks. The penalties could increase together with the amount of concentration on riskier loans.

To Litan's suggested changes, I would propose two additions:

1. Regulations could require an early warning system to guard against too rapid growth of any appreciable asset category. Many bank failures result from expanding particular types of loans too fast. Such growth often reflects the herd instinct. When bankers rush to make one type of loan that seems especially profitable, a catch probably exists. The potential excess profitability is likely to mean that something has been left out of the analysis. Other problems arise. A sudden rapid growth usually requires the use of loan officers who lack required skills. In addition, experience shows that diversification over time, as well as in other dimensions, is a requirement of a sound portfolio policy. A sharp increase in one type of loan means that such diversification is missing.

In the warning system, a flag might be raised any time a quarterly regulatory report showed an annual growth rate in any appreciable asset class (including major industries) of more than some selected rate, such as over 15 percent. Alternatively, a flag might also go up if the growth exceeded some percentage of the bank's capital—say 10 or 20 percent.

Such a warning would require both management and the regulators to examine the rapidly growing class of assets in greater detail. An underwriting review independent of the loan officers might be required. The examiners would have to comment specifically on the reasons for and quality of the growth. The analysis would be incorporated into the bank's rating.

2. A second approach to the problems raised by the cyclical action of real estate and other types of lending would be to allow the capital-asset ratio of banks to vary with the business and lending cycle. Instead of assuming that the minimum level of capital should be the same at all times, perhaps minimum capital asset ratios should rise as the economy expands and decline in recessions.

While the average ratios might be higher than now contemplated, the lowest minimums would still give the necessary protection. The increase in capital requirements as the economy expanded would require that greater attention be paid to the long-run profitability of any rapidly growing lending sphere. The lower minimums in a recession would remove some of the pressure toward cumulative liquidations.

Such a cyclical change in reserve requirements would mean that the pressure for regulatory relaxation could be met, but not at the potential expense of depositors and the insurance fund. The desired flexibility would be gained through higher requirements during expansions rather than too slack regulation during recessions.

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