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Testimony of

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Mr. Chairman and members of the Committee, I am pleased to be here to address developments in the banking system and the near-term outlook for bank failures. This topic has attracted increasing attention, as recent studies released suggest that the commercial banking industry has problems of the magnitude approaching what we have seen among thrifts. This possibility was even raised during the latest Presidential debates. One study, in particular, states that the number and assets of failed commercial banks will soon surge.

As the Committee knows, a significant number of commercial banks remain troubled, and their assets are substantial indeed. However, in my view, there should be no so-called "December surprise." A number of commercial banks will be closed in the coming months partly due to implementation of new prompt corrective action authority, but mainly as a result of procedures already in place. The costs of these failures may be larger than we would like, but they should be a small fraction of some estimates recently cited in the press.

Mention has also been made of the recent pace of bank and thrift closings, which have been fewer than previously expected so far this year. In the case of thrifts, some slowdown has resulted simply because of lack of funding needed by the Resolution Trust Corporation to resolve institutions that should be closed. However, I am aware of no reduction in the pace of resolutions for commercial banking institutions that was not warranted by conditions at each bank.

This year has been an especially favorable period for many banks, and the industry's improved profitability has helped some institutions to remain at least temporarily solvent beyond the period in which they had been expected to fail. Such favorable events, better explain the pace of bank closings than charges of an orchestrated slowdown.

In the remainder of my remarks I will provide an assessment of the outlook for the commercial banking industry and, as requested, will indicate the capitalization and under-capitalization of particular groups of banks. However, I will defer to the FDIC for other specific figures regarding the number and estimated costs of near-term bank failures and the general strength of the Bank Insurance Fund (BIF).

Significant Problems Remain

During my testimony in June regarding the condition of the commercial banking system, I cited the stubbornly high number of banks that were considered to be problem institutions--those with supervisory ratings of 4 or 5. While the figure has improved slightly since then, more than 950 banks with assets of nearly $500 billion remain troubled. This current level represents significant progress in reducing the number of problem banks from its peak of nearly 1,600 institutions at the end of 1987, but their combined assets are clearly large.

Through mid-October, 85 BIF-insured commercial and savings banks holding $28 billion in assets have failed this

year, but only $4.3 billion of these assets were related to commercial banks. So far, savings banks, which are operationally more akin to thrifts, have dominated this year's results. By comparison, 90 commercial banks with $42 billion in assets had failed by this time last year. In the normal course of events, we can expect additional commercial banks to fail during the remaining months of 1992, and not all of them will be small. Overall, however, their number and especially the amount of affected assets should be well below the totals for 1991.

Prompt Corrective Action

As the Committee knows, the prompt corrective action provision of the FDIC Improvement Act (FDICIA) becomes effective near year-end and will change the rules for closing troubled banks. Beginning December 19, 1992, authorities will be able to close institutions that are "critically undercapitalized," although still technically solvent. Banks critically undercapitalized, in turn, are defined by statute as those having tangible equity equal to or less than 2.0 percent of total assets. The Act provides for specific steps to be taken at that point and at other less-than-adequate levels of capital.

Institutions that are critically undercapitalized must be placed in conservatorship or receivership within 90 days, unless the appropriate federal banking agency and the FDIC determine that other actions are best. To avoid seizure, such institutions must have positive net worths and be improving their

condition in a number of specified ways. Although we are still developing operating procedures to implement these requirements, presumably some of the critically undercapitalized institutions would meet the necessary tests and continue to survive. Others, however, should expect to be closed in the months to come.

The Committee requested information on the number of banks in each category of capital rating. As of mid-year, 98 percent of all BIF-insured commercial banks met the minimum capital standard for being at least adequately capitalized, and 93 percent of the industry was considered "well capitalized" (Attachment A). About 230 banks, however, were undercapitalized and could be directly affected by prompt corrective action in some way. Of these, less than 50 institutions with total assets of roughly $8 billion risk being closed because of their critically undercapitalized designation. The remaining under-capitalized banks face other regulatory sanctions if their ratios do not improve.

When evaluating these figures, note that not all problem banks have ratios that show them as being under-capitalized. For that reason, the legislation also permits the agencies to reduce by one category the assessment of a bank's capital adequacy on the basis of factors other than capital, with the exception that a bank may not be downgraded in this manner to the critically undercapitalized level. Such reclassifications could occur for any institution deemed to be engaged in an unsafe or unsound practice, and FDICIA permits that finding on the basis

of a less-than-satisfactory examination rating and failure by the institution to correct the deficiency. While not yet implemented, these procedures will alter the initial classifications derived from published financial statements and shown in Attachment A.

Recent Studies

I would like at this point to comment on studies that have been cited recently in the press, particularly the book entitled "Banking on the Brink." In my view, and as I have stated on behalf of the Federal Financial Institutions Examination Council, this publication has serious errors and shortcomings. Important assumptions are extremely pessimistic and outdated; its methodology is poor; and important calculations reflect a misunderstanding of bank regulations. As a result, its conclusions significantly overstate the likely cost of resolving problem banks and contribute to misperceptions about the state of the industry's health. Other studies have also forecasted large costs to the public for resolving troubled commercial banks. They, too, overstate their case and, so far, have been wrong.

Forecasting is difficult, and the best forecasters can make mistakes. Especially in banking, the industry's outlook depends heavily on future economic conditions, and those conditions--as I well know--are hard to predict. Current economic growth is slow, and any decline could adversely affect many banks, reverse recent progress, and increase resolution

costs. Forecasters, however, and especially public officials, have obligations to be reasonable, as well as forthcoming. Taking into account my outlook for the economy and that of the Federal Reserve, I strongly disagree with assertions that we are facing a "hidden" or unexpected surge of problem banks or in resolution activities.

Recent Performance of Banking System

Part of my more optimistic assessment rests on the recent performance of the industry, which continues to improve: earnings are at record levels; average capital ratios are at 25-year highs; and nonperforming assets continue to decline. Investors have also recognized improvements and look more positively on publicly traded bank stocks.

During the first half of this year (the latest period for which industry data are available), commercial banks earned almost $16 billion and more than 0.90 percent on assets--the strongest annualized rate of profitability in the post World War II era. This increased profitability was also widespread, with nearly 62 percent of all banks reporting returns on assets of more than 1.0 percent. If maintained for the year, that share of highly profitable banks would be the largest since 1981. Partial third-quarter results suggest the improvement remains strong, with some 250 of the largest banking companies that have reported indicating 9-month profits averaging 35 percent greater than those for the same period last year.

Increased earnings, reduced dividends, and record stock sales have also helped substantially to strengthen the capitalization of commercial banking organizations and to intensify a trend that has been observable for a decade. The industry's equity capital of nearly $250 billion represents 7.23 percent of assets, the highest ratio since 1966. The industry's average risk-based capital ratio improved by 0.78 percentage points during the first six months of this year, alone, climbing to 11.53 percent and well above the year-end 1992 minimum standard of 8.0 percent. As mentioned, 98 percent of all banks had already met that standard by mid-year.

The principal concern to the industry and the main reason that banks fail is poor credit decisions and the subsequent drop in the quality of their loans. The 1980s were rough years for many banks, as developing country, agriculture, energy, and commercial real estate loans produced large losses and caused the volume of problem loans to surge. This experience has left many bankers with a greater appreciation of the need to maintain sound credit standards and to price their loans right.

Fortunately, however, the tide of growing problems seems to have turned. Since June, 1991, the volume of nonaccruing loans has steadily declined, while loss reserves have increased. At mid-year, reserves covered nearly 90 percent of the industry's aggregate volume of nonaccruing loans. The level of foreclosed real estate, which increased sharply in 1990 and 1991, is showing signs that it is beginning to stabilize. Office

vacancy rates remain high, and that problem will not be quickly resolved. Commercial real estate markets remain weak in many regions throughout the country, and some continue to decline. Generally, though, the implications for commercial banks of these problems seem to have improved.

Stock markets, generally early indicators, also view banks with increased favor. Market prices for the industry's 50 largest companies increased from an average of less than 90 percent of book value at year-end 1990 to nearly 150 percent earlier this month. Gains in stock prices of large banks sharply outpaced those of the S&P 500 index and provided market opportunities for many banking institutions. Since the beginning of 1991, the largest 50 companies, alone, have taken advantage of the improvement to issue a record $14 billion of new common and preferred stock in public and private offerings. Still other issues are in process.

Although the industry continues to have problems, important restructuring and consolidation efforts should also provide a boost, enabling banks to reduce their costs and eliminate excessive pressures to compete. The financial services industry increased rapidly during the 1980s, as foreign and nonbank organizations expanded their market shares. Mergers and acquisitions have helped bankers and regulators to strengthen weak banks in the past, and they should help in the future as well.

Deposit Insurance System

The FDIC can best estimate the effect of recent events on the strength of the Bank Insurance Fund. Much depends, of course, on the manner in which bank failures can be resolved. I believe that experience suggests that merging weak banks with strong ones, rather than liquidating them, is generally the best approach. That procedure seems to offer greater possibilities today, given the improved performance of much of the industry, including that of many large banks.

The continued strengthening of the industry and the higher insurance premium rates recently announced should also begin to reduce pressures and help to rebuild the insurance fund. Nevertheless, although the FDIC has provided substantial reserves for future costs that are available to use, the Bank Insurance Fund has been depleted, and some Treasury or further working capital borrowings may be needed before the fund is made whole. In the final analysis, though, I believe that statutory goals for rebuilding the fund to 1.25 percent of insured deposits will be met well within the allowed 15-year period.

Conclusion

Some banking institutions remain weak, but the industry's progress should not be overlooked. A few sizable savings banks have been closed in recent months, and other large savings and commercial banks may be closed in the months ahead. In general, though, a turn-around in the commercial banking

industry seems well underway. Reports of huge future losses make sensational headlines, but the economy would need to decline dramatically from current levels to produce losses that approach estimates seen recently in the media.

While recent events are clearly positive, I do not want to leave the impression that there are no concerns with the banking industry. Its underlying costs and competitive pressures remain great, and fundamental reform of banking laws is still needed. The Congress should consider legislation to permit the integration of our financial system similar to developments in Canada, Europe, and Japan and should act to remove barriers to interstate branching as well. Consideration should also be given to reducing the regulatory burden on banks. Such changes would help to improve further the profitability and the long-term competitiveness and viability of the U.S. banking system.

Attachment A

Number and Assets of BIF- Insured Commercial Banks, by Capital Category, June 30, 1992

	Amounts		Percent of Total	
Category	Number	Assets (Bns)	Number	Assets
Well Capitalized	10,871	$2,218.3	93.5	64.7
Adequately Capitalized	520	1,148.0	4.5	33.5
Undercapitalized	137	47.5	1.2	1.4
Significantly Undercapitalized	49	7.6	0.4	0.2
Critically Undercapitalized 1/	47	7.8	0.4	0.2
Total	11,624	$3,429.2	100.0	100.0

1/ Six banks with assets of $215 million have failed since June.