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Testimony by

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Mr. Chairman and members of the Committee, I am here today to discuss the condition of U.S. commercial banks and the Federal Reserve's recent efforts to implement new banking legislation and, more generally, promote a sound banking system. As the Committee knows, the industry has experienced an exceptionally stressful period in recent years, and many institutions continue to face rough times ahead. Recent performance, however, offers genuine encouragement that conditions in the banking system are beginning to improve.

These recent years have also been challenging for the bank regulatory agencies, as we have assessed the industry's condition, developed corrective actions, and implemented legislative initiatives. The period has also been a time in which we have placed great importance on inter-agency coordination, as I will point out in my comments today.

I will begin by discussing the recent performance and outlook of the banking system and then address recent supervisory actions of the Federal Reserve, including those taken to implement the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). I will then comment on the focus of banking legislation that the Board believes is still needed.

Condition of U.S. banking system

During recent years, conditions in U.S. commercial real estate markets and throughout the general economy have placed

great strains on much of the domestic banking system. From 1985-1991, for example, nearly 1,200 commercial banks failed, with a peak of 220 bank failures in 1988. Since then, the number of failures has declined to 127 banks last year and to 55 banks during the first five months of this year. But the aggregate assets of failed banks have remained high at $66 billion in 1991 and $13 billion in 1992, thus far.

Trends for troubled institutions (those rated CAMEL 4 or 5) are also disturbing. Their number remains stubbornly high, and their assets continue to grow. There were more than 1,000 problem banks at the end of 1991. That is a level roughly five times the figure a decade ago, although down substantially from its 1987 peak. Problem bank assets, at approximately $600 billion, are also unacceptably large and represent about 16 percent of total banking assets.

One result of these troubled times has been the depletion of the FDIC's Bank Insurance Fund, after reserving for anticipated losses. These threats and the industry's current condition make it likely that the Fund will remain under great pressure for some time to come. That projection is behind the FDIC's recent determination that higher insurance premiums are needed to meet the public policy mandate that the industry repay Treasury borrowings and rebuild the Fund balance.

The problems of banks in the last few years can be traced to conditions that prevailed a decade or more ago. Many of the industry's largest institutions entered the early 1980s

holding high levels of weak developing country loans and facing growing competition from thrifts and foreign banks, as well as from securities firms that were helping prime borrowers sidestep their banks. In addition, banks in the Southwest were holding deteriorating energy sector credits and searching desperately for an important new source of earnings. Along with many others, they sought to find better profits through increased lending in the commercial real estate sector.

By the middle of the decade, though, Southwest real estate values had plunged, related loans were uncollectible, and banks throughout the region were beginning to fail. Weak commodity and land prices were contributing to the collapse of hundreds of small banks in agricultural communities throughout the midwest and compounding pressures on the federal deposit insurance fund. But in most other parts of the country commercial real estate markets and related bank lending remained strong, despite rising levels of office vacancy rates. That condition reversed beginning in 1989 when economic problems surfaced in New England and then deepened when the rest of the nation slipped into recession in the summer of 1990, signalling the latest round in what has been the most turbulent period for the U.S. banks since the Great Depression.

The industry's average return on assets, roughly 0.50 percent during each of the past three years, is some 10-20 basis points below levels generally seen during the past two decades and reflects the depth of these problems. Recent profits were

even worse for many of the largest institutions and those in the Northeast and other areas where recent commercial real estate problems took their greatest toll.

Over-building through much of the 1980s, combined with weak demand recently, produced the greatest contraction of real estate values experienced in the United States since the 1930s. After the earlier problems in the Southwest, severe loan quality problems emerged in New England and spread quickly along the east coast, adversely affecting the Mid-Atlantic and Southeast regions. Weaknesses subsequently emerged in the Far West, especially in the southern part of California. Even the mid-section of the country, whose experience with earlier problems helped to avoid the worst excesses, has been affected by declining commercial real estate values. Much of the Southwest seems to continue a slow recovery from its own mid-decade debacle, but the full effect of problems in Southern California is still ahead.

Beyond the real estate sector, the earlier build-up in corporate leveraging together with the sluggish economy also contributed to the general deterioration in the quality of the industry's loan portfolio. As a result, the volume of nonperforming assets at the 25 largest banks increased by $13 billion (or 40 percent) during the two year period 1990-1991, even after sharply higher levels of net charge-offs.

Smaller banks have generally been less affected by commercial real estate conditions, but have not escaped without

some problems of their own. Those with assets less than $1 billion incurred a smaller, but still sharp, 17 percent increase in total nonperformings during the same period, with most of that increase attributed to general weakness in the economy, rather than to specific major events.

Overall, the industry's loan loss provisions climbed to nearly one percent of assets during each of the past three years, (three-to-four times the loss provision rate of the 1970s and early 1980s) and reached $33 billion last year. That provisioning, however, enabled the industry to maintain loss reserves at more that 80 percent of nonaccruing loans during the past two years and at a relatively high 1.6 percent of assets.

Outlook

Recently, there have been encouraging indications that conditions in the industry are beginning to improve, even though commercial real estate markets in many areas remain depressed. Most encouraging, perhaps, are indications that the volume of problem loans has started to trend down, as suggested by recent quarterly results. Whether that pattern will continue into the immediate future is unclear.

The improvement in large part reflects the process of working problem loans through the balance sheet, as banks restructure, charge-off, or write down their weak assets. With real economic growth having resumed and the burden of developing country loans all but gone for virtually all U.S. banks, the

industry should be able to focus even greater attention to the resolution of its other problems, commercial real estate credits in particular.

Lower interest rates have helped to improve the condition of most banks, as funding costs declined faster than revenues. Net interest income on a fully tax-equivalent basis increased from 3.55 percent in 1990 to an average of 3.71 percent of total assets for 1991, marking its fourth highest level in more than twenty years. This gain translates into nearly $5.5 billion of additional pre-tax net interest income for the banking industry. Lower rates also contributed to nearly $3 billion of gains last year from the industry's nontrading account securities and to a substantially larger volume of unrealized gains in the value of its investment portfolio. Since then, while securities gains remained strong in the first quarter of 1992, much of the unrealized portion has been lost.

A good part of the industry has also been restructured to generate additional revenues and reduce operating costs. Intra-market mergers, such as those recently seen in New York and California, were undertaken in large part to gain increased operating efficiencies that managements believed could be generated. So far, the stock market seems to agree. Other institutions, not involved in mergers, have implemented cost reducing measures as well and have also received generally favorable market reviews.

Average capital ratios for commercial banks are higher now than they have been in many years, despite the industry's problems. Bank equity at the end of 1991 was nearly 6.8 percent of industry assets, its highest level in more than 20 years and virtually a full percentage point higher than at the end of 1980. On a risk-weighted basis, the industry's 11.1 percent average total capital ratio at year-end 1991 was more than 3.0 percentage points above the minimum required for the end of 1992. Importantly, Tier 1 capital (equity) was 9.7 percent of risk-weighted assets--more than double its minimum standard. More than 96 percent of all BIF-insured U.S. commercial and savings banks now meet the minimum standard, and those meeting the standard hold more than 90 percent of the industry's assets. While we may take some comfort from these figures, it should also be emphasized that many institutions need to have capital ratios in excess of minimums, given the overall level of risk associated with their operations and loan portfolios.

The last important development I shall mention that bodes well for the industry is the increased attention bank managements are directing to strengthening their underwriting standards and pricing policies. That development, combined with an increased emphasis by bank supervisory agencies on more frequent on-site examinations, should have positive future results on the quality of banking assets.

The stock market's assessment of these factors has been very positive in the past year. During 1991, common stock prices

of the 47 publicly traded companies among the Top 50 rose on-average more than 60 percent. Although many bank stock prices started from exceptionally low levels, their average gain dwarfed the impressive 30 percent increase recorded last year by the S&P 500. So far this year bank share prices have continued to outperform the general market.

By another measure, the average ratio (both equity weighted and not) of market-to-book values of the common share prices of these 47 largest companies stood at more than 150 percent at the end of last month. That was nearly twice the ratio at the end of 1990. Taking advantage of these improvements, the Top 50 companies alone issued a record $7 billion of equity last year and another $375 million of convertible debt.

While banks are by no means "out of the woods," there are signs that the worst may be behind them. Some, of course, continue to have big problems and are likely to keep the number of bank failures and their costs to the FDIC at a high level. On balance, though, the broader outlook for the U.S. banking system seems brighter than it has in several years.

During the past three years, for example, the commercial banking industry has charged off nearly $85 billion in losses, an exceptionally high rate, while at the same time increasing its equity by more than $35 billion and boosting its loan loss reserves. That performance says much about the

industry's overall strength and resiliency and its ability to attract investor funds.

We should also not overlook the fact that, even in the especially troublesome past few years, many banks--including many large ones--have consistently performed well. During each of the past four years close to one-half of the industry, holding 35-50 percent of banking assets, earned a highly respectable return of one percent or more on assets, and another 30 percent of the industry earned at least a 0.50 percent return. In fact, 16 of the 50 largest U.S. bank holding companies earned a one percent or better return last year, and that number rose to 24 during the first quarter of this year. The progress many institutions have made to strengthen their credit standards and reduce costs should lead to further improvements in years to come.

Recent Supervisory Initiatives

Your letter of invitation asked that I describe some of the recent actions taken by the Federal Reserve to ensure the health of the banking system and to implement elements of FDICIA. I would like to begin by saying that strengthening the capital position of the banking system has been an important and long-term objective of bank supervision at the Federal Reserve and, as previously mentioned, significant progress has been made in that area.

As part of its administration of the Bank Holding Company Act, the Board has made clear its general policy that

institutions seeking approval for expansionary applications must be soundly capitalized and that mergers and acquisitions should result in even stronger and better capitalized institutions. That policy has prompted many banks and bank holding companies to raise additional capital, either for the direct purpose of completing proposed transactions or, more generally, to improve their condition before presenting their applications. In that sense, I believe the Board's policy played an important role in the record volume of new equity issued by major banking companies last year.

In other activities, the Federal Reserve continues to emphasize the importance of frequent, on-site, full-scope examinations. We have long believed that only through this process can supervisors adequately evaluate credit quality and standards, operating procedures, and other aspects of banking that are essential to the sound operation of a bank but which are difficult, if not impossible, to assess through off-site reports.

As part of this process, the Federal Reserve and the other agencies have been urging banks to strengthen their credit standards--a process that in some cases may have gone too far. Whether caused by overly critical supervision or by bank managements that were too conservative, the tightening may have had counter productive results, contributing to a so-called credit crunch and perhaps prolonging the recession in some regions of the country.

There are a number of more specific supervisory and regulatory efforts I would like to cite. The first involves an interagency statement issued in February of this year on the proper use by banks of so-called "high risk" derivative instruments--investments such as interest- or principal-only mortgage derivative securities. The position taken by the agencies was that such investments are generally to be considered unacceptable for depository institutions, unless the institution can clearly demonstrate that the effect of the instrument is to reduce the institution's overall interest rate risk.

The Board has also participated actively with other U.S. bank regulatory agencies and with agencies abroad under the auspices of the Bank for International Settlements (BIS) to administer and enhance the international risk-based capital standard. This on-going effort, which began in 1989 following adoption of the risk-based standard, has required significant coordination regarding interpretations of existing standards for credit risk. It has also involved considerable effort to develop measures dealing with interest rate risk, foreign exchange trading, and netting arrangements.

During much of the past year, the international effort regarding interest rate risk has been directed toward "converging" the capital standards of securities firms with new standards that would cover the trading activities of commercial banks. Currently, the participating banking and securities

regulators expect to submit a joint proposal for public comment on that effort this year.

Domestically, staff of the Federal Reserve and the other U.S. banking agencies have been developing their own approach to measuring interest rate risk that could apply to all U.S. banks--not only to the "internationally active" banks that would be directly covered by the efforts underway at the BIS. In its still-preliminary form, this "domestic" approach is generally consistent with measures being developed abroad, although less complex and data intensive. We expect that an interagency proposal for measuring the interest rate risk of U.S. banks will be issued for public comment next month. Subject to those comments, we plan to rely heavily on that approach in meeting the interest rate risk requirements of FDICIA's Section 305.

Staff are also working diligently on more than 20 other efforts to implement the many provisions of FDICIA. On one important matter, the agencies are near agreement on the key elements required to implement prompt corrective action. A detailed proposal on the subject is being completed and should be considered by the Board and issued for public comment later this month.

In April, the Board also amended its Regulations O and Y to implement requirements of Section 306 of FDICIA dealing with loans to insiders. Effective last month, these changes expand certain definitions of insiders, impose limits on a bank's aggregate lending to insiders (including their related

interests), and prescribe standards for such extensions of credit. The rules generally limit total lending to insiders to 100 percent of the bank's unimpaired capital and surplus, with an exception limit of 200 percent for banks with less than $100 million of deposits.

Last month, the Board also approved for public comment an advanced notice of proposed rulemaking regarding the safety and soundness standards included in Section 132 of FDICIA. Approval from the other agencies should be forthcoming shortly, and a joint statement will be issued at that time. We are also working jointly on ways to incorporate a bank's concentration risk and involvement in so-called "nontraditional" activities into capital adequacy assessments, both mandated by Section 305.

In May, the Board approved for public comment a proposal to amend its regulations H and Y to prescribe standards for real estate lending. The proposal, responding to requirements of Section 304, builds on earlier loan-to-value requirements that were liberalized by legislation in 1974 and removed with legislation in 1982. The proposal has not yet been formally considered by the principals of the other agencies, but is expected to be issued for comment this summer.

Currently, the Board is also preparing for public comment a new Regulation F, Interbank Liabilities, in connection with requirements of Section 308. This proposal would require banks and savings associations insured by the FDIC to develop and implement internal procedures to evaluate and control exposures

to other depository institutions, including those arising from both credit and settlement exposures. As drafted, it would establish outer limits of exposure, expressed as a percent of an institution's capital, that would generally be considered prudent. The Board expects to issue this regulation for comment later this month.

Regarding the Foreign Bank Supervision Enhancement Act, the Federal Reserve is in the process of hiring additional examiners so that it can coordinate and conduct more frequent examinations of U.S. offices of foreign banks, as directed by the legislation. The Board has also proposed revisions to its Regulation K to implement other provisions of the Act requiring applications by foreign banks to open U.S. offices and ensuring that they have adequate levels of supervision.

The restrictions on Federal Reserve lending to insured depository institutions that are undercapitalized or critically undercapitalized do not go into effect until December 19, 1993. This delay is essential, since the restrictions constitute a significant change in lending policy, and banking regulators need time to put in place the enhanced supervisory powers contained in the Act and use them to strengthen the banking system and reduce the need for banks to resort to sources of emergency liquidity. Nevertheless, the Federal Reserve has moved as quickly as is prudently possible to bring its administration of the discount window into line with the broad public policy direction of the Act. To this end, we are working closely with the FDIC to

resolve any failing institutions that may borrow from the window in a manner that protects the federal deposit insurance funds and, at the same time, avoids disorderly resolutions that could undermine public confidence in the banking system.

Preferred Legislative Focus

FDICIA contains many provisions designed to promote a safer and more prudent banking system. By serving to offset moral hazard incentives created by federal deposit insurance, prompt corrective action is one provision that we feel should have beneficial results. The Board's expanded authority to supervise and regulate foreign banks operating in the United States is another positive aspect that should help to deter problems such as we have recently seen.

Another clearly constructive provision is the requirement that the banking agencies review the laws they administer in light of the regulatory burden they impose on the industry. This requirement is consistent with the President's regulatory reform initiatives, an outgrowth of which is a commitment by the federal banking agencies to coordinate their policies, practices, and training even more closely than in the past.

In this connection, I would assure the Committee that the Federal Reserve takes this provision of FDICIA seriously and that it will conduct a vigorous review and make recommendations for changes, as appropriate. We will, of course, continue to

work to implement rules and regulations that are required by statute or that are necessary to ensure the safety and soundness of banking institutions. The Board has long been concerned about the costs and burdens associated with the accumulated effect of regulations. Without legislative relief, however, reducing regulatory burden significantly will be a much more difficult task.

Although these provisions should prove helpful, the Federal Reserve believes the legislation is flawed in other ways. Most important, it failed to provide relief from outdated structural restrictions that prevent the U.S. banking industry from operating more efficiently. I will say more on this later. It also piled increasing regulatory burdens on virtually all banking institutions, taking a shotgun approach to past problem areas.

The banking agencies have long had examination procedures and guidelines covering most topics mentioned in the legislation, and those materials are available to the industry. The agencies also typically review a bank's policies and procedures regarding credit underwriting, loan documentation, and other activities when they examine banks on-site.

Efforts to implement or enforce any standards of safety and soundness are obviously important, but there are remedies other than statutory change. In particular, I would urge the Congress to consider the resources, risks, and operating records of the thousands of small banking institutions in this country

when drafting new legislation. In many cases their resources are already stretched thin, and continued legislative and regulatory burdens, themselves, may threaten the viability of many community banks.

Numerous elements of the legislation also carry the risk of thrusting the regulators increasingly into the micro-management of the banks they supervise. These provisions include tighter limits on interbank credits; expanded record-keeping and reporting requirements in areas such as branch closings, auditing, small business loans, and truth-in-savings; and requirements that regulators impose operational standards for employee compensation, internal controls, interest rate exposure, asset growth, minimum earnings, and market-to-book ratios.

While, no doubt, there have been abuses in some of these areas that should be stopped, the Board believes that the approach taken in Section 132 is not the best solution. Indeed, some provisions, such as setting standards for minimum earnings and for market-to-book ratios, seem to be meaningless and raise questions about how such standards could be logically enforced. At best, much of the legislation will, in my view, simply increase costs to many banks.

The legislation also contains numerous incentives for banks to behave more cautiously and to maintain higher capital ratios: the FDIC's mandate to pursue least cost resolutions, the tighter discount window lending rules, limits on the use of brokered deposits, and prompt corrective action. These

provisions have positive features, but they also carry increased risks of worsening the availability of bank credit as banks respond by shrinking in size and avoiding risks that are basic to banking. In some respects, they could also increase the risk of liquidity problems for banks, as uninsured depositors seek safer havens at the first sign of trouble.

Constraint on risk taking may be needed given recent experience, but the need for a vital banking system must also be recognized. While requiring banks to increase their capital positions, the legislation provides them with few opportunities for new revenue sources or for reorganizing or expanding in more cost efficient ways.

In this connection, the Federal Reserve Board strongly urges that the Congress revisit fundamental reforms involving the elimination of the Glass Steagall and McFadden Acts. The structure and activities of the financial industry are changing; new markets are developing and expanding; and our banks must be allowed to keep pace. Permitting them more freedom to operate more efficiently and to compete more effectively under prudent supervisory rules is the best way to maintain a safe and sound banking system.

Conclusion

In closing, I would say again that the condition of the U.S. banking system appears to be improving, although many problem situations of greater or lesser severity remain to be

resolved. In particular, the FDIC's projection of the number and size of banks it expects to fail this year remains high, as are the figures for problem institutions. An increased supervisory role, such as that embodied in the annual full-scope examination requirements of FDICIA, should help deter future problems, but as noted, supervisory oversight and regulatory burden can be taken too far. At this point, the most positive step the Congress can take to improve the industry's long term outlook is to adopt more <u>fundamental</u> banking reforms enabling banks to compete more effectively both domestically and abroad.