Overview

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Indebtedness in the United States has increased dramatically—reaching a level that some consider alarming. Debt relative to income has expanded in virtually all sectors of the economy. For the four years ending in December 1985, growth in U.S. government debt outpaced gross national product (GNP) nearly 12 percent; household debt increased six percent faster than GNP, and business debt grew about three percent faster. Combined federal and private debt now amount to 173 percent of GNP.

The significance of increased debt is a matter of some controversy, as shown by comparing the papers prepared by Professors Friedman and Summers. We can all agree, though, that higher debt burdens increase the vulnerability of borrowers to adverse financial events. The current problems in our farm and energy sectors highlight the dangers of "too much leverage.

The great danger is that heavy debt levels will turn a mild or normal business downturn into a severe recession. In this scenario, an economic slowdown causes some highly leveraged firms to default on their obligations. Accompanying layoffs cause defaults among some leveraged households. The cycle of defaults and production cutbacks could feed on itself and make recovery much more difficult than it would have been with lower debt levels.

Professor Friedman views the accelerated borrowing as a sharp break with prior U.S. economic behavior. Professor Summers argues that the past stability of the debt ratio was a coincidence—that increases in private sector debt were offset by an independent reduction in U.S. government debt, from the high levels of World War II.

Whether one views the simultaneous growth of federal and private debt as an alarming new development or merely a coincidence, the question remains: how dangerous are the increased debt levels to the financial system and the economy as a whole? Perhaps I can best contribute to the discussion by focusing my remarks on the apparent vulnerability of the banking system in this higher debt environment. I will conclude with some general views regarding appropriate public policy actions.

Bank performance

Reasonable men may disagree over the implications to the financial sector presented by the rising levels of private and public debt. The scenario of snowballing defaults would not seem to bode well for banks — the "debt owners." Could the industry withstand such pressures? How strong is the industry?

Here, the news is mixed. Bank equity capital levels have increased in recent years—reducing the industry's own reliance on, and exposure to, leverage. I think banks are becoming more innovative, better managed, and looking for new ways to increase efficiency, expand business, as well as diversify risks. However, no one can dispute that some measures of the industry's performance are far from reassuring.

Banks have been failing at rates not seen since the advent of federal deposit insurance. Over the 40-year period from 1941 to 1980, only 262 banks failed. Since 1980, over 400 banks have failed. Last year's record of 120 bank failures will soon be eclipsed as 97 banks have already failed this year, and we expect another 40 to 60 more. Next year, will likely be as bad or worse.

The size of the failing banks is also increasing dramatically. For the 30-year period up through 1970, assets held by failed banks totaled $560 million. Since then, assets held by such banks, excluding Continental Illinois, have exceeded $40 billion, an average of $3 billion per year.

While failure statistics reflect past problems in the banking industry, other measures provide a clearer view of what lies ahead. A leading indicator of bank failures is the number of problem banks. Currently, the Federal Deposit Insurance Corporation (FDIC) has classified 1,411 banks as "problems." This compares with 1,140 at the end of 1985 and 848 the year before that. In fact, the number of problems has about quadrupled since 1981.

Other indicators portray a similar trend. Bank earnings relative to average assets have declined noticeably in recent years. This has occurred despite an increase in capital levels, which should have a positive effect on bank return on assets. Also, as Mr. Kaufman points out, the number of large bank holding companies whose debt is rated AAA has decreased from 14 ten years ago to only one today.

Bank earnings are also much more volatile. Once, almost all banks operated profitably—save for new banks just starting out. Today, many banks, including many established banks, are in the red. In 1980, less than four percent of all insured commercial banks finished with negative earnings. That percentage has steadily increased—rising to 11 percent in 1983, 14 percent in 1984, and over 16 percent in 1985.

To a considerable extent, this variance in bank performance can be attributed to geographical differences. For example, only 10 percent of the banks east of the Mississippi River lost money last year, while 22 percent of those to the west were unprofitable. Similarly, 86 percent of the bank failures in 1985 and 1986 have been in states west of the Mississippi River.

There are also significant differences between the performance of small versus large banks. Over 25 percent of commercial banks with under $25 million in total assets lost money last year. The return on average assets for banks in that size category was less than 40 percent of what it was for all other commercial banks. Until a few years ago, smaller banks consistently outperformed their large competitors.

The banking industry also faces significant asset problems. The levels of nonperforming assets are high and rising (Table 1). This is despite rising net chargeoff rates, which have more than doubled over the past five years, and are ten times what they were 30 to 40 years ago (Table 2). Moreover, nonperforming loans do not include a lot of international loans, which, as Professor Dornbusch and Mr. de Vries point out, are still a matter of considerable concern. The prospects for major declines in nonperforrning and chargeoff levels do not appear very bright—at least not in the short run.

Historically, there has been an inverse relationship between the performance of the economy, as measured by real GNP, and bank loan losses. In the post-World War II period prior to 1982, the level of chargeoffs at commercial banks lagged changes in real GNP by about three quarters. Well, three quarters have long passed since we came out of the last recession—and loan chargeoff rates are still going up. I would say one more historical relationship has proven itself unreliable during this unique economic period.

Looking at chargeoffs by loan type indicates that bank asset prob-

TABLE 1
Nonperforming Assets and Net Loan Losses ($ Billions)

	Nonperforming Assets* $	Net Loan Losses $
1986†	56.6	7.0
1985	51.0	13.1
1984	49.5	10.7
1983	46.0	8.4
1982	45.3	6.6
1981	NA	3.8

† First half
* Includes loans 90 days or more past due or on nonaccrual status and foreclosed real estate.

TABLE 2
Historical Net Loan Charge-Off Ratios

Year	Ratio
1934	3.421
1935	1.610
1936	0.875
1937	0.309
1938	0.585
1939	0.419
1940-44	0.072
1945-49	0.058
1950-54	0.063
1955-59	0.068
1960-64	0.146
1965-69	0.171
1970-74	0.304
1975-79	0.473
1980-84	0.520
1985	0.804
1986*	0.826

*First Half

lems are not confined to just one or two categories. Net chargeoff rates for real estate loans have more than doubled since yearend 1982. The same is true for commercial and industrial loans. In 1985 alone, net chargeoff rates for farm and consumer loans jumped by over 50 percent from the year before.

Reasons for declines in bank performance

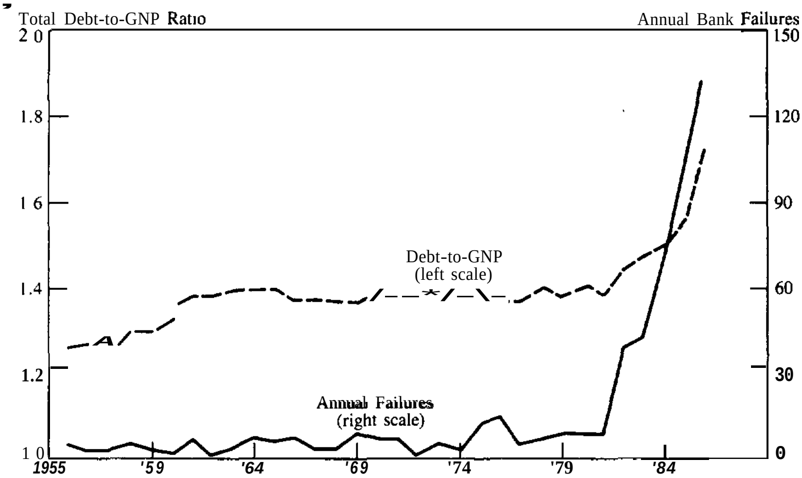
How can we explain this deterioration in bank performance—a deterioration that is particularly troubling since, in general, economic conditions have been favorable over the past several years? One obvious factor is that economic performance has not been favorable for all sectors of the economy. The agricultural and energy sectors have been exceptionally weak and are in the midst of a painful adjustment. These adjustments are not confined to the nonfinancial firms—the banks that serve these sectors are affected as well. The impact of these sectoral weaknesses on some of our nation's banks has been accentuated by the inadequate level of asset diversification. Banks, bounded by geographical or product constraints, were unable, and perhaps not anxious, to expand their borrower scope. One can only hope the painful adjustment experience of such banks will not be lost on those of us—banker, lawmaker, regulator—that determine the scope of future business options.

Another factor impacting current bank performance is the business environment that has quickly become much more competitive. The deregulation of interest rates, the entrance of new competitors, and the disappearance of some traditional banking markets have undoubtedly taken their toll on many banks. Pressure on interest margins has intensified and there is some evidence that quality standards have been relaxed in order to preserve spreads.

Finally, borrowers and lenders are adjusting to drastically lower inflation — deflation in some sectors. Debt repayment becomes much more onerous in moving from an inflationary to a noninflationary environment. The value of the dollars to be repaid, relative to the assets they bought, rises significantly. Buying now and paying later becomes much harder.

How does the increase in overall debt fit into the picture? Clearly, it makes matters worse. Mr. Kaufman considers the increased debt and simultaneous decline in corporate equity positions as glaring contributors to the erosion in credit quality. Clearly, economic weaknesses are exacerbated when high levels of debt are present. A 1985 FDIC study indicated a relationship between the levels of corporate debt burden (measured by the ratio of after-tax nonfinancial corporate debt service burden to nonfinancial corporate cash flow) and the level of bank failures. Over a 15-year horizon beginning in 1970, increases in corporate debt burden led increases in bank failures by roughly five quarters and accounted for about 62 percent of the variation in bank failures. While not completely explanatory, the relationship is statistically significant—and appears to be continuing (Chart 1).

CHART 1
Insured Commercial Bank Failures
and the Ratio of Total Debt to GNP, 1955-1986



To summarize, recent performance and conditions in the banking industry can be explained to some degree by more competition, sectoral weaknesses, and disinflation. But increased levels of debt in the nonfinancial sector also contribute to increasing numbers of nonperforming loans and resulting instability in the banking system.

Policy options

In terms of devising long-range regulatory and legislative actions to help meet current banking problems, there are no easy answers. As Professor Eisenbeis has pointed out, there are many outdated pieces of bank legislation that need revision. In that regard, the liberalization of geographic restrictions on banks is a positive development. The gradual relaxation of product constraints also is desirable. Both will help banks achieve greater asset diversification.

There are also certain actions that can be taken to reduce the incentive that the federal deposit insurance system creates for banks to engage in excessive risk-taking. The implementation of a risk-related deposit insurance premium system is one such measure. However, the issues involved in reducing excessive bank risk-taking by moving toward greater levels of so-called "market discipline" are complicated and have significant implications for the stability of the banking system.

Certainly, discipline is necessary, but how much, on whom, and when are the relevant questions. A balance needs to be drawn. Too little discipline may cause instability, but the risks of too much discipline are far more threatening. I **am** a strong believer that where fraud or insider abuse is detected, punishment should be swift and severe. Similarly, those who take excessive risks with depositors' money should pay for their mistakes. However, I am equally convinced that we should not be insensitive to the problems of innocent victims.

As this relates to the stability of the banking system and the handling of bank failures, the FDIC is making, and will continue to make, every effort to arrange merger-type purchase and assumption transactions as opposed to liquidations through deposit payoffs. On such transactions, depositors are protected but stockholders and management—those closest to the bank's problems—pay a heavy price. The impact on others is reduced. Banking services are continued. The risk of panic and uncontrollable instability is lessened.

Regarding the handling of problem institutions, I believe it is incorrect to view the concept of forbearance as something that always and everywhere may lead to higher costs in the long run. Where problems are more the result of adverse economic conditions than mismanagement or insider abuse, there is no point in trying to "teach the industry a lesson." The need is to help find a way across the low point, with minimum damage to the system.

Thus, we at the FDIC favor "capital forbearance," where bank management appears capable and there is reasonable hope for a return to viability. This will prove to be more cost effective than liquidating banks in a fire-sale environment.

Has the level of debt compromised the FDIC's ability to make good on its announced intention to protect depositors whenever possible? So far, the answer is no. The fund is healthy ($18 billion net worth), and it continues to grow. It has not joined the current trend to borrow its way to heaven. Even at current levels of bank failures, the fund should show a modest $0.5 billion gain this year. But, there is a level of defaulting debt that would jeopardize that ability. One thing is certain, the current trend line in bank failures cannot be extended for many more years without trouble. The climb it evidences is too steep.

Perhaps it is reasonable to say the same thing about the trend line depicting debt to GNP. It cannot continue to go up at this rate for many more years – the climb is way too steep.