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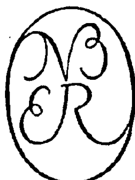
THE QUALITY OF BANK LOANS

A STUDY OF BANK EXAMINATION RECORDS

ALBERT M. WOJNILOWER
Federal Reserve Bank of New York

NATIONAL BUREAU OF  ECONOMIC RESEARCH

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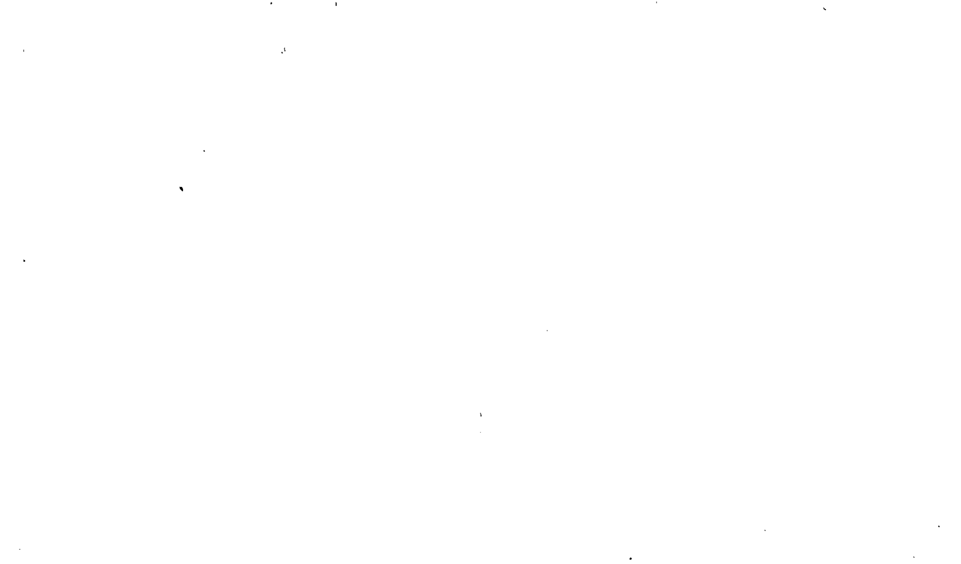

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Foreword

Albert Wojnilower's paper reports on one of the most extensive and important research projects undertaken as part of the National Bureau's Quality of Credit Program, a group of studies financed by a grant from the Merrill Foundation for the Advancement of Financial Knowledge.

One of the objectives of this program was to explore the potential uses, for economic intelligence, of the vast amount of information on credit quality that exists in the records of the public agencies charged with supervising and examining financial institutions. The National Bureau wishes to thank officials of the Federal Reserve System for permitting this important exploratory study of commercial bank examination data.

The quality of bank loans to business is, of course, of special importance. Commercial banks are the major financers of the short- and even intermediate-term cash requirements of business enterprises; and bank loans to business constitute an important share of the earning assets of the American banking system. The considerable losses sustained on business loans by American banks during the Great Depression, as well as the very large additional loans that became "frozen," were major factors in prolonging and intensifying the economic distress of those years. The hypothesis underlying the Bureau's study of bank examination data is not, however, that bank credit of doubtful quality may again contribute to disasters of such severity. It is rather that changing qualitative factors in bank loans to business may be a systematic factor intensifying cyclical movements in the economy, and that reliable and timely information on the subject may help to prevent an untoward intensification.

Before the Quality of Credit study was initiated, data on qualitative features of bank loans were extremely sparse. The Federal Reserve System's bank loan surveys of 1947, 1955, and 1957 had collected information on the size, terms, and borrower distribution of loans, but nothing on their quality directly. Except for a series on the percentages of the loans of insured banks rated as substandard by examiners, which was published by the Federal Deposit Insurance Corporation for 1934-51, the only published statistics on bank credit quality were annual

loss charge-off and recovery data. As indicators of quality, these data suffered from obvious shortcomings. They were generally not available for the period when the loans were contracted; the timing of charge-offs and recoveries was arbitrary and varied greatly among banks; and the data were available only for total loans, with no breakdown to show the particular kinds of loans or borrowers that ran into difficulties. Moreover, information regarding losses on loans comes far too late to be useful in interpreting current or prospective economic developments. What is needed for this purpose is a "before-the-fact" measure of the quality of current loans. As Wojnilower's study shows, examination data admirably fulfill these requirements. Examination records contain not only the relevant objective characteristics of loans (e.g., the size and industry of borrowers, and borrowers' financial ratios) but also judgments of loan quality made by experienced credit analysts.

A complementary study to the bank examination project was the Chicago Federal Reserve Bank's surveys of the loan losses and recoveries of its member banks during 1957, 1958, and 1959. Made by the Chicago Reserve Bank at the request of the National Bureau, these surveys classified losses by consumer, farm, real estate, and business loans. In the 1957 survey, the business loans on which losses occurred were also classified by the size and industry branch of the borrowers. These valuable surveys thus secured relative loss rates on classes of loans comparable to those for which bank examination ratings were available through this study. The fact that the pattern of criticism rates (i.e., the percentage of total loans of a given class criticized by examiners) on different size and industry classes of borrowers accords generally with that of loss rates among the same categories in the Chicago Reserve Bank study is one important proof that bank examination data constitute reliable measures of loan quality.

Wojnilower's concluding chapter points out the potential uses of examination data if collected on a broad and current basis. Not only would the data supply much valuable new information on the structural features of bank credit but they could also provide current "economic indicators" of the changing quality of bank credit. It is the National Bureau's hope that the supervisory authorities will exploit these potentialities and make the current information generally available. Although the confidential nature of the examination records for individual banks and individual borrowers must, of course, be preserved, it would in no way be violated by statistical tabulations combining the data for groups of banks and for classes of borrowers.

James S. Earley