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Statement by

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Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

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I am pleased to meet with this Committee to present the views of the Board of Governors on the condition of the banking system and to address the general areas covered in your letter of invitation. The Federal Reserve staff has worked with the other depository institution regulatory agencies and members of your staff to provide financial information and data on the condition of U.S. banking organizations. It is not my intent here to review all of these data in detail; rather, I intend to discuss our views on broad developments and conditions in the banking system and what supervisory steps we have taken to address these conditions.

In looking at the financial condition of the banking system, it is important to consider the environment within which banking organizations have been operating in recent years. Without question, the environment has been a difficult one -- characterized by considerable financial stress and volatility. As a consequence, many institutions, many segments of the industry, and, indeed, the industry as a whole have experienced rising levels of loan charge-offs and classified assets and, of course, the number of problem banks and failed banks has also increased significantly.

These problems are rooted in several causes. One, undoubtedly, is the transition to a less inflationary environment. As you know, inflation rates have drifted from double-digit levels in the late 1970s and early 1980s to low single-digit levels in each of the last several years. Unfortunately, inflationary expectations supported many farm, energy, and real estate loans that, in hindsight, we now know were not viable. This situation was aggravated by steep back-to-back recessions in the early 1980s that left a legacy of troubled loans, even as the economy began to recover in late 1982. A second type of economic transition--from a weak dollar to a strong dollar--struck hard at another large segment of the banking industry's customer base: manufacturers of internationally traded goods. Finally, the transition from a period of low or negative real interest rates and expanding export markets to a period of high real interest rates and declining export revenues, coupled with other factors, left many borrowers in less developed countries in weakened positions.

During this period, banks also have been confronted with competitive challenges from several directions. Thrifts, foreign banks, and even nondepository financial institutions have emerged as formidable competitors in many areas. The direct issuance of securities has proven to be a less expensive and more efficient form of financing than bank loans for many of the banking industry's prime customers. And, the deregulation of interest rates and the dismantling of geographic barriers have placed pressure on the margins of some institutions, although these developments should lead to a more sound and efficient banking system over time.

All of this was compounded by the inclination on the part of some depository institution managers to assume excessive risks with federally-insured deposits in the hope that the expected high rewards would accrue to investors. By far the majority of banking organizations are well-managed; however, mismanagement, improper lending practices, and other forms of excessive risk-taking have contributed to financial problems and the failure of a number of institutions.

Yet, despite these economic dislocations, problems and competitive challenges, most banking organizations remain fundamentally sound, and it is important not to lose sight of the important elements of strength that underlie our banking system. To be sure, asset quality problems remain and segments of the industry have been weakened by troubled farm, energy, real estate and foreign loans. On the other hand, many institutions continue to record favorable operating results, and the industry as a whole (and particularly the group of larger institutions) continues to build its capital strength. Indeed, I suspect that many institutions that have withstood the recent pressures on the industry may emerge in a much stronger competitive position.

Asset Quality

Asset quality difficulties have contributed to the prevailing unease about the health of the banking system. Loan problems and loan losses have increased during the past few years, despite more than four full years of economic expansion. This experience is especially troublesome and contrary to that of recent decades. In past periods of recession and recovery, a consistent pattern was observed: loan losses increased during the recession and immediately afterwards, but then improved as economic growth resumed. The relatively high level of troubled assets at some banks at this point in the recovery suggests that any major unforeseen economic or financial shocks could test the resiliency and solvency of the most vulnerable institutions.

The failure of asset quality to improve during the current economic expansion is due to special national and international economic conditions that have adversely affected particular borrowing sectors. The most obvious examples domestically are the agricultural and energy sectors. In the late 1970s and early 1980s, borrowers in these sectors took on large amounts of debt that could not be serviced when conditions subsequently deteriorated. While the wringing out of inflation had an important positive impact on the economy as a whole, the declines in the value of farm property and the price of oil led to an increase in the level of delinquencies and defaults on bank loans.

Depressed conditions in these two sectors have created serious problems in certain geographic areas. Particularly hard hit have been banks in the farmbelt states of the midwest and the energy-dependent states in the southwest. Asset quality measures of banks in these areas are generally lower than those of banks in other parts of the country.

Nonetheless, there are some signs that conditions may be stabilizing. The price of oil has recovered somewhat from very low levels, and in some areas the decline in farm asset prices has leveled off. While adverse effects on banks that lend heavily to these sectors will continue, we have, I believe, begun to work through these problems, and absent any unanticipated shocks, the worst may be behind us in these sectors.

We need to maintain our vigilance, though, over these and other areas of the loan portfolio. In parts of our country that witnessed the energy boom and bust, problems have spilled over into the real estate industry. New construction, especially for downtown office buildings, has finally slowed and even come to a virtual stop in some energy-area markets, such as Houston. Nonetheless, these markets remain depressed, with a large relative supply of available office space. Moreover, while construction has slowed in these markets, it has not done so in the aggregate. In 1986, real estate construction loans held by banks grew by nearly 20 percent, while total loans grew by less than 8 percent. Over the last three years, construction loan growth averaged 21 percent, compared with a total loan growth average of 10 percent. Thus, the banking industry remains highly exposed to conditions in the real estate market. Although 1986 witnessed some improvement in real estate vacancy rates, they remain relatively high by historical standards.

One additional area of the domestic loan portfolio that bears continued attention in the future is that of credit card loans. In recent years, many banks have solicited new accounts in a very aggressive fashion and have purchased existing accounts. These methods of securing new accounts have resulted in historically high charge-off rates. Although there is evidence that such rates may be peaking, losses are expected to remain high and many credit card portfolios remain vulnerable to narrowing margins and possible increased delinquencies.

An important determinant of asset quality at the major money center banks and some regional institutions continues to be the debt problems of the less developed countries. The adjustment process they have undergone has been painful and the difficulties facing these borrowers remain serious; nonetheless, some progress has been made in dealing with this situation. Despite some significant exceptions, most countries have been able to service their indebtedness over the last four and a half years. During this period, banks have been able to significantly improve their ability to absorb any losses from their loans to countries with debt problems. Since 1982, the capital of the 50 largest U.S. banking organizations has roughly doubled while exposure to troubled LDC borrowers has actually declined slightly. Thus, their exposure to the heavily indebted countries relative to their capital bases has declined sharply.

At the same time, many borrowing countries have made progress in strengthening their economies and their ability to service their external obligations. Most of these economies now are experiencing real growth, reducing their combined current account deficits considerably, and instituting many needed economic reforms. In the case of some countries, this has been achieved despite a significant decline in commodity prices and export revenues. In my view, the international debt problem has been managed through an extraordinary cooperative effort by borrowing countries, the international banking community, multilateral financial institutions and creditor governments. Moreover, while banks have shown a willingness to work with countries that undertake appropriate adjustment policies, this has been done without an excessive build-up of additional debt. The external debts of heavily indebted developing countries have increased at only a 3-1/2 percent annual rate over the past four years which, under normal circumstances, would imply declining debt burdens.

While I believe we are on a track that offers a reasonable prospect of long-run success, this is not to say, of course, that individual countries will not experience renewed problems from time to time. For example, Brazil is now facing a resumption of serious inflationary pressures which, with other factors, has led to a curtailment of debt service. It will take, no doubt, the concerted effort of Brazil and all of its creditors to manage this situation. Nonetheless, despite the impact that the international debt situation has had on bank earnings and asset quality, U.S. banks to date have proved able to cope with the effects of foreign debt problems and, in particular, with Brazil's moratorium on interest rate payments.

It is important to note that events of recent days underscore the prudence and wisdom of efforts, over the last several years, to strengthen the capital bases of our larger institutions. The support of Congress, as manifested in the International Lending Supervision Act of 1983, together with actions by both bankers and regulators in recent years, have resulted in significantly higher capital levels at most of our larger banking organizations. This should enable banks to withstand the pressures stemming from international lending difficulties of the type being experienced by Brazil. Indeed, it is a fundamental function of capital to absorb losses stemming from unanticipated shocks while maintaining confidence in the banking system. Although the difficulties facing many foreign borrowers are significant, the problems in Brazil should not obscure the progress made with other debtors. During 1987, new lending agreements have been signed or tentatively agreed to with Mexico, Chile, Venezuela, Argentina and the Philippines.

Having generally reviewed those segments of the loan portfolio that have been cause for concern in recent years, I would now like to address briefly recent trends in certain broad indicators of loan quality.

Overall, loan losses trended upward for most of this decade. For all insured commercial banks, the ratio of net charge-offs to average total loans has increased steadily since 1981; by year-end 1986, it had reached nearly one percent, an unusually high level for the industry as a whole.

Looking at specific size classes of banks, we find that the overall trend describes accurately each size group. No size class has fully escaped the general deterioration in asset quality, although some have done better than others.

In general, banks with assets of less than $100 million have the highest relative level of loan losses. The problems experienced by smaller banks largely reflects the relatively high concentration of agricultural credits in many of these institutions. The smaller regional banks, those with assets of between $1 billion and $5 billion dollars, have had the best performance, relatively speaking.

Nonperforming assets give some general idea of the level of problems in the loan portfolio. Nonperforming assets have increased or remained at relatively high levels in the last several years despite the extraordinarily high level of loan charge-offs over this same period. Among the various size groups of banks, nonperforming asset ratios are generally highest at the largest and the smallest banks. At year end 1986, for example, nonperforming assets averaged 2.34 percent of total assets for the 25 largest banks, up from 2.25 percent a year earlier.[1] For the smaller banks, those with assets of less than $300 million, the nonperforming ratio stood at 2.09 percent, unchanged from the prior year-end level. As I have already suggested, nonperforming assets are higher than we would like at this point in the economic cycle.

In general, the difficult period of asset quality problems through which we are passing firmly underscores, for

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[1]The figures for year-end 1986 do not include the effects of placing Brazilian debt in nonperforming status, which occurred in the first quarter of 1987.

both bankers and supervisors alike, the need for renewed attention to sound and prudent lending standards and practices, as well as the need for continued efforts to strengthen capital adequacy.

You have asked that we address the effect of "securization" on asset quality. Simply stated, a securitized loan is one in which the originator is not the ultimate investor. In a typical loan securitization, the originator sells a bundle of loans, rather than individual loans, and the loans are converted to securities backed by the loans. Of course, depository institutions can act as both buyers and sellers of securitized loans. Until now, loan securitization has occurred mainly in the residential mortgage market, where over half of all loans that are originated are subsequently securitized. Other assets that have been securitized on a much smaller scale include automobile loans, credit card receivables, lease receivables, and commercial real estate.

Securitization offers the potential benefits of diversification of credit risk, improved control over interest rate exposure, enhanced liquidity, and increased efficiency. The question of how securitization will affect asset quality, however, is difficult to answer with precision. The answer will no doubt lie ultimately in the quality of underwriting performed by those originating the loans to be securitized. The quality of lending could improve if securitization results in greater specialization and standardization in lending and if it is performed by the industry's most capable lenders. On the other hand, there is always the danger that too many institutions will attempt to participate in the securitization process and that credit underwriting standards will be compromised in the battle for market share. From a supervisory standpoint, we expect banking organizations that purchase securitized assets to conduct proper credit analyses and to assure themselves of the quality of the assets they are taking into their portfolios.

We sometimes hear that if banks securitize and sell their highest quality assets, the overall quality of bank assets will decline as relatively weaker assets that cannot be sold are retained on the balance sheet. While I see no necessary reason that banks that engage in this activity should relax their credit standards in general, examiners will, of course, continue to evaluate the condition of assets retained in selling bank portfolios, and supervisors have the latitude to require additional capital if an institution's credit profile changes as a result of such transactions.

One supervisory concern regarding securitization relates to whether the selling institution achieves a complete transfer of risk to the buyer before removing the "sold" assets from its books. Obviously, if the seller retains an explicit or implicit obligation to repurchase the securities with the aim of providing a credit guarantee or liquidity support, then the transaction has not reduced the risk to the selling institution. Moreover, if such obligations were, in fact, retained in connection with a large number of such "sales," risk could be significantly increased. To deal with this concern, we have generally recognized transactions as true sales only if the seller retains no risk of loss to its capital base. In general, if the holder of the securities has recourse to the bank, that is, if the bank is at risk, the transaction must be kept on the bank's balance sheet and the risk of loss must be backed by capital.

Earnings and Profitability

The economic difficulties and imbalances that have marked the 1980s inevitably have placed downward pressure on the earnings and profitability of the banking industry. Aggregate after tax earnings growth slowed from about an 11 percent annual rate in the 1970s to about a five percent annual rate in the first half of the 1980s, and earnings actually declined about one percent last year. Over this same period, asset and equity growth also have slowed, but more moderately. Consequently, key measures of aggregate industry profitability--return on assets and return on equity--last year fell to the lowest levels since at least 1970.

The deterioration in asset quality that I have described has been the dominant factor underlying declining industry profitability. U.S. banks' loan loss expenses, measured as a percent of average assets, have tripled since 1981. Indeed, this development accounts for much of the decline in profitability during this period. Declining interest rates have allowed banks to offset a substantial portion of their credit losses with gains from the sale of investment securities.

Profits from the sale of investment securities accounted for about one-sixth of total pre-tax income for the banking industry last year. Some of the very largest banking organizations have cushioned the impact of credit quality problems on profitability by achieving a very robust growth in other noninterest income, reflecting their increased emphasis on fee-based services, such as investment banking, securities processing, and cash management. It is not clear, however, how much these activities have contributed to the net income of these banks since data necessary to allocate certain expenses is not available. It is known that expansion of fee-based services has required substantial noninterest expenses in the form of investments in technology and the hiring of highly-paid staff. Indeed, at some of the largest banks, the growth of noninterest expense has outstripped that of noninterest income.

It is extremely important to realize, however, that much of the U.S. banking industry remains profitable. Earnings difficulties have been concentrated in the western half of the country, where the problems in the energy and agricultural sectors have loomed large and at the major multinational banks, which have been hurt by foreign loans and, in some cases, by concentrations of energy, real estate, and shipping loans. The largest banks also have been adversely affected by the loss of many of their most creditworthy customers to the securities markets and to foreign banks.

Those banks that have avoided the most serious asset quality problems generally have fared quite well. Indeed, the return on assets was at or near peak levels last year for many regional banks located in Federal Reserve Districts in the eastern half of the country. The resiliency of the banking industry is evident in data on net interest margins, that is, net interest income as a percentage of assets. Although the margins dipped somewhat last year, they remained well above the average for the 1970s. The deregulation of deposit interest rates does appear to have contributed to a narrowing of margins at smaller banks from the very high levels recorded early in this decade, but even at these banks margins generally compare favorably with historical levels. What is not clear, however, is the extent to which the attempt to earn high margins has induced banks to hold riskier loan portfolios.

Capital

While trends in banking conditions over the last few years may give rise to some uneasiness, our nation's banks, fortunately, have made considerable progress in strengthening their capital positions. This development is particularly noteworthy because capital plays a central role in fortifying the banking system. It acts as the buffer that provides protection to depositors, other creditors, and the deposit insurance fund when an institution reports negative earnings. The protection capital offers also serves to maintain confidence in the banking system as a whole.

It was only a few years ago that capital levels in the banking industry caused considerable apprehension about the ability of some banks to weather a difficult economic and financial environment. This apprehension was accentuated by the buildup in problem loans and off-balance sheet exposures that in many instances accompanied the thinning of capital cushions. Against this background, in December, 1981, the three federal bank regulatory agencies adopted formal minimum capital standards for banks and bank holding companies in order to halt the secular decline in capital ratios that had occurred and to counterbalance the increase in risk-taking that became evident during the 1970s. It is therefore comforting to note that since the adoption of the guidelines, the industry's capital base has been bolstered steadily by the issuance of common and preferred stock and long-term debt, and by the buildup of loan loss reserves.

Currently, all banks and bank holding companies must meet a minimum primary capital requirement of 5.5 percent and a minimum total capital requirement of 6.0 percent.[2] As these levels are minimums, banks normally are expected to, and in fact do, operate above them.

From our perspective, the capital guidelines have worked reasonably well. The long secular decline in bank capital ratios has been reversed. The larger banking institutions have

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[2]The principal components of primary capital are common stockholders' equity, perpetual preferred stock, loan loss reserves and certain debt instruments that must convert to stock. Total capital consists of primary capital plus secondary capital instruments--such as limited-life preferred stock and certain qualifying long-term debt securities.

made especially noteworthy improvement in their capital positions since the end of 1981. Over this period, the average primary capital ratio of the nation's 50 largest bank holding companies jumped from 4.7 percent to 7.1 percent -- which is well above the minimum guideline level of 5.5 percent. Of course, a complete assessment of capital adequacy must take account of both the quality of a banking organization's assets and the amount of any off-balance sheet exposure.

With regard to the latter, financial innovation has given birth to a wide variety of financing instruments which carry varying degrees of risk and serve different purposes but which do not find their way onto banks' balance sheets. Interest rate swaps, financial futures and options, forward rate agreements, and foreign exchange contracts are among the off balance sheet instruments banks use either to capitalize on or to hedge against interest rate and foreign exchange risks. Another group of off balance sheet items, often referred to as "direct credit substitutes," includes financial guarantees and standby letters of credit that back financial claims of third parties. A bank issuing such instruments bears essentially the same credit risk that it would have if it made a direct extension of credit to the customer. Commitments form yet another broad group of off balance sheet exposures.

The total volume of the industry's off balance sheet business is considerable. At year-end 1986, standby letters of credit issued by insured commercial banks amounted to $170 billion, foreign exchange commitments came to $893 billion, loan commitments were $571 billion, and interest rate and cross currency swaps totaled $376 billion. The numbers appear staggering, as indeed they are. However, it clearly would be inappropriate and misleading to relate the total volume of off-balance sheet exposures to the capital requirements of the banking industry. This is because in many cases the principal or face value of the instruments is not an indicator of the amount that is at risk, and because many of the assorted off balance sheet activities are used by banking institutions to reduce their exposure to risk. Therefore, it is important to look at these activities on a risk-adjusted basis.

In an attempt to provide some insight into the effect of the growth of off balance sheet items on capital trends, we have looked at a number of capital ratios adjusted for off-balance sheet risks. Based on our analysis, the capital ratios of the largest banking institutions appear to have improved over the last several years--even when off balance sheet activity is taken into consideration. For example, the ratio of primary capital to total assets including adjustments for off-balance sheet items for the 10 largest bank holding companies has climbed from 4.0 percent in December 1981 to 6.2 percent by year-end 1986. These results are not surprising given the huge amounts of new capital banks have raised over the last several years. These trends clearly demonstrate why capital, which long has been a sore point for the banking industry is becoming an important selling point for major U.S. banking institutions, which now are among the most strongly capitalized in the world.

As you may know, we have recently proposed, in conjunction with the other federal banking agencies and the Bank of England, a risk-based capital framework. In addition to factoring off-balance sheet risks into our analysis, other important objectives of this proposal are to recognize that certain liquid, low-risk assets require less capital backing than standard loans and to achieve greater convergence in the assessment of capital adequacy among countries with major financial centers. We currently do not collect all of the data necessary to calculate precisely the ratio as proposed. However, estimates for the 10 largest banking holding companies averaged approximately 6.3 percent as of June 30, 1986; by year end this figure had increased to 6.6 percent.

Capital ratios are, of course, lower if adjustment is made for problem assets. This is not surprising since one of the major functions of capital is to absorb losses resulting from problem loans. Yet, even if capital is reduced by a percentage of classified loans, we find that there has been an improvement over the 1982-1986 interval. For the 25 largest banks, for example, the average ratio of primary capital, adjusted for problem assets, to total assets increased from 4.0 percent at year-end 1982 and to 5.6 percent by year-end 1986. Some improvement in this ratio, albeit on a more modest scale, was also reported for other banks with assets of $1 billion or more. On the other hand, we noted some deterioration in this ratio for banks in the less than $300 million size category. The average for this group declined from 8.0 percent in 1982 to 7.7

percent by the end of 1986. This decline was in large part due to the disproportionate share of problem farm loans held by small banks.

An important goal of the recent joint proposal of the U.S. federal banking agencies and the Bank of England for the establishment of a risk-based capital framework was to reduce the competitive inequities that can arise when supervisory authorities in countries around the world introduce different capital requirements. I cannot emphasize strongly enough our interest in the competitiveness of U.S. banks. Only a strong, competitive and profitable banking system can remain healthy in the long run and fulfill the strategic role banks play in our economic and financial system. Thus, the Federal Reserve is committed to working with supervisors from other countries to encourage the development and adoption of more consistent and broadly accepted international capital standards of the type set forth in the U.S./U.K. proposal.

Another dimension of the issue is the competition from nonbank financial institutions, including thrifts institutions. Again, as a matter of both competitive equity and prudential concerns, it would seem desirable to bring the capital requirements of competing institutions into closer alignment. For this reason, we strongly support the efforts of the Federal Home Loan Bank Board to encourage thrift institutions to strengthen their capital positions.

You specifically asked that we address the issue of "double leveraging". Double leveraging refers to the practice of a parent company transforming debt it issues into equity at the subsidiary level. A bank holding company can leverage itself by issuing long-term debt and can then channel, or "downstream", the proceeds of the offering to its bank or nonbank subsidiaries by purchasing their equity securities. Double leveraging is often used to increase the capital of a subsidiary bank in order to satisfy regulatory capital requirements. By using the parent as a centralized conduit for the capital financing of subsidiaries, an organization can reduce its cost of raising funds.

An organization using double leveraging runs the risk that its subsidiaries will not be able to "upstream" the cash flow needed to service the parent's debt. A bank subsidiary, for example, may fail to earn sufficient income to pay dividends, the principal source of funds parent companies use to service their debt. The risks of double leveraging are borne by a parent organization's shareholders and uninsured creditors.

A commonly used measure of double leverage is the ratio of the parent company's equity investments in its subsidiaries to total parent company equity. Last year there was a significant decline in levels of double leveraging in the banking industry. The decline was particularly pronounced among the largest holding companies, where as a group, the ratio for the 25 largest dropped from 158 percent at year-end 1985 to 125 percent by year-end 1986. The decline in double leveraging can be attributed, in part, to a heightened awareness on the part of holding company creditors that the flow of funds from bank subsidiaries to the parent company cannot be assured, and in part, to increased supervisory scrutiny of parent company cash flow and its potential impact on the capital of subsidiary banks. In addition, since we apply our capital standards to consolidated holding companies as well as their subsidiary banks, there is a limit on the potential incentive for excessive double leveraging.

Liquidity

Liquidity is a difficult concept to define with precision and judgments on liquidity require consideration of a number of factors pertaining to both the asset and liability side of the balance sheet, as well as to off-balance sheet commitments. However, one helpful measure of liquidity is the degree of reliance on volatile, purchased liabilities to fund assets. Reliance on such liabilities has decreased in recent years, primarily because of the deregulation of interest rates which has enabled banks to compete more effectively for retail accounts. This trend has been offset to some degree by a decline in the holding of certain liquid assets by banking institutions; nonetheless, on net, liquidity appears generally to have improved over the last several years. Although dependence on managed liabilities has changed little in recent years at smaller banks, deregulation has removed the threat of deposit disintermediation, which was perhaps the most serious threat to their liquidity.

Brokered deposits generally have remained a very small share of total deposits of banks, and thus, for the most part, have not had a significant impact on liquidity. Although brokered funds have been abused in some specific cases, supervisors monitor the use of such funds closely, particularly in connection with our review of the overall use of purchased liabilities.

Problem and Failed Institutions

It is a widely known fact that the number of problem and failed banking organizations has risen at an uncomfortably rapid pace over the last several years. It is our expectation that, absent unforeseen adverse economic or financial developments, these numbers many begin to level off. However, we do not expect these numbers to decline in a significant way in the near term.

In data submitted to the Committee staff, the banking agencies have provided information on the total number of problem and failed commercial banks, and their aggregate deposits, in some detail. Therefore, I will touch briefly on the situation with respect to institutions under the jurisdiction of the Federal Reserve System.

At the end of March, 1987, there were 85 problem state member banks and 510 problem bank holding companies. These 85 state member banks represented 7.7 percent of all state member banks, while the 510 bank holding companies represented 7.9 percent of all bank holding companies and controlled approximately 8.5 percent of total banking assets.

As of May 8, 1987, 74 commercial banks had failed, compared with 41 over the same period in 1986. Of the 74 banks that failed, 5 were state member banks with total assets of $243 million; in all of 1986, 11 state member banks with total assets of $147 million failed. Over the five-year period of 1982 through 1986, the assets of failed state member banks represented 5 percent of total failed bank assets. To put this figure into perspective, state member banks comprised 18 percent of total bank assets at year end 1986.

Supervisory Actions

Over the last several years, the Federal Reserve has addressed the trends and conditions I have just described with a number of important actions designed to strengthen our supervisory policies, practices and procedures. Our objectives have been threefold: first, to implement supervisory policies that would improve the ability of banking organizations to withstand financial stress and adversity; second, to enhance our ability to identify in a timely manner financial and operating deficiencies that could weaken an organization's financial condition; and third, to strengthen our follow-up procedures, particularly by improving our techniques for communicating with boards of directors and, where appropriate, broadening our use of formal enforcement actions.

In carrying out our supervisory responsibilities, we attempt to balance the need to maintain a fully adequate supervisory framework with our desire to avoid impinging on the legitimate prerogatives of management or undercutting the benefits from greater competition in our banking and financial markets. While views may differ on the best way to strike this balance, the crucial public interest in the maintenance of a sound and stable banking system, and the existence of the federal "safety-net," underscore the critical importance of a strong and effective supervisory and regulatory framework.

I have already noted the efforts the Federal Reserve, together with the other federal banking agencies, has made over time to encourage banking organizations to strengthen their capital positions. The imposition of minimum capital standards in 1981, and the strengthening of these standards in 1983 and 1985, have played an important role in helping banking institutions to withstand the strains of the last several years.

In carrying out its day-to-day supervisory activities, the Federal Reserve has encouraged banks to operate above the minimum capital ratios established by regulatory rules. Banking organizations undertaking significant expansion are expected to maintain particularly strong capital positions that are well above minimum supervisory standards. In addition, within the last two years, we have reiterated and strengthened our policy on the payment of cash dividends to shareholders when a banking organization is experiencing financial problems. Accordingly, we have intensified our review of dividend payments by banking organizations and, when appropriate, have encouraged them to conserve their capital by adopting more prudent dividend levels.

As I have stated, we are in the process of further improving our capital adequacy policies through adoption of risk-based capital standards. A major objective of our risk-based capital proposal, as I have indicated, is to ensure that capital is adequate to support off-balance sheet exposures. In addition, our adoption of a risk-based capital framework will help to more accurately match an organization's capital requirements with its level of risk-taking and will contribute to broader international efforts to enhance capital standards for large multinational banking institutions. Such efforts are aimed at achieving stronger, more stable international banking institutions and markets, and at reducing the competitive inequities and distortions that can result from vastly different prudential rules among countries with important financial centers.

We have, as you may be aware, taken other prudential actions. Over the last several years, much time and effort has been devoted to heightening banking organizations' awareness of the potential risks associated with daylight overdrafts in large dollar payments systems and to giving bankers and examiners alike improved analytical and supervisory tools to monitor and control these risks. More recently, we have reiterated as clearly as possible our longstanding policy that bank holding companies should serve as a source of financial and managerial strength to their subsidiary banks. This is particularly important since banks benefit from the ability to issue federally-insured deposits and borrow from the Federal Reserve discount window. In light of subsidiary bank access to these "safety-net" protections, we expect their holding companies to stand ready to use available resources to support their banks during periods of financial stress or adversity, and we have underscored our policy to use our enforcement authority, when warranted and appropriate, to see that this is done.

In addition, we have taken actions to improve our ability to monitor the emergence of supervisory problems in banking organizations. In 1986, we increased the frequency of examinations to provide for at least an annual examination of state member banks and most large bank holding companies and semiannual examinations or on-site reviews for very large institutions and problem companies. This program has been supported by a significant boost in budgetary resources devoted to supervision and regulation and by an increase in the number of examiners from 835 in 1985 to 914 at the end of 1986. This more frequent on-site examination program has also has been made possible, in part, through increased cooperation with state banking departments in the form of greater reliance on state examinations of certain institutions, and through increased operating efficiencies. We also have revised our reporting requirements for bank holding companies to place greater emphasis on such indicators as the level of non-performing loans and off-balance sheet activities.

Taken together, those actions have strengthened our ability to monitor risk-taking and improved our capacity to take enforcement actions. Indeed, since 1982, we have greatly increased the number of enforcement actions such as cease and desist orders, written agreements and removal actions aimed at officers and directors. In the period 1980-82, the Federal Reserve System averaged 42 enforcement actions per year; from 1984-86, the average number of enforcement actions had increased to 177. Such actions are employed to require banks to improve their lending policies and procedures, strengthen management, terminate unsafe and unsound practices, and adopt more prudent funding, dividend and capital strategies.

Enforcement actions are but one form of supervision. Equally, or perhaps more, important are preventative actions such as our efforts to improve communications with directors who, of course, have primary responsibility to see that their institutions are operated safely and in compliance with banking laws and regulations. Toward this end, we have implemented a directors' summary report to spell out more clearly and effectively our supervisory assessment of an organization's problems and have broadened the involvement of senior Reserve Bank officials in meetings with directors of large institutions and those with significant problems.

Actions of the type I have just reviewed, of course, cannot deal with all of the problems facing our depository institutions. Thus, the Board continues to support legislation to recapitalize the FSLIC fund at an appropriate level. Moreover, while we are gratified by the actions taken by some state legislatures to permit out-of-state acquisitions of failed or failing banks, we do not believe these have alleviated the problem of finding buyers for troubled institutions in certain states. Thus, the Board continues to urge Congress to provide federal regulators with authority to arrange interstate acquis'tions of failing and failed institutions.

As you are aware, the Board has recently approved the applications of certain bank holding companies to engage in underwriting commercial paper, 1-4 family mortgage-backed securities and municipal revenue bonds. We have approved these applications subject to conditions to assure that the activity will be consistent with safe and sound banking practices and avoid conflicts of interest, concentration of resources, and other possible adverse effects. It is our hope that this action will provide banking organizations with additional sources of income and enhance in a meaningful way their ability to compete effectively with other nonbank financial institutions.

In the long run, of course, these activities should result in real benefits to banking organizations by promoting greater efficiencies, more competitive equity and more diversified sources of income. These will also, I believe, contribute to a stronger and more resilient banking system. In addition, a prudent expansion of bank holding company powers should provide significant benefits to customers in the form of greater convenience and competition and additional alternatives for obtaining important financial services.

In approving these applications, the Board acted under existing authority, applying a statute adopted over 50 years ago in very different circumstances, to a financial market place that technology and competitive forces have altered in ways that the enacting Congress could not have envisioned. Thus, we continue to urge Congress to recognize the competitive, technological, and international forces at work in banking and financial markets by providing a clear legislative framework for expanding the authority of bank holding companies to provide financial services, consistent with the need to maintain a safe and sound banking system and safeguards against conflicts of interest and self-dealing. We also believe Congress should address the need for change in the current prohibitions on corporate underwriting, recognizing that bank holding companies conduct such activities abroad in substantial volume. As part of more comprehensive legislation in the future, we feel that it would also be desirable to consider ways of encouraging more consistency in accounting, supervisory, and capital standards among various types of depository institutions.

Conclusion

The recent trends in the performance and condition of our nation's banks, notably, the deterioration in asset quality, the slide in earnings and profitability, and the growth in off balance sheet exposures, explain much of the current unease about banking. But the industry has been working to reverse these trends and much progress is evident. Many banks have put in place cost cutting programs, strengthened their capital positions, adopted more conservative lending practices, and generated new sources of income. The supervisory agencies, for their part, have implemented programs to help ensure that the banking system remains on a sound footing and that adequate safeguards are in place. All of these efforts should have the effect of putting banking organizations in a better position to withstand any additional unanticipated pressures and strains within our economy or financial markets.

While there is some justification for the prevailing sense of unease over banking, I believe that, on balance, much more is right in banking today than is wrong. The problems, while significant, are manageable, and I can assure this Committee that the Board will do its utmost to see that supervisory efforts will continue to be directed toward maintaining the soundness of the banking system.