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Statement by

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I appreciate the opportunity to appear before this Committee today to discuss the condition of the U.S. banking system. Before presenting the Board's testimony, I want to emphasize our belief that this regular exchange of views is helpful to the Federal regulators as well as to the Congress The oversight hearings process should aid in focusing on--and dealing with--perceived banking problems as they begin to develop.

At the outset, I believe it important to recognize that commercial banks in our country function as the department stores of finance. They serve both business and consumers, provide both short- and longer-term credit accommodation, and are involved as important financing sources in virtually all areas and lines of economic activity. Because of this pervasive and continuous involvement, banks tend to reflect the condition of the economy. When times are good, the banking system appears to be in good shape; when economic problems occur, they are likely to show up in the condition of banks as well.

This linkage has been dramatically demonstrated over the past few years. During the unusually severe recession of 1974-75, the banking system experienced its greatest problems since the 1930's. Primarily as a result of the downturn, classified assets of banks more than tripled from year-end 1973 to year-end 1975. Moreover, bank earnings, hurt by large loan losses and loss reserve provisions, levelled off or declined after their sharp rise during the early 1970's. A significant number of banks required remedial attention, and some--including a few large ones--had to be merged. Perhaps most serious, that earlier period witnessed the first significant erosion of public confidence in the banking system in almost four decades.

Since 1975, the economy has experienced a long expansion, albeit at an uneven rate. Predictably, the condition of the banking system has steadily improved. By year-end 1978, the dollar volume of classified assets was down by over 20 per cent from the peak, and non-performing loans at large banks had been reduced by more than one-third, even though total bank assets had expanded sharply in the interim. Much of this improvement in asset quality reflected a gradual workout of problems in the real estate sector, the area in which banks experienced by far their greatest difficulties during the recession, although other types of lending showed substantial improvement as well. Since 1975, also, bank earnings have experienced strong growth. Over the last three years, profits after taxes have risen more than 50 per cent in nominal terms, and the increase in 1978 alone was the largest for any single year in the past several decades. One major factor contributing to this outstanding earnings performance has been the rapid growth in bank loans, which reflected strong demands for credit both at home and abroad.

The economy has now reached the point at which growth has slowed--necessarily, in view of the accelerated inflation and limited potential for further output gains--and many analysts are predicting a recession in the period ahead. Although the Board does not necessarily subscribe to this view of an inevitabile recession, there obviously is a heightened risk of more difficult times in some industries and regions. And if a downturn of size should occur, the question is how well the banking system would weather it. Our view is that the system generally is again in good shape to face adversity, although financial problems could be exacerbated in those relatively few banks that have not yet recovered from their difficulties during the previous recession. We will be monitoring these institutions especially carefully in the period ahead.

Meanwhile, the current rapid inflation is having a major impact on the condition of the banking system, and one that is largely negative. First, inflation creates conditions that may adversely affect the quality of bank loan portfolios. Inflation tends to generate ballooning credit demands, even while interest rates are rising. High interest rates and rising indebtedness, in turn, expose borrowers to the risk of heavy debt servicing burdens--especially if things don't turn out as well as expected. The potentially harmful effect that spiraling interest rates can have on certain borrowers was vividly demonstrated in the case of the REIT's just a few years ago, when borrowing costs first rose sharply with tight money conditions and then sales and rentals failed to come through with the onset of recession. True, there were many other problems in the REIT industry--and in building generally--during that period. But an economic slowdown necessarily brings with it slower sales and reduced cash flows for many firms.

A second way that inflation may adversely affect the condition of the banking system is by putting downward pressure on bank capital ratios. Indeed, the moderate decline in the equity capital to total asset ratio for insured banks from 6.1 per cent at year-end 1976 to 5.8 per cent at year-end 1978 can be attributed mainly to the effects of the rapid inflation experienced over the last two years. This is because the inflation has been reflected in rapid growth of nominal GNP and hence in the needed financing associated with growth in real output and sales, even at a moderate pace. Bank credit, therefore, has been expanding rapidly, as banks have performed their traditional role in accommodating customer needs, and this expansion has tended to outrun the internal growth of capital from retention of earnings.

At the same time, inflation has limited external additions to bank capital by making equity financing more expensive. By pushing up interest rates, inflation encourages holders of bank stock to switch out of these stocks and into higher yielding debt instruments. The lack of demand drives the price of bank stocks down, thereby making equity financing more costly. In addition, inflation tends to make bank stocks less attractive relative to many other stocks. The reason is that banks, unlike most other businesses, hold few real assets whose market or replacement value can be expected to rise because of the inflation.

Inflation's adverse effects on bank stock prices is clearly evident in the market. During the last several years, the stocks of most of the nation's major banking organizations consistently have sold at only five to eight times annual earnings. Moreover, most of these stocks are trading at significant discounts from book value.

The current economic recovery and the attendant inflation have also featured an unusually strong and sustained expansion in consumer spending. As a result, and perhaps reflecting also vigorous institutional promotion, consumer debt has risen very rapidly--15 per cent per year, on average, over the past three years.

Consumer debt servicing burdens have risen apace, with monthly payments in relation to disposable income reaching a post-war record high late last year. This situation has raised questions about the capacity of consumers to service this debt, particularly if there should be any marked slowing in income gains or substantially higher unemployment. The implications for the banking system are of great importance because consumer loans make up more than 20 per cent of bank loan portfolios.

To date, the rise in consumer debt has not resulted in any appreciable rise in delinquency rates. However, we believe that the buildup of consumer debt could become a problem, and should be closely monitored. Accordingly, we are in the process of reinforcing bank examination procedures to assure a careful review of the quality of consumer lending and the controls over this lending that banks are employing.

Economic shocks and dislocations also can have an impact on the banking system, primarily by affecting the financial condition of borrowers. By far the most severe exogenous shock to the economy in recent years was the quadrupling in oil prices by the OPEC cartel in late 1973. This action radically altered the cost structures of many businesses as well as the pattern of spending by consumers and others. The consequent downward pressure on profits in the affected industries increased the risk exposure of banks lending to these companies. Today's energy situation, though apparently not representing such a marked change as in 1973, will likely bring significant adjustments in some industries and markets also. Bank supervisors, accordingly, will have to be alert to possible consequences on the portfolios of affected banks.

Not all exogenous forces affecting the economy are this dramatic. Some evolve very slowly, but still have an important cumulative impact on various parts of the economy and on the banks serving it. One major example that comes to mind is the migration in recent years of business firms and population to the Sunbelt. This migration is having major impacts on the economies of the Sunbelt states and has provided banks located in these areas with strong growth trends and numerous business opportunities. On the other hand, the migration has had adverse effects in other areas of the country and has required banks in these areas to adjust their operations to a slower pace of expansion. Sharply different rates of bank growth--a necessary feature of our decentralized banking system--requires close attention by supervisors since it implies different strategies for such elements of banking condition as capital, liquidity and lending policies.

Another relatively new element in banking has been the strong trend toward international business. While the expansion in office facilities and business abroad has brought many benefits to American banks, it has also exposed them to certain risks--both economic and political. Probably the major risk relates to lending. In addition to normal credit risks, lending abroad involves so-called "country risks." These include the possibility that a foreign country may not be able to generate enough foreign exchange to service its debts, as well as the more remote chance that a change in government could result in the new regime repudiating some or all of its foreign indebtedness.

Historically, American banks have had excellent results in their foreign lending, with the ratios of losses to loans significantly below those sustained domestically. However, this good record should not obscure the relatively unpredictable economic and political risks associated with some of this lending, particularly in the uncertain environment that prevails.

I hope that these examples have helped to demonstrate the close link that exists between banks and the economy and to show that the condition of the banking system is inevitably exposed to various unpredictable economic shocks and surprises. When the economy experiences problems such as a recession, rapid inflation or major dislocation, we can be quite sure that many banks--the department stores of finance--will encounter some degree of adversity also.

Given our inability to know in advance what economic problems will emerge, how can bank supervisors help to ensure that banks will be able to overcome these difficulties and continue to serve effectively the banking needs of our country? One thing that we can do is to make sure that banks employ prudent lending standards and hold their commitments within reasonable bounds. We recognize that banks must take risks in order to meet the legitimate borrowing needs of their communities. But these risks must not be excessive, they must not unduly tax the resources of the institution, and they must promise adequate compensation after allowance for risk.

Second, banks must keep their capital ratios sufficiently high to cushion losses and maintain public confidence during adversity. It is evident that banks are now having difficulties maintaining their capital ratios due to inflation and poor equity capital markets. However, the supervisors will expect banks to resist any slippage through the current period of difficulty and make every effort to improve these ratios whenever possible, particularly when the environment for equity financing turns more favorable.

Third, banks should be encouraged to employ the principles of diversification in all major aspects of their operations, both at home and abroad. In particular, they should strive to diversify their loan and security portfolios, avoid undue reliance on volatile sources of funds and maintain adequate liquidity to meet all foreseeable contingencies. Diversification will not prevent banks from taking losses, but it should reduce the possibility of a bank encountering such major difficulties that its viability is threatened.

Since the hearings last year, the Federal Reserve, in cooperation with the other Federal banking agencies, has taken several actions designed to encourage diversification of risk and to assure prompt and effective supervisory response to emerging banking problems. A new uniform examination system for assessing country risk in international lending by U.S. banks was developed. This system is designed to identify and discourage undue concentration of credit by banks in individual foreign countries. The agencies also introduced a new uniform bank rating system that expands the number of financial factors that the agencies will consider in rating banks. This rating system should help us identify more precisely those banks in need of particularly close supervisory attention.

Turning to the bank holding company area, there is substantial evidence that the condition of holding companies is continuing to improve. This improvement in large part reflects the healthier condition of bank subsidiaries, which constitute a very large part of most holding company organizations. But parent companies and their nonbank subsidiaries also are generally in better condition than during the mid 1970's. Holding company management appears to be exercising greater prudence in parent company financing, and fewer parents are experiencing difficulties in meeting their debt service commitments. In the nonbank sector, most holding companies appear to have turned around the major problem areas, such as mortgage banking, that emerged during the mid 1970's. Here again, the economic expansion has played an important role.

Several actions have been taken during the past year that should help improve bank holding company supervision.

One major step was the introduction of a bank holding company rating system. This system has standardized the evaluation of the financial condition of holding companies and has helped to identify those companies with significant financial problems. The Federal Reserve also is continuing to implement its recently expanded program for inspecting bank holding companies. This program involves the inspection on an annual basis of all holding companies with consolidated total assets exceeding $300 million, and incorporates a standardized report form focusing attention on the assets of nonbank subsidiaries, holding company debt, and the financial condition of the consolidated organization.

The passage last year by the Congress of the omnibus Financial Institutions Regulatory Act should prove helpful in our supervisory responsibilities. As requested by the supervisory agencies, this Act provided for expanded cease and desist powers and civil penalties for violations of banking laws and regulations. The Act also gave the Federal Reserve the authority to require the divestiture of a nonbank subsidiary of a holding company if such subsidiary constitutes a serious risk to the safety of a holding company bank.

In recent months the supervisory agencies have been actively implementing numerous other titles of the Act. This implementation process, which is now largely behind us, has required the issuance of regulations and policy statements on interlocking directorates, changes in bank control, correspondent accounts, financial privacy and electronic fund transfers. During the large-scale implementation effort, the supervisory agencies have worked closely together to assure uniformity in the resulting regulations and supervisory procedures. It is too early to say, of course, what experience will be in monitoring and enforcing these new requirements.

One section of the Act also created the Federal Financial Institutions Examination Council. The Council, which is composed of principals from the five Federal financial regulatory agencies, should help to increase even further the cooperation and coordination among the agencies that have been achieved in recent years. The Council is now a going business and I can assure you that the Federal Reserve will make every effort to help the Council carry out its mandate to accomplish greater uniformity and coordination in supervisory standards and procedures. This is certainly no time to permit potentially damaging banking practices to slip between any cracks in the supervisory process.

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