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Statement by

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I welcome the opportunity to appear before this Committee today on behalf of the Federal Reserve Board to discuss the condition of our nation's banking system.

This morning, I will review the general conditions and trends affecting the health of our nation's banking organizations and then discuss some of the financial and supervisory issues raised in your letter of invitation. I will also describe the supervisory steps we have taken to improve conditions in the banking system. In response to the Committee's request, the federal banking agencies have provided a large volume of financial data to the Committee's staff. Limitations of time and space do not permit me to cover all of this information in detail.

Overview of Banking Conditions

Conditions in the banking system tend to mirror conditions in the economy. We are now in the longest economic recovery in postwar history, and one might reasonably expect the condition of the banking system and measures of its aggregate performance to reflect that strength. Unfortunately, these aggregates may be deceiving because certain regions and sectors of our economy have been beset by serious structural problems over the last several years. For example, the rise of the dollar in the early 1980s hurt industries and firms in the Northeast and Midwest that depended on exports. Moreover, weaknesses in the agricultural and energy sectors of our economy have spread distress in the Midwest and Southwest regions of the country.

The resulting problems for the banking system have been aggravated by restrictions on geographic expansion that have left a large segment of our banking industry vulnerable to local and regional economic problems. Thus, despite a generally strong economic recovery, many financial institutions are under severe financial stress.

Beyond these regional and sectoral developments, our banking system has been buffeted during the 1980s by general forces and specific events that have challenged bank managers and supervisors alike. The industry has had to cope with unusual volatility in interest rates, exchange rates, and commodity prices. Moreover, during this period, many developing countries have experienced significant financial and economic problems -- a situation that has adversely affected the earnings and asset quality of our larger institutions.

In addition, competition in banking and the more broadly defined financial services industry has intensified, both at home and abroad. The change brought on by deregulation, product innovation, and technological advances can only enhance long-run efficiency, but in the short-run it has raised the costs and increased the pressures faced by the banking industry.

On top of all of this, debt has mounted rapidly. Households, businesses, and governments have taken on heavier debt loads, and in the process, the relationship between the volume of outstanding debt and the equity and earnings of borrowers to support that debt have worsened. In short, this development has contributed to weaknesses in asset quality and a corresponding increase in the risks faced by banks and other providers of credit.

In light of these developments, it is not surprising that major segments of the banking industry today confront significant problems and challenges. Indeed, 1987 was an extremely difficult year for our banking system as total nonperforming loans increased, earnings declined, and the number of problem banks and bank failures reached record highs.

While many banks continue to face serious problems, the vast majority of all institutions have been able to cope with the challenges confronting them and they are resolving their difficulties. Our economy continues to grow, and conditions in the agricultural sector have begun to improve. Growth of exports has helped strengthen our industrial and manufacturing sectors. Against this background, many institutions have seen their earnings and their asset quality improve. In sum, the banking system is basically sound, but it will continue to face many challenges in the coming years.

Regional and Sectoral Problems

Depressed conditions in the energy sector have resulted in enormous losses on energy loans and more recently on commercial real estate loans for banking organizations in the Southwest. Of the total of 2,870 banks in this region, 1,017 lost money last year; these losses meant a negative return on assets of 0.64 percent for banks in the Southwest. Nonperforming assets of the region's banks rose significantly. Real estate loans accounted for much of the increase, and, according to the available evidence, property values in many Texas markets have not yet bottomed out. The heavy losses of the last several years have eroded the capital of banking organizations in the region, forcing many to recapitalize or to restructure, and in some cases to seek supervisory assistance. While progress is being made, we still have a way to go before the problems in the Southwest will be behind us.

Similarly, banks operating in the farm belt or serving agricultural communities have shared the distress in the agricultural sector. Fortunately, 1987 saw a turn for the better. Farm commodity prices rose, production expanded, and farm income increased. Farmland values, which had been declining for a number of years, also began to rise. Last year, the aggregate net worth of farmers increased for the first time since 1980.

Improvements in the farm sector helped to relieve the pressures on banks serving farm communities. The profitability of farm banks, as measured by return on assets, rose on average from 0.34 percent in 1986 to 0.65 percent in 1987. The ratio of nonperforming assets to total assets also declined from a high of 2.2 percent in 1985 to 1.4 percent by the end of 1987. Finally, the capital ratios of farm banks also improved in 1987.

Another area of concern, which appears to cut across regional boundaries, is commercial real estate lending. In many locations, the supply of new office buildings has far outstripped the demand. Vacancy rates in many downtown and suburban office building markets are currently at or near record highs. As a consequence, some financial institutions that lent heavily during the construction boom are now experiencing credit difficulties. While the most serious problems appear to be concentrated in the Southwest markets that also suffer from problems in the energy sector, they are by no means confined to that region. Problems have begun to surface in the Southeast and elsewhere.

An area that bears watching in the future is leveraged buyout financing. While LBO financing offers the potential for attractive returns, it also poses high risks because it involves lending on a highly leveraged basis. As with any other type of lending, success depends on the quality of the credit analysis and on the manner in which the transactions are structured and financed. At this juncture, special caution is in order because LBO financing is a fairly new activity for banks and has yet to be tested in an environment of high interest rates or economic recession.

The International Debt Situation

The international debt situation significantly affected income statements and balance sheets of many multinational and regional banking organizations. In this area circumstances change frequently and progress is interrupted all too often. Despite these setbacks, meaningful progress has been achieved. For example, leaders in a number of borrowing countries have recognized the need to restructure their economies by placing greater emphasis on the private sector; by reducing trade barriers, public sector deficits, and unnecessary government restrictions; and by improving their external trade accounts and economic growth. Moreover, the large amount of capital raised by U.S. banks in recent years has reduced the size of their exposure to developing countries in relation to their capital bases.

Last year Brazil suspended interest payments on its medium- and long-term foreign-currency obligations. In response to this development and to uncertainties about the status of loans to other developing countries, banking organizations began to recognize formally the increased risk in their credits to developing countries. Virtually all of the larger banking organizations took substantial loan loss provisions, and loans to Brazil and some other countries were placed in nonaccrual status. The result was that, at the larger banking organizations, earnings turned sharply negative, nonperforming asset ratios soared, and equity capital ratios declined.

Brazil's leaders have acknowledged that the moratorium did not serve their country's interests. Indeed, Brazil recently made some interest payments on these loans, and is normalizing relations with its creditors in a constructive manner. The resumption of interest payments by Brazil reinforced the view that interruptions of interest payments are not a solution to the international debt problem. This offers promise for the continued cooperation of the parties involved in the years ahead.

Recently, a number of options have been developed that can help banks manage their exposure to developing countries, as well as help those countries reduce their outstanding debts. For example, banks have sold funds to companies seeking to invest in developing countries, engaged in debt-for-equity swaps for their own account, and exchanged part of their debt obligations for securities.

The Federal Reserve has also provided greater flexibility to U.S. banks by liberalizing regulations dealing with debt-for-equity swaps. Some regional banking organizations have significantly reduced their exposure by coupling increases in loan loss provisions last year with sales of developing country loans in the secondary market. A few smaller banks have exercised the option to withdraw from new money packages via so-called exit instruments -- for example, in connection with the recent Mexican exchange offer -- but such instruments have not yet gained wide acceptance.

Despite the progress that the borrowing countries themselves have made, and despite the options bankers have developed for managing their risk exposure, we have a long way to go before the LDC debt problem will be resolved. In the Board's view, the case-by-case approach put forward by Secretary Baker remains the best solution to these problems. It focuses on a revival of economic growth to enhance the debt-service capacity of the debtor countries and calls upon the commercial banks to sustain their lending while the countries regain access to international capital markets. In addition, the multilateral financial organizations are to provide their expertise and financial resources to help the countries to bring about external adjustment within a context of economic growth.

The Performance of the Banking Industry

Let me address now the performance of the banking industry in 1987. I will focus on the areas identified in the Committee's letter of invitation.

Asset Quality. As noted earlier, asset quality has been the greatest problem facing the industry. Last year, the ratio of nonperforming assets to total assets -- a key indicator of asset quality -- reached a postwar high. For all insured commercial banks, this ratio rose from 1.6 percent in 1986 to 2.1 percent at the end of 1987; for the 17 multinational bank holding companies, the ratio increased from 2.2 percent to 3.6 percent of total assets. The principal reasons for the increase were the placement of a large amount of LDC debt in nonaccrual status and the continuing energy- and real estate-related problems in the Southwest.

The asset quality picture has a positive side, however. If we set aside the effect of LDC nonaccruals and the problems in Texas, we find that domestic asset quality, as measured by the nonperforming asset ratio, improved last year. This improvement occurred despite the worsening of problems in the real estate sector. For example, after making these adjustments, the nonperforming asset ratio for the 17 multinational bank holding companies declined from 2.1 percent in 1986 to 1.8 percent last year. For banks under $1 billion in total assets, the ratio declined to its lowest level in five years. Another indicator of asset quality, the ratio of net loan charge-offs to total loans, confirms this trend. The net loan loss ratio for all insured commercial banks decreased 6 basis points in 1987 to 0.93 percent of average loans. Significant declines occurred also at banks with assets under $1 billion.

While these trends permit cautious optimism in the outlook for asset quality, both nonperforming asset ratios and charge-off ratios remain high. This is troublesome when we consider that we are in the sixth year of an economic expansion. In the past, bank asset quality has shown improvement at earlier stages of the economic recovery. Obviously, any unforeseen shocks or economic reversals could have serious negative implications for the loan portfolios of some banking organizations.

Profitability. Not surprisingly, the high level of problem assets has eroded the profitability of the banking industry in recent years. In 1987, the average return on assets for all insured commercial banks declined almost 50 basis points to 0.12 percent, and the average return on equity dropped a precipitous 750 basis points to 2.02 percent.

These aggregate measures of industry profitability mask disparities in the performance of banks in different size groups and in different regions of the country. The special LDC provisions taken last year caused significant losses or declines in earnings at the large multinational and regional institutions. Indeed, the average return on assets for the 25 largest banks declined from 0.51 percent in 1986 to a negative 0.79 percent last year. And, as I have indicated, banking organizations in the Southwest continued to experience substantial losses. Yet despite the dismal earnings performance of the industry as a whole last year, many institutions remained profitable. Over half of all insured commercial banks had returns on assets of 0.81 percent or more. Many organizations that maintained well-balanced portfolios and avoided excessive exposure in certain problem areas reported strong earnings. In addition, outside of the Southwest, banks with assets of less than $1 billion generally reported improved returns on assets and equity, reversing several years of declining profitability.

Some of the very largest banking organizations have cushioned the impact of credit quality problems on profitability by changing the composition of their revenues. These banks have achieved a robust growth in noninterest income, reflecting their emphasis on fee-based services, such as investment banking, securities processing, and cash management. Nonrecurring transactions such as asset sales have also boosted the earnings of many larger organizations, and trading account income has become an important component of revenue.

First-quarter earnings reports reflect an improvement over last year's depressed levels. While data are not available for all banks, the average return on assets for state member banks rose to an annualized rate of 1.00 percent. The profits of the 17 multinational bank holding companies were also up significantly, although many still relied heavily on nonrecurring gains. In general, aggregate bank profits should recover in 1988 from last year's depressed level because of lower loan loss reserves, tax benefits, and cost control and restructuring programs implemented by many institutions.

Capital. Although capital has long been an issue in the banking industry, it took on greater significance in 1987 because of the heavy losses sustained by many of the largest organizations. In 1987, the average ratio of equity capital (excluding loan loss reserves) to total assets for the 25 largest commercial banks declined from 5.1 percent to 4.3 percent. This decline marks a reversal of six years of steady improvement for this group. The ratio of equity capital to total assets also declined significantly for banks in the Southwest. For the remainder of the industry, however, ratios of equity to assets generally improved in 1987.

The ratio of primary capital, which includes loan loss reserves, to total assets for all insured commercial banks increased 49 basis points to 7.8 percent at the end of 1987. Much of this increase was accounted for by the increase in loan loss reserves, a result of the special LDC provisions.

The recent decline in equity capital ratios at our larger institutions, stemming from the heavy losses related to the LDC situation, has stirred understandable concern. But, one of the principal functions of capital is precisely to absorb losses and cushion other financial adversities. In this connection, the capital guidelines program that the federal banking agencies initiated in 1981 to encourage banks to strengthen their capital positions has proved beneficial and timely, for it clearly has put banks in a better position to withstand the financial pressures and problems that have confronted our banking system over the last several years.

Liquidity. We believe that the levels and trends of liquidity within the banking system are generally satisfactory. At the same time, some financially troubled banking organizations have experienced liquidity difficulties. In general, such organizations can obtain the funds they need to continue operations but, to do so, they typically must pay premiums over market rates. For some time, this has been the case for banking and thrift organizations operating in Texas. Unfortunately, the high premiums that weak institutions often pay compel healthy banks to raise their offering rates for deposits and other funds in order to compete with the weak institutions.

Let me stress, however, that liquidity has not been a problem in the system generally. The events surrounding the stock market collapse of last October underscored this point. During the week of October 19th, concern arose that liquidity in the banking system would dry up as a result of doubts about the creditworthiness of major market participants. Nevertheless, banks were responsive to the legitimate funding needs of their customers, and no large-scale liquidity problems developed. As you know, the Federal Reserve stood ready to provide the liquidity needed to prevent isolated problems from spreading through the financial system.

Problem and Failed Institutions

The problems and conditions I have described have resulted in a steady increase in the number of problem and failed banks since 1981. The number of institutions on the list of FDIC-insured problem banks and thrift institutions rose from 223 in 1981 to 1,575 at the end of 1987. Of that total, over 95 percent had assets of less than $300 million; and 88 percent were located where problems in the farm, energy, and real estate sectors have been most acute. In particular, the number of FDIC-insured problem institutions in the Southwest -- Texas, Oklahoma, Louisiana, Arkansas, and New Mexico -- increased significantly last year, more than offsetting an encouraging decline in the number of problem institutions in the Eastern and Central regions of the country.

Last year, 184 FDIC-insured institutions were closed and another 19 were granted open bank assistance, compared with 138 and 7, respectively, in 1986. In 1981, these figures stood at 7 closings and 3 assistance transactions. The results for last year show that 90 percent of failures and open bank assistance transactions occurred west of the Mississippi. While bank closings and open bank assistance transactions declined somewhat in the Midwest last year, the situation in the West and Southwest continued to deteriorate. In these regions, the number of closings and open bank assistance transactions increased from 84 in 1986 to 145 last year. Sixty percent of all bank failures in 1987 were located in only four states: Texas, Oklahoma, Louisiana, and Colorado. With respect to the commercial banks under the supervision of the Federal Reserve, 10 state member banks failed in 1987 versus 11 the previous year. So far this year the number of state member bank closings is larger than it was at the same point in 1986.

As these figures suggest, the problems have centered in states that historically have strictly limited branching and other forms of geographic expansion. In addition, federal restrictions have prevented institutions from expanding across state lines. These limits have severely hampered our financial institutions in diversifying their portfolios and, therefore, have left them more vulnerable to sectoral and regional economic strains.

We will all agree that the number of bank failures is too high, and much work needs to be done to address the conditions I have described. While we have begun to see some improvement in domestic asset quality at many institutions outside the Southwest, the continuing high level of problem assets suggests that we are unlikely to see any decline in the number of bank failures this year.

Supervisory and Regulatory Initiatives

The Federal Reserve has taken steps over the last several years to strengthen its ability to identify and address problems in the banking system. These steps include more frequent on-site examinations of large and problem banking organizations, more frequent meetings between Reserve Bank officials and bank directors, improvements in techniques for communicating with management and directors, the strengthening of supervisory enforcement programs for addressing mismanagement and unsound banking practices, the expansion of cooperative examination arrangements with state banking departments, and enhancement of examiner training programs. We have also tightened our standards for reviewing and approving applications of new banks to become members of the Federal Reserve System.

While structural and regional economic problems are major factors in explaining the high level of bank failures, we find that mismanagement, insider abuse, and criminal misconduct have played a role in many bank closings. To address these problems, the banking agencies have worked with the law enforcement agencies to improve our ability to detect improper banking practices and to identify, refer, investigate, and prosecute instances of white collar crime involving commercial banks. This program has resulted in more enforcement actions and criminal referrals. In the future, the banking and law enforcement agencies must continue to work diligently to address these problems.

The Federal Reserve has supported these efforts by devoting additional resources to the supervision function and by augmenting its force of supervisory personnel and field examiners. However, the problems we have faced have worsened in both number and kind. We believe the steps we have taken will prove helpful, but we will not be satisfied until the number of problem banks and bank failures is controlled. While it is not expected, any further deterioration in the banking industry could strain our resources and require more funds for the supervision and regulation function, as well as the expansion of our cadre of supervisors and field examiners.

Capital Adequacy. The Federal Reserve consistently stresses the role of capital in promoting the safety and soundness of our banking and financial system. Organizations experiencing financial problems, including weaknesses in earnings and deficiencies in asset quality, have been required to develop and implement plans to broaden their capital bases.

Mergers and Acquisitions. Capital adequacy is especially important in evaluating the proposals of bank holding companies to expand. The Board has long believed that banking organizations undertaking marked expansion or large acquisitions should maintain strong capital positions, well above minimum supervisory levels. Thus, the Board requires organizations making major acquisitions to support these plans with adequate capital, and it has discouraged merger transactions that weaken the capital position of the combined entity. In addition, in acting on merger applications, the Board has discouraged the use of accounting techniques or financial strategies intended to justify the payout or distribution of capital funds to shareholders when these resources may be needed to support the financial base of the merged organization.

Dividend Policy. In addition, we have discouraged excessive or unwarranted increases in dividends by banking organizations whose capital positions need strengthening. Indeed, the Federal Reserve has a fundamental policy that banking organizations under financial strain should consider reducing or even eliminating cash dividends in the absence of effective alternatives for raising capital.

Bank Holding Companies. In line with this emphasis on capital adequacy, the Board reiterated, in April of last year, its longstanding regulatory policy that bank holding companies should act as sources of strength to their subsidiary banks by standing ready to provide capital funds during times of financial stress.

Risk-Based Capital Proposal. The federal banking agencies have undertaken to strengthen supervisory standards for assessing capital adequacy through the development of an internationally accepted, risk-based capital framework.

This framework will help to achieve two important policy objectives of the Federal Reserve. First, it will encourage international banking organizations to strengthen their capital positions when necessary, taking into account off-balance-sheet exposure as well as conventional loans and investments. Second, the framework will serve to narrow competitive inequalities for international banking organizations stemming from differences in national supervisory requirements. This objective is particularly important in view of the internationalization of banking and financial markets.

The risk-based capital proposal establishes a common international framework for defining an organization's capital base that emphasizes core stockholders' equity. It also establishes procedures for factoring into the supervisory evaluation of capital needs, the riskiness of assets and off-balance-sheet exposures. In addition, the proposal sets out a schedule for achieving a minimum ratio of total capital to weighted risk assets: it is to be 7.25 percent by year-end 1990, of which at least 3.25 percentage points are to be in the form of common equity capital; and by the end of 1992, it is to be 8.0 percent, of which at least 4.0 percentage points must be common equity capital. The risk-based framework is still in the proposal stage, and the Board is currently reviewing comments and resolving the outstanding issues. We hope to implement the framework in conjunction with the other major industrial countries by year-end.

In general, the overwhelming majority of community and regional banking organizations will have little difficulty meeting the standards incorporated in the proposal. However, organizations whose capital positions are under pressures due to poor earnings, large loan losses, rapid growth, or excessive risk exposure may have to temper their growth, alter their asset mix, or raise additional capital to meet the minimum standards. As a rule, we believe banking organizations should endeavor to operate above these standards in order to maintain a critical buffer during periods of financial strain or adversity.

One of the major issues surrounding the requirements for risk-based capital is whether they will compromise the banking industry's ability to compete. The competitiveness of our banking system is, of course, a matter of concern to the Board. Clearly, it would be counterproductive to adopt a framework that would undermine the competitive position of our nation's banks. But, in the long-run, only a well-capitalized banking system can be a competitive and healthy banking system. Indeed, we have found that banking organizations with strong capital positions are the most effective competitors. Strong capital positions may actually give institutions a competitive advantage as customers, depositors, and investors seek stability and strength in their banks.

Expanded Powers

Although we believe that all these efforts will strengthen our banking institutions and make them more resistant to financial pressures, there are, of course, limits on what regulators can do unilaterally to deal effectively with the problems confronting our banking system. Congress has a key role to play in establishing an appropriate legal framework. The Board strongly supports Senator Proxmire's financial modernization bill, which would broaden the range of securities activities permissible for banking organizations by repealing the Glass-Steagall Act's separation of commercial and investment banking. This legislation will not only produce important public benefits, it will also enable banks to compete more effectively and broaden their sources of income. In addition, the serious problems experienced by banks in the Midwest and Southwest underscore the need to encourage greater diversification in our banking and financial system. Thus, it is essential that we continue to move ahead on interstate banking so that banks will be able to diversify their loan portfolios and deposit bases, thereby making themselves less vulnerable to regional economic difficulties.

Conclusion

In reviewing the year's events and the aggregate data on bank performance, one could easily conclude that banking is not a very good business to be in these days. However, that conclusion would be incorrect. To be sure, banking is no longer a highly protected and sheltered industry. Competition and deregulation have altered the dynamics of the industry and have created an environment in which now there are clear winners and losers. This new reality is evident behind the aggregate statistics, in the results for individual companies. We find that although many banking organizations reported very poor results in recent years, many others have turned in exceptionally strong performances. The large interstate banking organizations operating in the Southeast, New England, and the Middle Atlantic states are cases in point.

In recent years the problems in the banking sector have received a good deal of attention, as indeed they should. But, all too little attention has been given to the positive developments within the industry.

First of all, the ability of the overwhelming majority of institutions to absorb the severe shocks and stresses of recent years reflects their underlying strength and that of the banking system as a whole.

Second, bank managements have focused on the need to improve operations. They are rethinking their strategies and moving to restructure and streamline operations in order to meet the competitive challenges and enhance their profitability. They are focusing on improving credit analysis and on strengthening lending standards and risk-control systems. The capital positions of many of the larger money-center institutions are also being strengthened in order to meet the demands of the market and to comply with the proposed risk-based capital standards.

We are beginning to see some improvement in the asset quality of the domestic loan portfolios of banking institutions outside of the Southwest. While long overdue, this improvement should translate into better earnings performances. Earnings in the first quarter of this year appear to support this view. Yet, despite the positive signs, much work remains to be done by bank managers and supervisors alike before we can fairly say that the problems that beset many of our banking organizations are behind us.