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Statement by

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before the

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

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I appreciate the opportunity to appear before this Committee today to discuss H.R. 4701, the Financial Institutions Emergency Acquisition Amendments of 1986. That legislation would make a number of important, but still limited, changes to the emergency provisions of the Garn-St Germain Depository Institutions Deregulation Act of 1982.

For your convenience, I have attached to my statement a short, and I hope readable, explanation of the bill. In this statement, I will focus on the principal issues involved -- the urgent need for action and the means of balancing the effectiveness of the proposed measures with appropriate protection of the interests of individual states.

The federal banking regulators -- the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency -- have reached a common judgment that the tools we have now for dealing with emergency situations involving failed or failing banks, including those within sizable bank holding companies, are not fully adequate. That judgment was reached in the light of strains and pressures involving banks in entire states or regions of the country that, as a result of the turmoil in energy and agricultural markets, face unusually severe economic conditions.

The existing provisions of the Garn-St Germain Act provide for emergency interstate acquisitions of failed banks of $500 million or more. Companion provisions for thrifts are decidedly more liberal both with respect to size and other criteria. Both provisions have been decidedly helpful in dealing with points of strain. But the banking structure and economic conditions in states heavily impacted by energy and agricultural problems strongly indicates that these authorities need to be strengthened to provide further assurance that problems -- actual and potential -- can be dealt with expeditiously and in a manner that will avoid a potentially contagious and debilitating loss of confidence within a state.

Specifically, we are concerned that in states where major banking organizations take the form of multi-bank holding companies, we have the tools to deal with banks within that holding company structure as a coherent whole rather than piece-by-piece. We also believe that, in some situations, we can act more expeditiously, with less risk to confidence and to other banks and with less cost to the FDIC insurance fund, if mergers with out-of-state institutions can be arranged before a bank actually fails or requires FDIC assistance.

Specifically, our strong recommendation is that the emergency acquisition powers be expanded to:

allow the interstate acquisition of a multi-bank holding company, or some or all of the banks within a holding company, when a significant portion of the banking assets of a holding company are impaired;

reduce the bank asset size criterion for such interstate acquisitions to $250 million; and

permit acquisition of <u>failing</u> as well as failed banks.

As members of this Committee are aware, a series of developments over this decade have adversely impacted banks and led to an unusual number of failures and more generalized strains. Disinflation, strong competition, and rapid changes in technology and market values have all played a part.

Taken as a whole, the banking system has responded constructively and resiliently to these pressures. There is, indeed, highly encouraging evidence that the system as a whole is now gaining strength. Specifically, for most banks, capital ratios have improved, earnings have increased and nonperforming assets have been reduced.

Nevertheless, in certain areas of the country, particularly where the economy is heavily dependent on agriculture and energy, these strains have been particularly great; and they have been aggravated by the sharp declines in energy, agricultural, and land prices. It is mainly in those areas where we face a compelling need to be in a position to deal with problem situations in a manner that will protect, rather than undermine, the strength and stability of the whole, including the vast majority of institutions that are fully capable of dealing with their own problems so long as general confidence is maintained.

Fortunately, the banks, large and small, that have served now-troubled energy and farming businesses have typically been in a relatively strong position. They have generally been characterized by historically high capital ratios, good earnings and ample liquidity. The fact that they have been able to draw on these strengths has provided a strong first line of defense in dealing with the present pressures. Ordinarily, that should be adequate.

Supplementing their natural strength, the Federal Reserve is, of course, fully prepared to provide assistance as part of the process of making necessary adjustments to pressures through its discount window on liquidity and changes in deposit flows. The availability of that kind of normal and appropriate assistance by the central bank, backstopping the resources and resourcefulness of the banking organizations themselves, should in itself enable solvent institutions to adjust to the situation.

However, there is one remaining potential danger to stability of banking in these heavily impacted areas -- and therefore to the entire economies of some states or regions.

The failure of a few important institutions -- unless handled expeditiously and effectively -- could raise unwarranted concerns about other, basically sound banks, and lead to a contagious and spreading loss of confidence. It is that contingency that we want to deal with and toward which the proposed legislation is directed. The powers sought are precautionary. Perhaps they will, in the end, not have to be used. I hope not. But it surely would be imprudent to rely on that hope. Recent earnings reports and other difficulties at a few institutions point to the danger. A prompt Congressional response will, in itself, provide a strong message of reassurance.

The case for this legislation is, I believe, widely acknowledged in the states most directly concerned. The debate, as I have observed it, revolves around specific provisions of the proposed legislation that balance the need for effective action against the concerns of states, and banks within a state, that they be able to preserve their ability to determine the future of their state's banking structure.

In striking that public policy balance, Congress has already concluded that interstate banking acquisitions are appropriate in certain emergency situations -- those involving failed banks of $500 million or larger. In addition, separate provisions of present law permit out-of-state acquisitions of both failed and failing mutual savings banks meeting the $500 million minimum asset size requirement and of savings and loan associations without any restrictions as to size. I would also point out that current provisions of law allow the interstate or interindustry acquisitions of thrift institutions "where severe financial conditions exist which threaten the stability of a significant number of insured institutions or of insured institutions possessing significant financial resources."

Those provisions of existing law were adopted because Congress recognized the need for constructive preventative action to assure that a serious particular situation did not spread and get worse. The same motivation lies behind the present proposal. While the present situation, in our judgment, requires some further extension of authority for interstate bank acquisitions, care has been taken to limit the scope of that authority and to provide a key role for state bank supervisors; in fact, the proposal before you dealing with commercial banks is substantially narrower than the interstate acquisition arrangements for savings and loan associations that are now contained in the Garn-St Germain Act.

Main Provisions of the Legislation

Perhaps the most important change in the proposed legislation would be to permit the federal supervisory authorities to deal with the units of a multi-bank holding company as an integrated whole. This is a recognition of simply reality.

A number of states, including typically those impacted by adverse energy and agricultural developments, have a banking structure built around multi-bank holding companies. Normally, units in those holding companies operate with a large degree of interdependence, under common management. However, the financial condition of different banking units within the holding company may vary substantially.

As things now stand, the law permits us to deal with those units of a holding company bank-by-bank. Some individual banks within the holding company may reach the $500 million size limit specified by the Garn-St Germain legislation, but many units may not, even though the holding company is one of the major institutions in the state. In some cases, none of the units meets the present size test, even if the holding company is far larger. Yet, the failure of one or two important banking units of a holding company would be bound to affect the viability of the whole.

The proposed legislation deals with this situation by enabling the sale of some or all the banks within a holding company, or the holding company itself, to an out-of-state institution when at least one-third of the entire assets of the holding company are in failed or failing units, provided those troubled units collectively reach an aggregate asset size of $250 million.

The second proposal is to modify the asset size limit for an individual bank or for banking units within a holding company by reducing it from $500 million to $250 million. That reduction is in recognition of the fact that deeply troubled institutions of that size, particularly when incorporated in a larger holding company, may not in current circumstances be salable within a state. Indeed, in some cases the holding company involved may be among the largest banking institutions in the state. In other instances, the larger institutions in the state, while able to cope effectively with their own problems, may not be in a position to raise the amount of capital, or to provide the liquidity or management resources necessary for a major acquisition.

The third area of change would be to permit the sale of "failing" -- defined as a bank in danger of closing -- as well as "failed" institutions. The definition of failing is meant to be rigorous -- that is to only include an institution that, while technically still solvent, has no reasonable prospect for either maintaining the liquidity or raising the capital necessary to maintain itself as an independent institution without prolonged federal assistance.

The purpose is straightforward. Such a "failing" institution may be more attractive to a potential buyer than one actually in receivership. The sale might be arranged without disturbance to confidence. There would be no cost, or a lesser cost, to the FDIC.

Limitations on the Use of the Emergency Powers

As I indicated earlier, the debate on the proposed legislation appears to center much less on questions of basic purpose and rationale -- which seems to be broadly accepted -- than on the appropriate specific limitations designed to protect the rights of states. This is a matter to which we have devoted considerable attention. We believe an appropriate balance has been struck consistent with the need for operational effectiveness. That need includes the simple fact that out-of-state purchasers of failed or very troubled institutions will simply not be available, or available only at very heavy cost to the FDIC, unless the acquired banks can be operated profitably in highly competitive markets.

Specifically:

> Interstate acquisitions could only be made of banks (or units in a holding company system) when their operation as independent going concerns is no longer feasible.

Only the chartering authority -- state or federal as the case may be -- could initiate the process of interstate acquisition by determining the bank is failed or failing.

A minimum-size requirement has been maintained, although at a lower level.

An out-of-state acquirer of a bank or bank holding company would have its subsequent expansion rights limited to the three largest metropolitan areas or cities within a state.

In all cases, consultation with the relevant state bank supervisor would be required as to the possibility of an in-state solution. In the case of a failing or failed institution when the FDIC provides assistance, bidding priorities of present law favoring an in-state solution are retained, and an objection by a state supervisor could be overridden only by a unanimous vote of the FDIC board. In the case of a failing institution where no FDIC assistance is provided, no interstate acquisition could proceed if the supervisor certifies that there is a qualified in-state (or, when regional arrangements exist, regional) acquirer unless the Federal Reserve Board determines that the proposed in-state buyer does not in fact have adequate financial resources.

Finally, the authorities provided would end after five years.

We believe these safeguards are reasonable and workable, balancing the legitimate concerns of the states and competing banks with the broader interest in effective action to deal with emergency situations. They build upon concepts and tests in existing law, either for banks or thrifts. I am not aware of serious concerns that those existing authorities have been abused.

So far as the "failing bank" test is concerned, the intent is plainly only to deal with institutions that, in terms of strong liquidity pressures or impaired capital, would otherwise require large and prolonged official assistance if they are able to survive at all, with ancillary risks to the FDIC fund. In effect, the only alternative to merger would be to make them wards of the government for an indefinite period.

If such institutions were permitted actually to fail, it is widely accepted that they would be eligible for interstate acquisition. If that premise is accepted, the new provision for "failing" banks appears certainly reasonable as a matter of further protecting the FDIC fund and the stability of other banks that could be infected by a confidence crisis. Such a provision has already been adopted for thrifts. Strong preference would be provided for an in-state "solution," if in fact such a solution exists -- in fact, that protection would be stronger than if, under current law, the banks failed and FDIC funds were more directly at risk.

In all cases of failing institutions, the board of directors or the stockholders of the institution itself would have to agree to a proposed merger. Some have questioned whether that might lead to a preference for an out-of-state partner willing to pay a higher price. That is one reason that the relevant state supervisor has been provided an effective veto power so long as there is, in fact, a feasible in-state partner ready, willing, and able to provide the necessary capital and other support.

Other questions have arisen with respect to the necessity to deal with the units of a multi-bank holding company as a whole. In some instances, dismemberment of a holding company may indeed be possible. But that will not always, or even typically, be consistent with achieving the purposes of the legislation -- speedy and orderly disposition of severe problems in a manner consistent with the stability of the banking system over an entire state or region.

Specifically, in cases where the failed or failing units within a holding company are key units of the system, piece-by-piece disposition would imply that sister banks are cut adrift, without the operating, accounting, and product delivery systems often centered in lead banks or the holding company itself. Units that might have been both solvent and liquid within the holding company structure would find their viability undermined if they had to maintain themselves as independent units -- units that would inevitably be tinged by their past association with a failed holding company organization. Nor are individual units of a holding company likely to be attractive to potential out-of-state acquirers. The associated uncertainties and potential disruptions are precisely what the bill is designed to avoid.

Conclusion

It is an unhappy fact that economic conditions in some states have brought strains and strong pressures on elements of the banking system in those areas. At the same time, there is every reason to believe those problems can be contained and diffused in a manner that will preserve and support the essential stability of the banking system, and thus avoid aggravating already difficult economic circumstances.

To assure that result, supervisory and regulatory agencies do need some limited additional authorities so that they can act with dispatch and at minimum cost, both in financial terms and in terms of maintaining confidence. Those authorities would be provided by H.R. 4701.

The bill has been carefully drafted to limit its scope totally to emergency situations for a limited period, at the same time reconciling conflicting demands of public policy. Congress in the past has acted with care and effectiveness in providing necessary authority to deal with problem areas in both the banking and thrift industries.

Failure to act now could only increase the risks that the ultimate costs would be far greater. We want to forestall a crisis, not to pick up the pieces after the damage has been done.

I strongly recommend you take the crucial further steps required by the present situation with the clear sense of urgency the situation demands.

Financial Institution Emergency Acquisition Amendments of 1986

I. General Provisions

The Federal banking regulators have requested that the Garn-St Germain Act of 1982--which permits acquisition across state lines of failed banks having assets of $500 million or more--be changed and augmented in the following respects:

-- That the size threshold for interstate emergency acquisitions be lowered from $500 million to $250 million.

- That an interstate rescue be permitted when a bank is "failing"--in danger of closing--rather than actually closed.

- That the interstate acquisition of a bank holding company or of some or all of the banks in a bank holding company be permitted if the assets of the banks in danger of closing in the holding company total $250 million or more and constitute at least 33 percent of the banking assets of the holding company.

- That the out-of-state banking company be permitted to expand its operations to the three largest cities or metropolitan areas in the state of the acquired banking institution.

II. The In Danger of Closing Test

The bill provides a qualitative test to determine when an interstate acquisition may be made of a bank that is "in danger of closing."

-- A bank is defined as "in danger of closing" (1) if it is not likely to be able to meet the demands of its depositors or pay its obligations and there is no reasonable prospect for it to do so without federal assistance; or (2) if it has incurred or is likely to incur losses that will deplete all or substantially all of its capital and there is no reasonable prospect of replenishment of its capital without federal assistance; or (3) if there are other grounds for closing the bank under state law.

- The appropriate federal or state chartering authority must certify in writing that a bank is "in danger of closing." The appropriate chartering authority is the State bank supervisor in the case of state chartered banks and the Comptroller of the Currency in the case of federally chartered banks.

III. State Banking Structure Protections

Careful protections to preserve the opportunity of an in-state solution are included in the legislation. The particular safeguards depend on whether or not the FDIC provides financial assistance in connection with the interstate acquisition.

A. Unassisted Acquisitions

In the case of acquisitions of failing institutions that take place without FDIC financial assistance:

-- Before a failing institution can enter into discussions with an out-of-state company, the State bank supervisor must be notified and the company must attempt to arrange an acquisition within the state or within its region if the state is part of a regional compact.

- If in-state and regional efforts are unsuccessful, any application for an out-of-state acquisition must describe the efforts made to arrange an in-state or regional acquisition and the reasons for rejection of any in-state or regional proposal.

- If an application is submitted for an out-of-state acquisition, the Federal Reserve must consult the State bank supervisor.

- The State bank supervisor must be given a reasonable opportunity to object to approval of the application--in no event less than 48 hours.

- The Federal Reserve cannot approve the application if the State supervisor certifies that an in-state or regional applicant has offered to acquire the institution and has the financial and managerial resources to be likely to be able to secure regulatory approval.

- The in-state or regional applicant does not have to match or exceed the out-of-state bid. The in-state or regional offer need only be sufficient to recapitalize the failing banks and not involve FDIC assistance.

- Only if the Federal Reserve determines that the in-state or regional party certified by the State supervisor does not have the financial resources to recapitalize the failing institution, can the Federal Reserve approve an out-of-state acquisition.

- The acquisition must be approved by the board of directors of the bank that is in danger of closing or its holding company.

B. FDIC Assisted Acquisitions

In the case of acquisitions of failed banks or those that take place with FDIC financial assistance, the following safeguards are included in present law or in the proposed legislation:

-- The FDIC may assist a merger or acquisition across state lines only where the board of directors of a failing bank requests that the FDIC do so.

- If the best offer--in terms of lowest cost to the FDIC--is made by an out-of-state company, then the FDIC shall permit any in-state or other bidder whose bid was within 15 percent or $15 million (whichever is less) of the best offer, to submit a new bid. In making a final determination on bids, the FDIC is directed to give priority to an institution from the same state. In considering offers from different states, the FDIC is required to give priority to offers from adjoining states.

- The FDIC must consult with the State bank supervisor before the FDIC can assist an interstate merger or acquisition.

- The State bank supervisor must be given a reasonable opportunity to object to the interstate merger or acquisition--in no event less than 48 hours.

- If the State supervisor objects to the interstate acquisition, the FDIC may go ahead with the transaction only by a unanimous vote of the FDIC Board of Directors, and a written certification of its decision must be provided to the State supervisor.

IV. Other Provisions

- The bill specifically prohibits providing financial assistance by the FDIC to any nonbanking subsidiary of a holding company in an assisted interstate transaction.

- If the FDIC provides financial assistance to a failing bank with total assets of $250 million or more and the bank is not acquired by an out-of-state company at the time the assistance is given, the bank and its holding company affiliates shall remain eligible to be acquired by an out-of-state bank or holding company as long as the assistance is outstanding.

- The Federal Reserve would be authorized to waive notice and hearing requirements in approving emergency acquisitions.

- The bill extends for five years the emergency provisions of Title I of the Garn-St Germain Act. Those provisions and the provisions added by this legislation would sunset in five years.