STATEMENT ON

IMPLICATIONS OF TAX REFORM LEGISLATION ON BANKING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

BY
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I appreciate this opportunity to present the FDIC's views regarding the pending tax reform legislation and its likely impact on the safety and soundness of the banking system and on the federal deposit insurance system.

As a matter of policy, the FDIC does not take a position on pending tax legislation except where we feel a particular provision will have a negative effect on the soundess of the banking system. With regard to the current proposal, we have focused our attention on the one provision we feel will work to the detriment of the system -- elimination of the reserve method of accounting for bad debts. Thus, my comments include only a limited review of the other provisions of the proposal and their likely effects on the banking system.

The current tax reform proposal represents the most ambitious restructuring of the U.S. tax code ever undertaken. The effects on the operations of businesses and consumption patterns of consumers are not well defined and may not become evident for some time to come. It is clear that taxpayers will rearrange financial arrangements in response to new and different tax incentives. Banks are no exception; they will adjust to this new environment. However, as with any change in rules, adjustments can create new, and exacerbate existing, problems.

Before addressing specific provisions of the pending tax reform, I would like to provide some perspective by briefly reviewing the condition of the banking system and what we see as the likely trend within the system.

Bank Performance

Banks have been failing at rates not seen since the advent of federal deposit insurance. Over the 40-year period from 1941 to 1980, only 262 banks failed. Since 1980, over 400 banks have failed. Last year's record of 120 bank failures will soon be eclipsed as 100 banks have already failed this year, and we expect another 40 to 60 more.

While failure statistics reflect past problems in the banking industry, other measures provide a clearer view of what lies ahead. A leading indicator of bank failures is the number of problem banks. Currently, the FDIC has classified 1,418 banks as "problems." This compares to 1,140 at year-end 1985 and 848 the year before that. In fact, the number of problem banks has increased sixfold since 1981 (Table I).

Other indicators portray a similar trend. Bank earnings relative to average assets have declined noticeably in recent years. This has occurred despite an increase in capital levels, which should have a positive effect on bank return on assets.

Bank earnings are also much more volatile. Once, almost all banks operated profitably -- save for new banks just starting out. Today, many banks, including many established banks, are in the red. In 1980, less than four percent of all insured commercial banks finished with negative earnings. That percentage has steadily increased -- rising to 11 percent in 1983, 14 percent in 1984, and over 16 percent last year.

There are significant differences between the performance of small versus large banks. Over 25 percent of commercial banks with under $25 million in total assets lost money last year. The return on average assets for banks in that size category was less than 40 percent of what it was for all other commercial banks. Until a few years ago, smaller banks consistently outperformed their large competitors.

Although the levels of nonperforming loans within the industry have moderated somewhat over the past two years, they remain high. This is despite rising net charge-off rates, which have more than doubled over the past five years, and are ten times what they were 30 to 40 years ago. The prospects for major declines in nonperforming and charge-off levels do not appear very bright, at least not in the short run.

Looking at charge-offs by loan type indicates that bank asset problems are not confined to just one or two categories. Net charge-off rates for real estate loans have more than doubled since year-end 1982. The same is true for commercial and industrial loans. In 1985 alone, net charge-off rates for farm and consumer loans jumped by over 50 percent from the year before.

Tax Reform Provisions Affecting Banks

While there are several provisions that affect banks directly, any provision that alters consumer or business decisions indirectly has an influence on banks. These "indirect" effects may influence a bank's sources and costs of funding, the types of investments it chooses, and the quality or asset value of existing credits.

The direction and magnitude of many of these effects currently are not well understood. Some may prove to be relatively insignificant from a safety and soundness point of view. Only time will tell. At this point, I would like to review those provisions directly affecting banks and those "indirect" effects that are perceived to present some concerns.

Tax Rates

The current top corporate tax rate is 46 percent. This would be changed to 34 percent and is the only aspect of tax reform which would be directly favorable to banks. The tax savings to banks from lower tax rates are difficult to estimate since

tax-induced changes in bank portfolios would likely cause a considerable change in banks' taxable income. Ignoring these other effects, we estimate the lower rate would reduce banks' annual U.S. income tax liability about $1 billion.

Bad Debt Reserves

No provision of the proposed tax law troubles the FDIC as much as the elimination of loan loss reserves for large banks. Current tax law allows all banks to maintain reserves computed under either the percentage method or the experience method. The percentage method allows reserves to be maintained at 0.6 percent of eligible loans. This percent was ratcheted down from 2.4 percent under the Tax Reform Act of 1969. Back then, loan losses were running well below 2.4 percent and the intent was to phase banks into the experience method. Now though, loss rates have more than doubled and are significantly above 0.6 percent. This phenomenon has caused many banks to "voluntarily" switch to the experience method which effectively allows reserves to be based on a six-year moving average of loss rates.

Under the proposed law, banking organizations with total assets of $500 million or more would no longer be allowed deductions for bad debt reserves. Losses in their portfolios could only be recognized when specific loans have been identified and charged off. Moreover, these organizations would have to recapture (something the Tax Reform Act of 1969 did not require) existing reserves over four years unless they qualify as a troubled organization.

The FDIC, from the beginning, has opposed this tax change. We do not object to banks paying their fair share of taxes, but we feel strongly that providing for bad debt reserves is good accounting, good business and good banking. In our view, anything that discourages banks from providing for losses in their loan portfolio is potentially dangerous. Last year, net loan charge-offs amounted to $13.1 billion or 0.80 percent of year-end loans. We have not seen a rate that high since 1936. Table II compares the loan charge-off ratio over the last five decades. The ratio is over ten times what it was in the forties and fifties and nearly double what it was in the seventies. We and other regulators are continually encouraging banks to reevaluate their loan portfolios and adequately provide for potential losses. Table III indicates that banks have been increasing their reserves while their losses also have increased. The level of nonperforming, subquality assets continues to outpace the growth

in reserves. The change in the tax law will certainly not help in the effort to get banks to increase their reserves.

The elimination of the bad debt reserve deduction for large banks not only has adverse safety and soundness implications, it represents the loss of a reasonable and legitimate business expense. It is simply a fact that loan losses occur before they are identified. If it were otherwise, we would probably have a lot fewer bank failures -- banks would know to avoid certain credits before it becomes too late. Moreover, we see no reason for the arbitrary distinction between large and small banks. Bad debt reserves are just as appropriate for a $550 million bank as they are for a $450 million bank.

Currently, there are 525 banks with over $500 million in assets. However, the proposed law takes away deductible bad debt reserves from banking organizations with consolidated assets over $500 million. Nearly 2,600 banks are affiliated with larger bank holding companies and would lose their bad debt reserves. As a group, 399 banking organizations, with $2.3 trillion in assets and about 80 percent of the loans in the banking industry would be affected.

These banks will have to recapture existing bad debt reserves over the next four years. We do not know the volume of these reserves that will be subject to recapture. However, in light of the effective minimum of 0.6 percent of qualifying loans and recognizing that many banks have switched to the experience method, we have assumed that the number is between $7 and $12 billion. Using a 34 percent tax rate, this provision would cost the industry between $2.4 and $4 billion.

The tax law would allow certain "troubled" banking organizations to defer recapture of their loan loss reserves. Such organizations are those whose nonperforming assets exceed 75 percent of their equity. At this point though, it is not clear what assets are to be counted as nonperforming, how equity is to be defined and whether the 75 percent test would be applied on an individual bank or on a consolidated basis. It is also not clear whether or not a "troubled" bank can elect <u>not</u> to defer recognition in order to use up expiring Net Operating Losses.

The FDIC has attempted to calculate the effectiveness of this ratio in identifying problem banks. We assumed nonperforming assets include only loans 90 days or more past due and nonaccrual loans. Not counted as troubled assets was foreclosed real estate, though we believe it should be. We

also assumed that capital referred to total book equity and did not exclude intangibles such as goodwill.

Of the 398 affected organizations, only 14 organizations have a ratio over 75 percent. These 14 banking organizations represent 60 banks of which 31 are currently on the FDIC's problem bank list. Of all the banks affected by the tax change, 104 are on our problem list; so the troubled bank test identified less than one-third of problem banks losing their bad debt reserves.

When computed on a consolidated basis, the troubled bank ratio grants relief too late and where it is least needed. All but two of these 14 companies reported losses in 1985 and, for them, the tax effect of recapture is probably a moot issue. These companies may actually be better off from a tax standpoint to recapture reserves now rather than later.

The test does somewhat better if applied on an individual bank basis, i.e., if the ratio is computed separately for each bank in the holding company rather than for the consolidated organization. On this basis, relief is granted to 51 of the 104 problem banks affiliated with large banking organizations. Moreover, resources of nontroubled banks cannot be used to save a troubled affiliate. Capital is regulated on an individual bank basis. Also, the Federal Reserve Act prohibits banks from acquiring low quality assets from affiliates. Therefore, it seems more logical to apply relief based on the condition of the individual banks rather than the consolidated organization.

The ratio also does better at lower levels. At 50 percent instead of 75 percent, the ratio would grant relief to nearly two-thirds of our large problem banks -- if applied on an individual bank basis. At that level, only eight percent of all large banks would qualify as troubled.

In sum, we think taking away the bad debt reserve is a move in the wrong direction and that the troubled bank test does little to change that. At a minimum, we urge Congress to ensure that the test is applied on an individual bank basis, and that "troubled" banks are given the option to recapture reserves. We also think 75 percent is too high a threshold (50 percent would be more realistic) and that foreclosed real estate should be counted as nonperforming assets.

Interest to Carry Tax-Exempt Securities

In general, banks will not be permitted to deduct interest expense incurred to carry tax-exempt securities acquired after August 7, 1986. Since banks historically have been one of the most significant holders of tax-exempt securities (currently holding approximately $140 billion or about one-third of total tax-exempt issues), yields on these issues are likely to increase. We already have observed an increase in the yield of tax-exempts, most likely in part because of this provision.

This provision may depress the value of tax-exempts currently held in bank portfolios. Interest deductibility would continue for these securities while held as investments, but sales would be at market prices reflecting the new tax rules. Banks needing to sell their municipals for liquidity or tax planning purposes would have to absorb the loss.

This provision, coupled with the corporate minimum tax (discussed below), will impact small banks disproportionately. Small banks have invested relatively more in tax-exempt securities than have larger institutions. For example, banks with less than $100 million in assets hold about 30 percent of all municipals but less than 20 percent of industry assets. A more equitable solution, it seems to us, would be to allow the current rules to follow existing securities until maturity or for a specified number of years. We suspect this would have minimal impact on taxes since most banks would otherwise hold the securities until maturity. It's the few banks that would need to liquidate that we're concerned about.

Corporate Minimum Tax

The proposed tax law also repeals the present add on minimum tax and creates a new alternative minimum tax (AMT). After 1989, banks will have to compute their AMT based on their earnings and profits. We are not aware of the final rules that will govern this calculation and thus are unable to assess the likely impact on the banking industry. Until 1989, the transition rules will essentially require banks to recompute their taxes based on 20 percent of the sum of taxable income plus one-half of tax preference items. Banks will be liable for the greater of this AMT or normal computed taxes. The largest tax preference item is income on tax-exempt bonds. Banks with a large proportion of tax-exempt income -- on the order of 60 percent or more of accounting income -- will be subject to the minimum tax. Most banks will not be affected although, again, smaller banks hold a larger

portion of municipal securities. A number of smaller institutions undoubtedly will have to pay more taxes. Moreover, this impact will be exacerbated by the proposed change regarding the deductibility of costs of carrying municipal securities. Unfortunately, banks looking to reduce their holdings of municipals would face a somewhat less receptive market to the loss of interest deductibility described above.

Net Operating Losses

The effect of subjecting banks to the same rules as other taxpayers (carryback three years; carryforward 15 years) will be to force banks to rely more on future tax liabilities to recapture current losses. Under existing laws, banks operating in a loss position can realize immediate tax benefits (cash refunds) until taxes paid over the immediately preceding ten years have been recaptured.

Receiving immediate tax benefits in response to a loss is of significant importance to a bank and, in some cases, can mean the difference between solvency and insolvency. The tax committees recognized this and, in light of the current economic climate affecting many institutions, adopted transitional rules that would allow the ten-year carryback provision to remain for losses attributable to bad debt losses in tax years beginning before 1994. This will soften the impact of tax reform for institutions affected by current problems. Perhaps unintendedly, it also recognizes that expected losses in a loan portfolio cannot be promptly identified -- the reason we advocate the continuation of loan loss reserves.

Investment Tax Credit

Repeal of the investment tax credit will primarily affect banks with sizable leasing operations. Direct lease financing has been one of the fastest growing areas in banks' portfolios, with the industry currently having an investment in excess of $24 billion in this activity. One of the attractions of lease financing is the tax benefits that accrue to the banks due to purchases of assets eligible for the credit. In 1985, banking companies claimed approximately $600 million in such credits. For the most part, these credits have been taken by larger banking organizations. Smaller institutions will be relatively unaffected.

Repeal of this credit most likely will result in increases in leasing costs to lessees and a diminution of banks' involvement in lease financing.

Foreign Tax Credit

The operation of the foreign tax credit and the effect the tax reform package will have on credits available to banks is complex and the impact is not yet clear to the FDIC. A number of the larger U.S. banks are significant participants in overseas loan markets, with total foreign loans currently at about $100 billion. These institutions used about $1.2 billion in foreign tax credits to reduce their U.S. tax liability. The proposed tax law will curtail the use of such credits. Essentially, banks will no longer be able to average credits from high and low withholding countries where the country's withholding taxes on interest earned are five percent or more. The proposed limitations will reduce the relative attractiveness of foreign loans. Presumably, banks will demand a higher yield or seek alternative investments.

In an effort not to discourage lending by U.S. banks, the proposed law provides for a five-year transition for 34 International Monetary Fund countries. The identity of these countries has not been made public, although presumably they include the 15 countries covered by Secretary of the Treasury Baker's plan to aid less developed countries. Loans to these countries account for about one-third of all loans to foreign countries.

Other Provisions

As stated earlier, virtually every provision of the tax reform legislation will have some effect on bank operations. Some are more obvious than others. The provisions relating to real estate investments (longer depreciation schedules and restrictions against offsetting losses against earned income) may reduce the value of foreclosed real estate currently held by banks. At the present time, banks hold about $8 billion in foreclosed real estate, about double what it was four years ago. These provisions could also reduce the quality of some loans secured by income producing properties. We are particularly concerned about loans to limited partnerships operating primarily as tax shelters.

The restrictions on eligibility to make tax-deferred contributions to an IRA will also affect banks. These accounts have grown in importance in terms of funding sources, and currently banks hold about $52 billion, or 26 percent, of all IRA deposits. The new rules will diminish the importance of IRAs for banking institutions. Banks will have to develop

new products to fund growth. This transition may likely be more difficult for smaller institutions.

Conclusion

The FDIC strongly supports the objectives of the proposed tax change. There is no disagreement that banks, as well as other taxpayers, should each pay a fair share of the national tax bill. What's fair is largely a matter of perception and clearly banks suffer from the perception that they pay less than their fair share of taxes. The banking industry has argued, at various times, that federal income taxation should not be viewed in isolation, and that other implicit taxes, such as the cost of keeping noninterest bearing reserves with the Federal Reserve System and the lower yield earned on tax-exempt bonds, should be considered. My purpose today is not to support either side in this controversy. However, tax legislation cannot be evaluated without considering the incentives provided by the revised structure and the realities of the "real world."

In the case of banking, the real world involves a significant number of banks adversely affected by problem sectors: energy, agriculture, international obligations and, in some cases, commercial real estate. In this situation, the incentives, tax and otherwise, should be for banks to reserve adequately to cover anticipated losses so as not to present an overvalued balance sheet. The tax reform proposal does not accommodate this; in fact, the incentive is to provide minimal reserves, and realize losses only when specific loss items can be identified. Not only does this provide the wrong incentives, it does not correspond to the realities of the credit granting process.

With our limited knowledge of the details of other tax revisions, it is difficult to assess fully the impact on banks. On balance, U.S. income taxes will most likely increase for the banking industry, but we fully expect banks will adjust their business strategy to minimize the impact on their after-tax earnings and their capital. To the extent banks are unable to preserve after-tax earnings, the value of their capital -- and thus their ability to raise it -- will be lessened in the marketplace. In this regard, capital markets have consistently assigned less value to the earnings of banks than that given other industries. Should the markets perceive the proposed tax law affects banks worse than other industries, raising capital will become even more difficult. This effect would come at a time when the industry is facing its greatest strains in recent history.

TABLE I

Problem and Failed Banks

	Failed Banks*	Problem Banks (Period-end)
1986 (Aug.)	100	1,418
1985	120	1,140
1984	80	848
1983	48	642
1982	42	369
1981	10	223

*Includes assistance transactions

TABLE II

Historical Net Loan Charge-off Ratios

	Ratio
1934	3.421
1935	1.610
1936	0.875
1937	0.309
1938	0.585
1939	0.419
1940-44	0.072
1945-49	0.058
1950-54	0.063
1955-59	0.068
1960-64	0.146
1965-69	0.171
1970-74	0.304
1975-79	0.473
1980-84	0.520
1985	0.804
1986*	0.826

*First Half

TABLE III

Net Loan Losses, Nonperforming Assets
and Book Bad Debt Reserves
($ - Billions)

	Nonperforming Assets	Book Loan Loss Reserves	Nonperforming Assets to Reserves#	Net Loan Losses
1986*	$ 56.6	$ 26.2	46.3%	$ 7.0
1985	51.0	23.1	45.3	13.1
1984	49.5	18.6	37.6	10.7
1983	46.0	15.4	33.5	8.4
1982	45.3	13.2	29.1	6.6
1981	NA	11.4	----	3.8

*First Half

#Includes loans 90 days or more past due or on nonaccrual status and foreclosed real estate.