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Statement by

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and

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before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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Governor Coldwell and I appreciate the opportunity to appear before this Committee today to testify on the condition of the U.S. banking system. Before commencing our testimony, I want to emphasize the Board of Governors' support for these annual hearings. The Board believes that the impact that our banking system has on our economy is too important to go without periodic review and hopes that hearings of this kind will add to the public's understanding of the banking system and will enable all of us to view specific problems in a better perspective.

The Board's testimony today will be in two parts. In the first part, I will discuss several fundamental changes taking place in the banking environment, and will present, in general terms, the Board's current assessment of the condition of the banking system. In the second part of our testimony, Governor Coldwell will review in greater detail recent trends in the principal indices of bank soundness.

Perhaps the factor that has resulted in the most far reaching changes to the banking environment has been the rapid development of a more interdependent world-wide economic system. This modern-day phenomenon was brought about by improvements in communications, transportation and by the uneven distribution of resources among countries. Responding to the opportunities afforded by the global economy, American banks have substantially expanded their service offerings and have increased greatly the number of locations at which these services are provided.

Accelerating demands for new banking services can have both positive and negative implications for bank soundness. On the plus side, they can open up important new profit opportunities. For example, some American banks that blazed the trail in international banking have found this area to be particularly profitable and now derive a substantial amount of their current earnings from this source. Moreover, developing new products and serving additional geographic areas enable banks to diversify their operations, thereby reducing risk.

On the other hand, serving new product and geographic markets can present problems. Such expansion requires bankers to acquire new skills and to assimilate a great deal more information. It also requires bankers to cope with new types of risks. For example, the expansion of U.S. banks abroad has required management to deal with such forms of risks as country risk and foreign-exchange risk.

A second major change in the banking environment in recent years is that banking has become considerably more competitive. This trend is evident almost everywhere we look. We see the large money-center banks opening loan production offices throughout the nation and competing against the large regional banks for business loans.

We see banking organizations, through the holding company structure, expanding throughout much of the nation to serve local mortgage and consumer lending markets. We also see large U.S. banks competing more and more with large foreign banks in the major financial centers abroad. And, finally, we have seen foreign banks enter the U.S., sometimes on a more favorable basis, and win a significant portion of the business loan market.

In addition to this increasing competition within commercial banking, we are witnessing a gradual homogenizing of the entire financial sector. Little by little, savings and loan associations, mutual savings banks and credit unions are becoming more like banks as limiting legislation is removed and new ways to avoid restrictive barriers are found. To a lesser extent, banks are also experiencing increased competition from other types of financial institutions and even from some firms outside the financial sector.

This constantly increasing competitive environment is certainly desirable for bank customers. But for banks, increased competition may exert downward pressure on profit margins. With profit margins falling, banks in recent years have had the option of accepting these lower margins or taking greater risks in order to maintain them. Banks have responded by doing both.

Finally, during the 1970s, banks also have had to operate in a much less hospitable economic environment than during the two previous decades. This was most dramatically demonstrated by the deep recession in 1974-75 when banks experienced large loan losses and had to contend with the only significant erosion of public confidence in banks in several decades. However, the banking system did weather the problems of the mid-1970s, and since then bank managements have become more conservative in their philosophy and operations. Yet, given the key role that banks must play in financing our economy, there are obvious limitations in the adjustments that managements can make. Consequently, if the domestic and international economy in the future should continue to exhibit the degree of instability of the 1970s, we must expect that some banks will experience occasional problems.

Having discussed some of the recent fundamental changes in the environment in which banks operate, I would like to turn to the Board's overall assessment of the current condition of the banking system. During last year's testimony, Chairman Burns stated that the condition of the banking system had improved during 1976. I am happy to report that--by most traditional measures--this improvement continued during 1977 and into early 1978. Moreover, in the Board's judgment, the banking system today is in good condition.

Probably the most important factor accounting for the improvement in banking in the last year or so has been the continued expansion of the economy. Last year, real gross national product rose almost 5 percent, after rising 6 percent the previous year. This steady expansion in the economy clearly played a role in the decline in bank failures in 1977 to only six.

But the improvement in the condition of the banking system has been due to more than a healthier economy. In the past several years, bankers have demonstrated a more conservative approach to lending, capital and liquidity than they exhibited during the early 1970s. Moreover, bankers have been diligent in trying to work out the large amount of loans that became troublesome during the recent recession. Finally, I believe that bank supervisors can claim some credit for the improvements in banking. During the last few years, they have used a variety of measures to persuade individual banks to strengthen their financial conditions and to avoid unwarranted expansion.

So far I have painted a rather positive picture of recent trends in the condition of the banking system. However, I want to emphasize that problems and challenges still remain. The number of problem banks is still large by historical standards and the volume of troubled loans in bank portfolios is still uncomfortably high. These and other problems will continue to require the close attention of both bankers and bank supervisors.

Another important challenge is posed by the continuing erosion of membership in the Federal Reserve System. Over the past five years, 254 banks have left the System, and the proportion of total bank deposits held by member banks has dropped from 77 percent to 72 percent.

The increased willingness of banks to drop their membership in the Federal Reserve System has a simple cause. It is just too costly to be a member. Member banks are required to hold a significantly larger proportion of their assets as non-earning cash reserves than are other banks and savings institutions. And in this period of inflation and increased competition between banks and other institutions in providing payments services, the burden of membership is particularly severe.

Fair competition among member banks and other depository and credit institutions requires that this membership burden be eliminated. If it is not, we can expect a continued, probably an accelerated, erosion of membership in the Federal Reserve. This threatens to weaken our financial system, as more and more of the nation's payments and credit transactions are handled outside the safe channels of the Federal Reserve, as fewer and fewer banks have immediate access to Federal Reserve Bank credit facilities, as a national presence in bank supervisory and regulatory functions becomes increasingly diluted, and as implementation of monetary policy becomes more difficult.

I have now completed my general remarks. Governor Coldwell will now present the balance of the Board's testimony.

Mr. Chairman, I would first like to review recent trends in the principal indices of bank soundness. These indices include bank asset quality, liquidity, capital and earnings. In our judgment, an understanding of trends in these indices is crucial in evaluating the current condition of the banking system and formulating bank supervisory policy.

The quality of bank assets is reflected by the volume of assets classified by bank examiners and by the volume of non-earning assets being carried by banks. During 1977, the amount of classified assets of insured banks declined by about 10 percent, after more than tripling between 1973 and 1975. Moreover, the amount of assets classified by examiners as doubtful and loss--the two most serious classifications--declined by about 20 percent. Banks with assets exceeding $5 billion experienced a slightly greater relative decline in classified assets than did the rest of the banking system. However, these large banks still have a much higher level of classified assets relative to their capital than do other banks.

Other measures of bank asset quality also have shown marked improvement. Available data indicate that nonperforming assets (which include non-accruing loans, renegotiated loans, and real estate acquired in foreclosure) fell roughly 15 percent last year--despite a 13 percent rise in total bank assets.

The major asset problem still facing banks is troubled real estate loans. Many of these loans were made during the real estate boom of the early 1970s to finance projects that became at least temporarily difficult to market. Many banks have been forced to carry large amounts of these loans on a non-earning basis, thereby depressing their earnings. During 1977 and early 1978, the demand for these real estate projects continued to pick up, and as projects were sold off, the quality of bank real estate portfolios improved. This progress, however, has been slow, and still more time and improvement in certain segments of the real estate sector will be required before these loans are worked down to a more reasonable level.

At present, the banking system appears to be in a satisfactory liquidity position, partly due to a sizable build-up in U.S. Government securities during 1975 and 1976. Last year, however, bank liquidity decreased. First, banks significantly increased their reliance on relatively volatile liabilities such as large time deposits and Federal funds. In addition, banks slightly reduced their holdings of securities with maturities of less than one year.

From the end of World War II through 1974, bank capital ratios declined almost steadily. Moreover, this decline picked up momentum during the early 1970s when rapid asset growth, particularly abroad, far outdistanced the growth of capital. It was during this period that the capital ratios of some of the Nation's major banks declined to what we regard as undesirably low levels.

Since 1974, however, bank capital ratios generally have improved--rising sharply in 1975, climbing somewhat more in 1976, before declining moderately last year. A primary factor in last year's decline was the rapid 13 percent growth in bank assets.

In recent years, banks have relied principally on retained earnings to build up their capital. In the aggregate, banks typically retain about 60 percent of their net income. Recently, most external financing of banks has been supplied by bank holding companies, which now own almost all of the Nation's largest banks. These holding companies in turn have resorted largely to long-term debt issues to obtain funds. One reason for their heavy reliance on long-term debt, at least since 1974, is that the market value of bank holding company stock has been depressed. Even today, the stocks of many of the Nation's largest holding companies are selling at only six to eight times earnings, and many also sell well below book value. These unfavorable market conditions have made it very costly for these organizations to add to their equity capital through the sale of common stock. As an alternative, several large holding companies have recently resorted to issuing preferred stock.

Another key factor in determining the condition of the banking system is bank earnings. Last year, earnings were impressive, with net income of insured banks up 13 percent over the 1976 level. Several factors were primarily responsible for this performance. The first was the rapid growth in earning assets, with loans alone up over 15 percent. Second, provisions for loan losses declined about 11 percent, reflecting an even sharper drop in actual net loan charge-offs. Third, the amount of loans on which interest was not accruing was reduced significantly.

It should be pointed out to the Committee that the favorable earnings presented by the banking data are based on generally accepted accounting principles which do not take adequate account of inflation. As you know, inflation erodes nominal monetary values, including bank capital, assets, and liabilities.

The one major factor that hindered earnings last year was narrower spreads between yields on earning assets and the cost of funds. For example, the spread between the prime rate, which banks charge their best domestic customers, and the rate that banks pay on their large certificates of deposit averaged 1.3 percentage points during 1977, compared to 1.7 percentage points during the prior year. Banks also experienced some reduction in spreads on their foreign business during 1977. These reductions in spreads, both here and abroad, are evidence of increasing competition among financial institutions.

During the first quarter of this year, banks continued their strong earnings performance in nominal terms. While complete data are not yet available, net income appears to have increased by about 20 percent over the first quarter of 1977. Declining loan loss provisions and a reduction in nonperforming assets again accounted for part of the improvement. But foreign exchange operations also contributed strongly to increased profits for some large banks.

Having briefly reviewed the principal indices of bank soundness, I would now like to turn to several potential problem areas that have recently received considerable public attention. The first area is the agricultural sector, where net income from farm operations last year was about one-third below the prosperous years of 1973-74. This decline has been due both to escalating costs of production and to declines in commodity prices. In contrast to declining income, farm debt has risen by about 60 percent since 1974.

These unfavorable financial trends have made it difficult for some farmers to service their debt. As a result, some farm banks have experienced slower loan repayments and increased requests for loan extensions. So far, however, farm banks have not experienced a serious deterioration in the quality of their loan portfolios. Moreover, while the loan-to-asset ratios of many of these banks are significantly higher than normal, these banks generally have not encountered serious liquidity problems. In sum, most farm banks are now in satisfactory condition and should continue to prosper, assuming that the recent squeeze on farm profits does not continue for an extended time.

Another area of concern is the financial condition of New York City. As we all remember, the near-default of New York City in 1975, following the severe recession and the failure of several large banks, sent shock waves throughout the financial community. Since 1975, New York has made considerable progress toward putting its financial house in order. However, it has not been able to regain access to capital markets, and since 1975 it has had to rely on the Federal Government for financial support in the form of seasonal loans. Continuation of some form of Federal aid beyond this June is now being considered by the Congress.

In order to determine the exposure of U.S. banks to a possible default by New York City on its obligations, the three Federal bank supervisory agencies, in early 1978, completed a survey of the ownership of New York securities by commercial banks. The obligations covered included those issued by New York City, by New York State, by New York State agencies, and by the Municipal Assistance Corporation.

Briefly, the early 1978 survey indicated that 306 banks held New York securities exceeding 20 percent of equity capital. New York City obligations held by these 306 banks totalled $554 million

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Briefly, the early 1978 survey indicated that 306 banks held New York securities exceeding 20 percent of equity capital. New York City obligations held by these 306 banks totalled $554 million for the banks to obtain full information about the capabilities of individual foreign borrowers and of borrowing foreign countries to service external indebtedness.

In the last year, U.S. bank supervisory authorities have made considerable progress in adding to the information available on the external lending of U.S. banks. A new comprehensive report--jointly developed by the Federal Reserve, the Comptroller of the Currency and the Federal Deposit Insurance Corporation--now periodically obtains information from the major banks about the country distribution of their international loan portfolios with breakdowns by broad category of customer and by maturities. This information is structured to provide a better assessment of the country risks in the banks' international loan portfolios. As such, it allows the banking agencies to be more watchful about these risks in individual banks.

Aggregate data from the first country exposure survey, which was conducted in June, 1977, was released early this year. This survey included all U.S. banks with total assets exceeding $1 billion. These banks reported having, in aggregate, $164 billion in claims on foreigners which were denominated in currency other than that of the foreign country. They also had an additional $45 billion in local currency claims that were largely funded by local deposits. Seventy percent of these $209 billion of claims were on, or were guaranteed by, residents of developed countries, usually Group of Ten countries.

The survey also showed that banks had $46 billion of credit outstanding to non-oil producing less developed countries (LDCs) and Eastern European countries. This amounted to about 6.5 percent of the total assets of these banks.

In December of last year, the second survey of the foreign lending of U.S. banks was conducted, and the results should be available shortly. This survey will furnish valuable information to the banks in their own efforts to assess, control and monitor their international lending. In addition to the survey results, cooperative efforts among central banks and international institutions are continuing to add to the information available to commercial banks about external borrowings and external indebtedness of the main borrowing countries.

While country risk is a proper subject for concern, perspective must be maintained on the country exposures of U.S. banks. Actual defaults by countries on their external debts, public or private, have been rare in recent experience. The risks to the banks, therefore, are less in terms of ultimate collectibility of credits than in terms of liquidity and income resulting from possible failure of countries to service properly their external borrowings.

While the recent, slower pace of international lending by U.S. banks and the apparent heightened sense of caution in that lending are healthy developments, there are still several areas for concern. First, a few countries to which U.S. banks have made loans are having serious economic and financial problems and are having difficulty in servicing their external debts promptly. Second, some U.S. banks have a rather sizable exposure in individual countries relative to their capital and reserves. Finally, interest rate spreads on some recent international loans have narrowed and maturities have lengthened to an extent where the return to banks may not be commensurate with the risks involved. This development is somewhat worrisome because international earnings now comprise a substantial portion of the total earnings of our largest banks and because earnings remain the principal source for strengthening their capital positions.

Before concluding this testimony, I would like to inform the Committee what the Federal Reserve has done in the last year to improve our policies and procedures for supervising state member banks and bank holding companies. Some of these changes have resulted from problems that had surfaced in recent years. In November, 1977 the Board approved an expanded program for the inspection of large bank holding companies. The two essential elements of the program are an increased frequency of inspections and the standardization of the inspection report.

All bank holding companies with consolidated assets in excess of $300 million will now be inspected annually--unless non-banking activity and parent company debt are considered minimal, in which case inspections will continue to be conducted once every three years. The impact of the increased frequency of inspections will be approximately to double the number of large holding companies inspected on an annual basis and to increase the percentage of total holding company assets inspected annually from about 45 percent in 1976 to 85 percent when the program is fully operational.

The standardization of the report form is expected to provide a variety of benefits, including the framework for a comprehensive review of nonbank assets and holding company debt levels, greater consistency, an increase in the on-site efficiency of the inspection process, the capacity for centralized training of inspection personnel, and the ability to allocate personnel more efficiently among the Reserve Districts.

During the past year, the Board, in conjunction with the Reserve Banks, has implemented a bank surveillance system that aids in the identification of actual and potential financial problems of banks. In addition, several new bank holding company surveillance capabilities were developed to enhance existing screening techniques, data collection systems, and analytical reports. Recently, resources have been devoted to improving supervisory reports used in the surveillance process, to streamlining the reports so as to reduce reporting burden on respondents, and to expediting the use of the data.

I want to emphasize that 1977 saw further accomplishments in interagency cooperation and standardization of procedures. Central to the success of this effort was the formation of the Interagency Supervisory Committee in March of 1977. This Committee, which is an adjunct of the Interagency Coordinating Committee, consists of the senior supervisory officials of the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Home Loan Bank Board, National Credit Union Administration, and Board of Governors of the Federal Reserve System. The purpose of the Committee, which meets monthly, is to review supervisory issues and practices and to develop wherever possible uniform policies and procedures. During its first year of operation, the Committee inaugurated the uniform shared national credit program in which a team of examiners from the three agencies annually reviews loans in excess of $20 million that are shared by two or more banks. Such review eliminates the need for a separate analysis of the loan at each participating bank and leads to consistent treatment by examiners. Second, agreement among the agencies has been reached on the definition of a concentration of credit. This agreement will insure a consistent treatment of credit concentration by the three agencies in future years. Third, staff of the three agencies have agreed on the principles of a uniform system for rating all banks, and each agency is currently testing the system.

In closing, Mr. Chairman, I would like to restate the central thesis of our testimony--that while continued vigilance is still necessary, the condition of the banking system is now good and, by most measures, is better than it was at the time of last year's hearings.

Chart 1

NUMBER AND TOTAL ASSETS OF STATE MEMBER BANKS WITH COMPOSITE 3 OR 4 RATINGS, 1972-77

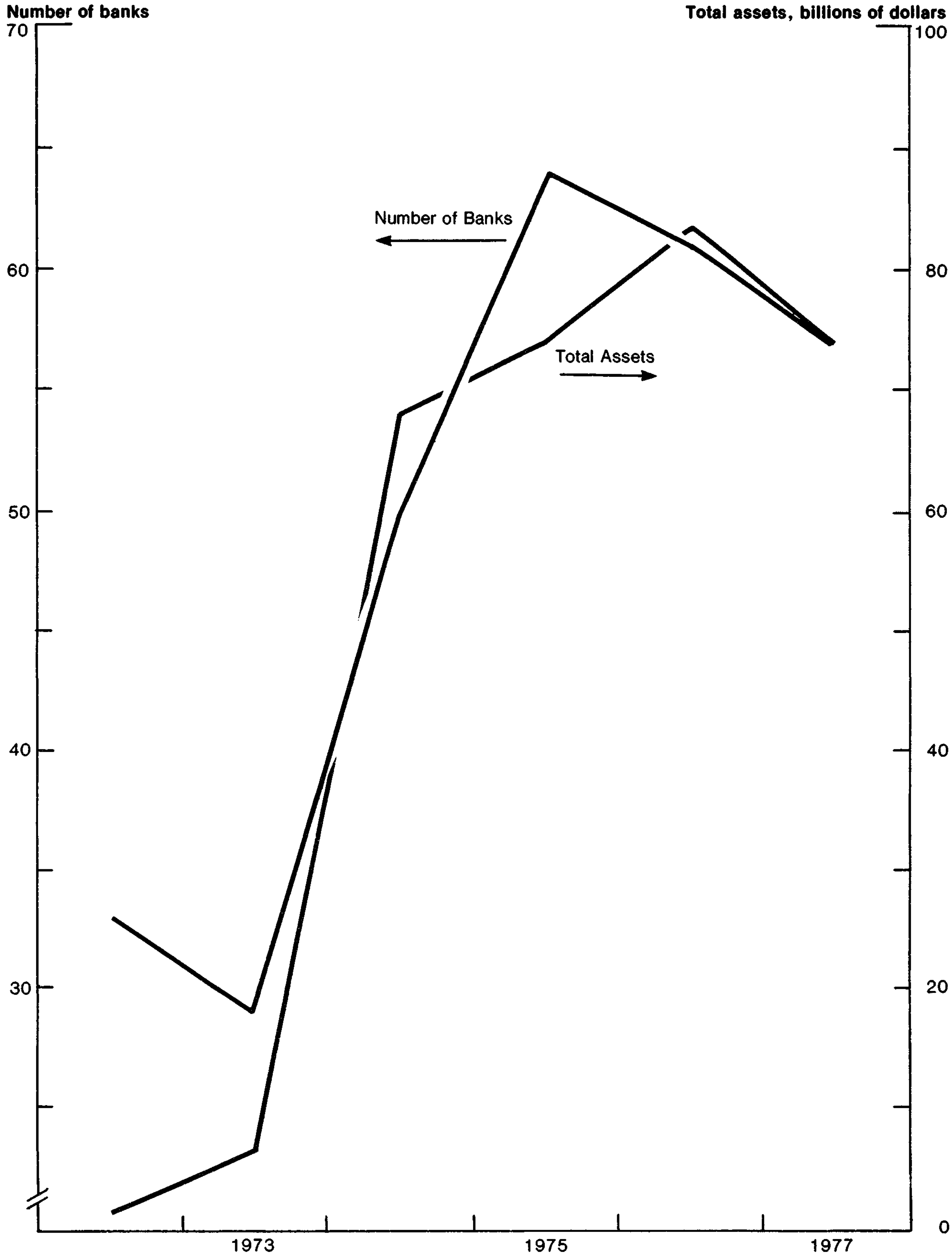
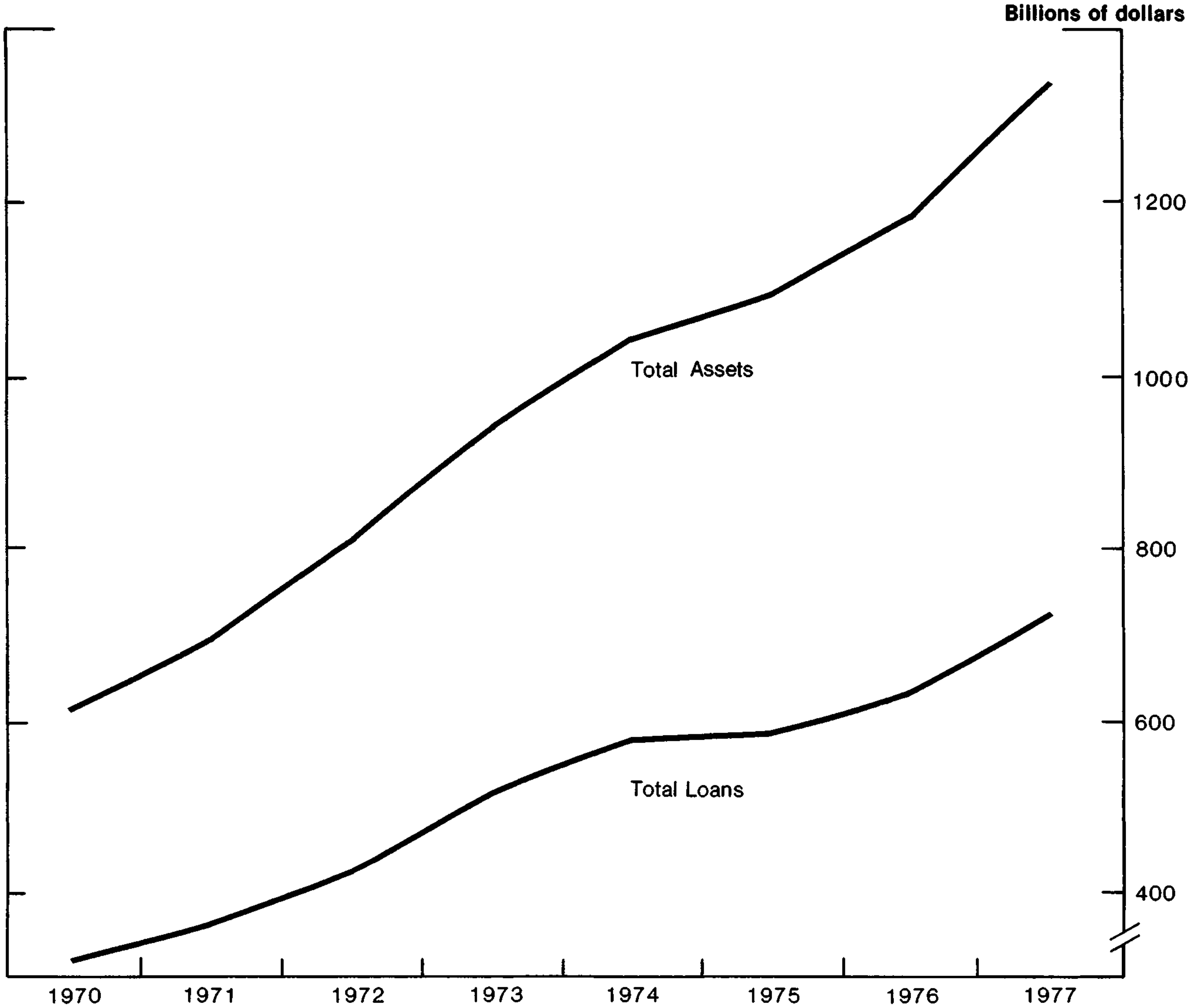


Chart 2

AMOUNT AND GROWTH OF TOTAL ASSETS AND TOTAL LOANS OF ALL INSURED COMMERCIAL BANKS, 1970-77



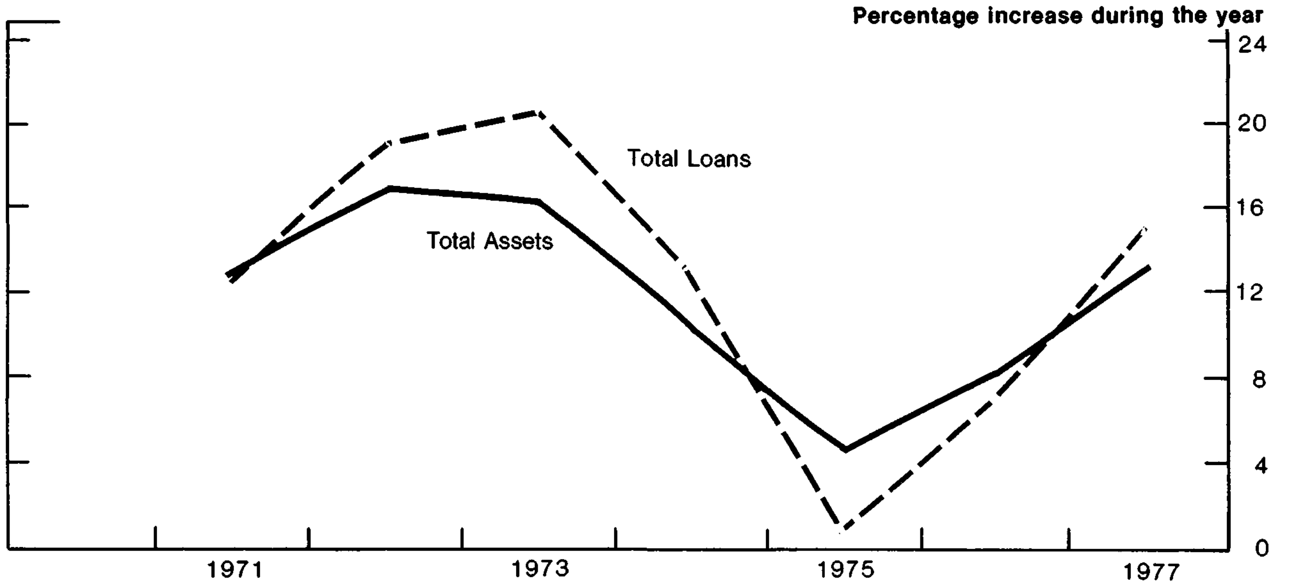


Chart 3

AMOUNT OF CLASSIFIED ASSETS OF MEMBER BANKS, 1973-77

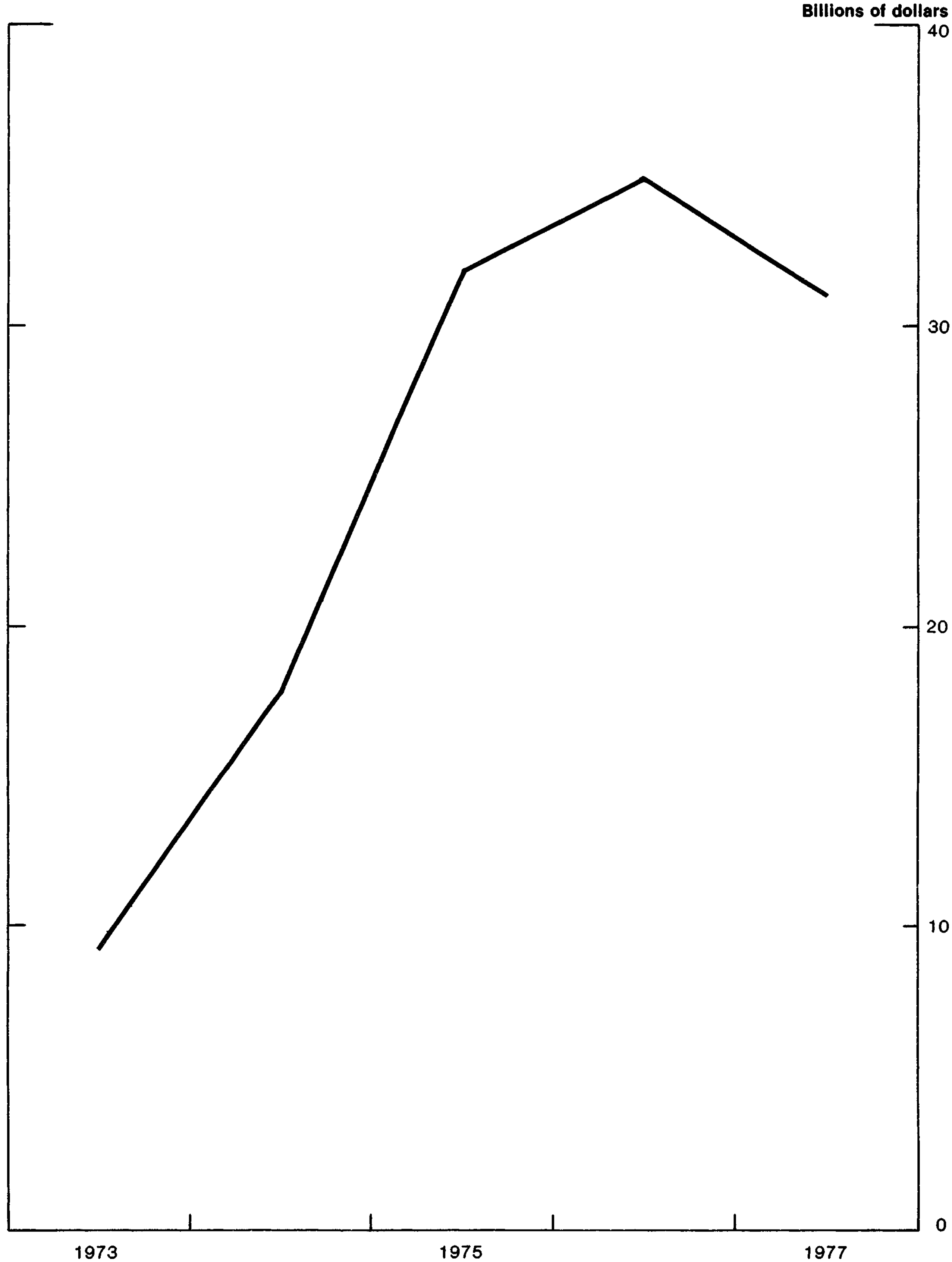


Chart 4

CLASSIFIED ASSETS OF MEMBER BANKS AS A PER CENT OF TOTAL ASSETS, 1973-77

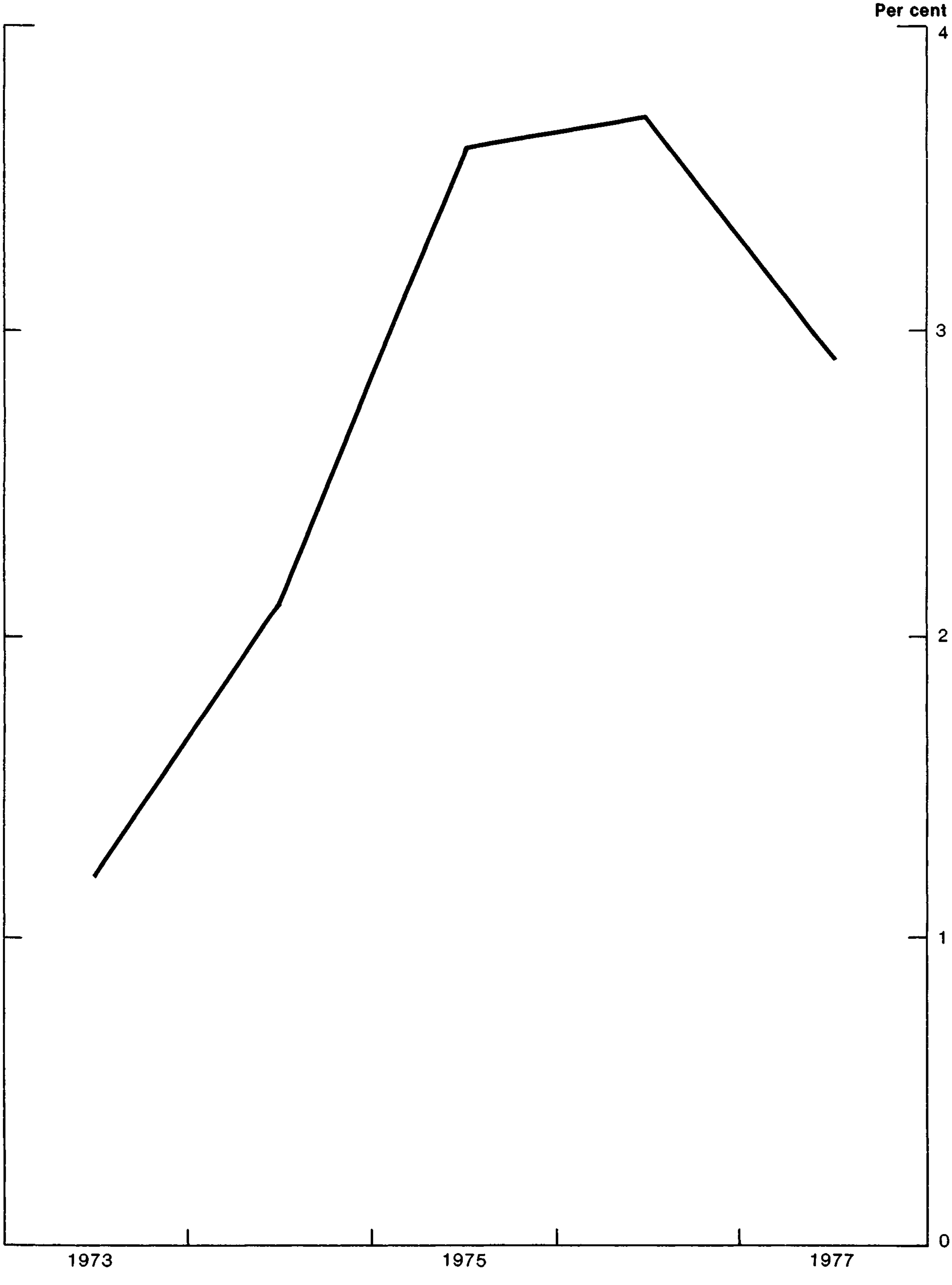


Chart 5

PROVISION FOR LOAN LOSSES AS A PER CENT OF TOTAL LOANS FOR ALL INSURED COMMERCIAL BANKS, 1970-77

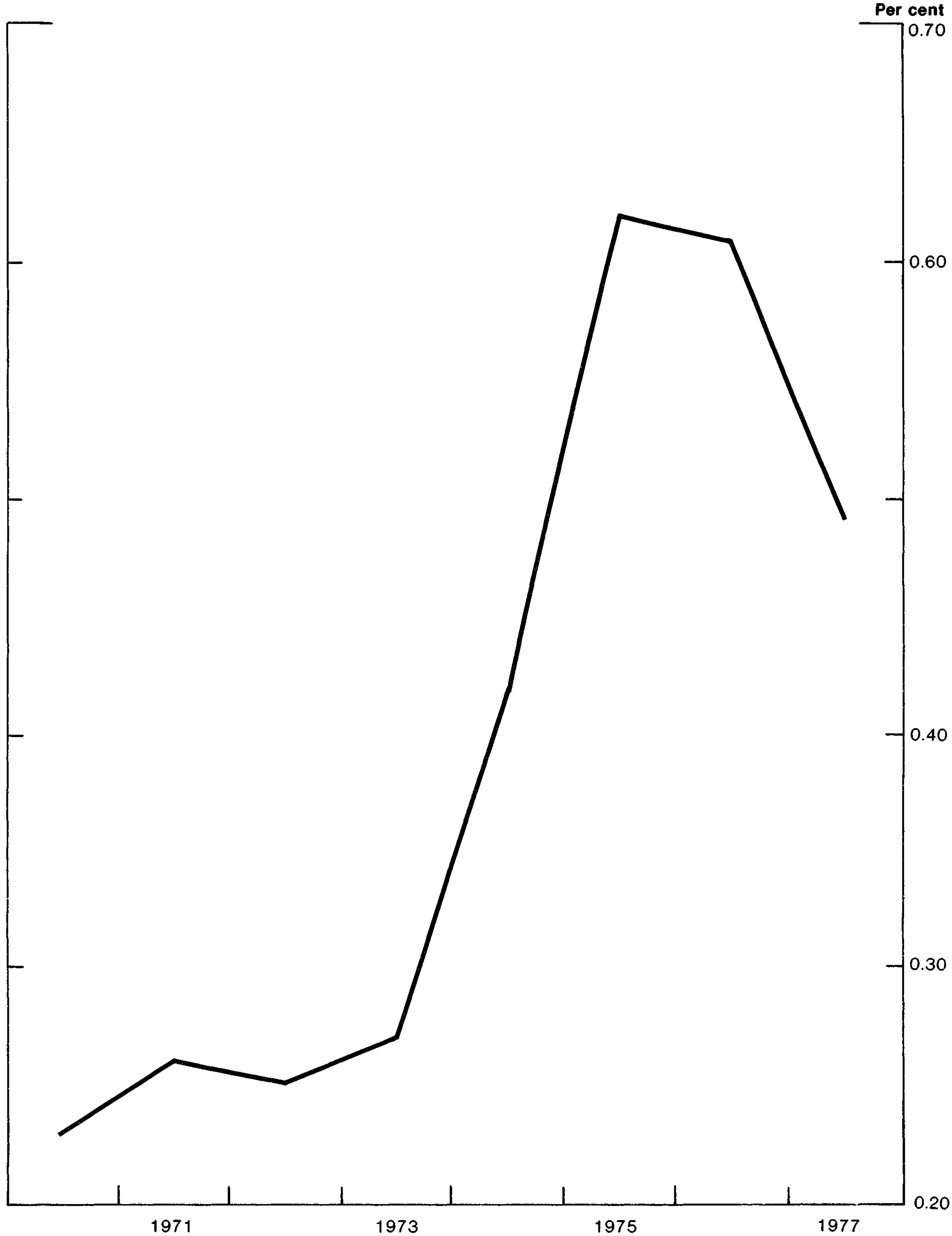


Chart 6

PROVISION FOR LOAN LOSSES AS A PER CENT OF PRE-TAX INCOME FOR ALL INSURED COMMERCIAL BANKS, 1970-77

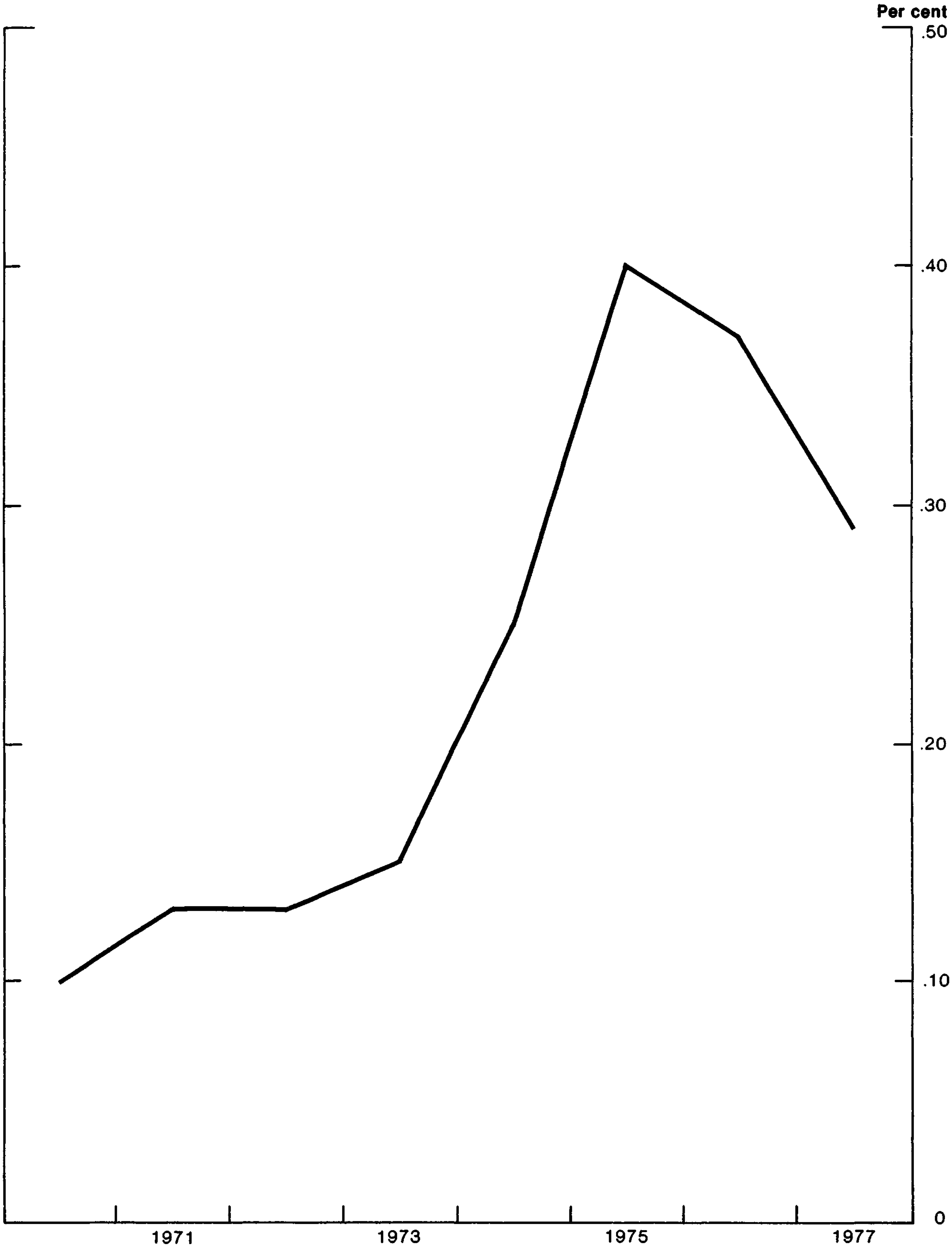


Chart 7

AMOUNT AND GROWTH OF EQUITY CAPITAL OF ALL INSURED COMMERCIAL BANKS, 1970-77

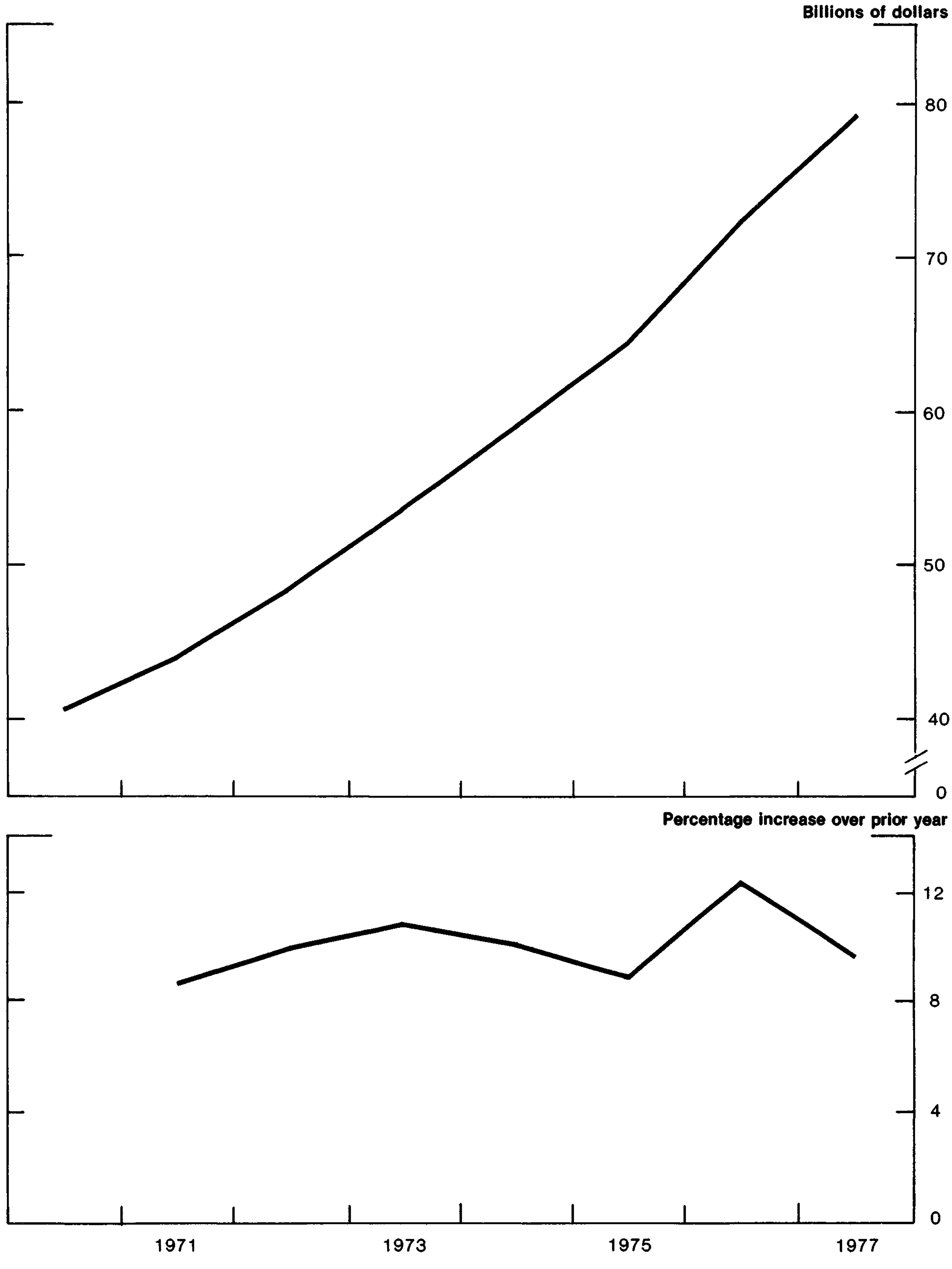


Chart 8

CAPITAL RATIOS FOR ALL INSURED COMMERCIAL BANKS, 1970-77

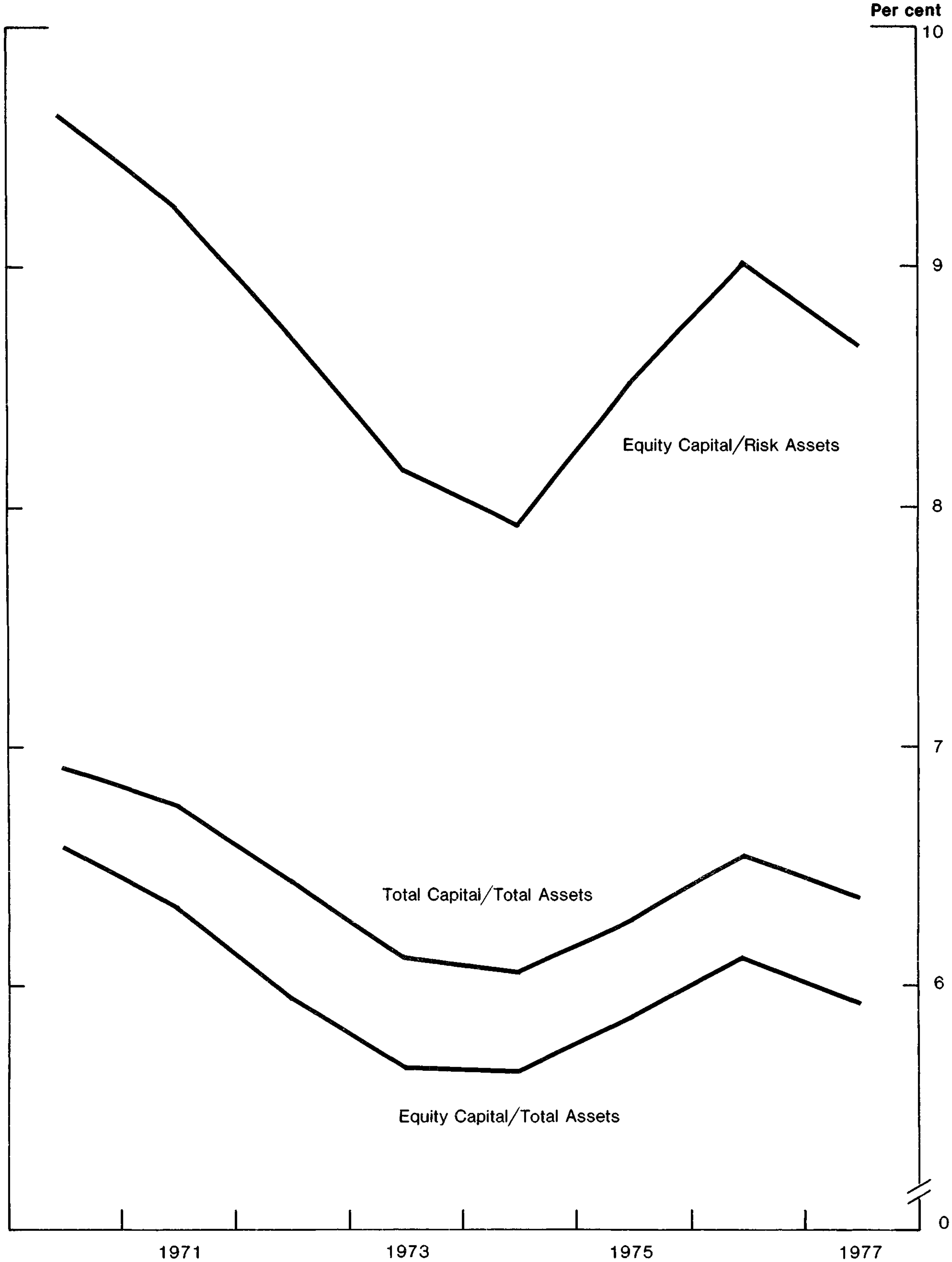


Chart 9

AMOUNT AND GROWTH OF NET INCOME OF ALL INSURED COMMERICAL BANKS, 1970-77

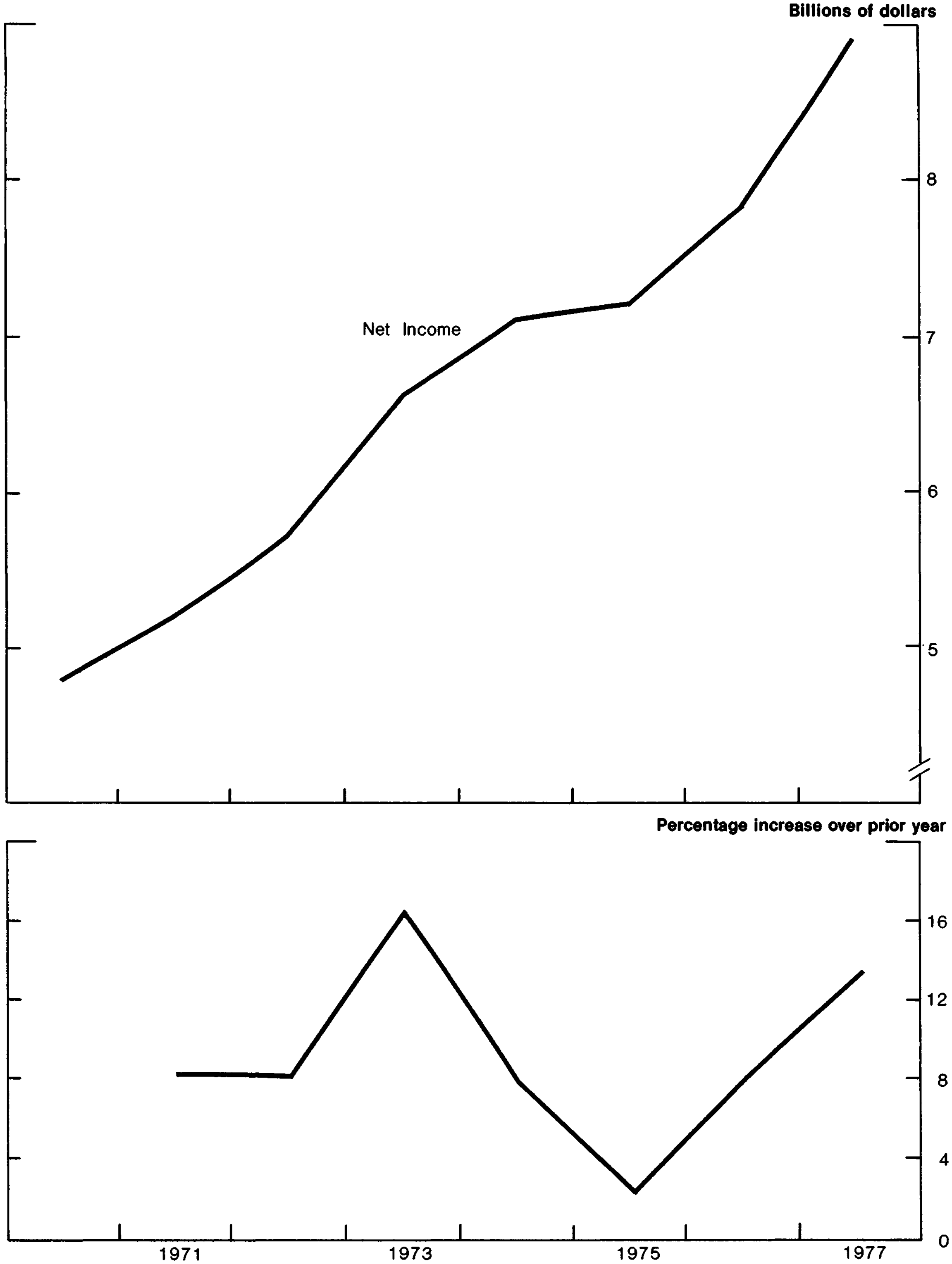


Chart 10

NET INCOME AS A PER CENT OF TOTAL ASSETS FOR ALL INSURED COMMERCIAL BANKS, 1970-77

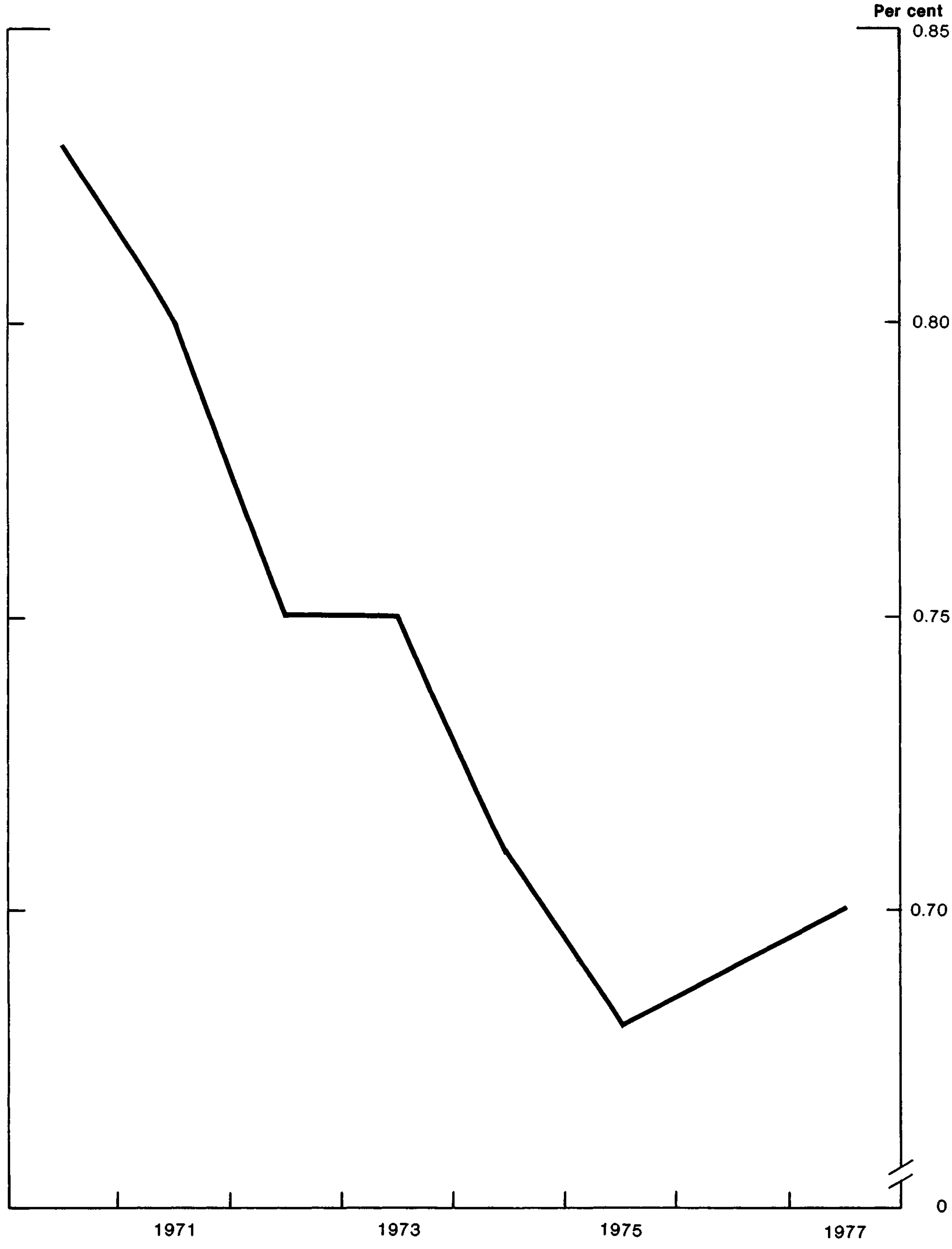


Chart 11

NET INCOME AS A PER CENT OF EQUITY CAPITAL FOR ALL INSURED COMMERCIAL BANKS, 1970-77

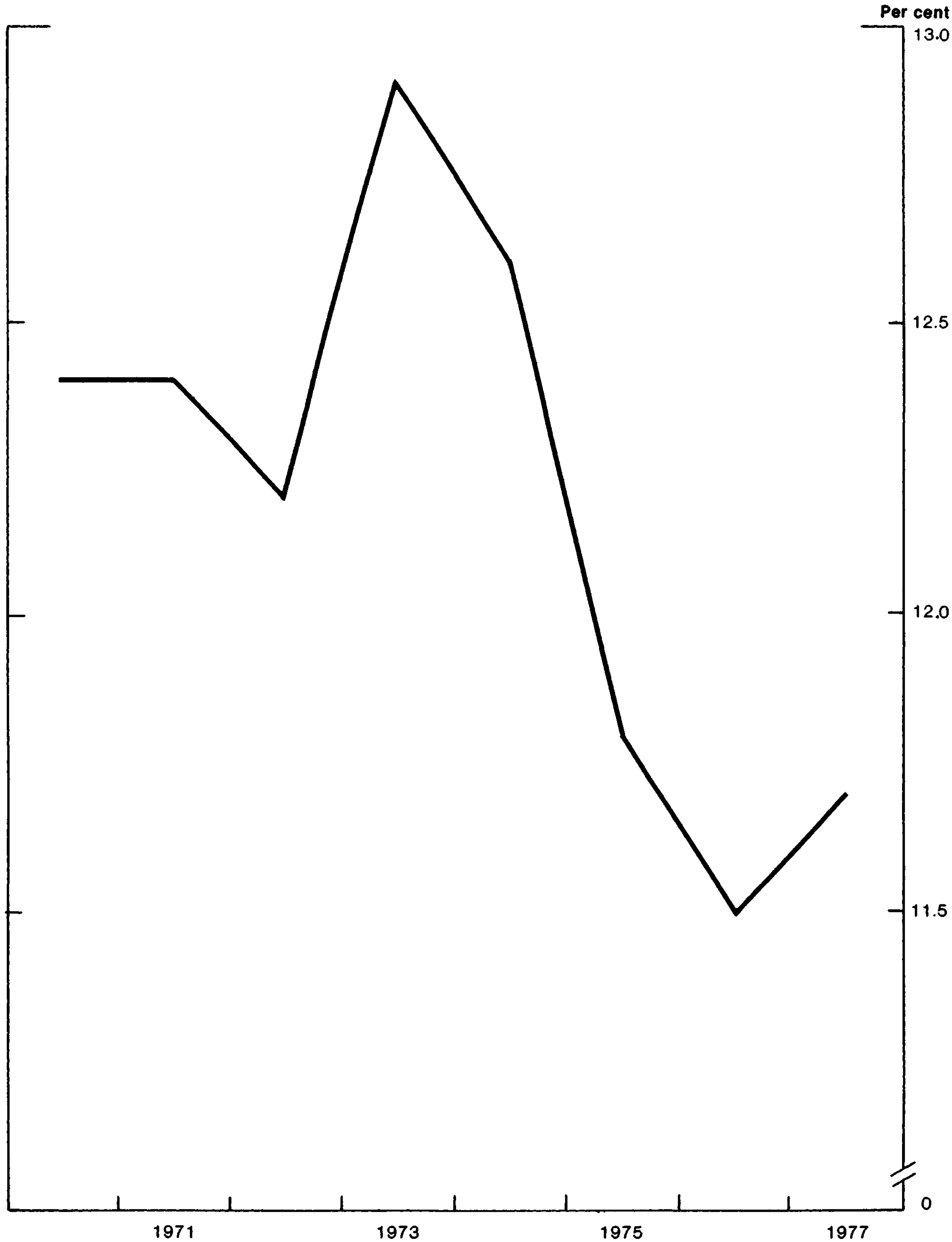


Chart 12

DIVIDEND PAYOUT RATIO FOR ALL INSURED COMMERCIAL BANKS, 1970-77