FDIC Speeches

TESTIMONY OF

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ON

THE FINANCIAL CONDITION OF FDIC-INSURED INSTITUTIONS

BEFORE THE

Senate COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
~~UNITED STATES SENATE~~

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Good morning, Mr. Chairman and members of the Committee. I am pleased to present the Federal Deposit Insurance Corporation's views on the condition of the banking industry and its insurance fund. At your request, the regulators already have submitted, through the Federal Reserve Board, a variety of statistics. My testimony today will provide an overview of the financial condition of FDIC-insured banks and respond to the specific questions raised in your letter.

First let me suggest a perspective for my remarks. The business media ordinarily focus on banking problems -- as does, in fact, my own testimony today. That is only natural as most of our time is spent dealing with those problems. However, the real news is that, despite increased competition from all sectors of the financial community, severe economic problems in parts of our country, and an unprecedented pace of change in the industry, the banking system as a whole is sound and is getting sounder. Given a reasonable ability for the system to evolve and adapt through a prudent restructuring of the financial services industry, that assessment should continue to be true over the long run.

GENERAL ECONOMIC CONDITIONS

I would like to preface my discussion of the financial condition of the banking system with some general observations on the economy.

In last year's testimony we suggested that agricultural problems had bottomed out and that slow gradual improvement could be anticipated for 1987. That turned out to be the case and improvement in that sector is expected to continue in 1988. Despite this improvement, the problems of agriculture and agricultural banks are not over. The upturn is slow and banks' performance normally lag the economy both on the way up and on the way down. However, even though problems are still there, the trend is in the right direction.

We also indicated last year that the energy economy had apparently reached bottom, but the ripple effect had not yet run its course through the rest of the local economy. Therefore, banks could expect more problems. It is perhaps arguable whether or not the energy sector had indeed bottomed out. It does not appear any worse than last year, but certainly no one would describe it as in a robust recovery. There is no doubt that the ripple effect, particularly in the real estate markets, continues to cause serious problems for banks. Office vacancy rates in energy-centered areas are among the highest in the nation. A large volume of property is being withheld from the market, though not by the FDIC, to prevent oversupply. Hopefully, property value declines are nearing an end. Even in that event, the adverse effect on the economy and on banks in these areas will continue for some time.

Last year we also expressed some concern over the aggregate levels of debt outstanding, especially consumer debt, with much of it owed to commercial banks. While we are still concerned, the rate of increase in this debt has been reduced, thus decreasing the probability that it will become a major banking problem.

Another area of concern is interest rates, particularly the effect a rise in rates would have upon the thrift industry. Many of these institutions already are having problems with asset quality. If interest rates increase, the resulting impact on thrift earnings may well exacerbate the financial difficulties of that industry. Fortunately, interest rate risk in the banking industry is not large at this time.

FINANCIAL CONDITION OF THE INDUSTRY

Capital -- Aggregate primary capital of all insured commercial banks grew from $214 billion at year-end 1986 to $234 billion at year-end 1987, a 9.4 percent increase. However, nearly all the growth in primary capital occurred in the reserve for losses component which resulted from the loss provisions made by the large money center banks for troubled loans to developing countries. This new reserving provided adequate, if not comfortable, reserves against developing country loan risk. Smaller banks continue to have higher capital to asset ratios than larger banks. The Southwest Region, dominated by the energy industry and once comprised of banks with some of the strongest capital ratios, experienced sizable declines in capital during 1987, and now exhibits some of the weakest capital ratios.

The growth in capital outpaced the less than two percent growth in assets during 1987. The industry as a whole currently has an adequate level of capital. However, a continued growth in capital is necessary to maintain that position, especially if asset growth returns to higher levels.

Current minimum capital rules set substantially similar capital requirements for all banks, regardless of asset size or the identity of the bank's primary Federal supervisory authority. These capital-to-asset, or leverage, ratios continue to serve as useful tools in assessing capital adequacy, especially for banks that are not particularly active in off-balance sheet activity. However, the FDIC believes there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banking organizations. While a risk-based system may require certain individual institutions to increase capital, these increases will help to further stabilize and strengthen the banking system.

The FDIC recently joined the OCC and Federal Reserve in issuing for comment a risk-based capital proposal based on an internationally agreed outline. This proposal is part of an ongoing effort by the bank regulatory authorities, both in the United States and in foreign countries, to encourage the establishment and convergence of international capital standards that would apply to all international banking organizations.

The FDIC proposal would apply to all State nonmember banks, regardless of size. However, we are considering ways to minimize the impact on smaller banks by exempting them from unnecessary and cumbersome reporting requirements. Our present estimate is that few smaller banks would be required to increase capital as a result of applying the proposed risk-based standards. At this time, the proposal would not replace or eliminate our existing capital maintenance regulations, which require minimum levels of primary capital and total capital as a percent of total assets. However, once the risk-based capital framework is fully implemented, the FDIC, in conjunction with the other Federal banking agencies, will consider whether the existing regulatory leverage ratios should be left in place. If the agencies decide to retain a leverage requirement, the FDIC also will consider whether the definition of capital for leverage purposes should be revised to conform to the definition of capital used for risk-based capital purposes.

The proposed risk-based capital framework sets forth: (1) a definition of capital for risk-based capital purposes; (2) a system for calculating risk-weighted assets by assigning risk weights to balance sheet assets and off-balance sheet items; and (3) a schedule, including transitional arrangements, for achieving a minimum supervisory target ratio of capital to risk-weighted assets.

The risk-based capital ratio focuses principally on broad categories of credit risk. However, the ratio does not take into account many other factors that can affect a banking organization's financial condition. These other factors include overall interest rate risk exposure; liquidity, funding and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; the level and severity of problem and adversely classified assets; and management's overall ability to monitor and control other financial and operating risks. For this reason, the final supervisory judgment on a banking organization's capital adequacy may differ significantly from the conclusions that might be drawn solely from the organization's minimum risk-based capital ratio.

The risk-based capital framework would apply to all international banking organizations. The ratios in the proposal have been established with a view toward maintaining a safe and sound banking system rather than achieving the lowest common denominator. There are competitive equity concerns in light of the fact that investment banks, savings and loan associations and nonbank financial intermediaries would not be subject to the risk-based capital framework. However, efforts will continue to eliminate or minimize competitive inequities among financial institutions of all types, to the extent that such action is consistent with a safe and sound banking system.

An important question with respect to international capital standards is whether they should apply only to banks (as they do in foreign countries), or to banks _and_ bank holding companies as proposed in the United States. This is a difficult question since the United States is the only country which regulates holding companies. It is our view that competitive equity would be served by _not_ subjecting holding companies to the new risk-based capital requirements.

A risk-based capital framework will not be finalized until after the Federal banking agencies have consulted further with banking regulators from other countries and carefully evaluated the public comments received in response to the current proposal.

Some of what appears as new equity in banks is the result of double-leveraging by holding companies. Double-leverage has been a potential cause for concern for several years. Thus, the FDIC analyzes double-leverage on a case-by-case basis during the examination of individual banks. Double-leverage occurs when the parent company incurs debt and uses the proceeds to purchase equity in its bank or nonbank subsidiaries. Since the normal practice is to service this debt through dividends from the subsidiaries, excessive debt service requirements of the parent can be a threat to the banks in the holding company. There have been a number of examples of bank holding company leveraging that have weakened the banks in the system.

Double leverage is an important issue in the pending legislation to restructure the financial services industry. If there is to be an effective firewall, we must be able to protect the bank from its holding company and holding company creditors. The FDIC emphasized this position in the recent statement of protection regarding First Republic of Dallas, Texas. All depositors and other general creditors of First Republic's banks are fully protected, but the FDIC made it clear that these guarantees DO NOT extend to the holding company creditors or shareholders. Furthermore, the assistance the FDIC provided First Republic was guaranteed by the holding company and its affiliate banks, and was collateralized by a pledge of certain assets of the holding company. The holding company banks were not allowed to pay dividends to service holding company debt.

Many multi-bank holding companies coordinate their banks' activities so closely that the bank holding company system effectively operates as a single banking enterprise. Yet when a bank within the system fails, the FDIC must deal with that bank as if it were independent. In effect, the FDIC must act as if there is no connection between the failed bank and the rest of the system unless it can take some action to prevent this result.

Some bank holding companies and their creditors have seen a way to turn this situation to their advantage. By concentrating poorer assets in a single bank, and then letting that bank fail, the bank holding company can shift the cost of those assets -- the loss it would otherwise be forced to realize -- to the FDIC. This technique amounts to a misuse of the FDIC's resources, which can do substantial harm to the Federal safety net for depositors.

Recent experience also has shown that creditors and shareholders can impose unwarranted costs on the Federal safety net in other ways as well. In some cases, the FDIC arranges open-bank assistance transactions which avoid the disruption that bank failures inflict on communities. Open bank transactions may require the consent of creditors and shareholders of the holding company. However, in some situations creditors and shareholders have sought to "hold up" the transaction in an attempt to receive greater consideration than that to which they would have been entitled if the bank had failed. This imposes added costs on the Federal safety net.

We are seeking legislation that would allow us to meet this challenge. In fact, a draft legislative proposal was circulated to the members of this Committee last week. (A copy of the draft statutory language and an explanation is contained in Appendix B.) The proposal would establish a special emergency procedure to deal with failing banks that belong to multi-bank holding companies. The procedure would allow the FDIC -- in conjunction with the Federal Reserve and the banks' primary regulators -- to require the consolidation of a failing bank with other banks in the holding company. It is designed to improve the asset quality of a failing bank within a multi-bank system without affecting the health of the system as a whole.

We also would like to report on the status of capital in FDIC-insured savings banks. As of year-end 1987, all FDIC-insured savings banks reported positive net worths, even when their outstanding net worth certificates were not taken into account. This is an improvement over 1983 when 5 institutions with $11.5 billion in total assets reported negative net worths when their net worth certificates were not counted. Capital levels in savings banks have increased over the last 5 years due to improved earnings performance and conversions to a stock form of ownership. From 1982 to 1985, net worth certificates totaling $710 million were issued to 29 savings banks that were experiencing severe losses due to interest rate mismatches. At year-end 1987, three banks had remaining net worth certificates outstanding aggregating $315 million.

Earnings -- In 1987 commercial banks had their worst year for profitability since the Great Depression. Commercial banks earned $3.7 billion, down nearly 80 percent from $17.5 billion earned in 1986. Their return on assets of 0.12 percent and return on equity of 2.02 percent were the lowest levels since 1934. A soaring loan loss provision, over 67 percent higher than 1986, fully accounted for the industry's year-to-year drop in earnings. Loan loss provisions attributable to the international operations of U.S. banks were $20.6 billion, $18 billion higher than a year earlier. Absent the extraordinary reserving for LDC loans, net income would have been roughly equal to the 1986 level.

Earnings performance ratios for commercial banks have not been consistent among asset size groups or geographic locations. The largest banks reported poor earnings for 1987 due to their sizable loss provisions for international credits. After the large money center banks are excluded, the results for those banks west of the Mississippi River are poorer than those east of the Mississippi. Poor economic conditions in the energy States and Farm Belt are the primary contributor to the West's poor results.

The Southwest Region is a major area of earnings weakness. The region's banking sector is operating at a loss, with 36 percent of the banks in the region unprofitable for 1987 and the return on assets a negative 0.64 percent. A persistent high level of problem assets, despite high levels of charge-offs, points to a continuation of this problem for the region. The region's earnings also are depressed by the effect of the lowest net interest margin in the country. The region's well-publicized S&L and economic problems influence the banks' cost of funds which, coupled with a weak loan demand and high levels of nonperforming assets, compresses the net interest margin.

There have been a variety of developments in recent years that make satisfactory earnings for the banking system as a whole more difficult to achieve. Among these are poor economic conditions in certain areas of the country, the tendency of the largest most creditworthy customers to access the credit markets directly, and intensified competition from nontraditional banking business. However, the outlook for the immediate future is cautiously optimistic.

Banks continue to be creative in developing new products and services to increase their sources of income. Significant fee income is being generated by letters of credit and swaps, markets which continue to grow dramatically. Fee income from securities underwriting and other services is growing and would provide additional sources of income should these markets be opened to banks. The FDIC believes the banking system can provide new services and that new bank powers will provide new opportunities for profit in a safe and sound manner. Of course, proper controls and appropriate surveillance by the regulators will be necessary.

Assets -- Nonperforming assets at year-end 1987 are highest in the largest 25 banks and in the Southwest Region with 3.46 and 4.18 percent, respectively, of their total assets in nonperforming status. Insured commercial banks as a group have 2.11 percent of their total assets in nonperforming status as of year-end 1987. Problem assets (i.e., assets subject to adverse classification by the regulators) reflect trends and concentrations similar to nonperforming assets, with problem assets being 1.16 percent of total assets in the largest 25 category and 1.95 percent of total assets in the Southwest Region. All insured commercial banks had 0.91 percent of total assets classified as problem assets at both year-end 1987 and 1986.

We believe that the asset quality problems have for the most part been identified and steps are being taken to reduce banks' risk exposure. However, recovery will be slow. There are further losses to be recognized in these acknowledged problem areas and the high levels of problem assets will remain until the economic conditions are markedly improved.

Bank exposure to LDCs continues to decline as a percentage of capital. During 1987, most major U.S. banks significantly increased their bad debt reserves against loans to lesser developed countries. The money-center banks have reserves against approximately 25-30 percent of their non-trade LDC exposures. The large regional banks took additional reserves or charge-offs and now have reserves covering approximately 50 percent of their non-trade LDC exposures. Based on the use of 25 percent of export income to service debt, this level of reserving appears reasonable for present conditions.

These increased bad debt reserves severely depressed earnings but had no major ramifications on the U.S. financial system. The large reserves probably have served to enhance the flexibility banks have in dealing with LDC debt. In that regard, the Mexico/U.S. Treasury backed bond swap was less successful then originally envisaged, but it hopefully will lead to other innovative approaches under the "menu of options" to deal with the situation. Perhaps the major effect of the reserve action is that it has bolstered the perception that the LDC problem is concentrated, more than ever, in a handful of the largest U.S. banking companies.

Asset growth, which was less than two percent during 1987, showed the smallest annual increase in almost 40 years. Banks experienced shrinkage in those loan categories suffering quality problems, i.e., agricultural, energy, commercial real estate, and international. These shrinkages were essentially offset by growth in home equity loans, which stood at $33 billion at year-end, and other consumer lending. Banks continue to strive to expand lending in these new areas. However, competition remains heavy. Banks realize the possible adverse affects of heavy concentrations of assets. Most strive to minimize this risk while continuing to serve their customers' legitimate credit needs.

New products and services are being developed to help spread this risk and to take advantage of commercial banks' strengths. "Securitization" is one such practice which allows banks to emphasize one of their strengths -- being an efficient originator of loans. Securitization activities, initially used in the mortgage banking area, are now expanding into other markets. They provide banks with additional sources of revenue without the capital requirements and costs associated with the warehousing of loans. Securitization also allows diversification of portfolio by region and thus helps to avoid concentration problems such as those currently being experienced in the Southwest.

Liquidity -- During the latter part of 1987 banks enjoyed a large inflow of deposits at lower interest rates. This resulted partially from the October stock market decline. Up until that time, banking sector deposits had increased at a steady, albeit slow, pace. However, 1987 fourth quarter deposits grew at an annualized rate of 11.7 percent.

Overall, sources of banks' funds appear stable and liquidity is adequate. However, in the Southwest Region, institutions with sizable amounts of uninsured deposits are vulnerable to sudden deposit outflows. As evidenced by First Republic, funding sources can be influenced by poor operating results and uncertain conditions. This demonstrates that market discipline by depositors and creditors still exists despite insurers actions to protect all depositors in large institutions. However, we believe that the potential trouble spots have been identified and the FDIC has shown it is willing and able to be a stabilizing influence when the need arises.

The FDIC was generally satisfied with the banking system's support of the securities market during the October stock market decline. We believe the banks' response was consistent with safe and sound banking practices and they were able to assist in providing liquidity where needed. This support can be shown by a fourth quarter surge in loan demand.

BANK SUPERVISION

Our supervisory efforts continue to be directed toward maintaining the safety and soundness of the banking system and protecting the insurance fund against unnecessary loss. In addition to supervising directly on the federal level some 8,000 insured state nonmember banks, we monitor the condition of approximately 6,000 national and state member banks and cooperate with the other federal and state regulatory authorities in their efforts to assure the safe and sound operation of these insured banks.

One of the FDIC's primary goals has been to increase the level of onsite supervision by reducing the time intervals between onsite examinations. After evaluating our overall examination projections in terms of staff resources, operative procedures and the appropriate level of onsite examination, we decided to move toward more frequent examinations. Our goal now is to have an onsite examination every 24 months for well-rated institutions (those rated 1 or 2) and an onsite examination every 12 months for problem and near problem institutions (those rated 3, 4 or 5). Obviously such a goal cannot be accomplished overnight, but we have made considerable progress. Currently, we are averaging once every 34 months for satisfactory banks, once every 23 months for marginal banks and about once every 19 months for problem banks.

We recently have initiated a new program for coordinating FDIC supervision with state supervision -- known as the Supervisors Annual Flexible Examination (SAFE) Program. Under this program the FDIC sets <u>annual</u> plans for supervisory activities with state authorities. It is a flexible program that emphasizes results. Basically, we envision treating many examinations conducted by state examiners as our own. These state exams would be placed on our examination cycle database, and would be counted as examinations by the FDIC for purposes of tracking adherence to our examination schedule guidelines. Where state examinations are accepted as our own, FDIC presence in these banks for full-scope examinations would be delayed -- possibly for up to an additional two years for 1 and 2-rated banks, and an additional one year for 3-rated banks. In the case of 3-rated banks, our presence would depend on trends in the individual banks.

At year-end 1987, the FDIC employed roughly 1900 field bank examiners. We intend to increase this number to about 2100 by the end of 1988. Our examiner force had declined to only 1389 in 1984 from the previous high of 1760 examiners in 1978 when we had only 342 problem banks and 7 bank failures. In contrast, there are currently over 1,500 problem banks and a possibility of up to 200 failures this year. Once we reach our goal of 2,100 we will decide whether we should expand our force further or remain at that level.

We have changed our recruiting methods and standards since deciding in 1985 and 1986 to increase the field staff by 30 percent. By improving our recruitment techniques and hiring the best possible candidates, we were able to hire 421 new trainee examiners in 1987 with a collective college grade point average of 3.4 out of a possible 4.0. It will be some time before these new people are sufficiently trained to be able to carry a full load of responsibility. We are building a new training center at Virginia Square, Virginia, to improve our ability to train our field forces as well as those employed by the states.

Even though we are not at our goal for examination frequency, the expanded work force has enabled us to complete more examinations in 1987 than in 1986. The number of safety and soundness examinations increased 14 percent and compliance examinations increased 60 percent during the past year. The need for effective supervision becomes even more critical as banks obtain expanded powers and undertake to engage in various nontraditional activities. Effective supervision also is a necessity in limiting the federal insurance safety net to banks and not allowing it to expand to bank holding companies.

A major innovation in our examination program has been the expanded use of automation and personal computers. We developed an automated examination report that is now utilized for all safety and soundness, trust, compliance and EDP examinations. Additionally, several specialty programs are available to assist our examiners with tasks ranging from APR calculations in consumer compliance examinations to analyses of capital adequacy. Personal computers have given our field staff immediate access to the data on the Corporation's mainframe computer and the tools to present current data in typewritten or graphic form. The automated report also provides the means to more accurately gauge overall time utilization and productivity trends.

FAILED AND PROBLEM BANKS

The condition of the banking system is generally sound although there continue to be areas of strain. Bank failures are at record levels. In 1987, 184 FDIC-insured banks failed and another 19 received financial assistance to avert failure, including 11 in the BancTexas group. Unfortunately, we have been setting new records each year, and this year is not expected to be an exception. As of April 30, there have been 59 failures and 13 assistance transactions which, inclusive of the First City and First Republic transactions, involve approximately 140 banks. This rate is about on a par with last year's but with more assistance transactions in the current mix. If the current pace continues, we can anticipate about 200 failures and assistance transactions this year as well. It should be noted that almost 90 percent of these failures were west of the Mississippi River and banks in Texas alone accounted for over 30 percent of all bank failures so far this year.

Although the trend is finally downward, the number of problem banks also is near the record level. As of April 30, 1988, there were 1505 FDIC-insured problem banks with total deposits of $289 billion, down from 1,575 as of year-end 1987 but still over the year-end 1986 number of 1484. In mid 1987, the number of problem banks peaked at 1624 with deposits of $300 billion. Of the problem banks, approximately 500 are agricultural banks and 158 are energy banks. Eighty nine percent of the banks on the current problem list are west of the Mississippi River and over 61 percent are in the 6 states of Colorado, Louisiana, Kansas, Minnesota, Oklahoma and Texas.

It is important to note that there is considerable turnover in the specific banks on the problem bank list. Since the number of problem banks peaked in mid-1987 there have been 461 banks added to the problem bank list and 580 deleted from the list through April 30 of this year. Of the 580 deleted, 155 were the result of closings or receipt of FDIC assistance, 79 were the result of mergers and 346 were the result of improvements. The decline in the number of problem banks is primarily attributed to two factors, gradual improvement in the agricultural areas of the country and merger activity, particularly in Texas. We expect the number of problem banks to decline slowly although problems will continue to be severe in those areas dependent on the energy sector.

The pattern of increases and decreases in the number of problem banks correlates with economic conditions. While much of the country and most sectors of the economy now are experiencing relative prosperity, the differences among areas are much wider than has been experienced historically. The areas west of the Mississippi River, with economies that are importantly based on energy, have pockets of severe recession or even depression. Most of the FDIC's problem banks today, and for the rest of 1988, are located in these distressed regions. The statistics contained in our Quarterly Banking Profile (Appendix A) indicate clearly the problems by geographic area.

Deficiencies in bank management and policy exacerbate the natural tendency for banks to suffer from weaknesses in the economy. Historically, inept or abusive management has been a primary cause of problem banks and this remains true today. Management's underwriting standards and credit judgments must remain prudent even when the economy is strong so that the impact of inevitable economic downturns is moderated.

Even though economic problems now are of greater importance than normal in explaining bank problems, management remains an important cause of most banks' difficulties. We do not hesitate to use our formal enforcement powers when circumstances warrant. In 1987, we initiated 91 insurance removal proceedings under Section 8(a) of the Federal Deposit Insurance Act, 130 cease and desist actions under Section 8(b) and 22 removal actions under Section 8(e). Numbers of these actions are down modestly from 1986 except in the case of Section 8(a) actions, which are higher due to including national and state member banks most of which are in the Southwest.

The downturn in agriculture and energy has been so severe and protracted that today, in these depressed areas of the country, many banks with good records and acceptable management are having financial difficulties. As regulators, we are using new approaches in supervising <u>these</u> institutions. We believe that formal enforcement actions -- while very useful and appropriate in many situations -- are counterproductive in those cases where management is acceptable, the bank's problems are the result of adverse market conditions, and the prospects for recovery are good, given a reasonable economic cycle. The FDIC seeks to work cooperatively with the management of such banks in a joint effort to restore the financial stability of their banks.

Our Capital Forbearance program is an example of the approach which we believe has been useful and beneficial to both the FDIC and participating banks. As of April 30, 1988, the FDIC has approved 154 applications for capital forbearance, while denying 68. Of the 126 banks in the FDIC's capital forebearance program on March 31, 1988, 57 improved their primary capital ratio since being approved. There have been 27 banks which have been terminated from the capital forebearance program. Two of these institutions were removed because of improved financial condition and four others merged into healthier institutions. Six more of these banks failed and the remaining 15 were removed due to noncompliance with the capital plan.

Banks participating in the program outside the west and southwest are improving. Many banks in the program throughout the country also are making good progress. Restoring financial health does not occur overnight but we believe that this program is a sound approach, which is doing the job it was designed to do. We will be evaluating the program and measuring its results carefully in the future.

A somewhat similar program (loan loss deferral) was authorized for agricultural banks by Congress last year. It is too early to determine the success of this program. However, as of April 30, 1988, 62 banks have applied for the program, with 15 applications approved, 10 denied and the remainder still under review.

With regard to the role of fraud and insider abuse in bank failures, we believe that such misconduct contributed significantly to about one-third of the bank failures in 1986, 1987 and so far in 1988. Outright criminal conduct was responsible for 12 percent to 15 percent of bank failures. For example, from January 1985 through 1987, 98 of the 354 banks that failed were cited by examiners as having at least some element of fraud or insider abuse. Those 98 failed banks had assets of $2.7 billion and cost the FDIC nearly $676 million. Our experience since 1985, however, suggests a somewhat lessened impact of fraud and abuse compared to the late 1970s and early 1980s.

The FDIC recognized a need to strengthen efforts to deal with fraud and abuse and has taken several major steps since 1984 to improve the situation. We published a list of time tested "Red Flags" and other warning signs of fraud and abuse to be used as an aid to examiners and auditors. We designated some 60 examiners as bank fraud specialists to be given specialized training in bank fraud and insider abuse. Later this year, an intensive, highly specialized training session will be held for these examiners. It will focus on criminal motivation, early detection and investigative techniques. Other training courses for examiners and liquidators have been developed or improved.

We have published guidelines for banks to use in setting up or revising their codes of conduct and, earlier this year, we mailed to all of the banks under our supervision our Pocket Guide for Directors, a copy of which is attached as Appendix C. The Guide provides directors with practical guidance in meeting their duties and responsibilities.

These initiatives with respect to the bank fraud problem will help contain this ever-present problem by fostering public confidence and deterring future abuses.

FAILING BANK RESOLUTION AND LIQUIDATION ACTIVITIES

The FDIC is constantly seeking innovative ways of efficiently resolving failing bank cases and meeting our deposit insurance commitments. In light of the record number of bank failures over the past few years, we have been especially concerned that we maintain our sound cash position. This objective requires the prompt resolution of failing bank cases in a manner that minimizes our costs and cash outlays and results in the FDIC acquiring as few bank assets as possible. Thus, we are actively pursuing, whenever possible, whole bank transactions where the new owners of a failing or failed bank recapitalize the bank and assume all or substantially all its assets with the smallest possible contribution from the FDIC. This approach permits us to realize maximum value on the assets of the failed or failing bank, with only minimal disruption to existing borrower and depositor relationships and the community at large. In addition, as part of our SAFE cooperative program with state regulators we have arranged to give purchasers up to four weeks to examine a failing bank and decide whether they want to purchase it on an open or closed basis.

In keeping with our desire to conserve cash while maximizing our recoveries on acquired assets, we have developed new initiatives to obtain maximum net present value from liquidation assets in the shortest possible time. These initiatives include an aggressive marketing program -- including bulk sales -- designed to move loans and other assets back into the private sector; a stepped up management review of assets in litigation and large dollar assets; and an increased emphasis on seeking settlement on outstanding claims whenever practical rather than pursuing protracted litigation. However, we do not "dump" assets below current appraised values.

As a result of these initiatives, we were able to collect $2.4 billion by liquidating assets from failed banks last year, a 38 percent increase over the $1.7 billion collected in 1986. These efforts have enabled us to hold our inventory of managed assets from failed banks steady at about $11 billion despite a record number of bank failures with even greater record numbers in terms of dollars of failed assets involved.

With regard to the "too big to fail" problem, we suggest that the answer depends in part on how one defines the "problem." It may be that governmental protection of the largest banks in different countries is a premise which, in the United States, tends to be defined in terms of the extent of deposit insurance protection. Certainly, our experience to date in resolving several large failing bank cases suggests that the costs and dislocations of failing to fully protect certain bank depositors and creditors appear unacceptable. Since this appears to us to be the case with regard to banks over a certain size -- that is, depositor losses in such banks threaten the stability of a region or possibly the entire banking system -- then we must seek instead to consider how to extend comparable protection to smaller institutions.

Appendix D provides some thoughts on various alternatives, all of which unfortunately have some undesirable side effects. Certainly the greatest threat to the sufficiency and viability of the deposit insurance fund is posed by the largest banks that might be considered "too large to fail." If depositors in these banks are to be fully protected, there would seem to be relatively little more cost to the fund in extending that protection to smaller banks as well. However, this would further reduce the market's ability to discipline the system and thus could further increase the burden of government supervision. As yet, we have found no alternative which satisfies the criteria of providing a level playing field between larger and smaller banks, maintains what is left of depositor discipline and protects our system when big banks fail.

As a matter of policy, and consistent with statutory criteria, we are attempting to resolve smaller failing bank cases in a manner that protects all depositors whenever possible. This approach tends to minimize some of the perceived disparate treatment between large and small banks. By attempting to extend full protection to depositors of smaller banks we also tend to reap the full benefits of stability to the banking system that such an approach entails. In a relatively small number of cases, however, we have no choice under current law but to pay off insured depositors up to the statutory maximum. The losses of uninsured depositors in these cases amounted to only a little more than $80 million last year, or less than .99 percent of the total deposits of all failed banks and banks receiving open bank assistance.

When considered as a whole, our treatment of large and small failing banks is in most important respects remarkably similar. In virtually all cases, equity holders and subordinated creditors are substantially wiped out or suffer severe losses and senior management and directors are replaced. Bank depositors and creditors receive ALL of their funds in the vast majority of cases. In fact in 1987, 72 percent of the failed bank's were handled by purchase and assumption transactions which assured all depositors 100 percent of their funds.

ADEQUACY OF THE FUND

The financial condition of the FDIC remains strong and stable despite a record number of bank failures and assistance transactions, including the second largest in our history in 1987. At year-end 1987, the insurance fund's net worth was $18.3 billion, a modest increase of roughly $50 million over the previous year. Based on current estimates of loss in 1988, including the loss on First Republic of Dallas, Texas, we may experience a small decrease in the net worth of the fund in 1988.

The composition of the fund is as important as the balance. At year end 1987, nearly 91 percent of the fund balance, or $16.6 billion, was represented by cash and liquid U.S. Treasury Securities. The amount of these liquid assets declined by only about $500 million in 1987 even though record demands were made upon our fund.

The preservation of our cash is largely the result of the innovation in handling failures which we mentioned previously. The flexibility and capacity represented by what is essentially cash is one reason we are confident that the FDIC fund remains adequate to handle any foreseeable problems in the banking system.

Even though the fund is strong and stable, it is not increasing at a rate commensurate with the growth in deposits. In 1986 the ratio of reserves to insured deposits dropped from 1.20 percent to 1.12 percent. This decline continued in 1987 to 1.10 percent. Until the number or size of bank failures declines from present historically high levels, it is difficult to foresee the ratio of insurance reserves to insured deposits increasing. Indeed, a further decline in 1988 is anticipated largely due to the continued economic problems west of the Mississippi.

FDIC - FSLIC

While we believe that the FDIC fund is sufficient to deal with problems in the banking system as we see them today, we do not have the financial capacity to function as insurer of commercial banks, and restore the solvency of the Federal Savings and Loan Insurance Corporation as well. If additional funds are required by the FSLIC in the future, we believe they should be supplied without endangering the financial condition and capacity of the FDIC. We do not believe a merger of the funds is desirable under current conditions. Despite this view, we are studying various suggestions with respect to a merger in the event the Congress decides such action is required. In addition, we have offered whatever assistance we can to the FSLIC in terms of administration, asset liquidation, developing supervisory policies and procedures, training or other operational assistance.

Although there are some problems in the banking industry, there is no inventory of operating FDIC-insured insolvent banks. The fund is adequate, and commercial bank problems -- outside recognized troubled areas -- appear to be stabilized or on the decline. With new products banks could further improve their safety and soundness.

We believe that addressing the FSLIC problem should entail an overview of the workings of the entire federal deposit insurance system. This issue is of great importance. Accordingly, we have formed a group of knowledgeable people from both within and outside the FDIC to study, and make recommendations in, this area. We have asked for input from all interested parties. We expect our study -- "A Federal Deposit Insurance System for the 90s" -- will be completed before year-end.

CONCLUSION

The banking industry is experiencing a stressful period of evolution. There are serious problems and challenges for banks, bankers the regulators and especially for the establishment of appropriate public policy by the Congress. The questions and problems are not easily answered but they can be managed. Mistakes may occur, but correcting and learning from mistakes is often better than inaction. Actions taken now will shape the health and worldwide competitiveness of U.S. banking into the next century. We look forward to cooperating with the Congress in whatever way possible to insure that the industry remains the safe and sound backbone of the U.S. economic system and a capable competitor in world markets.