

BANK
AND THRIFT
SUPERVISION
IN TODAY'S
ENVIRONMENT

AN ADDRESS BY

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BEFORE THE

UNITED STATES LEAGUE OF
SAVINGS INSTITUTIONS

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I. Introduction

I am delighted to be here this morning. You are strong supporters of constructive legislative reform, as evidenced by your recent letter to the House Banking Committee endorsing expanded emergency interstate bank acquisitions authority. We look forward to continued cooperation with the U.S. League in a wide variety of areas.

II. Discussion

It's nearing mid year and it's time to take stock of the likely results for 1986 for the Federal Deposit Insurance fund. I'm pleased to report that despite a likely record number and size of failures and assistance transactions, the fund is operating at a surplus of a predicted 1 billion plus dollars for this year.

To this date, we have handled 55 failures and assistance transactions with an average asset size of \$43 million. Our problem bank list has grown from 1150 at the beginning of the year to over 1300 on this date. Last year we experienced 120 failures.

We estimate that failures and assistance transactions for the year will be at a new high, between 140 and 160. Our costs on this number of transactions are estimated to approach 1 billion dollars, and we will acquire three billion dollars of loans and other assets from failed banks which will require liquidation.

While we will continue to add to our insurance fund, the increase will come from interest earned on our investments. Unfortunately, there was no rebate on insurance premiums for 1986. Because of carryovers of previous years' losses, a 1987 rebate is unlikely as well.

These predicted results could be improved if we have an unusual gain on the sale of our interest in Continental Illinois Corporation. They could be, of course, much less favorable were we to have a major bank failure. Thirty-eight of the failures for the year to date were purchase and assumption transactions, 16 were payoffs, and one was an assisted transaction. Our costs increase when we are unable to find bidders for failed banks, so all of our insured banks should be interested in helping us achieve changes in the law which will improve the possibility of our finding buyers for failed institutions.

I thought it was important that all involved in the financial depository institutions business be familiar with the status of the FDIC-insured fund, even if many of you are insured by FSLIC. The public confidence in banks and thrifts certainly is based on insurance. Members of the public do not distinguish between the funds to any great extent.

I meet on a regular basis -- and have conversations even more frequently -- with Ed Gray and his staff and with people in the Treasury and elsewhere who have a thorough working knowledge of the situation at the FSLIC.

The Federal Home Loan Bank Board has been handling its problem institutions appropriately and with due dispatch, given the limits imposed by circumstances beyond its control. The Bank Board has been handicapped -- not so much by a lack of money, which gets so much attention in the press -- but by the handcuffs under which it has to operate, with OMB restrictions, manpower and salary constraints, and all the rest. But the Board has made great strides in the past year in solving these problems and I believe Chairman Ed Gray and his people have done a fine job.

A consensus is developing on the need for the proposed recapitalization program developed by the Board and the Treasury, so the funding situation also appears very close to being resolved. We at the FDIC are fully supportive of the new plan for refinancing FSLIC and we will assist it in every way that we can.

The FSLIC-insured savings industry, meanwhile, has been outperforming most others in the stock market. The institutions have been experiencing their best portfolio spreads in 30 years or more, and the industry has just about locked up a record year for net earnings. So, the outlook for the savings industry and, by extension, for its primary deposit insurance fund, is outstanding.

There is another matter I want to address on this general subject of the two insurance funds. It has been suggested that the considerable cost of recapitalizing the FSLIC will result in an exodus from FSLIC to FDIC insurance, especially on the part of the strongest institutions. You might expect that we would throw open the doors and say walk right in. But that is not the case.

I happen to believe very strongly in the need to maintain two funds and doing what is required to keep both of them viable. I support the position of the Treasury that a link should be drawn between current membership in the FSLIC and all the rights and advantages available to savings institutions. I also believe that if an institution is FDIC-insured it should be FDIC-supervised. In other words, we would not oppose legislation which would automatically deny Federal Home Loan Bank membership and status as a savings and loan holding company to any institution which moves from FSLIC to FDIC insurance. Those who chose to switch would in effect become commercial banks and bank holding companies.

Our guiding principle in our relations with our fellow financial institutions and insurers is our version of the 11th Commandment, "Thou shall not speak evil about our friendly competitors or their insurance fund." We'd welcome all of you adding that Commandment to your list, as Chairman Ed Gray has certainly done. It will serve all of us well in the long run.

I have referred to the Bank Board problems with OMB. As you know, we too are now involved. Given the disastrous effect of that agency's involvement with the Bank Board, one would think that the record would be clear that bank supervisory agencies are best run by independent bipartisan boards. This would seem to be especially true today, at a time when, as I've described, problem financial institutions are at record levels. Yet at this time OMB decides to apply a 36 year-old statute to the bank regulators (outside of the Fed, which at the moment apparently looks too tough to take on).

OMB's basic argument is that it must supervise these agencies because they could affect the unitary budget. Now we all know in fact that the budget is affected only because in government it's the practice to add apples and oranges when it helps make things look better. Thus some years ago it was decided to add the surpluses of the Fed and the FDIC to the budget numbers. But in the FDIC's case no funds are available to meet the deficits of the government since they are committed by law to be returned as rebates of premium or added to this reserve for future losses. No tax dollars are involved, and no deficits have been incurred. Based on this record, achieved while I was elsewhere, it's hard to believe that OMB doesn't have other more

important deficit reduction initiatives to which it should direct its attention. OMB's guiding tenet seems to be: "Bless them when they operate at a surplus -- we'll let them join us."

The FDIC also faces an immediate threat from proposed Gramm-Rudman Act budget cuts. In keeping with the spirit of Gramm-Rudman, we have voluntarily reduced our 1986 budget by 4.3% or \$8.5 million. This required making cutbacks in a number of important areas. We curtailed hiring and training of personnel, reduced travel, postponed building improvements, and deferred a number of important projects. These projects included developing better management information systems and other computer programs that would facilitate bank supervisory activities and other insurance-related functions.

We are most concerned about the potential impact of Gramm-Rudman on our capabilities to carry out our supervisory role, which includes the examination and oversight of troubled and failing banks. To appreciate the extent of our concerns, let me explain where our examination and supervisory program stands now.

Currently, the FDIC has a force of about 1,670 field examiners, a third of whom have less than one and one-half year's experience. These are the individuals who actually go out to examine banks, and they account for 85% of the professional staff of our Division of Bank Supervision. The size of the field force is almost exactly where it was five years ago, but a lot has happened since then. In 1981, commercial banks earned a return on assets of 81 basis points, 27 percent more than they earned in 1985. Three times more banks lost money in 1985 than in 1981. Today we have about 1,300 problem banks -- six times what we had back then. In 1981, ten banks failed; we average that many in a month now.

This increase in problem and failing banks has put a major strain on our field examiners, a force which, because of self-imposed restrictions, was allowed to shrink. By the end of 1984, our field force was down to 1389, 16% lower than its 1981 level. We began to fall behind as the banking problems grew. No longer were we able to meet our policy guidelines, which call for examinations of marginal and problem banks (CAMEL 3, 4, and 5 ratings) at least once a year with visitations

in between. In some of our regions, we're averaging 20 months between exams. As for satisfactory banks (CAMEL 1 and 2 ratings), our policy is to go up to three years between exams, and we're not always able to do even that. Experience has shown us that examinations two to three years old quickly lose their value. Too often, we go into strong banks to find they've become weak.

Beginning in 1985, the FDIC started to rebuild its examination force. Our tentative target is to reach a well-trained force of 1,800 full performance examiners by the end of this year. We hope to reach this level by cutting back hiring in other areas. We are studying whether additional examiners might be needed to fulfill our supervisory responsibilities in these turbulent times.

Our field examiner turnover rate has been running about 11-12% and we have had to hire about 450 examiners over the last year to get where we are now. Currently, one-third of our field force has less than one and one-half years in experience. This imbalance impacts our productivity. Training these people, most of which is done on the job, takes a substantial amount of time away from our seasoned examiners -- time needed to examine. It's taking longer to complete examinations, particularly in marginal and problem institutions where we've had to start many of these people. In 1985, for example, the examinations of such banks averaged 24% longer than in 1984.

We must continue our efforts to strengthen our examiner force if we are able to stay on top of our supervisory problems. We do not see how this could be done under the more drastic cutbacks anticipated under Gramm-Rudman for 1987 and beyond. As we have done this year, we would attempt to minimize the impact on our field force. But assuming Gramm-Rudman cuts on the order of 10-20%, major examiner reductions would be unavoidable. For every 100 examiner reduction, we would lose the capability to conduct about 225 examinations a year. Examiner cutbacks of 15% would eliminate over 600 examinations in 1987.

We firmly believe stretching out examination intervals any further in this banking environment would be counterproductive and not cost-effective. The net effect of the "savings" will be higher insurance costs and less stability in the financial system.

Vital automated services supporting bank supervision would suffer as well. Even extremely modest cuts in the order of 10% would indefinitely delay integrating bank performance data sources into our offsite surveillance system. This would also prevent the maintenance and upgrading of data bank software relied on by the FDIC, the Comptroller of the Currency, and the Federal Reserve. Such cutbacks would seriously undermine our ability to perform cost-effective off-site monitoring.

In short, the Antideficiency Act and Gramm-Rudman threaten the ability to monitor the safety and soundness of depository institutions. I believe it is in the interest of your industry and the country to support legislation in the banking committees of both houses of Congress which will settle this issue of exemptions, so we can all spend our time on our primary responsibility, which is in fact a full time job.

Now let me conclude by congratulating you on a pleasant subject -- the recent thrift industry turnaround.

Bank Board assistance helped forestall some failures. But it took bold action by the thrifts themselves -- combined with a timely drop in interest rates -- to produce black ink. Many thrifts brought in new management, analyzed their operations, and charted new courses for themselves. Restructuring became the name of the game. Numerous thrifts unloaded old low-yielding mortgages in 1983 and 1984 and acquired securities, including mortgage-backed paper. As a result, the median ratio of residential mortgages to assets fell from nearly two-thirds in 1982 to just over one-half in 1985. The ratio of securities to assets climbed from under 15 percent in 1982 to just under 20 percent in the 1984-1985 period.

Thrift industry members are carrying out a strategy for success. Under Chairman Gray's fine leadership, the Bank Board also is taking the steps needed to ensure the sound supervision of the thrift industry. Like the FDIC, the Bank Board realizes that if the market is to work efficiently, investors -- and savers -- should be able readily to compare thrifts. Adherence to GAAP accounting provides a good means for comparison. The Bank Board's recent proposal to move toward GAAP standards would make it easier to compare FDIC-supervised thrifts with thrifts regulated by the Board. Besides facilitating comparisons, GAAP accounting also renders a good portrayal of a thrift institution's health -- one that does not disguise losses.

Supervisory policies are also converging in the area of capital standards. As you know, the FDIC last year adopted a 6 percent minimum capital requirement, of which 5.5 percent must be primary capital. That's basically consistent with the Bank Board's proposed new approach. The FDIC also recognized the special need of institutions below the regulatory minimum -- mutual savings banks especially -- to increase their capital over time. To that end, we provided a transition rule that also meshed with the Bank Board's policy. Overall, I think you will find that there is no disharmony between the two agencies on the issue of capital adequacy. We both agree that thrifts and banks need to maintain a sound capital base -- both for their good and for ours.

In short, we at the FDIC and the Bank Board will do our best to coordinate our supervisory approaches, in order to minimize uncertainty on the part of thrifts, their customers, and their investors.

III. Conclusion

I've very much enjoyed speaking to you. I could go on. But, apropos of thrift, I think I'd better heed an old Danish proverb. It warns, "He who really wants to save should begin with his mouth."