For Release on Delivery
10:00 A.M. EST
April 9, 1986

Statement by

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of the Federal Reserve System

before the

The Subcommittee on Financial Institutions
Supervision, Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

April 9, 1986

I appreciate the opportunity to discuss the difficulties that some banks are facing as a result of farm, energy, and developing country loans. As requested, my remarks will center on the nature and magnitude of risk exposure in each of these sectors and on appropriate measures to deal with them. I also plan to offer a few remarks on the commercial real estate situation. The Federal Reserve, in conjunction with the FDIC and OCC, is supplying the related information and statistics requested.

The banking system today continues to deal with a series of adjustments to changing economic conditions and to contractions in specific industries and geographic regions. Very substantial volumes of loans have had to be written off, loan loss reserves have been augmented, and capital resources have been built up using a variety of debt and equity instruments. In this, the banking system has exhibited an ability to adapt to changes in loan asset quality at the same time that the liability side of the balance sheet has changed under the twin forces of market developments and deregulation. In recent years, the banking system has survived numerous periods of stress and uncertainty, including the collapse of Drysdale Securities, the silver crisis, the failure of Penn Square Bank, and the near-failure of Continental Illinois. During a period of deregulation and intensified competition, the system could not have weathered these events if it were not fundamentally sound.

The strength of the industry is also demonstrated in various performance indicators. Last year, net earnings in the industry increased by roughly 17 percent. This increase was accompanied by a boost in the ratio of primary capital to assets, marking the fifth consecutive yearly rise in that important ratio. I might add that last year's improved earnings were aided by a combination of higher net interest income and noninterest income, which indicates strength in the core lending business as well as in other activities such as trading, merchant banking, and other fee generating services.

In short, the banking industry shows some robust signs. These positive factors should be kept in mind as one looks at the more troubling areas, such as farm, energy, and developing country loans.

The Farm Sector

The current problems affecting the agricultural sector are more serious than any encountered since the Great Depression. These problems have been brought on by the worldwide increase in agricultural production, which has driven down crop prices and, with them, farm incomes and asset values. While all farmers have been adversely affected by these conditions, those farmers that entered the decade with substantial debt have naturally encountered the most difficulty. Their problems have, of course, been compounded by the relatively high interest rates that have prevailed over the current decade.

Our estimates suggest that perhaps a third of the full-time family farmers are experiencing moderate to severe financial stress. This group owes about one-half of the farm debt owed by such farmers.

Several recent developments should aid the farm economy, including the dramatic fall in energy costs and the substantial declines in interest rates and in the exchange value of the dollar. The recent farm bill also offers an additional source of support for farm incomes.

However, supply conditions for farm products suggest that a substantial rebound in crop prices, and thus in farm incomes, is not likely to take place over the foreseeable future. Consequently, farmers with relatively heavy debt loads will continue to face serious difficulties.

The majority of farm debt is not in fact owed to commercial banks, but to the Farm Credit System, the Farmers Home Administration, and to individuals. About one-fourth of total farm debt is held by commercial agricultural banks, which for purposes of this testimony are defined as those banks having 25 percent or more of total loans related to agriculture.[1]

The recent problems in the farm economy have inevitably been transmitted to many of the farm banks. Such problems are manifested in data on nonperforming loans, problem banks, and failed banks, among other measures.

At year-end 1985, nonperforming loans numbered close to five percent of gross loans at agricultural banks versus about three percent at non-agricultural banks.

Likewise, agricultural banks dominate the ranks of problem banks--that is to say, banks which are low rated 4, or 5 by examiners using a scale of 1 to 5. As of February 1986, farm banks represented over 40 percent of all problem banks.

Agricultural banks are also overrepresented in terms of failures. In 1985, 62 of 120 failed banks were classified as farm banks. In 1986, a

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[1]In previous testimony the Federal Reserve Board has defined "agricultural banks" as banks with a ratio of farm loans to total loans that exceeds the average of such ratios at all banks, currently about 16 percent. The 25 percent cut-off is used in this testimony so that our definition is consistent with that used by Comptroller of the Currency and the Federal Deposit Insurance Corporation. A table showing key statistics based on both definitions is provided along with other data submitted to this Committee.

similar pace has continued; 9 of 21 failed banks, as of March 25, were farm banks. With no imminent recovery in the farm economy in sight, it is expected that farm banks will continue to account for a disproportionate number of failures.

Most of the failed farm banks have been very small, and thus their failure has had less effect on the overall banking system than at the local level. The effect at the local level, however, has been damaging. For example, of the 62 farm banks that failed in 1985, 43 of these were the only bank in the community. In most cases, a merger with another banking company was arranged. However, it has become increasingly difficult to arrange takeovers of failed institutions. In 1985, no merger could be arranged for 11 failed farm banks; the depositors were paid off and the institutions were liquidated.

Having reviewed the negative side of the farm bank situation, I would like to touch on the positive side to provide a balanced perspective. Over 95 percent of the total loans at agricultural banks are performing, and one-half of these banks reported earnings equal to 10 percent or more of equity. Also, agricultural banks generally have a substantial capital cushion to absorb loan losses. In fact, the capital to assets ratio for all agricultural banks averaged 9.8 percent in September of last year, well above the 7.5 percent ratio for the entire banking system.

The Energy Sector

In addition to problems in the farm sector, conditions in the energy industry resulting in part from declining oil and gas prices have created serious strains on banking organizations, particularly those located in the Southwest. While this situation has intensified with the recent sharp drop in oil prices, problems associated with energy lending have their roots in the oil shocks and energy shortages experienced in the decade of the 1970s. The intense concern over the continued availability of energy supplies, and the inflation psychology of this earlier period led many observers, including bankers, to conclude that the price of oil and other forms of energy would continue to move upward over time. Energy based loans were seen as particularly safe and profitable.

The rapid increase in energy lending during this period is reflected in the statistics on shared national credits (SNC), which capture energy loans and commitments. A shared national credit is any loan or group of loans (including unused commitments) to one borrower that exceeds $20 million and is shared by two or more banks. The aggregate of such energy loan exposure included in SNC credits increased from $6.7 billion in 1977 to $56.9 billion in 1984. This growth, in turn, paid handsome dividends for a time for energy lenders. From 1979 to 1982 the asset growth and profitability of large bank holding companies (i.e., those with assets in excess of $1 billion) in the Southwest generally exceeded the growth and profitability of comparable companies in other regions.

But by 1982, the energy boom in the Southwest began to end. Successful conservation efforts and the back-to-back recessions of the early 1980s tempered demand for energy while new non-OPEC supply sources grew. The combined result was a reversal in the upward pressures on energy prices. Serious strains within the banking system surfaced in 1982 with the failure of the Penn Square Bank and the severe repercussions of this failure on other large banking organizations. As everyone here no doubt recalls, loans and participations purchased from Penn Square inflicted substantial losses on a number of banks and contributed to the huge loan losses and severe liquidity crisis at Continental Illinois National Bank in the period from 1982 to 1984. Energy problems also led to the closing of the First National Bank of Midland, Texas in 1983, one of the largest actual failures of a commercial bank in the United States.

In addition to signifying the emergence of serious problems within the energy sector, some of these events, to be sure, also reflected the consequences of questionable lending decisions and practices and inadequate management controls.

By 1983, the return on assets of many large banking organizations in the Southwest fell well below the levels of similar banking organizations nationwide, and the loan loss experience of heavy energy lenders significantly exceeded the experience of similarly-sized nonenergy banking organizations. While earnings of bank holding companies in the Southwest improved in 1984, last year the return on assets of these companies once again fell well below their national peers. Furthermore, the relative level of nonperforming loans in energy-oriented organizations in that region greatly exceeded national peer group averages.

Between 1982 and 1985, the aggregate volume of oil and gas credits classified under the SNC program (i.e., those larger credits of poor quality) increased from $1.2 billion, representing 2.6 percent of the capital of the SNC energy lenders, to $8.4 billion, or 9.8 percent of the capital of these energy lenders. While shared national credits do not include all energy loans in the banking system and the effects of the most recent drop in oil prices have yet to be reflected in these figures, the increases nonetheless reveal the pressures being experienced by some energy lenders.

The difficulties experienced by energy lenders since 1982 reflect the on-going adjustment process in the energy sector. As energy supplies have continued to grow relative to demand and prices have fallen, the value of oil and gas equipment and reserves has declined, and the cash flows of many borrowers have been severely reduced. This has eroded the financial strength of a considerable number of energy borrowers, forcing some into bankruptcy and preventing others from servicing their loans in accordance with the original terms and conditions. The result, as has already been noted, has been that many energy banks and institutions in the Southwest have been forced to cope with serious asset and earnings problems over the last four years. In 1984, 11 banks failed in Texas and Oklahoma, states with a considerable number of energy lenders. This number amounted to roughly 14 percent of all bank failures in that year. Last year, the number of bank failures in these states doubled to 22, or approximately 19 percent of all bank closings.

Pressures on these lenders have increased since year-end due to the further sharp declines in oil and gas prices. These developments have exacerbated the problems of many energy-related firms and energy lenders, including some sizable institutions. Many banks in energy producing areas or with heavy energy exposure are also experiencing strains from loans to troubled real estate and agricultural borrowers, and in some cases have exposure to foreign countries dependent on the production and export of oil.

A recent survey by the FDIC identified 563 federally insured banks with assets over $100 million and oil and gas loans in excess of 25 percent of total capital. The survey found that these institutions held over $61 billion in energy loans, with $57 billion (92 percent of the total) held by 59 large regional and multinational banks with assets over $1 billion. Of the smaller banks identified in the survey, over 80 percent were located in the states of Texas, Oklahoma and Louisiana.

Recognizing the problems in the energy sector, banks in the Southwest began to make significant additions to their loan loss reserves in 1982 and have continued to do so.

To improve our understanding of the financial condition of large energy lenders, the Federal Reserve, with the cooperation of the FDIC and OCC, is conducting a special energy inspection of bank holding companies with assets in excess of $500 million and significant energy exposure generally in excess of 25 percent of capital. Through these special inspections we will obtain more current information on the aggregate oil and gas exposure of these organizations, the volume of nonperforming energy loans, and the condition of their large oil and gas credits.

Mr. Chairman, the Federal Reserve, together with the other federal banking agencies, recognizes that conditions have shifted sharply and unexpectedly in both the agricultural and energy sectors of our economy. In view of the continued deterioration in agriculture, the Federal Reserve in February of this year renewed in a slightly modified form the simplified seasonal credit program for agricultural banks. This program is designed to make funds available at the discount window to agricultural banks experiencing especially strong loan demands. This change is designed to assure that agricultural banks will not face liquidity constraints in accommodating the needs of farm borrowers over the planning and production cycle.

In addition, the banking agencies in March of this year issued a joint statement on policies to assist basically sound, well managed farm banks to weather this period of economic adversity. These policies among other things:

1) Permit banks experiencing heavy losses due to external factors to operate with reduced capital levels, even if below the minimum standards set down in our supervisory guidelines, provided the banks are following prudent lending and financial practices and have the clear potential for replenishing their capital positions over a reasonable period of time;

2) Reaffirm the agencies' long-standing policies of not discouraging banks from forbearing on farm loans through appropriate debt restructurings in cases where there is a reasonable prospect that restructurings will work to the advantage of the bank as well as the borrower;

3) Refrain from requiring automatic charge-offs of debt restructurings when their terms meet the criteria of generally accepted accounting principles; and

4) Revise supervisory reporting procedures for restructured loans that are performing under the new terms in order to more accurately reflect the status of such loans and to avoid the suggestion that such loans are a component of nonperforming assets.

While these policies were initially developed in connection with our review and consideration of problems in the farm sector, the dislocations and uncertainties resulting from the recent sharp decline in energy prices have created serious pressures for some energy lenders as well. Therefore, the Federal Reserve and other federal banking agencies recognizing these pressures have agreed to follow these policies in supervising energy banks as well. For its part, the Federal Reserve Board has already instructed the Reserve Banks to conform their practices and procedures to the policies outlined in the joint statement.

I hasten to point out that none of these steps, of course, is intended to shield banks engaged in unsafe and unsound or objectionable practices from appropriate supervisory enforcement action. Rather, the intent is to adopt supervisory policies that will assist banks that are fundamentally sound and well managed, and that have taken reasonable steps to strengthen their positions and conserve their capital.

Despite the assistance provided by these policies, some banking organizations may continue to experience severe and prolonged financial stress. In order to augment flexibility to deal with the more serious cases, the Board would encourage modification of the provisions of the Garn-St Germain Act of 1982 which prohibit acquisitions of failed banks across state lines before an actual failure occurs and which also prohibit acquisitions of failed banks with assets under $500 million. The Board believes that these two constraints should be eased by allowing the across-state acquisitions of failing banks and by reducing the size of such banks that can be so acquired. In addition the Board believes that the acquirer of a failing bank should also be permitted to purchase the holding company that owns the bank and other affiliates of the bank. These modifications would help to minimize losses to the deposit insurance fund, and also help to maintain banking services in small communities.

One further means of promoting the maintenance of banking services in small communities is through the relaxation of state branching restrictions. Such an easing would enable out-of-territory banking institutions to acquire small banks when a separately organized and capitalized bank might not be viable.

Commercial Real Estate

In addition to the agricultural and energy sectors, another area that bears close watching is commercial real estate and, in particular, the office building market. In many areas of the country the supply of newly constructed office buildings has greatly exceeded the demand and this has translated into extremely high vacancy rates. In fact, the office building vacancy rate in metropolitan areas reached 20 percent at the end of last year, the highest rate in the postwar period. To put this in perspective, the previous postwar high, which occurred in the mid 70s, was 11.5 percent.

A large part of the general overbuilding in the office market has been a regional phenomenon, most prevalent in the Sunbelt states. What is especially troublesome, however, is that difficulties brought on by the decline in energy prices have greatly reduced the demand for office space in cities such as Houston and Dallas, where vacancy rates are now among the highest in the country. Thus banks that were heavily involved in financing both the Texas energy and real estate booms have been dealt a particularly severe blow. In other cities in the Sunbelt such as Fort Lauderdale and Tampa the vacancy rates exceed 25 percent and are expected to remain at high levels during 1986. Weakness in the office building market has prompted owners to offer concessionary rental rates in order to attract tenants. Nevertheless, many buildings remain vacant, or nearly vacant, and this situation has greatly increased the exposure of banks that are heavily involved in commercial real estate lending. To some extent the decline in interest rates should help to alleviate the cash flow problems of those that have borrowed heavily to finance commercial real estate.

International Lending

I would now like to turn to the banks' international activities. Loans to foreign borrowers have attracted considerable attention since 1982 when several countries were unable to continue servicing their external debts as initially contracted. Prior to 1982, U.S. and other banks had rapidly expanded their lending to many countries. For example, claims on

Latin American borrowers by U.S. banks rose from $38 billion to $84 billion during the period 1977 to 1982. However, by 1982 economic and financial conditions for many of these countries were deteriorating. Countries' debt levels and market interest rates were high; the United States and major European countries had not yet emerged from serious recessions; and commodity prices were weak. The international debt crisis began to seriously threaten bank earnings and capital and became a major concern to us all.

While problems in international lending remain, the environment has clearly changed, and most U.S. banks appear better prepared now to handle these problems than they have been in many years. Since 1982 the banking industry has substantially increased total capital funds, while total claims of U.S. banks on Latin American borrowers have tended to stabilize. Though still large, exposure relative to capital has declined significantly.

Among U.S. banks, the exposure to the heavily indebted countries is concentrated in the nine largest international lenders, which account for almost two-thirds of all loans by U.S. banks to Latin America. The exposure of most other U.S. banks is relatively small. It is especially encouraging, therefore, to note that by raising additional capital these large banks have reduced their relative exposure to Latin American countries from almost 180 percent of total capital in 1982 to about 130 percent today. It is also important to recognize that these lending relationships are long-term in nature and that U.S. and other foreign banks must continue to play important roles in financing the economic growth of these countries.

A second encouraging factor is that both the banks and the debtor nations have generally addressed payment problems in a reasonable and nonconfrontational way. Since 1982, foreign countries throughout the world have negotiated over 50 separate restructuring agreements, often by postponing principal payments while remaining current on interest. Argentina, which has received much attention in recent years because of its external debt problems, has made significant progress, and by the early part of this year had eliminated all interest arrearages on its public sector debt. Most other major debtor countries are similarly current on their public sector interest payments.

Comprehensive data on nonaccrual loans to developing countries are not available, but the amount is relatively small. One indication is the fact that one of this country's largest lenders recently reported that only about 7 percent of its loans to foreign countries that had refinanced their debt were on a nonaccruing status. This rate is significantly higher than its overall rate of nonaccruing loans, but remains a relatively small percent of its loans to countries with payment difficulties. Moreover, most of the foreign nonaccruing loans are to private sector borrowers and are due largely to commercial credit problems, rather than transfer risk problems.

The United States and other major countries have recognized the serious and long-term nature of the problems many of the major debtor countries face and have endorsed policies that, when implemented, should help these countries to regain economic health. The Baker Initiative, which combines additional private and World Bank lending with structural reforms within the debtor countries, represents a sound approach to resolving many countries' payment problems. Many countries have already adopted elements of the approach outlined by Secretary Banker. Argentina and, most recently, Brazil have undertaken major economic reforms designed to reduce their inflation, encourage local investment, and promote a more rational pattern of economic growth. Argentina's brief experience under its programs has given promise of what can ultimately be achieved. But permanent success for Argentina, Brazil and other debtor countries embarking on such programs will depend on the willingness of the industrial countries to maintain open markets for the exports of these countries as well as on the countries' ability to regain the confidence of their citizens. By merely adopting policies that stem the flight of capital and encourage the return of prior outflows, many countries could significantly reduce their external debt problems.

The recent decision by the Executive Board of the International Monetary Fund to work jointly with the World Bank in providing at least $3 billion or more of new financing to the least-developed countries should also help the economies of these poorest nations. The nominal interest rates of one-half of one percent annually should be an attractive incentive for many of these countries to enter the program and work with these organizations to implement needed reforms. Although U.S. banks have relatively little exposure to these countries, this lending facility and the IMF-World Bank coordination that it represents are helpful and encouraging developments.

Finally, declining oil prices have improved the economic outlook for Brazil and other heavily indebted countries and declining interest rates are generally having a beneficial effect on the debtor countries. With the recent decline in interest rates it is estimated that the Latin

American countries alone will save $10 billion annually in interest costs on their short-term and floating rate debt.

Mr. Chairman, despite the progress that has been made, significant difficulties remain in this sector of bank lending. The continuing fall in oil prices has severely disadvantaged Mexico and other oil exporting nations and the full effects of this trend have not yet been felt. In addition, many uncertainties surround the adjustment programs of developing countries and could threaten continued progress.

Nevertheless, recent economic reforms adopted by some countries, the lower interest rate environment, and the significant additions to bank capital provide hopeful indications that progress is being made. Recent actions by some Latin American countries to allow more foreign direct investment are also movements in the right direction and consistent with the principles embodied in the Baker plan. A number of state-owned firms have been designated for partial or complete sale. There is some additional emphasis upon measures which would stimulate the private sectors in the developing countries, thus providing for the expected need for increased employment in those areas. With continued cooperation and free trade, the debtor countries and their creditor banks should be able to avoid major problems.

Strengthened Supervision

I think we can agree that the difficulties in banking underscore the need for a strong supervisory framework. Such a framework is all the more important if we are to proceed with deregulation in the banking industry. At the Federal Reserve, we have taken a number of initiatives to improve our supervision of banks and bank holding companies. I would like to review with you a few of those initiatives.

First, we recently announced intensified schedules for the examination and inspection of banks and bank holding companies. Under the new schedule, banking organizations that are experiencing problems, as well as the largest organizations, will be examined or inspected semiannually. We have also been increasing the size of our examination staff to meet these new scheduling requirements.

Second, we recently formalized and strengthened the process of communicating examination and inspection findings to the directors of banking organizations. Senior Federal Reserve officials, including Federal Reserve Bank Presidents, will communicate these findings directly to directors of those banks and bank holding companies subject to the intensified exam schedule. In addition, a written summary of examination findings--separate from the complete examination or inspection report--will also be distributed to these directors. It is encouraging that many bank Boards of Director and Chief Executive Officers are concerning themselves with the quality of assets and with the review processes by which that quality is maintained. In many cases, a more senior officer has been given the responsibility under the Board and the CEO. More often committees made up of outside directors have been set up to monitor the working out of problem loans and assets and the processes by which the institution exercises control over their asset portfolio.

Third, in the area of capital adequacy, minimum capital requirements were adopted in 1981 in order to reverse the decline in bank and bank holding company capital ratios. Since 1981 capital ratios have shown a strong increase. The minimum capital requirements were raised in

April of last year for regional and multinational institutions, and the disparity in minimum capital requirements between large and small institutions was eliminated. In January of this year we announced a proposal to supplement the existing capital requirements with an adjusted capital measure that, among other things, would take into account the risk associated with off-balance sheet banking activities. In addition, we issued guidelines on bank and bank holding company dividend policies to ensure that such policies do not weaken an organization's financial position.

And finally, we have taken steps to expand and improve the flow of information on banking institutions in order to strengthen our capacity to monitor the financial condition of banks and bank holding companies and to detect problems at an early stage.

At this point, Mr. Chairman, I would like to address a question that has been raised frequently in connection with the ongoing debate on the tax bill as to whether the reserve method of computing the allowable tax deduction for bad debts should be repealed. The proposed repeal would of course make it more costly for banks to maintain loan loss reserves. Moreover, I argue that it would inhibit the growth of loan loss reserves by discouraging banks from maintaining reserves at levels at which they might otherwise, thereby creating some risk in terms of bank safety and soundness. From my perspective as a bank regulator, I believe measures should be taken to encourage banks to increase their loan loss reserves. Therefore, from that perspective, I would favor the retention of the existing tax treatment for loan loss reserves, or its liberalization. But I recognize, of course, that a decision on this matter must be made against the need to achieve reductions in the budget deficit.

Another matter that has received considerable attention recently is the whole issue of accounting flexibility. For example, there have been a number of proposals that would allow banks to defer over a number of years the charge-off of uncollectible loans. While I strongly endorse the ongoing efforts to improve accounting principles and practices, I would caution against any changes--such as the deferral of loan charge-offs--that would impair the meaningfulness or credibility of bank financial statements.

In summary, Mr. Chairman, the banking industry as a whole has demonstrated a remarkable ability to withstand the financial pressures and volatility of the last several years. To be sure, a considerable number of banking organizations are experiencing severe strains resulting from heavy exposure to the agricultural, energy, and in some cases, the real estate sectors. However, it is important to keep these problems in proper perspective and recognize that the great majority of banks remain in healthy condition and the system is fundamentally sound.

Much progress has been made over the last several years in encouraging banking organizations to increase their capital bases, and this has contributed significantly to the ability of banks to withstand periods of uncertainly and adversity. The prospects of lower inflation and interest rates and improved economic performance generally augur well for the future health and stability of our banking system.