FDIC Speeches

TESTIMONY OF

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ON

CONDITION OF THE BANK INSURANCE FUND

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Subcommittee. We are pleased to report on the integrity of the Bank Insurance Fund and the status of supervision as the Federal Deposit Insurance Corporation begins to implement the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). The Bank Insurance Fund is solvent and can meet the obligations as we foresee them today. The FDIC's supervisory staff will meet its obligations under the new legislation but only with extraordinary efforts and with some start up strains.

Status of the Bank Insurance Fund

Despite reporting the first operating loss in our fifty-five year history at year-end 1988, the overall financial condition of the FDIC remains strong, and the outlook for the Bank Insurance Fund is positive. For the first six months of 1989, net income for the Fund was $171 million. Comparing this to the same period in 1988, Insurance Fund revenues increased by eight percent, while expenses fell 40 percent. We expect the fund to break even or show a slight reduction for the full year and to show an increase in 1990.

Last year a record 200 banks failed and 21 institutions required financial assistance. These included the failure of First Republicbank in Dallas and the assistance of the Houston-based First City Bancorporation. Overall, the FDIC set aside reserves for losses on approximately $80 billion of failed or failing

bank assets in 1988, more than the combined total of assets handled during the Corporation's first fifty-five years.

Included in the 1988 operating loss was the commitment of funds to handle the resolution of three large problem banks in Texas -- MCorp of Dallas, Texas American Bancshares of Fort Worth, and National Bancshares Corporation of San Antonio -- all of which were resolved earlier this year. In total, provisions for insurance-related losses in 1988 were $6.3 billion, more than twice the provision in 1987. As a result, the Insurance Fund declined 23 percent from $18.3 billion, to a net worth of $14.1 billion at year-end 1988. For the first six months of 1989, provisions for insurance losses were $1.3 billion, significantly below the $2.4 billion reserved after the same period one year ago.

The composition of the Fund is an important barometer of its condition. At year-end 1988, nearly 74 percent of total assets, or $16.5 billion, was in the form of cash or U.S. Treasury securities. Despite record insurance-related outlays, new approaches to dealing with bank failures and aggressive management of assets under liquidation enabled the Corporation to maintain the investment portfolio of U.S. Treasury securities at a level essentially unchanged from 1987. The flexibility these liquid assets provide is another reason we are confident that the Bank Insurance Fund will remain adequate to handle any foreseeable problems in the industry.

Assessments from insured institutions and the interest earned on the portfolio of U.S. Treasury securities are the primary sources of FDIC income. In 1988, the FDIC assessed insured banks at the rate of 8.3 basis points of assessable deposits -- the static rate required by law prior to enactment of FIRREA. Income from assessments totaled $1.8 billion, an increase of $77 million from 1987 assessments. During the first six months of 1989 assessment revenues increased by $58 million over the comparable period of a year ago. This increase is in line with our 1989 projection of $1.9 billion in assessment income by year-end. Interest on our portfolio of U.S. Treasury obligations for 1988 amounted to $1.4 billion, a slight decline from 1987. For the first six months of 1989, interest earned on Treasury obligations was $711 million, a $16 million increase over the same time period in 1988.

In addition, the sale of NCNB, First City and Continental Illinois National Bank stock will contribute significantly to income in 1989. However, this will be balanced by the necessary repayment of approximately $3 billion in loans and advances from the Federal Reserve Banks of Chicago and Dallas which resulted from the Continental Illinois and NCNB Texas Bridge Bank agreements. This will only affect the composition of the fund, not total net worth.

Several provisions in FIRREA provide the FDIC with additional flexibility to help ensure that the Bank Insurance Fund can

effectively address future problems in the industry. The statutory assessment rates have been increased as a result of FIRREA. In 1990, insurance premiums will increase to 12 basis points of assessable deposits, and in 1991 to 15 basis points. We estimate that, with a modest four percent annual growth rate in assessable deposits, assessment income would be about $3 billion and $3.9 billion in 1990 and 1991, respectively. In addition, the FDIC has the flexibility to increase these rates based upon the experience of the Fund. The increased statutory rates and the flexibility to change those rates will allow the Fund to attain and then maintain the 1.25 percent target ratio of the Insurance Fund to insured deposits. This ratio also may be increased if the FDIC determines that there is a significant risk of substantial loss to the Fund. The law also provides for entrance fees on institutions entering or converting to the Bank Insurance Fund in order to preserve the designated reserve ratio.

Notwithstanding the record level of failures and assistance transactions, in 1988 the FDIC acquired only 106,000 assets from failed and assisted institutions with a book value of $9.3 billion. This was a significant decline from the past three years when the FDIC had 178,000 assets with a book value of $11.3 billion having been acquired by year-end 1987; 192,000 assets with book value of $10.9 billion by year-end 1986 and 180,000 assets with book value of $9.6 billion by year-end 1985.

This reduction can be attributed to improved marketing strategies and new approaches to selling failed-bank assets. Retaining fewer assets from bank failures means that the FDIC has more cash available for dealing with problem banks, and there is less federal intervention in the marketplace.

Our success in reducing the size of the existing asset portfolio was facilitated greatly by the success of our "whole-bank" purchase-and-assumption program. In a "whole-bank" purchase-and-assumption transaction, the acquirer agrees to assume most of the assets of the failed bank, including the nonperforming loans. Thus, by pursuing "whole-bank" deals, more failed-bank assets remain in the private sector.

We began using "whole-bank" transactions in 1987, and completed 19 of the 133 purchase-and-assumption transactions that year by passing almost all of the failed banks' assets. Of the 164 purchase-and-assumption transactions completed in 1988, sixty-nine, or 42 percent, were "whole-bank" transactions.

With respect to the assets retained by the FDIC, strong marketing and asset management has resulted in significant asset sales at or near current appraised values. Our policy is that every asset is for sale at the appraised market price. Getting these assets back into the private sector at market prices is the first step in helping troubled regional economies recover.

The Economy and the Condition of the Banking Industry

The financial well-being of the industry determines the financial condition of the Bank Insurance Fund. Bank failures and open-bank assistance transactions were at record levels during 1988 in size, number, and total cost to the Insurance Fund. This year, as of early September, 155 banks failed with aggregate assets in excess of $26.6 billion. However, we believe that the worst of the problems in the banking industry are behind us. We expect this year's failure rate to be similar to or slightly better than last year and we project the pace of bank failures to slow next year. As more fully described later, the number of problem banks has decreased from 1,624 in mid-1987 to 1,193 as of September 15, 1989. This is the first time since the beginning of 1986 that the number of problem banks has been fewer than 1,200.

The condition of the banking industry is closely tied to the state of the national and regional economies. We attach our most recent _Quarterly Banking Profile_--released last week--which provides statistics on current banking results. Banks have had record profits for the first six months of this year. Furthermore, the outlook for inflation and interest rates is positive at present.

Regional economies have been improving, particularly in the Midwest, where the agricultural recovery has led to a strong

performance by banks in that region. Although the economy in the Southwest has shown signs of improvement, the lingering effects of the oil and gas industry deterioration and the collapse of the real estate market continue to limit the recovery of Southwestern banks. Most failed banks in 1988 were located in Texas, Oklahoma and Louisiana. Texas alone accounted for 113 failures -- more than half of all failures last year. So far this year, Texas has accounted for about two-thirds of all failures. The number of problem banks is decreasing in all areas of the country except the Southwest. Though the number appears to have leveled off, the slow recovery in the Southwest has precluded any improvement there.

The level of nonperforming assets historically has been an early indicator of a problem. Industrywide, nonperforming loans have been rising slowly in 1989, and now comprise 2.25 percent of total loans. Although they are not at the 2.6 percent level reached in early 1987, the regional breakdown of nonperforming loans is something we are monitoring closely.

In the Northeast, a softening real estate market has boosted the level of noncurrent real estate loans in bank portfolios. Second quarter results for the Northeast region show noncurrent real estate loans to be 2.76 percent of all real estate loans, an increase of more than one percentage point over the second quarter of 1988. The Northeast also is where most of the FDIC-insured savings banks are located. The condition of these

institutions has weakened over the past few years, as net interest margins have narrowed and nagging asset quality problems have become more pronounced. However, the relatively strong capital position of these institutions will help to reduce potential losses to the Insurance Fund.

Overall, banks have performed well and profit levels are impressive. During the first half of 1989, banks earned a record $14.3 billion, compared to $10.4 billion in the first half of 1988, while return on assets (ROA) for the first six months was 0.91 percent as compared to 0.69 percent for the same period one year ago.

Bank Supervision

The FDIC directs its supervisory efforts toward maintaining the safety and soundness of the banking system and protecting the deposit insurance funds. We are the primary federal supervisor for over 8,000 state nonmember commercial and savings banks with over $900 billion in assets. In addition, 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 ensure the safe and sound operation of these insured banks.

A major goal of the FDIC's bank supervisory program is to control risk. This is accomplished through a combination of

on-site examinations; off-site monitoring; the exchange of information with other regulators (state and federal); the development of supervisory guidelines, policy statements, rules and regulations; the use of informal and formal enforcement actions and, if needed, the termination of insurance.

In July of last year, we revised our statement of goals regarding examination priorities to increase the level and frequency of on-site supervision. Our goal is to have an on-site examination every 24 months for well-rated institutions (those rated 1 or 2) and one every 12 months for problem and near-problem institutions (those rated 3, 4, or 5). Some of these intervals can be extended if an acceptable state examination is conducted.

In 1988, we conducted 4,019 on-site safety-and-soundness examinations compared to 3,653 in 1987 and 3,194 in 1986. We expect to complete more than 4,100 examinations during 1989. We had expected to do considerably more than 4,100 this year, but had to revise that goal due to our involvement as conservator for insolvent thrifts. Even with that additional role, however, we will still exceed last year's examination tally.

As of March 31, 1989, ninety-one percent of the 4- and 5-rated state nonmember banks had undergone an FDIC examination, visitation, or state examination within the preceding twelve-month period. The other nine percent are monitored

closely, and in most cases were examined within the last two years. This nine percent of the 4- and 5-rated banks generally already had supervisory corrective actions in place, and management was being responsive to these supervisory recommendations.

Also, as of March 31, 1989, only eight percent of all 1- and 2-rated state nonmember banks have not had an FDIC or acceptable state examination or visit within the last three years. It is important to note that even when the FDIC has not conducted an on-site examination within the goal period, the bank's condition has been analyzed through quarterly off-site monitoring, short on-site visitations or targeted examinations and the review of state and other federal agency examination reports, and other pertinent information. It is only after these reviews that the examination cycle is extended. We continuously look at all problem and special situations and review work completed by the other federal and state regulators. Since many of our banks are members of multibank holding companies, we also review holding company reports from the Federal Reserve and examination reports of other banks in the holding company to remain as informed as possible.

Today's banking environment demands that we identify emerging trends with potential areas of risk and pinpoint individual banks with symptoms of higher than normal risk. The traditional methods of conducting on-site examinations based on fixed

examination cycles are giving way to more continuous methods of supervision. We believe our current program of using on-site examinations or visitations complemented with off-site activities is the most efficient use of supervision resources at this time.

Improvement in examination frequency is accomplished by increasing the number of field examiners. We have been increasing staff since 1984, when our examiner force numbered only 1,389. At year end 1988, the FDIC employed 1,983 bank examiners and we expect this number to increase to about 2,400 by the end of 1989. We are hiring talent as rapidly as they can be absorbed and expect to establish a new, higher staffing target when we complete an analysis of resource requirements for our thrift responsibilities under FIRREA.

In order to continue to attract and retain the best possible candidates, we have recently increased salaries and are building a new training center. Further, we are able to hire very good talent due to an expedited hiring procedure available with respect to college students who have a 3.5 grade point average or who are in the top ten percent of their class. We are committed to maintaining our own well-trained examiner work force and to providing training support to examiners from state banking departments.

Our examiner turnover ratio of approximately 12 percent during 1988, while somewhat high, is mostly reflective of the increase

in new hires over the last few years. Traditionally, turnover is above average for newly hired examiners. This rate is nevertheless higher than we desire and we are currently studying ways to retain as many of our highly trained and qualified examiners as possible.

Our cooperative Federal/State examination program, which was implemented in July 1988, is providing valuable support and flexibility to our bank examination work. It has built on our long-standing tradition of federal and state cooperation by explicitly stating the FDIC's policy to communicate and coordinate regularly with the states and to make maximum use of state examination resources. The support this program provides was recently demonstrated when a significant part of our examination force was required to assist in assuming control of over 200 S&Ls. With the help of the state supervisors, we saw that all banks in need of close supervision continued to receive it. We expect that our responsibilities for savings associations will take full advantage of acceptable work by the Office of Thrift Supervision and the various states.

Thrift Supervision

FIRREA has assigned the FDIC substantial responsibilities for the supervision of some 2,900 savings associations. In addition to deposit insurance and general backup enforcement

responsibilities, the FDIC also has responsibility for overseeing several important thrift activities -- such as the exercise of nontraditional powers, the holding of junk bonds and the acquisition of brokered funds.

In order to assure that these responsibilities are fully and properly addressed, we expect to have an FDIC on-site presence, either a full scale examination and/or a targeted visit(s), in every insured savings association by the end of 1990. Our approach will emphasize coordination and close working relationships with the Office of Thrift Supervision and state regulators with the goal being timely and effective supervision of savings and loans and the avoidance of duplication of effort on the part of the various regulatory agencies.

We will fulfill our new thrift industry responsibilities, but only with extraordinary efforts and some start up strains. We also intend to meet those responsibilities without material impact on our supervisory role on the commercial bank side.

Bank Capital

In March of this year, the FDIC joined the Comptroller of the Currency and the Federal Reserve Board in adopting risk-based capital guidelines. These guidelines establish ratios of total capital to risk-weighted assets of 7.25 percent by year-end 1990 and eight percent by year-end 1992. Currently, these guidelines are in addition to the six percent leverage ratio which is

uniformly in place at all three federal banking agencies.

The Comptroller of the Currency has suggested a new capital standard which has been issued for public comment. We support important parts of the Comptroller's initiative. First, we agree the various capital components need to be commonly defined in applying both the leverage and the risk-based tests. Moreover, we can agree on the proposed three percent core equity requirement as well as the exclusion of reserves for loan and lease losses as a component of core capital.

However, the Comptroller's proposal envisions no additional leverage requirement beyond the three percent core and we think that is unwise as it would lower capital requirements during a period of problems in both the thrift and banking industries. Our analysis indicates that the Comptroller's current proposal would reduce the required minimum amount of capital in the banking system by at least $8 billion. As the insurer of the industry, we would regard that as being an undesirable effect. Thus, we believe the three percent core leverage test must be supplemented with a total capital requirement which could include secondary forms of capital such as those allowed under the current leverage framework.

Common capital standards among the three Federal banking agencies have been beneficial to the industry as well as the insurance fund. We are confident that acceptable common

standards will be developed before the risk-based standards first begin to apply at year-end 1990.

Capital standards are only a first step in the supervisory process for evaluating capital adequacy. Many other factors must be weighed before determining whether a bank's capital is adequate for its particular circumstances. Additional capital above regulatory minimums will be necessary in institutions contemplating significant expansion plans or those with higher than normal risk profiles. Factors such as interest rate risk, asset quality, earnings performance, and the level of debt outstanding in areas such as lesser developed countries and leveraged buyouts, are fully considered by examiners when evaluating a bank's capital adequacy. However, minimum standards are a safeguard which becomes more significant as the supervisory force meets the challenge of enlarged responsibilities.

Problem Banks and Enforcement Actions

After reaching an historical high of 1,624 in mid-1987, the list of FDIC-insured problem banks has been declining. This is due primarily to increased supervisory attention, improvements in the economy of the Midwest and the record number of failures. As of September 15, 1989, the Bank Insurance Fund's problem bank list contained only 1,193 institutions. Although failures contributed to the decline, many more problem banks have been

rehabilitated, usually with close supervisory guidance. In 1988, 680 banks were removed from the problem list, with only 221 removed as a result of failure or FDIC financial assistance.

Historically, inept or abusive management has been a primary cause of problem banks and this remains true today. Weak regional economic conditions reveal the vulnerability of weak managements and the combination is the key reason for the recent increases in bank failures.

During 1984 through 1988, of the 2,072 state nonmember banks that at some point were considered problem banks, 899 or 43 percent were the subject of some form of FDIC formal action. Additionally, informal actions such as memorandums of understanding and corrective resolutions by a bank's board of directors were used in less severe cases and where bank management was considered responsive and committed to correcting problems. In these instances, the FDIC seeks to work in cooperation with the bank's management in a joint effort to restore the institution to financial stability.

Our Capital Forbearance program is an example of the approach we believe is both useful and beneficial to the FDIC and participating banks. The program is available to any bank with difficulties primarily attributable to economic problems beyond the control of management. Under the Capital Forbearance program, a bank may operate temporarily with capital below

normal supervisory standards if it is viable and has a reasonable plan for restoring capital. Of the 193 banks admitted to the program through July 31, 1989, 113 banks remain in the program while 33 have been successfully terminated by restoring capital and 47 banks were terminated unsuccessfully. The period for banks to apply for this program expires on December 31, 1989.

The FDIC believes that an independent external auditing program combined with a strong internal audit function substantially lessens the risk that a bank will not detect potentially serious problems. It also complements the FDIC's supervisory process by further identifying or clarifying issues of potential concern or exposure, especially in banks where problems have been identified. As a result, we adopted a statement of policy in late 1988 which explicitly encourages banks to have an annual external auditing program performed by an independent auditor. We recognize that certain banks may decide not to engage a CPA to perform an opinion examination and in those cases, the FDIC recommends that each bank, at a minimum, have certain specific auditing procedures performed annually by a qualified independent external party. We have issued for comment a policy statement that contains specific recommended auditing procedures for five high-risk areas: securities, loans, allowance for loan losses, insider transactions and internal controls.

Fraud and Insider Abuse

The FDIC is taking a leading role in the fight against fraud and criminal conduct in the banking industry. Fraud and insider abuse contribute to about one third of bank failures and outright criminal conduct was present in about ten to twelve percent of bank failures in recent years. According to the Federal Bureau of Investigation, the financial services industry lost more than $2 billion due to criminal fraud cases closed in 1988, more than double any previous year's loss.

Since 1984, the FDIC has greatly strengthened its supervisory response to bank fraud and insider abuse. We published a list of time tested "Red Flags" and other warning signs of fraud and abuse to be used by examiners and auditors. These have proven very effective in ferreting out such practices. Training for all examiners has been improved, and about 70 senior examiners have been chosen as fraud specialists. They have been given extensive training in fraud detection and investigative techniques. This "fraud squad" can be called upon to conduct full-scale fraud investigations leading to a referral of apparent criminal activity to the Department of Justice. They can assist federal investigators and prosecutors to understand complex transactions and serve as expert witnesses at trial. They also are available as a resource for other FDIC examiners and act as on-the-job trainers for less experienced examiners.

We believe that fraud losses should be restored to the federal deposit insurance funds wherever possible. The FDIC is working with the Department of Justice to convince judges to order restitution to the insurance funds when losses are attributed to dishonest insiders or customers. We think restitution orders should be sought and granted as a matter of course to minimize the cost of criminal acts to the insurance funds and to prevent offenders from enjoying their ill-gotten gains.

Less Developed Countries (LDC) Debt Situation

The regulatory agencies are implementing the International Lending Supervision Act in a manner consistent with the language and legislative history of the statute. Through the Interagency Country Exposure Review Committee (ICERC), the regulatory agencies have required that specific reserves be established against appropriate loans. The agencies have required increased capital in those banks involved in international lending. Risks to the banking system have been reduced significantly.

We continue to believe that decisions on reserving for losses should be determined by individual borrower's debt service capacity. We find nothing to support banks reducing their LDC reserves at this time. For those banks with intentions to dispose of LDC loans, higher reserves could be appropriately determined by secondary market values. Future actions in this area will depend upon the results of current negotiations now underway with debtor countries.

Leveraged Buyout (LBO) Debt

We are taking special supervisory action to monitor banks' participation in high-yield, high-risk "junk" bonds and highly leveraged loans used to finance corporate restructurings. Banks have currently invested about $150 billion in leveraged buyout loans. Rising interest rates or an economic downturn could result in highly leveraged businesses defaulting on these loans. Although banks usually reduce their exposure to losses by selling the bulk of these loans, defaults on the amounts they do retain could result in losses to the institutions. Concentrations in this area must be avoided. At this time we see no immediate threat to the insurance fund.

However, should there be an economic downturn, defaults on such debt could increase the risk of failures and thereby increase costs to the FDIC. Thus, as insurer, we will continue to closely monitor LBO transactions to assure that risks are controlled.

That concludes my prepared remarks. I would be happy to respond to any questions at this time.