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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

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I am happy to appear before this Committee today to discuss the condition of the financial system. The Board continues to believe that these annual hearings are useful for putting banking developments into perspective, and that they also provide a good forum for discussing legislative initiatives that may be needed to help assure the continuation of a sound financial system.

Recent data on the condition of commercial banks indicate that the banking system has worked out most of its problems of the mid-1970's and is now in generally good shape. The number of bank failures during each of the last three years has been below the levels prevailing during the mid-1970's; and last year no bank of size had to be closed. Moreover, the number of problem banks is well below the level of the mid-1970's and is at an acceptable level. For example, only about 2 per cent of the state member banks supervised by the Federal Reserve now require special attention, and these banks hold only about 1 per cent of total state member bank assets.

The quality of bank assets also has improved over the last several years. Aggregate classified assets of commercial banks at year-end 1979 were down more than 25 per cent from year-end 1976, even though bank assets increased by over 40 per cent in the interval. Looking at the nation's larger banking organizations, nonperforming assets (which include non-accruing and reduced rate loans and real estate acquired in foreclosure) amounted to about 1 per cent of total assets at year-end 1979, compared to a little over 2-1/2 per cent three years earlier. Real estate loans and foreclosed properties continue to be the largest category of problem assets.

In the last three years, bank earnings have strengthened, and the rise in the aggregate has been well above the growth of overall corporate profits. In 1979 alone, bank earnings rose 19 per cent, aided by good growth

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of bank assets and loans and well maintained net interest margins. So far in 1980, bank earnings have risen moderately further. I should note, however, that this earnings performance is considerably deflated when account is taken of inflation, and that the return on equity in banking remains well below that realized in manufacturing industries as a whole.

In past hearings, this Committee has expressed particular concern over the secular decline in bank capital ratios. The Board shares that concern and regrets that, over the past three years, the decline in capital ratios has resumed, so that, at the end of 1979, the average ratio was little better than at the previous low reached in 1974. As before, the problem continues to be that banks have been faced with strong credit demands from their customers, given the inflationary environment, while the capital markets have remained very unreceptive to new stock financing. Retained earnings simply have been insufficient to keep up with asset growth.

I am glad to report that there was almost no further slippage in bank capital ratios last year, however, and that the prospects are good for some improvement in the current year. First, the slowdown in the economy is retarding the demand for loans by both consumers and business, so that the growth in bank credit should slow. Moreover, the voluntary special credit restraint program is designed to hold bank loan growth this year within a range of 6 to 9 per cent, and we firmly intend to see that the result is achieved. Even though banks probably will still not be able to raise much equity this year due to depressed bank stock prices, retained earnings may well be sufficient to keep capital growing more rapidly than this reduced pace of bank credit expansion.

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While most of the statistical indicators of the condition of the banking system are thus positive, it is important to recognize that we appear to be entering a period of greater risks for the economy and financial markets. Recent economic data clearly indicate that the economy is now on the decline, and the rate of that decline up until now appears considerably sharper than most had anticipated. Based on our experience in previous recessions, this economic downturn is likely to result in an increased incidence of problem loans during 1980 and probably on into 1981.

One area of particular concern to many bankers and supervisors is consumer debt. Even before the economy began to decline, consumer installment loan delinquencies as a per cent of outstanding loans were rising; and the continuing squeeze between earnings and inflation and increasing unemployment almost surely will accelerate the trend. The implications of the liberalized personal bankruptcy laws bring added uncertainty in this important area, since there has been no experience with the new provisions during a time of adversity.

Banks also have large loan balances outstanding to several major corporations whose financial problems have been well publicized. Such problems could well tend to multiply and, if not resolved, some banks could experience significant losses. We believe, however, that most banks will be able to absorb any such losses through charge-offs to quite sizable loan loss reserves, backed up by a generally favorable underlying earnings flow.

External shocks and dislocations also are likely to be having an adverse impact on banks, largely by affecting the financial condition of certain borrowers. We are all well aware of the impact that the dramatic increase in petroleum prices is having on the economy. This upsurge has radically changed

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the cost structures of some businesses and altered the pattern of consumer expenditures, not only for goods but also for travel and other services. These developments are eroding the earnings of some firms that borrow from banks, thereby reducing their ability to service their debt. This situation is exacerbated by the historically very high current costs of debt needed to carry receivables, inventories, and recent capital improvements. The dramatic increase in petroleum prices also has contributed to a deterioration in the balance of payments of many non-oil producing less developed countries. Many of these countries are significant borrowers from American banks and some could have difficulty servicing their debts if they should experience excessive deficits for an extended period.

In recent months, high interest rates also have had a very adverse effect on the earnings of thrift institutions and some banks that have balance sheets concentrated in longer-term fixed rate assets. The earnings of these institutions are especially vulnerable because they have more variable rate liabilities than variable rate assets. The sharp decline in interest rates over recent weeks--particularly rates on large negotiable CD's and money market certificates--should begin fairly soon to give these institutions some much needed relief. But we cannot be sure of future interest rate trends, and the earnings of these institutions will remain exposed to excessive volatility so long as they are unable to achieve a better balance between variable rate liabilities and variable rate assets.

Given these many risks and uncertainties, the five Federal financial institutions supervisory agencies, as a matter of proper contingency planning,

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recently submitted a legislative proposal to the Congress to deal with possible future problems in the banking and thrift industries. This proposal would authorize interstate acquisitions of failed depository institutions in certain emergency situations. It would also expand the authority of the supervisory agencies to extend emergency financial assistance to depository institutions critically squeezed by general economic adversities.

The Board supports the entire legislative proposal jointly submitted by the five agencies. In my testimony today, however, I will limit my comments to those parts of the draft legislation that are most directly related to the Federal Reserve's supervisory responsibilities.

One section of the draft legislation would amend Section 3(d) of the Bank Holding Company Act to permit, in exceptional circumstances, an out-of-state bank holding company to acquire a large commercial bank that has failed or a bank holding company controlling a large commercial bank that has failed. Similarly, an out-of-state bank holding company would be permitted to acquire a newly chartered commercial bank that is the successor through purchase and assumption of the assets and liabilities of a large savings bank that has failed. At present, Section 3(d) of the Bank Holding Company Act prohibits an out-of-state holding company from acquiring a bank unless such acquisition is expressly permitted by the statutes of the state in which the bank to be acquired is located. Only several smaller states have such statutes.

Amending Section 3(d) to permit such out-of-state acquisitions, we believe, would have several important potential benefits. First, it could substantially increase the number of potential bidders for a large failed institution, thereby reducing the possibility that the institution would

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have to be liquidated for lack of a buyer prepared to make a cost-effective bid. If the authorities were forced to liquidate the failed bank, the community would permanently lose the bank's services. In addition, uninsured depositors of the bank could suffer losses, undermining public confidence in the banking system. If forced liquidations were to occur at a time when institutions were generally recognized to be under pressure, the domino effects of such a development could become very serious indeed.

Under current law, it may be difficult or impossible to find an instate buyer for a large failed institution. In some states, such as Illinois, present branching and holding company laws prohibit instate organizations from acquiring a failed bank and keeping its office open to the public. Moreover, even if state holding company or branching laws permit an instate acquisition, there may be no such organization with the financial resources and managerial capability to make the acquisition. This is particularly likely if the failed bank is one of the largest in the state. Finally, even if there are one or more organizations in the state that could acquire the failed bank, the acquisition might have such serious anticompetitive implications within the state that it could not be permitted under the existing anti-trust standards.

Another reason for allowing out-of-state acquisitions by bank holding companies in these exceptional forced marriage circumstances is to avoid giving foreign banks an advantage in acquisitions that is denied to all out-of-state U.S. banking organizations. Such preferential treatment of foreign banks seems to us unfair, and runs counter to the concept of equal national treatment of U.S. and foreign banks underlying the International Banking Act.

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In drafting the proposed legislation, the agencies were careful to place severe limitations on the potential use of the interstate acquisition provision in order to protect the interests of both the public and existing State preferences as to structure. First, such acquisitions would be permitted only in cases where a bank has already fallen into such circumstances that its principal supervisor is prepared to declare it insolvent, and therefore it has failed. Institutions that are simply in danger of failing would not be covered by this authority. Second, interstate acquisitions would be permitted only in cases involving a large commercial bank or savings bank. A failed commercial bank would have to have total assets in excess of $1.5 billion, or be one of the three largest commercial banks in its state. A failed savings bank would have to have total assets in excess of $1 billion, or be one of the three largest thrift institutions in its state. Third, the Examination Council would have to certify to the Board, with at least four of its five members concurring, that an emergency exists, and that an intrastate acquisition of the failed bank is not in the public interest or is otherwise not feasible.

Finally, it should be noted that the proposed legislation would give the Board authority to reject any potential interstate bidder in an emergency acquisition of a failed bank on grounds that the acquisition would have an adverse effect on competition or concentration of financial resources in any region or in the nation as a whole. All in all, in the Board's judgment, these stringent limitations should remove any concern that the proposed legislation would promote interstate banking in contravention of Congressional intent, or that it would lead to a significant reduction in competition or increase in the concentration of banking resources.

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