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Introduction and Summary

The confidential files of bank examiners, which are a veritable treasure trove of financial data, were one of several new sources explored in the Quality of Credit Program. This paper presents a sampling of the statistical material gathered by the National Bureau from such examination files of three Federal Reserve banks, which were made available for the first time for research purposes. Stringent measures were taken, of course, to keep the reports of individual banks and borrowers confidential. It is hoped that the promising results obtained in this work, essentially a pilot study, will eventually lead to the current assembling and publication of pertinent statistics from bank examinations.

Before summarizing the results of this paper, a brief outline of the contents may be in order. Chapter 2 describes the bank examination process as it bears on criticism of loans, and briefly sketches and evaluates the aggregate statistical results. Chapter 3 investigates the relation between the incidence of criticism by examiners and the industry and size of the borrower, and compares the results with those yielded by other measures of loan quality. Chapter 4 explores the aggregate data for criticism rates over time and compares their behavior with other indicators of credit quality. The fifth and final chapter describes the many types of valuable statistical information that are locked up in the bank examination records and urges a program for their publication in summary form.

Summary of Findings

The principal conclusions of the study summarized below are tentative and subject to important qualifications, because of the limitations of the data and because in most instances inferences had to be drawn from incomplete and not necessarily clear-cut evidence. In particular, the sample of banks and loans employed is very small and in some respects unrepresentative. The conclusions are, therefore, perhaps best regarded as illustrative of the kinds of results that might be obtained from this type of data if they were available for a large number of banks over an extended period.

1. In the course of the annual examination of a bank, many of its business loans are evaluated individually. Some of these loans may be formally "classified" (i.e., criticized as excessively risky). During 1951-57, the dollar volume of all criticized loans (business and otherwise) at the sixty commercial banks in our sample was on the order of 1 per cent of the loan total (Chapter 2). This was well below the rate that prevailed at these banks during 1947-50, and below the rate at all insured commercial banks during 1939-49. (Data for insured banks were published by the Federal Deposit Insurance Corporation for 1939-51.) In most banks, almost all criticized loans are business loans, partly because most other loans are small in size and not subject to individual examination. The incidence of criticized business loans averaged on the order of 2 per cent during 1953-57.

Roughly four-fifths of the criticized loans are usually classified as "substandard," meaning that they involve substantial risk of nonpayment. The remainder are classified as "doubtful" or "loss," indicating that partial or total charge-off of the loan seems inevitable. For 1947-57, from 55 to 75 per cent of the sample banks, including most of the larger banks, had less than 1 per cent of their total loans classified as substandard in any given year. Most of the remaining banks had rates below 5 per cent, but in almost every year a few exceeded this ratio (Chapter 4).

2. The incidence of criticism by examiners varies considerably with the industry and size of the borrower (Chapter 3). Within most industries, loans to smaller borrowers incurred criticism more frequently than loans to larger firms, but the incidence for small firms in some industries—for example, nondurables manufacturing and finance—was below that for large firms in other industries. (These results refer to 1957, the only year for which this particular type of information was obtained.) The pattern of the criticism rates for twenty-four industry-size groups (e.g., "large" finance companies or "medium-sized" retailers) on the whole resembled that shown by other measures of loan quality

cross-classified in this way, such as loan loss rates for Chicago Federal Reserve District member banks, and Dun and Bradstreet credit ratings. These various indicators of loan quality and relevant data from the Bank Examination Survey suggest, moreover, that the ranking of industry-size groups by loan "quality" remains fairly stable over time.

3. Data on examiner criticism of total loans (without reference to type of loan, industry, size, or any other borrower attributes), which were available for 1947-57, show that the annual changes in the criticism rate were quite consistent with the changes in industry and size composition of loans and in financial ratios, as well as with those in other indicators of loan quality, such as credit ratings and business failures and discontinuances (Chapter 4). The only clear divergence occurred in 1957, when it appears that examiner standards, if defined narrowly in terms of borrower financial ratios, may have become less stringent. Of course, many other factors besides financial ratios enter into examination standards.

4. The sample was too small to yield quarterly data for criticism rates. However a quarterly "diffusion" index was constructed for 1948-57, giving for each quarter the percentage of those banks examined that showed declines in criticism rates (higher "quality") from the previous examination. The index itself fluctuated quite erratically, but a four-quarter moving average showed a distinct cyclical pattern. The moving average rose during business contractions, attaining its peak rather early in the ensuing business expansion. It declined during the later stages of the business expansion, falling to its trough prior to the onset of recession.[1]

[1] Certain additional results of the study are included in my "Changes in the Quality of Business Loans of Commercial Banks," unpublished Ph.D. dissertation, Columbia University, December 1960. Briefly stated, these are:

A. Banks apparently take industry and size differentials in risk into account in their lending policy. They usually lend to a larger proportion of business firms in industry and size groups with lower criticism rates and to a smaller proportion of firms in groups with higher criticism rates. It appears that during business cycle expansions, high-risk industries become more prominent among the borrowers, but the resulting increase in risk is offset by a decline in the proportion of loans outstanding to the generally riskier small borrowers. The process seems to be reversed during times of business contraction and early recovery.

B. Changes in loan quality over time within industry-size groups were analyzed from balance-sheet data available for 1953-57 for many of the borrowers who were on the books of these banks in 1957. The financial ratios calculated for these firms were, on the whole, consistent indicators of loan quality and also were of predictive value since the relative financial standing of groups of firms tended to remain stable over time despite changing levels of financial ratios. For this group of borrowers, loan quality as measured by financial ratios apparently showed little over-all change in 1954, declined in 1955, rose in 1956, and fell once more in 1957.

C. In addition, changes in the credit standards of the banks over this period were inferred by comparing the financial ratios of new borrowers in each year with those of other borrower groups. Credit standards apparently eased in 1954 and 1955, tightened in 1956, and eased again in 1957. The changes in credit standards applied to new borrowers, moreover, were sufficient to affect appreciably the direction of change in the average financial ratios of the entire group.