TESTIMONY OF

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ON

THE CONDITION OF THE BANKING INDUSTRY AND THE FDIC FUND

AND

THE SUPERVISORY AND ASSISTANCE ACTIVITIES OF THE FDIC

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FEDERAL DEPOSIT INSURANCE CORPORATION

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

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Good afternoon, Mr. Chairman and members of the Committee. I am pleased to have the opportunity to testify today on the condition of the banking industry and the Federal Deposit Insurance Corporation fund, as well as on the supervisory and assistance activities of the FDIC.

In these challenging times, we believe the FDIC has functioned well and in full accord with Congressional intentions -- as embodied in the Federal Deposit Insurance Act -- with respect to the purpose, function and operations of the Corporation. In developing FDIC policies, we are guided by the following goals and principles:

- to maintain a safe and sound banking system and public confidence in that system;
- to enforce applicable laws, rules, and regulations governing banking;
- to reduce the cost to, and thus to preserve the financial viability of, the FDIC insurance fund;
- to emphasize private-sector resolution of banking problems;
- to enhance competition;
- to increase consumer services and protection; and
- to maintain the dual banking system.

With these guiding principles as background, our statement today details the FDIC's views and procedures regarding the changing role of deposit insurance, the status of the insurance fund, the condition of the banking industry, the role of bank supervision, the resolution of failed and failing banks, the need for additional legislation and deposit insurance reform.

THE CHANGING ROLE OF DEPOSIT INSURANCE

Deposit insurance was established some 55 years ago and today is at a watershed period. It was originally created as a reaction to severe problems the banking industry faced during the Depression. That beginning was not without controversy. Small depositors and small banks supported the plan, while larger institutions opposed anything that would help put smaller institutions on a more equal footing.

The role and form of deposit insurance as conceived in the 1930s have changed dramatically as the structure of the banking system has evolved. New competition, deregulation, disintermediation, new technologies and geographic expansion have combined to make banking a decidedly different business than it once was. Significant changes in the operation of the deposit insurance system have occurred, revealing stark differences from the original concept.

For example:

- Some small banks contend that the FDIC's use of the deposit insurance safety net gives unfair advantages to large institutions by not allowing the largest institutions to fail -- the "too-big-to-fail" doctrine. Granted, protection of depositors and creditors in large failing banks has distorted the system. However, no major industrial nation has allowed its largest banks to fail since the depression because the financial fallout is so difficult to predict. Moreover, the failure of a large bank likely would have significant international competitive ramifications. Thus, we now have an insurance system -- which was designed to help small banks compete with big banks -- that is criticized by some small banks as favoring big banks.

- Another example is that, the Federal Reserve System, traditionally considered the lender of last resort, has become the next-to-last-resort lender. The deposit insurance system has become the last resort for protecting failing banks and, thus, the stability of the system. For example, when First Republic went to the Fed window last winter, withdrawals increased because depositors and creditors were fully aware of the Federal Reserve's policy of requiring collateral for its liquidity lending. However, when the FDIC arranged a loan of $1 billion and stated unequivocally its intention to protect depositors and creditors, the run stopped. So the FDIC has become the back up source for insolvent banks that need to be protected. The creators of the fund could not have envisioned such a role for the FDIC.

- Third, the status of the holding company in the banking system has been drawn into question by recent FDIC policy. For example, when the FDIC assured that all depositors and other general creditors of the First Republic banks of Texas would be fully protected, such protection was NOT extended to the holding company's creditors or shareholders. This FDIC policy is critical when considering such issues as whether and what new activities should be permitted to holding companies and whether it is appropriate to apply the proposed risk-based capital standards to holding companies. Again, the current role of bank holding companies in the banking system was not envisioned under the original deposit insurance system.

Recent experience with deposit insurance -- in both the banking and thrift industries -- indicate that, while the FDIC continues to fulfill its mission, substantial improvements are necessary to the system. Improvements are necessary in order to:

- o contain potential insurance losses;
- o restrict the scope of the federal safety net;
- o improve supervision; and
- o provide more efficient and fairer handling of failed banks.

What started as a simple protection for small depositors (and small banks) has become, in the current environment, a major factor in the operation of the financial depository system. Federal deposit insurance, improperly controlled, has the potential to severely damage the entire financial system.

STATUS OF THE FUND

The financial condition of the FDIC remains strong despite recent record numbers 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. As announced previously, based on current estimates of loss in 1988 -- including the loss on First Republic and two other large banks in Texas -- we expect a modest decline in the net worth of the fund in 1988. Once those transactions are consummated, however, the main financial cost should be behind us and the insurance fund should begin to grow again in 1989.

The composition of the fund also is an important barometer of the fund's condition. At year-end 1987, nearly 87 percent of the fund balance, or $16.1 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 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.

CONDITION OF THE BANKING INDUSTRY

Overview

The condition of the banking industry and its future prospects are vitally dependent on the state of the economy and particular economic sectors and geographic areas. Consequently, some general observations on the economy seem appropriate.

In 1987 problems in the agricultural industry bottomed out and a slow, gradual improvement began. Continued improvement in that economic sector is expected to continue in 1988, barring serious problems resulting from the current Midwest drought. Nonetheless, the problems of agriculture and agricultural banks are not over. The upturn is slow and banks' performance normally lags the economy both on the way up and on the way down. However, even though problems still exist, the trend is in the right direction.

It is perhaps arguable whether problems in the energy sector bottomed out in 1987. So far this year energy problems do not appear any worse than last year, but certainly no one would describe that industry to be experiencing 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 to prevent oversupply. The FDIC is carefully arranging its property sales to ensure fair market value. 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, we have expressed 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.

Despite increased competition from all sectors of the financial community, severe regional economic problems, and an unprecedented pace of change in the industry, the banking system as a whole is sound and improving. 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.

Although the condition of the banking system is generally sound, 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. Historical data on failures and assistance transactions are provided by Tables 1, 2 and 3.

As of June 30, there have been 87 failures. In addition, there have been 15 assistance transactions which, inclusive of the First City[*/] and First Republic transactions, involve approximately 146 banks. If the individual banks in First City and First Republic are not counted separately, the total number of failed- and assisted-bank transactions are 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 more than 200 failures and assistance transactions this year as well. Importantly, over 90 percent of the failures thus far in 1988 have been west of the Mississippi River, and banks in Texas alone have accounted for over 40 percent of those failures.

Although the trend is finally downward, the number of problem banks also is near the record level. Historical data on problem banks are contained in Table 4. As of May 31, there were 1,495 FDIC-insured problem banks with total deposits of $288 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 1,624 with deposits of $300 billion. Of the problem banks, approximately 433 are agricultural banks and 158 are energy banks. Eighty-

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[*/] Although not consummated until 1988, the cost of the First City transaction was fully reflected in our 1987 financial statements.

nine percent of the banks on the current problem list are west of the Mississippi River and 64 percent are in the six states of Colorado, Louisiana, Kansas, Minnesota, Oklahoma and Texas.

There is considerable turnover in the specific banks on the problem bank list -- a fact that sometimes goes unnoticed. Since the number of problem banks peaked in mid-1987, there have been 496 banks added to the problem bank list and 625 deleted from the list through May 31. Of the 625 deleted, 168 were the result of closings or receipt of FDIC assistance, 85 were the result of mergers and 372 were the result of improvements. The decline in the number of problem banks is attributed primarily 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 broader than in the past.

The areas west of the Mississippi River, with economies that are based on energy and agriculture, have pockets of severe recession or even depression. Most of the FDIC's problem banks today, and those anticipated for the rest of 1988, are located in these distressed regions. Many of the involved states have unit banking laws which tend to limit opportunities for diversification geographically and by economic sector. The statistics contained in our Quarterly Banking Profile (Appendix A) indicate problems by geographic area.

Key Indicators

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. Increases in the reserve for losses made by the large money-center banks for troubled loans to developing countries accounted for nearly all the growth in primary capital. 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. In fact, as of year-end 1987, only 115 banks -- with total assets of about $11 billion -- of the approximately 13,500 FDIC-insured commercial banks had primary capital ratios of three percent or below.

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-assets, 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 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. Imposing risk-based capital standards is an important initiative designed to reduce risk in the 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 <u>and</u> bank holding companies as proposed in the United States. This is a difficult question since the United States is the only country that regulates holding companies.

Insofar as FDIC-insured savings banks are concerned, 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 five 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 five 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.

<u>Earnings</u>. Earnings are the lifeblood of any business and commercial banks in 1987 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 at 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. In fact, excluding loan loss provisions, only 695 banks in the United States -- with assets of $54 billion -- failed to generate sufficient earnings in 1987 to cover their operating expenses. Texas banks accounted for 60 percent of those assets.

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 far 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 thrift 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.

Notwithstanding regional banking problems, 1988 earnings prospects for the industry as a whole are very promising. We expect that for 1988 the commercial banking industry's aggregate income will exceed the previous historic high of $18.1 billion earned in 1985. Although the earnings will be dampened by continuing banking problems in the Southwest, those losses will be offset by improvements in other areas, especially by the collection of $1.6 billion of income foregone on Brazilian loans since early 1987.

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 non-performing 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.

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 intense. 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, fourth-quarter deposits in 1987 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

Given the commitment of the federal government to the safety of insured deposits, it is clear that we must find ways of limiting or controlling the risks assumed by insured banks. Certainly market discipline has a role to play but it cannot be relied on exclusively or even substantially to protect the government's interest. We believe that interest must be protected primarily and directly through effective bank regulation and supervision with a decided emphasis on the flexibility of supervision.

Our experience in the Southwest to date has been instructive. From a supervisory standpoint, it is difficult to fault anyone for failing to anticipate the precipitous decline in oil prices and the effects that would have on the economy of the Southwest. It is hard to be an effective naysayer when everything is booming. On the other hand, it is also clear that in the euphoria of the oil boom many bankers failed to heed, and the regulators failed to adequately enforce, certain prudential lending standards that might have moderated the effects of the subsequent economic decline on individual banks.

These standards include risk diversification, cash flow and market analyses, sound collateral margins and the individual liability of borrowers with substantial net worth as additional support for indebtedness. Such standards are appropriate for all banks, including well-capitalized banks whose capital can be quickly dissipated in an economic downturn, particularly when the bank has concentrated its lending activities in one economic sector or geographic region.

Even though economic problems now are of greater importance than normal in explaining bank problems, management remains an important cause of most banks' difficulties. Deficiencies in bank management and policy exacerbate the natural tendency for banks to suffer from weaknesses in the economy. Wherever the circumstances warrant, the FDIC initiates formal enforcement actions. In 1987, we initiated 91 insurance termination proceedings, issued 107 cease-and-desist orders, and began 18 removal actions.

The downturn in the agricultural and energy industries has been so severe and protracted that today, in certain depressed areas of the country, some banks with good records and acceptable management are having financial difficulties. As regulators, we are using new approaches in supervising these 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.

Capital Forbearance and Loan Loss Deferral

The capital forbearance program adopted by the banking agencies is an example of the approach we believe has been useful and beneficial to both the FDIC and participating banks. This is a program for solvent banks with below expected

capital and which have reasonable prospects for long-term viability. As of May 31, the FDIC has approved 155 applications for capital forbearance, while denying 68. There have been 30 banks that have been terminated from the capital forbearance program. Two of these institutions were removed because of improved financial condition and five others merged into healthier institutions. An additional six more of these banks failed and the remaining 17 were removed due to noncompliance with their capital plan.

Banks participating in the program outside the West and Southwest are improving. Many other banks in the program throughout the country also are making good progress. Restoring financial health does not occur overnight but we believe this program has been effective in accomplishing its purpose. 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. As of May 31, 66 banks have applied to the FDIC for the program, with 18 applications approved, 10 denied and 28 still under review. Nine banks were determined to be ineligible and one application was withdrawn. It is too early to determine the success of this program.

Fraud and Insider Abuse

Fraud and insider abuse are frequent elements 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. We estimate that 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 receive 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 FDIC supervision our Pocket Guide for Directors, a copy of which is attached as Appendix B. 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.

Examination and Examiners

One of the FDIC's primary goals has been to increase the level of onsite bank supervision by reducing the time intervals between onsite examinations. After evaluating our overall examination projections in terms of staff resources, operating procedures and the appropriate level of onsite examination, we have 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). Unfortunately, this 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 annual 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 1,900 field bank examiners. We intend to increase this number to about 2,100 by the end of 1988. Our examiner force had declined to only 1,389 in 1984 from the previous high of 1,760 examiners in 1978 when we had only 342 problem banks and 7 bank failures. In contrast, there are currently nearly 1,500 problem banks and the possibility of more than 200 failures this year. Once we reach our goal of 2,100 we will decide whether we should expand our force further.

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, however, before these new people are sufficiently trained to be able to carry a full load of examination responsibility. We also are building a new training center at Virginia Square, Virginia, to improve our ability to train our field forces.

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 the number of compliance examinations increased 97 percent during the past year.

A major innovation in our examination program has been the expanded use of automation and personal computers. We have developed automated examination reports that are 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 gauge more accurately overall time utilization and productivity trends.

FAILED- AND FAILING-BANK RESOLUTION

Alternatives

When a bank's failure is imminent, the FDIC must consider how it will discharge its obligations as both the insurer of the bank's deposits and the likely receiver of the failed bank. Although the response of the FDIC to each possible bank failure may be somewhat different, there are generally three categories of alternatives available. Generally the FDIC will make each alternative available to an interested investor.

First, direct financial assistance may be available to keep the bank from failing. This approach is available only if the Board of Directors of the FDIC finds that either the assistance required is less costly to the FDIC fund than any other alternatives available to the FDIC or that continued operation of the bank is essential to provide adequate banking service in the community.

Since assistance transactions are the product of negotiation, each has its own unique characteristics. The FDIC, however, imposes certain uniform requirements. The assistance required must be less than that required under other alternatives. In addition, the failing bank must provide all interested

qualified investors an opportunity to present alternative assistance proposals. Generally, our philosophy is that the assistance provided should be no greater than the amount required to offset any deficiency between realizable asset values and liabilities. Furthermore, failing banks almost invariably have unrecognized losses to the extent they are capital deficient. For this reason, we require that new investors be found to recapitalize the bank and that the effect on existing shareholders be comparable to closing the bank. In cases involving widely held banks, existing shareholders may be left with a residual ownership interest -- such as one to two percent -- in order to induce a favorable shareholder vote. In other cases, shareholders are left with no ownership interest.

The tax consequences of FDIC assistance for the revitalized institution (as well as the extent to which tax attributes of the preassisted institution carry over) are issues that invariably arise during negotiations with new capital investors. Investors generally have not been able to work out the tax issues with the Internal Revenue Service until well <u>after</u> the assistance transaction with the FDIC has been negotiated. The uncertainty surrounding the tax consequences of assistance transactions is a real detriment to attracting new capital for troubled banks. Resolving tax issues beforehand -- ideally through a clear legislative mandate -- would be very useful. Thus, the FDIC has been actively pursuing clarification of these tax issues with the tax-writing committees of the Congress. We would appreciate any support this committee can provide in this area.

The second alternative available in addressing failing banks is a direct payoff of the insured deposits. In this situation the bank is closed and the FDIC is named receiver. The depositors are paid up to the $100,000 limit of

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insurance protection and the institution is liquidated. Depositors above the insurance limit are paid, to the extent possible, only after the failed bank's assets are liquidated. A variation of a direct payoff (called "an insured deposit transfer") is when insured deposits are transferred to another bank which acts as paying agent for the FDIC. A direct payoff is the least desirable, and usually most costly, alternative. It results in an interruption of vital banking services to the community served by the failed bank. In addition, because the failed bank's main office and branches are permanently closed, virtually all the failed bank's employees lose their jobs.

The third and most prevalent alternative is a "purchase-and-assumption" ("P&A") transaction. Under this alternative, which can be structured in several ways, a healthy bank assumes all the failed bank's deposit liabilities, including uninsured deposits, and agrees to acquire some or all of the failed bank's assets. The assuming bank receives an infusion of cash from the FDIC to make up the difference between the value of the assets and the liabilities assumed. The current FDIC policy is to try to arrange, wherever possible, so-called "whole bank" transactions where the assuming bank acquires all the assets of the failed bank, including the bad loans, with the minimum contribution from the FDIC.

A new temporary solution now available to the FDIC is a "bridge bank." In this case, the FDIC can operate the failed institution, for up to three years, until a buyer can be found.

The open-bank assistance transaction and the P&A have proven to be highly effective means of providing a cost-effective resolution for failing and failed banks, and have been used in the overwhelming majority of bank

failures. They minimize disruption to depositors and the community generally, and maintain confidence in the system. These transactions, as well as being cost-effective, also generally protect all depositors, regardless of amount, and often general creditors as well.

Because of the benefits associated with these two means of dealing with failing and failed banks, the FDIC attempts to engage in such transactions wherever possible. In 1986, when a total of 145 banks either failed or were assisted, 98 P&A transactions were consummated and 7 open-bank assistance transactions were undertaken. In 1987 there were 133 P&As and 19 assistance transactions out of a total of 203 transactions. As of June 30, of a total of 102 failed or assisted banks, 66 were P&As -- including 38 "whole bank" transactions -- and 15 were open-bank assistance transactions. 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. However, uninsured deposits in these cases amounted to only a little over $80 million last year, or less than one percent of the total deposits of all banks that failed or received open-bank assistance.

Current Objectives

In light of the record numbers of bank failures over the past few years, we have been especially concerned with maintaining a 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's acquisition of as few bank assets as possible. Thus, as mentioned above, we are actively pursuing whole bank transactions whenever possible. 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, more recently and 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 settling outstanding claims whenever practical rather than pursuing protracted litigation. However, our policy and practice is to not "dump" assets for below-current appraised values.

As a result of these initiatives, the FDIC collected $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 that involved even greater record numbers in terms of dollars of failed assets involved.

<u>The "Too-Big-to-Fail" Issue</u>

As mentioned above, the "too-big-to-fail" matter is another important issue currently facing the FDIC in resolving the problems associated with failing

and failed banks. It may be that governmental protection of the largest banks in the major industrialized countries is a premise which, in the United States, tends to be defined in terms of the extent of deposit insurance protection. In resolving several large failing bank cases we have deemed it unacceptable to fail to fully protect certain bank depositors and creditors because of the resultant economic costs and dislocations. Because the failure of banks over a certain size threatens the stability of a region -- or possibly the entire banking system -- it may be prudent to consider instead how to extend comparable protection to smaller institutions.

Appendix C provides some thoughts on various alternatives, all of which unfortunately have some undesirable side effects. The greatest threat to the sufficiency and viability of the deposit insurance fund is posed by the largest banks. 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 means that we are committed to providing open bank assistance or some variation of the purchase-and-assumption transaction as preferred alternatives. Use of these alternatives tends to

minimize some of the perceived disparity of 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 fact, 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 their funds in the vast majority of cases. In fact in 1987, 72 percent of failed banks were handled by purchase-and-assumption transactions, assuring all depositors 100 percent of their funds.

First City and First Republic

Two failing bank cases, First City and First Republic (which is still pending), warrant special comment because of their recency, size, and the lessons they provide. They also demonstrate our commitment to promoting stability without extending the safety net to bank holding companies, bank managers and shareholders.

First City. The recapitalization of the subsidiary banks of First City Bancorporation, Houston, Texas, was consummated in mid-April, 1988 and involved approximately $970 million of FDIC assistance accompanied by approximately $500 million in new equity capital from private investors. The transaction was an open-bank assistance transaction and, accordingly, required

the consent of common and preferred shareholders. As a condition of the FDIC assistance, and in order to insure viability of the recapitalized institution for the private investors, substantial concessions also were required from creditors of the First City holding company in accordance with our existing policy statement on open-bank assistance.

Because First City was an open-bank transaction, the concessions by the shareholders and creditors were voluntary. Any shareholder not wishing to participate in the restructuring could vote against the plan. Similarly, any creditor refusing to participate could refrain from tendering the debt security held by such creditor. Unlike the decisions involving shareholders, where the approval of the holders of two-thirds of the outstanding shares basically would bind all shareholders to the restructuring, the decisions of the debtholders were individual decisions. That is, each debtholder could make his or her own determination of whether or not to participate in the restructuring, unaffected by decisions of other debtholders.

The holders of approximately 67 percent of the outstanding debt voluntarily participated in the restructuring in which they received a cash payment of less than the face value of their debt obligation in exchange for the obligations. The holders of approximately 33 percent did not voluntarily exchange their indebtedness for cash, and thus continued to hold their debt. However, they did not receive a cash payment from First City of 100 cents on the dollar. They merely continue to hold their debt security under the preexisting terms.

In our view, participation in the debt concessions was substantial and sufficient for the private investors to inject $500 million of new equity into

First City. While certain individual creditors might have received greater benefit than if the insolvent First City banks had failed, it is our view that the aggregate concessions on the indebtedness comported with the guidelines contained in our policy statement. It is unclear what the creditors would have received in the event the insolvent First City banks actually had failed. As of March 31, 1988, of the 60 banks then in the First City system, 52 still had positive net worths and 56 had positive primary capital. Furthermore, the advantage of an open-bank transaction like First City is that the disruptions resulting from bank closings are avoided.

Another point also should be made clear. When originally announced, the recapitalization proposal contemplated that 90 percent of the debt would be exchanged for the cash payment, while 10 percent of the debt would remain outstanding on its original terms. The FDIC did not increase its financial commitment to the restructured First City when the ultimate debt concessions obtained were less than originally contemplated. This increased debt burden was assumed by the new investors, not the FDIC.

First Republic. On March 17, 1988, the FDIC announced an interim assistance plan for First RepublicBank Corporation, Dallas, Texas, involving a $1 billion loan to the two largest banks in the First Republic system. The announcement included an assurance to depositors and general creditors of the First Republic banks that in resolving the First Republic situation, bank depositors and banks creditors would be protected and that services to customers would not be interrupted. The FDIC specifically provided no assurance to creditors of the First Republic holding company or other non-banking subsidiaries. Further, these assurances related only to depositors and creditors other than

the First Republic banks themselves. That is, the inter-bank funding from one First Republic bank to another is not protected by the FDIC assurances.

In exchange for the assistance, the First Republic holding company guaranteed the $1 billion loan and collateralized that guarantee by pledging the shares of 30 of its bank subsidiaries. This loan was further guaranteed by each of the First Republic banks. First Republic also agreed to substantial restrictions on its operations, management, and policies.

At the time of the assistance, First Republic had total assets of $33 billion, was the largest bank holding company in Texas, and was the largest bank holding company outside New York, Chicago, and California. It is a major clearing bank, dependent to a substantial degree upon continued relationships with other banks, major corporate customers and others. Due primarily to major losses, First Republic suffered a severe erosion of confidence during the first quarter of 1988. As a result, it was losing not only deposits and other funding, but equally important, it was losing or was in danger of losing significant corporate and other banking relationships that would be difficult, it not impossible, to replace. The situation became so severe that First Republic requested the assistance package from the FDIC and was willing to pledge virtually its entire equity to the FDIC in exchange. The FDIC, in turn, determined that the assistance package was the most appropriate method of lessening the ultimate risk to the insurance fund posed by the situation.

The FDIC assured depositors and general creditors of the Republic banks that, as it acted to provide a long-term solution for the First Republic situation, the FDIC would arrange for a transaction that resulted in the depositors and

creditors continuing to have deposits in and claims against an operating bank as a result of open-bank assistance transactions or a variation of one of its traditional purchase-and-assumption transactions.

It is important to understand the legal basis for the granting of such assurances. Section 13 of the Federal Deposit Insurance Act specifies the various alternatives available to the FDIC in assisting failing or failed banks. Among the alternatives are providing direct assistance to the banks to prevent their closing or providing assistance to another entity to facilitate the acquisition of the banks. Such alternatives generally have the effect of protecting depositors and other creditors of the banks. If any alternative other than paying off insured depositors and liquidating the assets of the failed bank is to be exercised, normally the cost of exercising such alternative must be no greater than the cost of liquidating the banks. However, the FDIC may also grant assistance in those instances where the failing bank is found to be essential to the community in which it operates. In our opinion, a determination of essentiality is available whenever severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, and the Board of Directors of the FDIC determines that the assistance will lessen the risks to the deposit insurance fund.

With respect to First Republic, the FDIC, in consultation with the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, determined that severe financial conditions existed that threatened the stability of a significant number of insured banks, as well as insured banks possessing significant financial resources. In making this determination, the

FDIC Board of Directors did not, and could not, extend deposit insurance coverage to all depositors and insured creditors. Instead, the Board committed itself to accomplishing a long-term resolution of the First Republic problem in a manner that would not result in loss to depositors or other general creditors of the bank. In providing such assurances to depositors and general creditors, the Board of Directors of the FDIC acted in order to lessen the risk posed to the insurance fund.

Clearly the size of the First Republic system, the multibank holding company situation so predominant in Texas, and the attendant intra- and inter-company funding relationships played an important role in assessing the risks to the deposit insurance fund. The Board examined and took into consideration the impact of the failure of First Republic on other bank holding companies located outside the state. In the view of the Board, the potential costs of allowing the lead bank of this major regional bank holding company to fail without taking into account the impact on the banking system would have been extremely shortsighted and imprudent, given the critical goal of preserving the insurance fund and the greater responsibilities of providing stability and confidence to the banking system generally.

At the time that a long-term solution is found for First Republic, the actual transaction (be it an open-bank assistance transaction or a purchase-and-assumption transaction) ultimately may be less expensive to the FDIC than the liquidation of the bank and paying off the insured deposits, and thus may satisfy the cost test provided in Section 13(c) of the FDI Act. Our preliminary analysis of First Republic and our general experience lead us to believe that this may be true. However, at the present time we are unable to make such calculations.

PROPOSED EMERGENCY CONSOLIDATION LEGISLATION

Multibank holding companies generally 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 individually. In effect, the FDIC must act as if there is no connection between the failed bank and the rest of the system.

Some bank holding companies and their creditors have seen a way to turn this situation to their advantage. Most multibank holding companies exist in states that have restricted branching. In most cases, the bank subsidiaries are commonly named and are commonly advertised. The bank subsidiaries support their lead bank to the same extent as if they were branches of that bank. For instance, individual "downstream" (or subsidiary) banks frequently deposit many times over their capital account in the lead bank and these amounts often are well over the $100,000 coverage limit. The subsidiary banks also may make unsecured loans to the lead bank. This captive funding is used by the lead bank to finance its lending activities.

This arrangement concentrates the bank holding company's assets in a single bank (usually the lead bank). If the lead bank's lending practices are inferior, the bank holding company effectively isolates its poor-quality assets in that bank. Moreover, the bank has the resources to make far more poor-quality loans than would be the case if the bank did not serve as the conduit for its affiliated banks' funds. When the lead bank's assets deteriorate sufficiently to threaten its solvency, the affiliated banks may

withdraw their deposits--leaving the FDIC with the losses. 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 interfere with the Federal safety net in other ways as well. In many cases it is in the best interest of the local community and of the banking system for the FDIC to arrange open-bank assistance transactions. These transactions are designed to avoid the disruption that a bank failure would inflict on a community. However, open-bank transactions require the consent of creditors and shareholders of the holding company. In a number of cases the creditors and shareholders have delayed these transactions in an attempt to receive greater consideration than they would have been entitled to if the bank had failed. These creditors and shareholders have imposed added costs on the Federal safety net because of the FDIC's desire to prevent the closing of the bank.

We are seeking legislation, that previously has been submitted to all members of this committee, to address these problems. This legislation would establish a special procedure for dealing with failing banks that belong to multibank 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 protect the public interest by ensuring that the banking assets of a holding company system are appropriately applied towards solving problems in a subsidiary bank prior to requiring the expenditure of FDIC funds. We hope this committee will adopt this measure.

DEPOSIT INSURANCE - A SYSTEM FOR THE 90s

Deposit insurance has successfully protected depositors and helped to maintain the stability of our banking system. Today, deposit insurance protects some $2.5 trillion of deposits held by large and small depositors in approximately 14,000 banks of all sizes, including 330 with deposits in excess of a billion dollars. Deposit insurance is now firmly entrenched as a part of our economic landscape and it is unlikely the public would countenance any serious diminution of the protection afforded.

Nevertheless, the deposit insurance scheme is facing serious new challenges to the sound operation of the system which must be addressed in order to assure its continued viability. That is why the FDIC is undertaking a complete review of deposit insurance and its role and operation in the current banking environment. Our study on this subject, "A Deposit Insurance System for the 90s", has been underway for several months. We expect to have the study completed by year-end and believe it will be a useful contribution to the future of the deposit insurance system.

Here are some of the fundamental questions to be answered in constructing a better deposit insurance system.

Can supervisory mechanisms control risk? This is key to the future of the system. If supervision doesn't work, the ability to borrow on the credit of the United States can be misused and abused. As we enter an environment providing banks with greater powers, how will supervision need to adapt to keep the system safe and sound? Are our present supervisory resources,

personnel, examination procedures, offsite monitoring systems, and supervisory sanctions adequate? And, once problem banks have been identified, are our present regulatory powers sufficient to deal with institutions that pose a high risk to the insurance fund?

How can the market be used to control risk in today's environment? Is depositor discipline really alive and well despite insurance and big bank protection? Can we increase market discipline and thus promote safety by statutory and *de facto* deposit insurance coverage ceilings, changes in coverage to include only short-term deposits, or the introduction of private coinsurance? Should we control rates paid on insured deposits, or provide insurance only for individuals and not corporations?

How far should the "safety net" extend? The FDIC's treatment of certain large Texas banks demonstrates our present position that we will not extend the "safety net" to holding companies.

How can we improve the way we handle failing banks? Should large bank depositors be protected, and if so, by whom? How can we handle failed banks so as to treat large and small banks more equitably?

Should the FDIC operate more in the manner of a Reconstruction Finance Corporation ("RFC") of the 1930s? An RFC approach would involve loaning capital to banks that are still solvent but clearly in trouble. This approach might save us losses by preventing failures, but on the other hand this means greater government intrusion into the marketplace. Currently we have opposed the use of FDIC funds in this manner.

Do we price deposit insurance appropriately? Would a system of risk-related premiums do a better job than our current system of explicit and implicit pricing? Can we find a formula that will be mechanical, accurate and defensible? Should foreign deposits be subject to assessment?

Of course, no study of deposit insurance can avoid addressing the issue of a merger of the FDIC and FSLIC funds. We do not favor a merger under current conditions. If such a merger is mandated by Congress, we believe that an administrative merger might provide some cost savings.

While changes may be needed in view of the highly competitive and broad-based markets in which banks operate today, we should not lose sight of the success of deposit insurance to date and the essential soundness of the system now. Since the FDIC was founded, we have resolved over 1,300 failed or failing bank situations. Not one depositor has lost a penny of his or her insured deposits and the vast majority of all depositors have received all of their deposits, insured and uninsured. This result has been paid for by the use of premiums paid by the banks. This is a record of which we all can be justifiably proud.

Mr. Chairman, I would be pleased to respond at this time to any questions you or the other members of the Committee may have.