

"The California Banking Industry - A Health Report"

Remarks by

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Recent newspaper reports of "problem" banks or holding companies, including some in California, have created a misimpression of serious weakness in the nation's banking system which I would like to correct. I believe that the banking system in California is basically healthy, and I am advised that the same can be said of the nation's banking system as a whole.

For the most part, the recently published names of individual banks and bank holding companies were based on examinations that occurred in 1974 and are at least one year out of date.

As you are aware, the U.S. economy passed through a period of extreme inflation in 1973 and early 1974, followed by the most serious recession of the post World War II period in late 1974 and early 1975. As might be expected, many banks were adversely affected by these general economic conditions.

By mid-1974, funds for the expansion of bank credit were available only at record interest rates, as money and capital markets tightened drastically in the face of double digit inflation, and commercial banks became virtually the only source of credit for many borrowers. The resultant heavy loan demand in this period strained the liquidity of many banks.

Although the managements of some banks may have been overly aggressive in their extensions of credit, the banking system as a whole performed extremely well in these difficult circumstances. When the recession developed in late 1974, it intensified the problems confronting the banking industry. Certain sectors of the economy, such as housing, were particularly hard hit by a fall in demand, and the

quality of assets banks held in these sectors deteriorated sharply. By late 1974 and early 1975, many banks were grappling with the twin problems of low liquidity and a rise in loans with interest in default. Bank regulatory agencies concentrated on these problems in their examinations, a fact that is reflected in the "problem" banks lists which have recently gained so much publicity in the press. Although the problems I have mentioned merited close attention, they never were a serious threat to the solvency of the banking system, and the inherent strength of the banking system carried it safely through this difficult period.

Another point that I want to make is that the role of examination reports has been subject to some misinterpretation. The term, "problem bank," is imprecise. In most cases, it means that a problem exists for a bank's management, not that there is an immediate threat to the solvency of the bank. A problem situation means that the long-run health of the bank requires corrective measures, to rebuild liquidity or to improve the quality of assets. The purpose of the examination process, I want to emphasize, is to insure that weaknesses, where they do exist, are corrected. If weaknesses are found to exist, such reports will show where corrective action by management is needed. In virtually every case criticism of assets and suggested corrective action do not mean that a bank is in any immediate danger of failure.

In California, where I am familiar with current conditions, the Federal Reserve Bank of San Francisco shares regulatory responsibilities with the Regional Administrator of National Banks, the Regional Office

of the Federal Deposit Insurance Corporation and the California State Banking Department. Close cooperation exists among these agencies, all of which share the common goal of ensuring the health and competitive vigor of the banking industry. The Federal Reserve Bank, as always, stands ready to assist individual member banks with its credit facilities. In some situations the Federal Reserve also has the power to lend even to nonmember institutions, should the need arise.

On the basis of information available to me, I believe that California banks have acted to correct most of the weaknesses that surfaced in 1974 and early 1975. The regulatory agencies have urged appropriate remedies where needed, and as a group the banks have responded, even though some cases remain that we continue to watch closely and to advise. California banks have rebuilt their liquidity, have instituted more cautious credit policies, and are gradually working their way out of problem loan situations. In this process of readjustment, the recovery of the economy has helped, and the prospect of continued economic expansion should insure that the California banking system is in a position to finance steady and sound growth in the state's economy.

An important ingredient in the health of the banking system is attitudes of bankers. I believe that the dangers of overly optimistic lending policies and low liquidity have been brought home. The management of banks have been reminded of the traditional banking virtue of prudence by the events of the past two years, and they have cooperated in strengthening their institutions' financial positions. These attitudes of management are reflected in current financial data reported by banks.

At the present time, we have both a strengthening economy and a sound banking system in California. There should be no doubts about these basic facts. For that matter, the information I have received from other parts of the country suggests that banking elsewhere is similarly gaining strength. In testimony this week on behalf of the Federal Reserve System, Brenton Leavitt, Director of the Board's Division of Banking Supervision and Regulation, reported to Congress that, although the number of state member banks and bank holding companies subject to special supervision had increased by the end of 1975, he felt that the recovery of the economy would bring about a reduction of such cases. Improvement in the quality of bank loans typically lags behind a turn in the economy, and banks and bank holding companies have shown their capacity to make necessary adjustments. Also according to the Federal Deposit Insurance Corporation, only 121 banks out of 15,000 banks in this country were regarded as having serious problems on January 1, 1976. Despite the recent newspaper stories about large "problem banks" or "problem bank holding companies," the FDIC emphasized that no bank with \$1 billion or more in deposits was in their "serious problem" category.

The ability of banks to make needed adjustments indicates strength, not weakness, and the fact of these adjustments shows that examination procedures of the various regulatory agencies are having their desired effect. In brief, I would say that the financial system here, as elsewhere in the nation, has undergone a period of retrenchment and adjustment because of very difficult economic problems. However, I also believe that the process has been accomplished in an orderly manner that will make tomorrow's banking system even stronger and more responsive to the nation's financial needs.