STATEMENT ON

MAGNITUDE OF BANK DIFFICULTIES
IN THE AREAS OF
AGRICULTURAL LENDING, ENERGY LENDING,
AND
LENDING TO LESS DEVELOPED COUNTRIES,

PRESENTED TO

the SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
House COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
~~HOUSE OF REPRESENTATIVES~~

BY

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Mr. Chairman, members of the Subcommittee, I welcome this opportunity to meet with you. As you requested, I will be as precise as possible in discussing the magnitude of bank difficulties in agricultural lending, energy lending, and lending to less developed countries.

You also asked if any changes in existing law or regulation are needed. The question is directly on target. We do need legislation, and we need it now. The most pressing issue is the bank acquisition provisions of the Garn-St Germain Act of 1982. Those provisions expire on April 15, less than one week away. Those provisions should be extended and their scope should be expanded in several important repects. These changes are important if the FDIC is to have the tools it needs to minimize outlays by the deposit insurance fund, minimize community disruptions, and foster safety and soundness of the banking system as a whole.

Before I address the interstate provisions, let me touch on the lending difficulties.

Agricultural Lending

There are close to 4,000 banks which have at least 25 percent of their loan portfolio in farm loans. Most of these banks are located in the Midwest and Great Plains states. They are typically small, with total assets equal to only about 4 percent of all commercial bank assets in the U.S. Our problem bank list includes 468 farm banks, or 40 percent of all problem commercial banks. Both the number and percentage of problem farm banks has risen sharply. In 1983 there were just 106 problem farm banks, that constituted 22 percent of problem banks. Failures in farm banks are also running high. In 1985, 62 of a record number of 120 failures and assisted transactions involved farm banks.

Farm lending is directly tied to the agricultural economy and we see signs of improvement. Interest rates are way down, reducing debt servicing costs. The decline in oil prices will also benefit the farmer, reducing the cost of fuel, fertilizer and other petroleum based farm supplies. The reduction in the value of the dollar increases the potential for overseas sales. Importantly, we see evidence of firming farmland prices. Thus, there is some light at the end of the tunnel. My own experience shows when everyone is convinced how bad things are, they inevitably start to get better. I think we're about at that point now -- which is the underlying rationale behind our recently announced capital forbearance policy.

Energy Lending

The recent fall in the price of oil has been a benefit to most sectors of the economy but it has presented real economic problems for the oil and gas industries and three principally affected states, Texas, Oklahoma and Louisiana. A recent study of energy lending indicated about $57 billion, or 92 percent, of identified energy loans are in the portfolios of banks with total assets of $1 billion or more. Thus, energy lending is primarily a problem of the large regional and multinational institutions. In addition, of the 563 commercial banks identified in the energy survey, 103 or 18 percent are on the FDIC's problem bank list. At the April 1985 shared national credit review, 17.5 percent of oil and gas credits were criticized. This compares unfavorably to other industries where only 5.4 percent of loans were criticized. The next shared national credit review will be conducted shortly. The volume of problem loans is expected to expand dramatically. But this is not a big bank problem only. There is spillover of loan problems to many of the smaller banks operating in affected states; unemployment has swelled, real estate prices have fallen and State tax revenues are threatened. Problems will worsen if the price of oil stays at current levels for an extended period of time.

Less Developed Country Lending

Lending to less developed countries is concentrated in the 24 biggest banks. Many of these banks have sizable concentrations in LDC loans well in excess of their primary capital accounts. We are all aware that reschedulings, primarily through the IMF, have served to buy time. However, the long-term solution to the loan problems in most of these countries is true economic reform in the debtor country. Capital flight must be discouraged and productive foreign exchange generating investment must be encouraged. The Baker initative is a step in the right direction. Some signs of economic reform are now visible, particularly in Argentina and Brazil. Lower interest rate levels will help all LDC borrowers. The decline in the price of oil is a two edged sword, benefitting most LDC's but hurting the oil exporters, Mexico, Venezuela and Nigeria. LDC loan problems will persist for many years. All three Federal regulators have taken positive action. Capital ratios at the big banks have been increased. Loan valuation reserves have also been increased although more is needed. In this regard the proposal to eliminate tax deductibility of these loan reserves is not helpful. The LDC lending problem is serious, but it is less serious than it was three years ago. In our opinion the problem is manageable.

Needed Legislation

Let me now speak of the urgent need to extend and improve the bank acquisition provisions of the Garn-St Germain Act of 1982 that expires in less than one week. The current provisions provide for out-of-state purchases of failed commercial banks and failed or failing mutual savings banks with assets of $500 million or more. These provisions have materially increased the FDIC's options in handling several bank failures. In February of this year, for example, they were used in the failure of Park Bank in Florida, and at least $37 million was saved by the FDIC as a result of this transaction alone.

But these provisions have significant limitations. Eligible commercial banks, may be acquired only if they are closed. In contrast, an eligible mutual savings bank may be acquired prior to closing. Absent specific state legislation, existing law does not provide for acquisition of holding company affiliates of a failed or failing bank. In addition, if a bank is acquired by an out-of-state bank holding company, the bank may expand throughout the state by branching if permitted, but not by holding company acquisitions. This means in unit banking states, the out-of-state bank holding company's entry is limited to the site of the bank it acquires. This is a major disincentive to acquisitions in unit banking states.

As a result, we believe the law needs not only to be extended but also to be broadened and improved. Our purpose is to provide the FDIC greater flexibility in order to reduce the cost to the Federal Deposit Insurance Fund, minimize disruption of financial services to the communities involved, and maintain the safety and soundness of the banking system as a whole.

Briefly, our proposal would do four things. First, it would lower the size threshold of a bank eligible for acquisition. Second, it would permit the acquisition of failing as well as failed commercial banks. Third, it would extend the scope of the provision to include bank holding company systems as well as banks. Fourth, it would require equal treatment for acquiring banks in the state of acquisition.

Now for some specifics. The existing interstate provision works this way. When a bank of $500 million or more in total assets is closed, the FDIC, as receiver, may arrange the sale of assets and assumption of liabilities of the closed bank by an out-of-state bank or holding company. The $500 million threshold is too high a hurdle, as most troubled banks are considerably smaller. We propose a reduction to at least $250 million. We are finding that it is becoming ever more difficult to arrange within state purchase and assumption transactions, and the transactions we do arrange are now on average more costly to the insurance fund. Energy sector banks are of particular concern. Reducing the $250 million limit will permit us to arrange acquisition transactions that otherwise might not occur.

Second, arranging an assistance transaction for failing banks before failure can be cost effective. Franchise value would be less eroded by the flight of bank customers and tax loss benefits are retained. In addition, the process of decline into insolvency that can create a ripple effect in the financial community may be avoided. Thus, an out-of-State acquisition should be permitted not only for failed banks, but also for banks in danger of closing. We would define a bank "in danger of closing" as a bank that is no longer viable and able to adequately serve the needs of its community. This would increase the potential for finding a private solution with a lesser commitment of FDIC funds, while reducing community disruption.

Third, an out-of-state holding company should have the ability to buy the stock of the failing bank and to buy stock of any of the bank's affiliates. The existing law suffers from the serious defect of not providing for the situation where a failing bank is an integral part of a larger banking organization. This failure could result in the dismemberment of existing established systems with disruptive effects in the local community.

Fourth, the out-of-state purchaser should be accorded all of the branching and acquisition rights of any other holding company operating in the state of the acquired bank or holding company. To do any less would discourage purchasers of failing or closed banks in unit banking states.

The current law contains a number of safeguards developed when these provisions were enacted in 1982. These include notice to and an opportunity for objections by the State banking supervisor and rebidding procedures under certain circumstances. We believe these are appropriate if the FDIC is providing assistance.

We have worked with the Federal Reserve Board and the Office of the Comptroller of the Currency in preparing the proposal. Both agencies are in agreement as to the need for the legislation.

While the improvement of the interstate provisions of the Garn-St Germain Act of 1982 is the most pressing of needed legislation because of the April 15 expiration, we also need additional help both in the form of failure management legislation and legislation to help prevent failures from occuring. I will briefly touch on some of these legislative proposals, which I outlined in testimony before the Committee on Banking, Housing and Urban Affairs of the United States Senate, on March 13.

The FDIC needs more time to handle failed or failing institutions. As regional and interstate banking become the pattern in the country, more time to assemble bidders is necessary. Sudden systemic disruptions to sectors of our economy also argue for the FDIC to have conservatorship and bridge bank powers. A Federal depositor preference statute is also important. This would allow the FDIC to handle more small bank failures as purchase and assumption transactions and facilitate the handling of a large failed bank by overcoming the problem of satisfying sometimes considerable nondeposit liabilities, particularly in connection with guarantees, off balance sheet activities and litigation.

Finally, but not least important, the traditional independence of bank regulators is threatened. The bank supervisory system must remain independent in order to quickly respond to fast changing events in a nonpartisan manner.

Deregulation requires vigilant supervision. The increased competition among banks and between banks and other institutions, including nonbank banks, has narrowed profit margins and, possibly, encouraged risk taking. Ownership of nonbank banks presents conflict of interest possibilities which must be monitored. A quality examination staff is critically needed to evaluate these risks. Extensive lending problems in the farm, oil and gas, and less developed country sectors require additional supervision of the best quality. After 36 years, the Office of Management and Budget has suddenly asserted new (and we believe unfounded) jurisdiction over the FDIC, the Comptroller of the Currency and the Federal Home Loan Bank Board under the Antideficiency Act of 1950. The Congress should move immediately to exempt the three Federal institutions from asserted OMB control in order to maintain independence, competence and flexibility in the regulators' operation. In doing so, the Congress is well aware that the regulatory agencies are self-funded and do not require taxpayer dollars. Oversight of agency budgets should remain under the Congress.