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Statement by

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SUMMARY OF TESTIMONY BY THE FEDERAL RESERVE BOARD ON THE CONDITION OF THE BANKING SYSTEM

The last several years have been especially turbulent ones for U.S. banks. Although its problems have been far less than those of thrifts, the banking industry is only now emerging from a difficult period in which historically large numbers of banks have failed.

An important theme when describing the recent performance of the banking industry is that many institutions have made progress toward increasing their profitability and also their reserves and capital base. The pace of improvement has been slow, bank failure rates continue to be unacceptably high, and clear pockets of real and potential problems remain. Several large institutions, in particular, are reporting third-quarter losses due to asset quality problems that, in some cases, will give them losses for the year. Nevertheless, the industry seems to be better prepared to deal with its problems now than it has been in several years.

The current condition of the industry reflects in large part the length and nature of the current business cycle. Although we are currently benefitting from the longest peacetime expansion in U.S. history, it has not been felt equally by all sectors of the economy. In particular, the energy and agricultural sectors, foreign loans, and real estate markets have presented banks with substantial problems that, in varying degrees, remain today.

Profitability. Earnings of the U.S. banking industry rebounded strongly during 1988 and have continued, for most institutions, into 1989, as well. Average return on assets during 1988 for all insured commercial banks was 0.80 percent, the industry's highest reported annual figure in years. During the first half of 1989, the industry reported an annualized average return on assets of about 0.90 percent. Until most recently, much of the improvement since 1987 has reflected sharply lower loan loss provisions by the largest institutions. However, that situation changed sharply in the third-quarter of this year, as some of them made large loss provisions, mostly for real estate and foreign loans.

Although these losses will temper the progress that much of the industry has made, they have led to larger reserves that should give these companies greater flexibility to deal with their problems. In some cases the losses have also been coupled with plans to issue additional common stock.

Asset quality. Asset quality remains the principal concern facing the industry. Loans to developing countries and real estate loans, especially in New England and the Southwest, remain of significant concern. At more than $100 billion, the industry's loans and commitments to highly leveraged borrowers could also present problems for some companies, if not properly managed.

Capital adequacy. The industry's primary capital ratio has increased from 7.9 percent at the end of 1987 to 8.25 percent at mid-year 1989. The general improvement has been widespread.

The preponderance of small- and medium-sized institutions now meet the proposed 1992 risk-based standard, and most large institutions also meet or are well on their way toward meeting that future minimum standard.

Problem and failed institutions. Through September 1989, 160 commercial banks failed, with total assets of $25.7 billion. The number and assets of problem institutions also remain historically and unacceptably high, but appear to have peaked. At the end of the third quarter, 1,166 commercial banks were considered problem institutions, compared with a high of 1,575 banks at the end of 1987. Most of them are located in the Southwest, while conditions in the West and Midwest have improved.

Conclusion. Overall, much of the industry has made progress during the past year and one-half to rebuild earnings and capital and to compete effectively. An important feature of this effort has been the industry's trend toward consolidation, brought about by mergers or acquisitions of failed institutions and the existence of interstate compacts. These mergers may benefit individual institutions and could also lead to a stronger and more competitive banking system. It could also, however, present some companies with new and expanded risks. While the condition of the industry may have improved, we must see further gains before we can say that the problems that have beleaguered the industry are behind us.

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I welcome the opportunity to be here today to present the views of the Federal Reserve about the condition of the nation's banking system. During the last several years, the U.S. financial system has had to operate in an environment characterized by rapid change that has led to significant pressures on many institutions. The landmark legislation that Congress recently enacted to deal with the savings and loan industry is a visible illustration of the problems that certain segments of our depository institutions industry have encountered in recent times. Although the problems of the U.S. banking system have been far less than those of thrifts, the banking industry is only now emerging from a difficult period in which historically large numbers of banks have failed. It is important as we go forward that we remain vigilant in our supervisory efforts to ensure that the banking system continues to rebuild its strength and maintain the confidence of the general public.

In my remarks today I will provide the Board's views of the general strength and outlook for the U.S. banking industry and of the principal issues that we face. I will also discuss some of the actions the Board has taken to foster a sounder, more resilient, and competitive banking system. In the process, I will generally address the areas cited in the

Committee's invitation letter. I would like to begin with an overview of current banking conditions.

OVERVIEW

An important theme when describing the recent performance of the banking industry is that many institutions have made progress toward increasing their earnings and strengthening their reserves and capital base. The pace of improvement may be slower than we would like, bank failure rates continue to be unacceptably high, and clear pockets of real and potential problems remain. Moreover, some large institutions, in particular, are reporting third-quarter losses due to asset quality problems that will give many of them losses for the year. Nevertheless, the industry seems to be better prepared to deal with its problems now than it has been in several years.

The progress--and the problems--that the industry has seen reflect in large part the length and nature of the current business cycle. Although we are currently benefitting from the longest peacetime expansion in U.S. history, it has not been felt equally by all sectors of the economy. The energy sector has been hurt severely by lower oil prices; the agricultural sector has been buffeted at times by low commodity prices and at other times by poor crop yields; conditions abroad have adversely affected the quality of many foreign loans and the strength of export markets; and the volatility of interest and exchange rates has increased the risks in many business sectors. These events have also contributed to excess supplies of real estate properties in some regions of the country that, at times, have produced sharp declines in real estate values. Those declines have not only created severe problems for many thrifts, but they have also affected some banks.

Technological change, financial innovations, and increased competition have also altered the environment for at least the major banking institutions. Foreign institutions, for example, have continued to increase their market share of U.S. business loans. Some of those foreign institutions have had lower capital standards and broader powers, providing them with a competitive edge. Many of the larger U.S. banking organizations have addressed this challenge, in part, by expanding their so-called "off-balance sheet" activities, such as interest rate swaps and financial guarantees, and by devoting more energy to developing new financing techniques. They have also requested--and received--somewhat broader powers so that they can continue to compete with both nonbank firms and foreign banks.

The growing movement toward interstate banking has further altered the competitive environment for U.S. banks. The number of mergers and acquisitions of major financial institutions has increased sharply in recent years due to the failure of some large institutions and to the adoption of regional interstate compacts by many states. In general, these structural changes should help U.S. banks compete in world markets by increasing their financial strength and operating efficiencies. It may also, however, present them with additional challenges to implement the organizational and operating changes they need in order to manage their risks effectively. As banking regulators, we need to monitor these developments carefully in the months and years ahead as the industry continues to revise its structure and as we resolve the insolvent S&Ls.

RECENT FINANCIAL PERFORMANCE

Let me now turn to more specific indicators of recent banking industry performance. In general, these measures have shown an improvement in recent periods, especially for the regional institutions which are less exposed to heavily indebted foreign countries.

Profitability. Earnings of the U.S. banking industry rebounded strongly during 1988. Average return on assets during 1988 for all insured commercial banks was 0.80 percent, compared with 0.11 percent in 1987. This recent performance represented the highest reported profitability measure for the industry in decades. Importantly, the strongest performance was reported by many of the largest banks, which were responsible for the industry's losses in 1987 and which have the greatest need to strengthen their capital positions. The 25 largest bank holding companies, for example, reported a return on assets for 1988 of 0.90 percent, mostly reflecting the earnings of their subsidiary banks. Their 1988 results, however, reflected loan loss provisions that, as a percent of assets, were significantly lower than they had been in recent years.

For many institutions, last year's relatively strong earnings performance has continued into 1989, as well. During the first half of the year, both the largest banks and the banking industry reported annualized average returns on assets of about 0.90 percent. Most recently, however, some of the largest institutions have substantially increased their provisions for loan losses, which will temper the earnings gain that much of the industry has made.

Much of the earnings improvement last year reflected sharply lower loan loss provisions by the largest institutions, but other factors were also important, as well. Many of the larger companies, in particular, have increased their emphasis on generating noninterest revenues and on controlling operating expenses. Noninterest income of the 25 largest bank holding companies, from such sources as investment banking, asset sales, service charges, and loan commitments, as well as from foreign exchange and securities trading and other activities, has more than doubled in the past five years relative to total assets. That trend may continue as the largest banking organizations search for ways to improve investor returns while minimizing their credit risks and their need for additional shareholder funds.

The relatively low level of loss provisioning continued through the first-half of 1989, as well. However, by the third-quarter, many of the largest companies had announced substantial additions to their reserves, mostly in anticipation of further losses among their foreign loans and domestic real estate credits. The latest provisions give several of the largest U.S. banking organizations reserves for developing country loans that exceed 50 percent of their exposure.

The appropriate amount for the reserve depends partly on the strategy of the lender toward this business. The indebted countries clearly need some access to new financing. Those institutions that take a long-term view and are prepared to work with the borrowers may well realize higher returns on their loans than will those who are willing to take near-term losses and withdraw from that market. There is no magic number regarding the appropriate volume of reserves for these loans. Nevertheless, our policy has been, and remains, to require additional reserves, when we believe that conditions warrant.

The third-quarter losses that some large companies have reported, while troubling, should better position the companies for the future. Moreover, some companies have coupled their announcements of special provisions with disclosure of plans to issue significant amounts of additional common stock. While efforts to resolve asset quality problems must continue, actions that increase loan loss reserves and strengthen capital are welcome.

Asset quality. Asset quality remains the principal concern facing the industry. Some earlier problems seem to have receded, such as those in the agricultural sector that ravaged many Midwestern banks, but others remain. Loans to some highly indebted countries continue to undermine the near-term earnings and competitive positions of some of the largest organizations, and the real estate markets have softened in several formerly buoyant sections of the country.

Real estate markets in New England, parts of the Southeast, and broad areas of the Southwest show the most visible signs of weakness. Problems in the Northeast have recently led several institutions there to make substantial provisions for real estate losses. Most of those expected losses, in turn, involve development and construction projects, including condominium projects, in particular. Recent trends in commercial vacancy rates, combined with other factors that could adversely affect that region's economy, could lead to problems for other banking institutions, as well.

Relative to total assets, the volume of nonperforming assets for the industry increased during the first half of 1989, after declining during 1988. The volume of weak assets remains stubbornly high for the larger banking organizations, in large part due to their exposure to foreign borrowers. Nonperforming assets of the 25 largest bank holding companies increased slightly to 3.1 percent of their total assets at mid-year, which is well above the average 2.2 percent reported by all holding companies. I will say more about the foreign debt situation later.

Exposure to highly leveraged borrowers, including involvement in leveraged buyouts and other highly leveraged financings, also has important implications for the risk profiles of banking institutions. Such transactions can be important vehicles for the necessary restructuring of some companies and, in this way, may contribute to the operating efficiency and financial performance of U.S. businesses. Nevertheless, the higher debt levels and relatively lower equity cushions that characterize such transactions can also weaken the borrower's ability to withstand financial adversity and, other things being equal, can raise the level of risk in bank loan portfolios.

At mid-year 1989, the 50 largest bank holding companies had total loans and commitments to highly leveraged borrowers of more than $100 billion, a 20 percent increase from the level they reported at the end of 1988. Although the vast majority of these claims are in the form of senior debt, the amounts outstanding are substantial for many companies, both in absolute terms and relative to their equity capital. This is clearly an area that warrants particularly close attention by bank managers and supervisors alike.

Capital adequacy. An important indicator of the strength of the banking system is the measure of capital adequacy. Accordingly, developing both an accurate measure and an appropriate standard for evaluating the capital adequacy of banking organizations has always been of prime importance. The international risk-based capital standard adopted during the past year represents a milestone in international cooperation and should help to strengthen capital standards throughout the world.

Although the new standard is not effective until the end of 1990 and will not be fully implemented until two years later, most banking organizations are focusing on those requirements now. We estimate that about 94 percent of the nation's commercial banks met or exceeded the minimum risk-based capital standard at mid-year, even under the more-rigorous 1992 definitions. Even many of the large regional and money center bank holding companies meet the standard, or are well on their way toward meeting it.

The actions some companies have taken to raise additional capital in response to the future risk-based capital requirements also improve their capital ratios, as measured by current standards. Primary capital, for example, which includes equity capital, loan loss reserves, and a few other components, averaged 8.25 percent of adjusted assets at mid-year 1989 for all bank holding companies with assets exceeding $150 million. That figure compares with 8.08 percent at the end of 1988 and with 7.90 percent the year before. This general improvement has been widespread.

Much of the improvement in recent years has come through slower asset growth, especially on the part of the larger institutions. During 1988, total assets of all insured commercial banks grew by only 4.4 percent, compared with rates of 7 to 8 percent during the first-half of this decade and with rates in the mid- to low-teens during the 1970s. Average asset growth among the 25 largest banks has virtually stopped, increasing by only 0.6 percent last year after being virtually unchanged during 1987.

Some of that slowdown reflects efforts to meet stronger capital standards, reduce foreign exposure, securitize assets, and focus on off-balance sheet and other fee-generating activities. Growth of outstanding loan commitments and foreign exchange and interest rate contracts, for example, has been much stronger than asset growth in recent years. Transfers of certain securities activities from banks to bank holding company affiliates also explains some of the slow growth by these large banks. Measured on a consolidated holding company basis, the 25 largest institutions grew by 4.2 percent last year.

The risk-based capital standard imposes specific minimum ratios for "Tier 1" (largely equity) capital as a percent of assets. That emphasis on equity should support and, hopefully, help to extend the improvement we have seen in equity-to-asset ratios. At the end of 1988, for example, bank holding companies with assets exceeding $150 million reported equity equal to nearly 6.0 percent of their total assets--more than a percentage point higher than at the beginning of the decade. Although the the 25 largest companies reported a lower average equity ratio of 5.33 percent, their relative improvement was even greater during that period.

The thrift industry problems have demonstrated the need for financial institutions to maintain adequate levels of tangible capital to absorb unexpected losses. The Federal Reserve shall continue to enforce prudent standards for state member banks and bank holding companies and ensure that these capital standards remain sound. The role of intangible assets, such as goodwill, in the capital measure for banks is minor now and will decline further during the next few years as the new standards are put in place. We shall also continue our efforts to coordinate those standards internationally so that they are administered similarly throughout the world and that U.S. banking organizations can compete worldwide on a more equitable basis.

The Committee has asked whether the Federal Reserve believes that the U.S. banking system currently has sufficient capital to protect the public interest and avoid a serious drain of the bank insurance fund. Many bankers will testify that we seem constantly to urge higher levels of capital. Increased risks resulting from greater competition, expanding powers, and a rapidly changing environment for banking services suggest that some institutions should have materially higher levels of shareholder funds. In those cases, we have and shall continue to urge institutions to raise the necessary funds. Overall, though, the Committee should recognize the considerable progress the industry has made to improve its capital position.

In addition to issuing more equity securities, the domestic banking industry has generated substantial funds through increased retained earnings. Over the last several years, a trend toward higher earnings and lower dividend payout rates of large banks were especially helpful in that regard. During the past five years, the retained earnings of all insured U.S. commercial banks rose by $39 billion, or 79 percent. By comparison, their total assets grew by only 31 percent.

The new risk-based capital standard will identify the need for capital by relating the requirements to the specific composition of risk each organization accepts. The measure, however, is not a panacea and cannot be put on automatic pilot and then ignored. An adequate capital standard is a critical element of a sound supervisory system, but it is only one of many components. Vigilant supervision, thorough examinations, and prompt enforcement actions are other essential elements that I will address next.

EXAMINATION EFFORTS

The Federal Reserve believes that frequent on-site examinations are a critical component of an effective supervisory framework. In this regard, the Federal Reserve's policy is to examine all state member banks and bank holding companies with significant operations on an annual basis, either directly or in conjunction with state supervisory agencies. Problem institutions are examined more frequently, and are subject to other more rigorous supervisory reviews.

Conditions of the past several years, in both the banking and thrift industries, have imposed significant pressures on our field examination resources. This year, in particular, our involvement in thrift institution examinations and closings has forced us to postpone the regular periodic examinations of some institutions that appear to be healthy and to limit the examination scope of others. While we can make such adjustments temporarily, we cannot do so for extended periods. Such actions would increase the possibility that problems could develop and grow without early detection. In light of these and other developments I have discussed in this statement, it is crucial that we continue to devote adequate resources to on-site examinations and other critical supervisory functions. It is also essential that we take any steps necessary to attract and retain qualified field examiners and supervisory personnel.

INTERNATIONAL DEBT SITUATION

A significant area of concern for some of the nation's largest banking organizations continues to be their exposure to developing countries. The U.S. banking system is now much less vulnerable to debt servicing difficulties by these countries than it was in the early 1980s. That is not to say that the problem is behind us. At mid-year, exposure to problem debtor countries still represented more than 90 percent of the combined primary capital of the 9 most internationally active U.S. banks and almost 40 percent of the capital of 13 others.

Fortunately, though, this vulnerability continues to decline from much higher levels a few years ago. During 1988, alone, those 22 large banks reduced their net exposure to problem debtor countries by almost $9 billion. In the first six months of this year, they reduced it another $4.5 billion. This progress has been made by reducing the exposure through a combination of asset sales, swaps, and charge-offs and, more importantly, by strengthening the capital and reserve base of the lending institutions. Indeed, by creating strong levels of reserves, most regional and super-regional banking organizations have nearly removed these exposures as a major determinant of their financial strength.

Several large banks have recently further increased reserves against developing country debt. On balance, the Board views this as a positive development toward strengthening the banking system. However, both the banks and the regulatory agencies must continue to review these reserves on an ongoing basis to ensure that the level of bank reserves and capital is appropriate with current circumstances. Moreover, from the banks' own perspective as well as from the perspective of the international economy, commercial banks should continue to work with the borrowers and the international institutions in a continuing cooperative effort to improve the economies of these countries and, thereby, their ability to service their debts.

PROBLEM AND FAILED INSTITUTIONS

During 1988, the number of failed banks had reached another post-war high of 200 institutions, compared with 184 in 1987. An additional 21 banks with assets of $13.5 billion were operating with FDIC assistance while a permanent solution was being reached. Since the total failures included numerous subsidiaries of several of the largest Texas banking organizations, the assets of the failed banks soared to $40.3 billion in 1988 from $6.9 billion the year before.

Both the number and size of bank failures has continued at high levels this year. Through September 1989, 160 commercial banks had failed, with total assets of $25.7 billion. The failures were heavily concentrated in the Southwest. Failures in the West and Midwest declined during 1988 from their 1986-1987 peaks and accounted for only 20 failures in the first nine months of this year. With respect to the Federal Reserve's specific activities, 9 state member banks have failed through September, compared with 21 for all of 1988.

The number and assets of problem institutions also remains historically and unacceptably high, but also appear to have peaked. Both figures declined slightly in 1988 and have dropped further during 1989. At the end of the third quarter, 1,166 commercial banks were considered problem institutions by the FDIC, compared with a high of 1,575 banks at the end of 1987. Most of them are located in the Southwest, while conditions in the West and Midwest have improved. Softness in the automobile industry could aggravate economic conditions in the Midwest but, barring new major problems, should not reverse the trends toward fewer problem banks in that area.

SUPERVISORY AND REGULATORY INITIATIVES

The Federal Reserve, often in cooperation with the other federal bank regulatory agencies, has adopted a number of significant measures in recent years to address real and potential risks in banks. As indicated earlier, we have also provided significant examination resources to help identify and resolve insolvent thrifts. Several of the major new initiatives are summarized below:

Capital standards. Late last year the Board adopted a new risk-based capital standard for state member banks and bank holding companies that was based on negotiations conducted through the Bank for International Settlements. As I have suggested, this international standard emphasizes the need for "core" shareholder funds, recognizes risks in certain off-balance sheet activities, and varies the amount of capital required for various types of assets by the amount of perceived credit risk contained in each asset or exposure. This standard should tailor each institution's capital requirements more closely to its willingness to accept risk and should also lead to more equitable competition among major banks worldwide.

The Board fully supports strong capital standards and has worked hard to improve the capitalization of the banking industry. Our influence comes not only through supervisory actions, but also from administering the bank holding company application process. When deciding requests of banking organizations to merge with or acquire other institutions, the Federal Reserve has and will continue to require applicants to raise additional shareholder funds, when necessary. This process will involve prohibiting poorly capitalized institutions from expanding through mergers and acquisitions and, at times, may even require other companies to strengthen their financial positions further. In that way, the structural changes occurring within the industry can lead to a stronger banking system.

Highly leveraged financings (HLFs). Early this year the Board revised its 1984 examination guidelines on HLFs, including leveraged buyouts, to strengthen its cautionary language and to stress further the need for lending institutions to thoroughly evaluate the financial strength of the borrowers. The new statement emphasized the importance of (1) evaluating cash flows under varying economic conditions, (2) setting reasonable "in-house" limits on the consolidated exposure of HLF borrowers, and (3) establishing specific policies, procedures, and controls for HLF lending. The statement also urged banks to price these credits prudently in order to reflect adequately the trade-off between risk and return and to avoid compromising sound banking practices in a search for market share and short-term gains.

The Federal Reserve Banks have also employed these guidelines to give special attention to loans to customers with exceptionally high debt profiles. In this connection, the federal banking agencies have recently developed a definition of highly leveraged financings that they can use for examination and supervisory purposes. Such a consistent definition should help identify trends and compare the exposures of individual institutions.

New securities powers. Earlier this year, the Board agreed to permit several large U.S. bank holding companies to expand their securities activities by underwriting, on a limited basis, corporate debt and equity within the United States. However, before the companies could conduct those new activities they were required to demonstrate that they had adequate capital, managerial expertise, and controls. The Board granted its permission immediately for them to underwrite commercial debt instruments, and by mid-year four companies had done that. However, the Board has withheld for at least one year its consent for them to underwrite equities. By its conditional approval, however, the Board indicated its willingness to allow U.S. banking organizations to provide that service, if proper systems are in place to control the risks.

This decision was made in response to changing market conditions and competitive positions and on the basis of existing authority granted in the Bank Holding Company Act. The Board was mindful of any increased risks such activities might present to the organization's core banking business and took special steps to ensure that the new underwriting powers were separated from the activities of any subsidiary bank(s) and that appropriate prudential safeguards were in place to protect affiliated banks. It also took special steps to ensure that the banking organizations conducting these activities were well capitalized or that they raised additional equity to support these incremental risks. That approach should improve the ability of domestic bank holding companies to compete more effectively with foreign and nonbank institutions, while protecting the public's interest in a safe and sound banking system.

Hostile takeovers. Through past decisions, the Board has indicated its intent to remain neutral on the issue of friendly or unfriendly acquisitions of domestic banking organizations. Its principal interest in all acquisitions continues to be that the resulting organization be financially sound and have a strong capital position. The Federal Reserve will not, however, allow an institution to weaken its own condition significantly, either in an attempt to consummate an acquisition or to prevent one.

Interbank payments system. An important and on-going objective of the Federal Reserve has been the implementation of policies both to reduce Federal Reserve risk in providing payments services and to induce private participants to be more prudent in controlling their daylight credit exposures, particularly on private large-dollar payment systems. The largest of these, CHIPS, has agreed to adopt rules making settlement of their system more certain through both collateral and loss-sharing devices. In addition, the Board has adopted guidelines to reduce credit exposures on other domestic and foreign clearance and payments systems.

Last spring, the Board also proposed additional measures to encourage depository institutions to control their credit exposure by expanding the scope of its payments risk reduction program. Among other features, the proposals will impose explicit prices on Federal Reserve daylight credits and expand the use of collateral as a risk control technique for book entry clearance of U.S. government securities. When fully implemented, these changes, together with private sector initiatives, should reduce the overall level of U.S. payments system risk, shift the mix of domestic risks toward the private sector and more accurately assign the risk to the private sector users of payment services.

CONCLUSION

These past few years have been difficult times for the banking industry, and significant problems remain. However, the performance of most institutions during 1988 and for the first part of this year, suggests that progress has been made. The number of failed institutions seems poised to decline; the capital ratios for most banking organizations have strengthened; and the most severe problem institutions have now been addressed. We must see further gains, though, before we can say that the problems that have beleaguered the industry are behind us.