## Response to the Joint Congressional Testimony of
## R. Dan Brumbaugh and Robert E. Litan

**Introduction:**

In their article entitled "Cleaning Up the Depository Institutions Mess" published in the Brookings Papers on Economic Activity, 1:1989, and in testimony before the Senate Banking Committee and the House Subcommittee on Financial Institutions, R. Dan Brumbaugh and Robert E. Litan suggest that the banking industry is much weaker than official reports indicate. They contend that, while the banking industry is generally sound, the existence of a sizeable number of insolvent and thinly capitalized institutions indicates that "actual" bank insurance fund reserves are far less than officially reported. From their analysis as of September 1988, Mr. Litan and Mr. Brumbaugh assert that one-third of the industry's assets were being managed by banks with sub-standard capital ratios. From these findings they concluded that actual FDIC year-end 1988 reserves were closer to $4 billion, rather than the reported $14.3 billion.

An updated version of their analysis using March 1989 data was presented to the Senate Banking Committee on October 5, 1989. In their testimony, Mr. Litan and Mr. Brumbaugh stated that they found 31 large banks with $22 billion in assets that were open but insolvent as of March 1989. In addition, they assert that 30 banks with assets of $9.3 billion had risk-adjusted capital ratios of 3 percent or less, and another 130 institutions with $929 billion in assets had risk-adjusted capital ratios of less than 6 percent. In other words, Mr. Litan and Mr. Brumbaugh claim that roughly $1 trillion of assets, or almost one-third of industry assets were held by banks with capital ratios of less than 6 percent. In their calculation of risk-adjusted capital ratios, the authors state that they followed the Basle guidelines with one exception: capital was defined as shareholder's equity (common, preferred and retained earnings) and subordinated debt. Loan loss reserves were not included in their definition of capital.

In an attempt to determine the extent of the exposure to the bank insurance fund, Mr. Litan and Mr. Brumbaugh applied a 26 percent loss ratio to assets in institutions they determined were insolvent, stating that 26 percent is the average loss ratio for the FDIC throughout the 1980s. A 10 percent loss ratio was applied to assets held in thinly capitalized institutions (those with capital ratios between zero and three percent), by reasoning that there is some likelihood that a portion of this group will become eventually insolvent. In doing so, they suggest that the bank insurance fund is about $7 billion weaker than official year-end 1988 reports. (The authors attribute about $6 billion of this loss to insolvent institutions and about $1 billion to probable failure of the thinly capitalized banks in the industry).

Attachment D

In their testimony before the House Subcommittee on September 19, 1989, Mr. Litan and Mr. Brumbaugh stated that the insurance fund was overstated by $10 billion at year-end 1988 (about $6 billion attributable to insolvencies, and about $4 billion attributable to undercapitalized banks). In that testimony, the authors referred to their analysis based on September 1988 data. At that time, Mr. Litan and Mr. Brumbaugh asserted that fifty banks with $45 billion in assets had risk-adjusted capital ratios between zero and three percent. When the analysis was updated using March 1989 data, Mr. Litan and Mr. Brumbaugh found that total assets in undercapitalized institutions (zero to three percent risk-adjusted capital) fell by some $36 billion. As of March 1989, the authors found only about $9 billion in assets in thirty undercapitalized institutions. Thus, their loss estimate regarding undercapitalized banks fell from $4 billion to about $1 billion, simply because more current data was used.

**Evaluation of the Litan/Brumbaugh Analysis:**

Table 1 illustrates the differences in the FDIC's analysis and the Litan/Brumbaugh assessment of the capital position of large banks in the industry as of March 1989. The results of this analysis show that, for large banks in the industry as of March 1989, 11 institutions with $2.7 billion in assets, less than one-tenth of one percent of industry assets were in insolvent institutions operating without resolution from the FDIC. One-quarter of one percent of industry assets, were in institutions that had less than a 3 percent capital ratio, while about 10 percent of industry assets were in institutions with capital ratios of between 3 percent and 6 percent.

The major difference between the Litan/Brumbaugh analysis and the FDIC assessment appears to be in the treatment of off-balance sheet items in the largest banks in the industry. The FDIC's assumptions regarding the extent of off-balance sheet activity by these large banks is in substantial agreement with a similar analysis conducted by the Federal Reserve.

In an attempt to relate the capital position of the industry to the level of reserves in the bank insurance fund, Mr. Litan and Mr. Brumbaugh make two crucial errors in arriving at the conclusion that fund balance is overstated by roughly $7 billion (a balance of $7.3 billion rather than $14.3 billion).

Their first error comes in determining the average cost-to-failed-bank-asset ratio for the FDIC during the 1980s. The authors arrived at a 26 percent average loss ratio through 1987, indicating in their article in the Brookings Papers that the average fluctuated widely, from a low of 10 percent in 1981 and 1985, to a high of 75 percent in 1982 and 1984. This is simply not the case. In fact, between 1980 and 1988, the FDIC's weighted average loss-to-asset ratio was 12 percent, registering a low of 10.4 percent in 1985, and peaking at 31.3 percent in 1987.

In addition, Mr. Litan and Mr. Brumbaugh fail to take into account that the majority of the insolvencies present in the industry were in the process of being resolved, and that reserves had already been established to account for the cost associated with these resolutions. Therefore, because the year-end 1988 bank insurance fund balance reflects the cost of resolving most of the March 1989 insolvencies, the $6 billion figure Mr. Litan and Mr. Brumbaugh associate with resolving these institutions is a significant overstatement.  If the actual average loss figure of 12 percent were applied to the $2.7 billion of assets we find in insolvent institutions, the resolution costs would be about $320 million, rather than the figure of $6 billion advanced by the authors.  Applying their 10 percent loss ratio to the assets in institutions falling in the zero to three percent capital range results roughly $1 billion in additional potential losses to the FDIC.

However, as the authors themselves point out, it is reasonably likely that these thinly capitalized banks will eventually become insolvent and require FDIC resolution.  Given that assumption, it would seem reasonable to expect that the failure of these institutions would occur probably within the next one-to-two years.  The cost of resolving these failures will be offset by the fund's additional premium and investment income earned in those years.  FIRREA provides for significant increases in assessment income so that the bank insurance fund will be sufficiently capitalized to handle future problems in the industry.  Assuming a modest 4 percent annual growth rate in insured deposits, projections for 1990 and 1991 alone show that income from assessments will be almost $3 billion and $3.9 billion respectively. Premium income will continue to increase until the fund reaches the target level of 1.25 percent of insured deposits.  Even if the aforementioned losses were incurred by the FDIC next year, the bank insurance fund would still show a net gain in reserves.  Thus, any analysis of future FDIC loss exposure should be balanced with a discussion of increasing premium income.

Mr. Litan and Mr. Brumbaugh suggest that their analysis underestimates the problems of insolvency and undercapitalization in the industry, because they have examined only those institutions with at least $50 million in assets.  We do not find that to be the case.  Banks with assets of less than $50 million account for less than 8 percent of total industry assets.  Therefore, as Table 2 illustrates, including small banks does not substantially change the analysis, nor does it substantially add to the potential costs to the FDIC.  Table 2 presents the capital position of the entire industry, using the risk-adjusted standards (excluding allowances), and updates the analysis by providing data as of mid-year 1989.

Based on risk-adjusted capital standards using data as of June 30, 1989, less than one-half of one percent of total industry assets are held in institutions with less than 3 percent capital; only 10.3 percent of total industry assets are held in institutions with capital ratios of 6 percent or less.  With respect to insolvent institutions, the addition of the small banks in the industry boost assets by about $1.5 billion by adding another 41 institutions.

TABLE 1

RISK-ADJUSTED CAPITAL POSITION OF BANKS WITH AT LEAST
$50 MILLION IN ASSETS AS OF MARCH 1989
(assets in billions of dollars)

FDIC ANALYSIS

| CAPITAL RATIO | NUMBER OF BANKS | ASSETS ($ billions) | | CUMULATIVE ASSETS ($ billions) | |
|---|---|---|---|---|---|
| < 0% | 11* | $2.7** | (0.1%) | $2.7 | (0.1%) |
| 0 - 3% | 35 | 9.1 | (0.3%) | 11.8 | (0.4%) |
| 3 - 6% | 113 | 325.2 | (9.9%) | 335.0 | (10.3%) |
| > 6% | 5380 | 2,612.9 | (89.7%) | 2,947.9 | (100.0%) |

* Excludes 22 banks with $18.7 billion in assets that have been
resolved by the FDIC.
** Includes 3 banks with $416 million in assets that are solvent on a
GAAP basis.

LITAN/BRUMBAUGH ANALYSIS

| CAPITAL RATIO | NUMBER OF BANKS | ASSETS ($ billions) | | CUMULATIVE ASSETS ($ billions) | |
|---|---|---|---|---|---|
| < 0% | 31 | $22.1 | (0.7%) | $22.1 | (0.7%) |
| 0 - 3% | 30 | 9.1 | (0.3%) | 31.4 | (1.0%) |
| 3 - 6% | 130 | 928.7 | (30.8%) | 960.1 | (31.8%) |
| > 6% | 5,380 | 2,055.5 | (68.1%) | 3,015.6 | (100.0%) |

TABLE 2

## CAPITAL POSITION OF THE BANKING INDUSTRY
## AS OF JUNE 30, 1989

| CAPITAL RATIO | NUMBER OF BANKS | ASSETS ($ billions) | | CUMULATIVE ASSETS ($ billions) | |
|---|---|---|---|---|---|
| < 0% | 52* | $4.2** | (0.1%) | $4.2 | (0.1%) |
| 0 - 3% | 106 | 8.6 | (0.3%) | 12.8 | (0.4%) |
| 3 - 6% | 245 | 314.3 | (9.9%) | 327.4 | (10.3%) |
| > 6% | 12,489 | 2,860.8 | (89.7%) | 3,188.2 | (100.0%) |

* Excludes 52 banks with $19.4 billion in assets that have been resolved by the FDIC.
** Includes 12 banks with $2.6 billion in assets that are solvent on a GAAP basis.