

Speeches

TESTIMONY OF

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ON

THE CONDITION OF THE COMMERCIAL BANKING INDUSTRY

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
UNITED STATES SENATE

10:00 A.M.
OCTOBER 25, 1989
ROOM 538, DIRKSEN SENATE OFFICE BUILDING

SUMMARY OF FDIC STATEMENT

The banking industry is relatively healthy and improving, even though the level of bank failures in the Southwest is still far too high. We have continuing concerns regarding credit to developing countries and loans to finance highly leveraged transactions. All in all, however, we think bank failures will decline in 1990 and see nothing on the horizon raising any significant threat to the Bank Insurance Fund.

The weakest regional economies have been improving, particularly in the Midwest, where the agricultural recovery has led to a strong performance by banks in that region. The Southwest is, and will remain through 1990, the region with the highest levels of problem and failed banks.

Banks in the Northeast recently have shown a declining trend in asset-quality indicators. The softening real estate market and continuing problems in loans to developing countries (which affect only the largest banks) have been primarily responsible for a rise in nonperforming assets for three consecutive quarters. However, we do not see these difficulties developing into anything requiring significant FDIC financial assistance.

In 1988, the FDIC handled 200 bank failures and provided financial assistance for the resolution of 21 additional institutions. Even though the number of bank failures has remained high during 1989, with 170 failures as of October 13, provisions for losses are down significantly. For the first six months of 1989, net income for the Bank Insurance Fund was \$171 million and we expect it to break even for the full year and to increase in 1990.

Capital levels in commercial banks are adequate and improving, but certainly not excessive at this time of increasing risks to the system. In the first half of 1989, commercial banks increased their equity capital by \$9.8 billion and have attained an equity capital-to-assets ratio of 6.44 percent and a primary capital-to-assets ratio of 7.99 percent. This is not to say that some banks are not sorely in need of additional capital. The supervisors are working closely with those banks to overcome the problem.

The Comptroller of the Currency has suggested a change to the leverage capital standard which has been in place for several years. 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 compared with a risk-based capital requirement supplemented with a six percent total capital requirement. Now is not the time to be reducing capital standards. The banking business is an increasingly volatile one and well known concerns remain in areas such as interest rate risk, concentrations, real estate volatility and loans to lesser developed countries.

Good morning, Mr. Chairman and members of the Committee. We are pleased to report today on the condition of the commercial banking industry. We also will be reporting on the condition 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 banking industry is relatively healthy and improving, even though the level of bank failures in the Southwest is still far too high. We have continuing concerns regarding credit to developing countries and loans to finance highly leveraged transactions. All in all, however, we think bank failures will decline in 1990 and see nothing on the horizon raising any significant threat to the Bank Insurance Fund.

The three banking agencies earlier have provided you with a book of statistics on bank performance and condition, problem bank levels and trends, bank failures and assistance transactions (updated numbers for closed banks and open bank assistance by FDIC as of September 30, 1989 are included as Attachment A), number and experience level of examiners, and examination hours by CAMEL rating. We also have attached to this testimony our most recent Quarterly Banking Profile, which provides current statistics on commercial banking results.

The Economy and the Condition of the Banking Industry

The overall financial condition of the banking industry is closely tied to national and regional economic conditions. Lately, national economic conditions have been favorable, with relatively low inflation and interest rates, and moderate economic growth. The weakest regional economies have been improving, particularly in the Midwest, where the agricultural recovery has led to a strong performance by banks in that region. The Southwest economy has shown signs of recovery, but this has not yet translated into significantly improved bank performance. Most failed banks in 1988 and so far in 1989 were located in Texas, Oklahoma or Louisiana. Texas alone accounted for more than one-half of all bank failures last year; this year, Texas has accounted for two-thirds of all failures. The Southwest is and will remain the region with the highest levels of problem and failed banks, at least through 1990, but we expect overall bank performance to show improvement next year.

In contrast, banks in the Northeast recently have shown a declining trend in asset-quality indicators. A softening real estate market has boosted the level of nonperforming real estate loans. These loans and the continuing problems in loans to developing countries (which affect only the largest banks) have been primarily responsible for a rise in nonperforming assets

for three consecutive quarters. These problem areas are expected to adversely impact this region's bank earnings in the second half of 1989. While some of the problems in the Northeast are now receiving public notice, we do not see these difficulties developing into anything requiring significant FDIC financial assistance.

The Northeast also is the location of most of the Bank Insurance Fund's ("BIF") insured savings banks. Since mid-1987, BIF-insured savings banks have experienced lower earnings attributable to shrinking net interest margins and rising loan-loss expenses.

Nonperforming assets of savings banks at the end of the second quarter were more than twice as high as a year earlier. Most of the problem assets were in real estate loans, which comprise the majority of state-chartered savings bank assets. As of September 30, 1989, 15 BIF-insured savings banks were on the "Problem List," representing only three percent of the industry; in contrast, nine percent of commercial banks were on the "Problem List" on that date. The number of BIF-insured savings bank failures has not exceeded two in any year since 1983. In view of the trend toward higher problem levels in real estate lending in the Northeastern United States, we expect some deterioration in these numbers in 1990.

Status of the Bank Insurance Fund (BIF) and Bank Failures and Assistance Transactions

Financial institution failures and open-bank assistance transactions were at record levels in 1988 in size, number and cost to the Insurance Fund. The FDIC handled 200 bank failures and provided financial assistance for the resolution of 21 additional institutions. Included in these numbers were the failure of First Republic Bank in Dallas and the assistance of Houston-based First City Bancorporation. Also included in the FDIC's 1988 operating losses was the commitment of funds to handle MCorp of Dallas, Texas American Bancshares of Fort Worth, and National Bancshares Corporation of San Antonio (all of which are being resolved during this year). In total, provisions for insurance-related losses in 1988 were \$6.3 billion. As a result, the net worth of the Insurance Fund declined more than \$4 billion, from \$18.3 billion to \$14.1 billion at year-end 1988.

Even though the number of bank failures has remained high during 1989, with 170 failures as of October 13, provisions for losses are down significantly. For the first six months of 1989, net income for the Bank Insurance Fund was \$171 million and we expect it to about break even for the full year and to increase in 1990. Moreover, we expect the number of failures to begin to decline and for this trend to continue into 1990. The number of

problem banks has been dropping for over two years, from a high of 1,624 in mid-1987 to 1,166 as of September 30, 1989, and this favorable trend is beginning to show up in the failed-bank numbers.

Not only has the Fund been adequate to handle the bank problems of the past few years, but liquidity has been maintained despite record insurance-related outlays. At year-end 1988, nearly 74 percent of the Fund's total assets, or \$16.5 billion, was in the form of cash or U.S. Treasury securities and this level has been maintained during 1989. New approaches to dealing with bank failures and aggressive management of assets held for liquidation have been responsible.

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. Insurance premiums will increase to 12 basis points of assessable deposits in 1990, and to 15 basis points in 1991. We estimate that with a modest four percent annual growth rate in assessable deposits, assessment income will be about \$3 billion in 1990 and \$3.9 billion in 1991. This compares to \$1.8 billion in 1988 and a projected \$1.9 billion in 1989. In addition, the FDIC has the flexibility to increase these rates based upon the experience of the Fund. The FDIC will continue to earn interest on the portfolio of U.S. Treasury securities held in the Fund. Interest income for 1988 amounted to \$1.4 billion and a similar amount is projected for 1989. The increased statutory assessment rates and the flexibility to change those rates should allow the Bank Insurance Fund to attain and then maintain the 1.25 percent target ratio of the Fund to insured deposits.

The FDIC ended 1988 with 106,000 assets in liquidation with a book value of \$9.3 billion. The assets were acquired from failed and assisted institutions. This was a significant decline from the past three years when at year-end 1987 we held 178,000 assets with a book value of \$11.3 billion; at year-end 1986 we held 192,000 assets with a book value of \$10.9 billion; and, in 1985, we held 180,000 assets with a book value of \$9.6 billion. This reduction can be attributed to the success of our "whole bank" purchase and assumption program where the acquirer purchases most of the assets of the failed bank.

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.

Our testimony now will focus on the seven specific questions raised in the Committee's letter of invitation.

1. Are you satisfied that commercial banks and their holding companies have enough capital to protect the public interest and avoid a future crisis at the Bank Insurance Fund?

Capital levels in commercial banks are adequate and improving, but certainly not excessive at this time of increasing risks to the system. We agree with Chairman Greenspan's recent remarks before the American Bankers Association regarding the role of capital. He emphasized that banks do not need exceptionally low capital ratios to produce an acceptable return on equity and that strong capital ratios do not preclude strong returns.

In the first half of this year, commercial banks increased their equity capital by \$9.8 billion and have attained an equity capital-to-assets ratio of 6.44 percent and a primary capital-to-assets ratio of 7.99 percent. These are the highest industry-wide capital ratios in recent years. Large banks in particular have steadily increased their equity capital as a percentage of total assets, aided by strong earnings and prompted by new risk-based capital requirements.

That is not to say that some banks are not sorely in need of additional capital. The supervisors are working closely with those banks to overcome the problem, where possible. As of September 30, 1989, the Bank Insurance Fund's problem bank list contained 1,166 institutions representing slightly less than \$200 billion in deposits. Most, if not all, of these banks are deemed to have inadequate capital.

Fortunately, most problem banks are rehabilitated, usually with close supervisory guidance. For example, in 1988, only about one third of the 680 banks that were removed from the problem list were removed as a result of failure or FDIC financial assistance.

Now is not the time to be reducing capital standards. The banking business is an increasingly volatile one and well known concerns remain in areas such as interest rate risk, concentrations, real estate volatility and loans to lesser developed countries.

The Comptroller of the Currency has suggested a change to the leverage capital standard which has been in place for several years. While important parts of the Comptroller's initiative have merit and my support, the issue ultimately boils down to, "Now is not the time to lower capital requirements." 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 compared with a risk-based capital requirement supplemented with a six percent total capital requirement. While most of the largest U.S. banks will be subject to a risk-based capital requirement that will be higher for them than a leverage ratio (as of the risk-based capital phase-in dates of year-end 1990 and 1992), the vast

majority of U.S. banks will continue to be governed by the six percent leverage ratio which is uniformly in place at all three banking agencies. Lowering the leverage ratio to just three percent core capital with no additional requirement will allow many financial institutions which currently exceed the six percent ratio to suddenly have large amounts of "excess capital" available to fund growth and/or reduce capital through dividends or in other ways. We estimate that almost 10,000 banks would be able to reduce their equity capital under the Comptroller's proposal, as compared with a six-percent total capital requirement.

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. We support limiting or eliminating the allowance for loan losses in this calculation.

Common capital standards among the three Federal banking agencies have been beneficial to the industry as well as the insurance fund. We believe that acceptable common standards must be adopted before the risk-based standards first begin to apply at year-end 1990.

2. Are you confident that earnings reported for the banking industry reflect the true earnings performance of the industry?

Commercial banks' net income totalled \$14.3 billion for the first six months of 1989, the most ever earned in a six-month period. This record level of earnings is attributable to the performance of the largest banks which have seen a dramatic rise in earnings due to improved net interest income, strong gains in noninterest income, and reduced loan loss expenses.

However, increasing problems in real estate loans in soft markets and continuing problems with loans to lesser developed countries are expected to be main factors influencing bank earnings in the second half of 1989 and beyond. At the end of June, the banking industry's loss reserves totalled just over \$45 billion, an amount equal to 62.6 percent of its nonperforming assets.

Recently published earnings reports indicate that some of the largest commercial banks added several billion dollars to their loan-loss reserves in the third quarter. These additions will raise the industry's reserves above the previous record level of \$50.3 billion reported in the first quarter of 1988. This boosting of reserves will be accomplished at the expense of industry earnings for the third quarter, and may produce a net

drop in commercial banks' combined equity capital. In this respect, the large banks' additions to loss reserves are similar in nature, albeit much smaller in scale, to their \$15-billion reserve boost in the second quarter of 1987. That boost, too, was made in response to perceived changes in the value of the banks' loans to developing countries. It represented a restructuring of their balance sheets, and resulted in a more accurate portrayal of their net worths. The latest additions to reserves will mean that subsequent reported earnings will more closely represent banks' "true" earnings performance. Our concerns regarding LDC lending and investments in real estate are discussed below.

In summary, bank earnings appear adequate to provide for the foreseeable losses in the banking industry and provide the support needed for capital growth.

3. Do you have any concerns about the portfolio composition (particularly investments in real estate, LBOs and LDC lending) of banks and their holding companies?

It is a supervisor's job to worry about all the risks that banks take on, including those arising from how they structure their balance sheet. As such, this is an area which receives a lot of our attention through off-site monitoring, special reviews and, of course, the regular examination process. The three areas raised in this question, along with interest rate risk, are matters of some concern in regards to banks' portfolio composition.

Lesser Developed Countries (LDC) Debt. The regulatory agencies have required that specific reserves be established against certain exposures to LDC debt. The agencies also have required increased capital in several banks involved in international lending. These requirements are regularly reviewed by an interagency committee composed of specially trained examiners. Because all the major U.S. banks have been able to reduce their relative exposures to LDC debt through increased capital and reserve levels, reductions, and write-offs, the risks to the banking system have been reduced significantly even though protracted problems in the LDC arena continue.

We believe that decisions on reserving for losses should be determined by each individual borrower's debt service capacity. For those banks intending to dispose of LDC loans, higher reserves could be appropriate, based on secondary market values. Thus, we applaud the conservative, extra provisions recently made by some banks. Future actions in this area will depend upon the results of current negotiations now underway with debtor countries.

It should be noted that all the money-center banks would continue to be solvent even if they wrote down to current

secondary-market levels all their exposures to the six major LDC countries.

Real Estate. Domestic real estate loans is the fastest growing item on commercial banks' balance sheets, increasing to a total of \$720 billion in outstandings as of June 30, 1989, or 36.2 percent of total loans. This amount is 12.8 percent higher than the same time last year. This growth has been most pronounced in the largest institutions.

This rapid growth gives us some concern, as would a similar rapid growth in any other asset category. Rapid growth is usually accompanied by a decrease in credit quality, and indeed we have begun to notice an increase in nonperforming real estate assets, including repossessed real estate, principally in the Northeast. It should be pointed out, however, that the Southwest banks still have the highest percentage of nonperforming assets, principally in real estate, with a rate that is over twice as high as the Northeast's.

We are monitoring the level and quality of real estate portfolios closely. While we foresee some unfavorable trends in real estate asset losses and charge-offs, the extent of these problems are not great enough to cause uncontrollable losses or substantial declines in earnings on an industry-wide basis. Some states permit bank investment in real estate. In all banks the dividing line between a loan with an "equity kicker" and a direct investment can be blurred. We believe banking institutions can safely and profitably invest in real estate, but that it generally should be done through non-bank subsidiaries and affiliates. We continue to seek regulatory means to create such a requirement.

Leveraged Buyout Financing (LBOs). LBOs or the more encompassing term "highly leveraged transactions" (HLTs) (which also includes recapitalization and acquisition financing) are a concern because of the volume and rapid growth of such transactions in the banking industry, especially at the largest institutions. Banks currently have invested over \$175 billion in HLT loans. We must point out though that the originating banks generally do not keep all HLT loans in their portfolios. Instead, they sell participations to others without recourse and retain only a small percentage of a transaction.

We are taking special supervisory action by monitoring banks' participation in HLTs very closely. We believe that to date, banks have managed their HLT financing risks acceptably. Of course, rising interest rates or an economic downturn could increase these risks, but we do not now see any serious threats to the banking industry.

4. Are you satisfied that bank examinations are being carried out in an effective and timely fashion?

Today's banking environment demands that we identify emerging trends and 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 have given way to more continuous methods of supervision. Our current program uses on-site examinations and visitations complemented with off-site monitoring, exchanges of information with other regulators (state and federal), and the use of supervisory guidelines, policy statements, and rules and regulations.

Our experience in recent years has indicated the need to increase the level and frequency of on-site supervision. As a result, in July of last year we revised our statement of goals regarding examination priorities. 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). The intervals for those rated 1, 2, or 3 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, we will still exceed last year's examination tally.

As of June 30, 1989, over 90 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 others are monitored closely, already have supervisory corrective action in place and, in most cases, have been examined within the last two years.

Also, as of June 30, 1989, only two 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. This percentage has been declining for some time now and we expect this trend to continue.

We have increased examiner hours spent on examinations of state nonmember banks from 1.3 million hours in 1985 to over 2.2 million hours in 1988. Most of this increase has been on banks rated 1 and 2, from 532,000 hours to over 1.2 million hours. In addition, those banks rated 3, 4, and 5 receive considerable review and processing by regional office and Washington office staff.

5. What is your record with regard to initiating and accomplishing your goals for enforcement actions?

The FDIC seeks corrective action from all institutions presenting supervisory concerns. Depending on the seriousness of the problem and the willingness and ability of management to effect correction, we may use an informal Memorandum of Understanding or we may proceed with formal action pursuant to Section 8 of the FDI Act. Attachment B describes the various types of enforcement powers available to the FDIC. It also includes a brief review of the circumstances which generally have led to the use of such actions.

During the period January, 1984 through March 31, 1989, 2,072 state nonmember banks had been considered "Problem Banks" and another 1,905 state nonmember banks were rated a composite 3 and considered a supervisory concern, although their possible failure was considered to be only a remote possibility. Seventy-four percent or 2,953 institutions were subject to some form of FDIC enforcement action. In most cases, the close supervisory attention afforded these institutions led to their rehabilitation. Only 448 or 11 percent of those banks failed or required FDIC financial assistance. Forty-four percent or 1,762 institutions improved their condition or merged with a stronger institution, and 1,767 or 44 percent remained in the "problem bank" (4- or 5-rated) or 3-rated categories. Attachment C provides a summary of the "problem bank" performance.

Enforcement actions, both as to type and scope, are tailored to the particulars of each problem situation. Our goal is to obtain correction using the most appropriate degree of intrusion. The FDIC believes that its enforcement actions are effective, especially in cases where bank management is cooperative and desirous of working together with the regulators to restore their institution to financial stability. The Capital Forbearance Program and the use of Agricultural Loan Loss Deferral are examples of this approach which have proven both useful and beneficial to the FDIC and participating banks. The basic goals and philosophy of these programs have long been used by the FDIC in our enforcement program.

However, whenever fraud, mismanagement, or insider abuse is present, the FDIC has not, and will not, hesitate to use its enforcement powers to the fullest. The new powers granted to us in FIRREA will allow us to increase our enforcement actions in such cases, especially in regards to individuals. We believe that fraud losses and unjust gains to insiders should be restored to institutions and 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.

6. What is your forecast of the condition of the banking industry for the next year?

Generally, we see the condition of the banking industry improving during the next year. The declining trend in the number of problem banks should continue and we expect the number of failed banks to decline from the record levels of 1988 and 1989, both in size and number. The Southwest will continue to be the region of the country with most of the problems, although all of the largest commercial bank problems in that region have been restructured. We expect overall bank performance in that region to show a slight improvement next year, but recovery will be slow due to that region's overbuilt real estate markets. Banks in the Northeast probably will show some declining trends due to problem real estate loans in that area's regional banks and also due to the fact that most of the large banks which are involved in LDC lending are located in that area of the country.

It has been suggested by others that the banking industry is much weaker than our analysis indicates. The analysis prepared by Mr. Litan and Mr. Brumbaugh and presented by Mr. Litan before this Committee concludes that ten percent of the industry's assets are in institutions that have less than a three percent capital ratio. However, our recent analysis is that less than one-half of a percent have less than a three percent capital ratio. Our response to their statement is provided as Attachment D.

7. What is your plan of action for remedying any concerns you have?

With respect to the adequacy and liquidity of the Bank Insurance Fund, we plan to continue to pursue "whole bank" purchase-and-assumption transactions whenever possible and to continue aggressive marketing of assets held for liquidation. The increase in premiums will allow the Fund to grow and substantial progress should be made toward the 1.25 percent target reserves-to-insured deposits ratio.

We will continue to stress a strong supervisory approach as one of our major responsibilities. 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 5,500 national and state member banks and approximately 2,900 savings and loans, and cooperate with the other federal and state regulatory authorities in their efforts to ensure the safe and sound operation of these insured institutions. A major goal of the FDIC's supervisory program is to control risk and to anticipate problems to the extent

possible. The concerns mentioned above will continue to receive special close supervisory attention and we are prepared to take whatever corrective enforcement action may be necessary if bank management is not otherwise responsive.

This supervisory program will need to be as effective and timely as possible. We intend to increase the number of examiners to about 2,400 by the end of 1989 and to hire even more during 1990. This will allow us to conduct even more examinations. We are building a new training facility and are committed to the maintenance of a well trained examiner force. In 1989 we expect to spend \$11.2 million on examiner training, an amount equal to almost 10 percent of total examiner compensation. We think that this is money well spent.

It is imperative that the FDIC attract and retain the most qualified individuals to be examiners. We are studying salary levels, benefits and programs intended to enhance job satisfaction in order to retain as many of our highly trained and qualified examiners as possible. 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. This year alone we hired 325 examiners under this expedited procedure. We are exploring with the U.S. Office of Personnel Management the possibility of lowering the 3.5 GPA minimum in order to increase the number of candidates available to us under this program.

Also, as noted, we intend to pursue bank fraud, mismanagement and insider abuse wherever found and to take all appropriate supervisory action against both individuals and institutions. We are working closely with law enforcement authorities to see that these matters are pursued to the fullest extent possible.

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 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.

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