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STATEMENT ON

IMPLEMENTATION OF CAPITAL FORBEARANCE

PRESENTED TO THE

COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
of the
~~House~~ COMMITTEE ON GOVERNMENT OPERATIONS
UNITED STATES HOUSE OF REPRESENTATIVES

BY

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9:30 a.m.

Mr. Chairman, the FDIC shares the committee's concern with the condition of the agricultural and oil and gas sectors of the economy. We have experienced a sharp increase in the number of failed banks in recent years, especially so with agricultural banks. There were only seven failures of agricultural banks in 1982 and another seven in 1983. In 1984 that number had jumped to 25 and increased again in 1985 to 62. So far in 1986 there have been 23 failures of agricultural banks. Though energy bank failures have not been as numerous, the deterioration in that economic sector over recent months from an already weak position has placed a significant strain on financial institutions operating in areas dominated by the oil & gas industry.

As a result of our concern, and after consultation with Congress, the three federal bank regulators adopted a program to assist banks in their attempts to work through the present period of weakness. Today, I will discuss the initial results of the program as it has affected the state nonmember banks under FDIC supervision.

The subject of these hearings is Capital Forbearance but that is only one facet of the regulators' program to aid the banks. The program is a package and the parts are designed to facilitate one another. In addition to capital forbearance we encouraged appropriate use of Financial Accounting Standards Board Statement 15 (FASB 15) in accounting for the restructuring of loans to

troubled borrowers. The principal thrust of this opinion is that banks can modify the terms of a loan, including forgiveness of principal and/or reduction of the interest rate, and not recognize a loss so long as the future contractual payments of principal and interest specified by the new repayment terms equal or exceed the amount of the loan on the bank's books before restructure. As a final element of our package, renegotiated loans were removed from the definition and schedule of nonperforming assets disclosed in quarterly call reports filed by all banks. This reporting change recognizes the reality that the chance of repayment on a restructured loan may well be greater than before the restructuring, and, so long as the borrower is meeting the new terms, the loan is performing.

The FDIC notified the Chief Executive Officers of all insured state nonmember banks of the details of capital forbearance in a Bank Letter dated March 27, 1986. A second Bank Letter dated April 11, 1986 dealt with the specifics of FASB 15. We have made a variety of additional efforts to communicate with the industry in addition to mailing out the bank letters. In Kansas, Nebraska, Iowa, Colorado, Oklahoma, and Texas our personnel have given a total of 17 seminars or presentations on capital forbearance. Some of them were joint with the Office of the Comptroller of the Currency and the respective state bankers associations. Video and audio tapes of these seminars have been made available to bankers in some states through the bankers associations or other private groups. We would estimate that between 1,500 and 2,000 bankers have seen these presentations on capital forbearance and FASB 15.

In order to insure that the policy was understood and consistently implemented in the field it was thoroughly discussed at several meetings among senior management personnel of our Washington headquarters and our Regional Offices. We have also developed standard operating procedures which are followed by all Regional Offices in dealing with capital forbearance.

As of March 31, 1986, there are approximately 2,700 state nonmember banks that meet the definition of an agricultural bank based on the loan volume test (Agricultural loans greater than or equal to 25 percent of the total loans). Of these banks, only 37 report capital ratios between 4 and 6 percent. Another 6 banks show capital between 3 and 4 percent and 2 banks have capital below 3 percent. It is not surprising than that only 37 state nonmember banks have applied for forbearance to date. The program provides that upon application, participation will be granted unless the FDIC denies the application or requests additional information within 60 days. It is only just slightly over 60 days since the program was implemented. Also the banks have until year end 1987 to request capital forbearance. It is only normal under these circumstances for a bank to delay decisions regarding participation, especially since many banks may need time to assess their capital position given the potentially positive impact of using FASB 15.

Also, as we have consistently said over past months, agricultural banks, in spite of significant recognized problems, remain among the strongest capitalized banks in the industry. What exists are farm banks with significant volumes of loans which may need to be restructured and/or may

result in a loss to the bank in the future depending on the strength of the farm economy over the next year or so. For many troubled farm borrowers, 1986 may be a critical year for determining their continuing viability. However, it will often be late fall or early winter before crops are harvested and sold. Until the crop cycle is complete for 1986 and the financial condition of farmers and the resulting impact on banks is determined, the possible need for capital forbearance will not be known. It may be well into 1987 before significant numbers of banks feel the need to apply for forbearance. Therefore, though it is important that we monitor progress, it is too early to make reasonable judgments regarding the program's effectiveness.

There is no reporting mechanism to identify oil and gas loans and therefore it is not possible to determine how many banks meet the loan volume test for capital forbearance. We did conduct an informal survey of our Regional Offices in an attempt to develop an estimate of banks which had significant exposure to oil and gas loans. The survey identified roughly 200 state nonmember banks but many of these did not have enough loans to meet the 25 percent test for capital forbearance.

Using the numbers of banks qualifying under the loan volume test and the numbers of banks below regulatory minimums for capital is not a complete measure of the program's impact. Our policy provides that any bank, regardless of the loan volume test, may obtain capital forbearance if they can support a case that the bank's financial problems are primarily due to adverse conditions in the agricultural and/or oil & gas sectors of the economy. This

would probably cover many of the 200 odd banks disclosed in our energy survey as well as any bank whose borrowers' jobs or business prospects have been hurt by the ripple effect of the weak agricultural and/or oil & gas sectors of the economy. Losses on loans to such borrowers may be a direct result of the weak economy even though the loans do not meet the definition of agricultural or oil & gas loans.

In addition most agricultural banks have enjoyed high capital ratios for many years. It has been a concern among these banks that the regulators would require that these high levels of capital be continued regardless of the economy. Bankers therefore reportedly were hesitant to restructure troubled agricultural credits and/or to take losses on loans for fear of the regulatory response to the adverse impact on capital. Our forbearance policy should have relieved some of this fear by publicly announcing that the regulators recognize the problem and are willing to permit for several years capital well below levels most banks have traditionally maintained. Also the ability to use FASB 15 should reduce the impact of loan restructurings on capital and further remove some of the hesitation bankers may have had to restructure and work out loan problems with borrowers who have a reasonable chance to recover. Until we gain more experience with this program it is not possible to measure the effect, or know, of decisions that have been made differently than otherwise would have been made due to the announced regulatory policy.

The program cannot and was not intended to keep insolvent banks or insolvent borrowers in business. It is recognized by most observers that the problems

in the agricultural and energy economies are so serious and have lasted so long, especially in agriculture, that some banks and even more farmers and energy businesses are unfortunately beyond help and will fail. As painful as this process can be, such failures are one of the ways the economy adjusts to changing conditions so that it can remain strong and viable. Our policies of capital forbearance, use of FASB 15 and reporting for renegotiated debt are intended to cushion, not prevent, this natural process by providing banks with the maximum flexibility possible in their credit and other bank management decisions and not burden them with unnecessary concern over the attitude of bank regulators. Given good bank managers and capable farmers and energy businessman, such decisions should work out to the long term advantage of all parties.

Thank you. I will be happy to respond to questions.