TESTIMONY OF
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ON
THE CONDITION OF THE BANKING AND THRIFT INDUSTRIES
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND REGULATORY RELIEF
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
10:00 A.M.
OCTOBER 21, 1997
ROOM 538, DIRKSEN SENATE OFFICE BUILDING

Thank you, Mr. Chairman and members of the Subcommittee. I appreciate this opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the condition of the banking and thrift industries and the deposit insurance funds. I am pleased to report that commercial banks and savings institutions are experiencing a period of unprecedented prosperity. This prosperity is due, in large part, to the ongoing economic expansion, which at 78 months is now the third longest since World War II. Buoyed by the economy's sustained growth and low inflation, commercial banks have earned record profits in each of the last five years. This, in turn, has helped the industry build its capital to levels higher than at almost any time in the last 60 years. Overall asset quality of commercial banks is also strong, probably the best it has been since 1982, when asset quality measures were added to bank financial reports.

The nation's savings institutions have benefited also from the strong economy. In 1995, insured savings institutions posted record earnings and the highest return on assets (ROA) since 1962. They would have posted new records last year if not for the special assessment capitalizing the Savings Association Insurance Fund (SAIF). The average capital levels of insured savings institutions now exceed those of commercial banks.

In my remarks today, I will first discuss the overall condition of the banking and thrift industries. I will then discuss the continuing trend of consolidation and integration among banks, thrifts, and other financial services providers. Following that, I will discuss developments that pose potential risks to insured institutions, including developments in credit card lending, subprime lending, high loan-to-value ratio (LTV) mortgages, syndicated lending, commercial real estate lending, derivatives, and the so-called "Year 2000 Problem." I will then update you on the condition of the two deposit insurance funds -- the Bank Insurance Fund (BIF) and the SAIF. I want to reiterate my belief that the BIF and the SAIF, both now fully capitalized and providing identical products to banks, thrifts, and depositors, should be merged to help ensure a more stable deposit insurance system. Finally, pursuant to this Subcommittee's request, I will summarize the FDIC's Strategic Plan, which was recently submitted to Congress pursuant to the Government Performance and Results Act of 1993.

CONDITION OF THE INDUSTRY

Commercial Banking

The banking industry continues to operate at levels of profitability that were unheard-of just a few years ago. Indeed, the strength of the industry is revealed in nearly all standard statistical measures. For the first six months of 1997, banks have been on a pace to achieve record earnings for the sixth consecutive year. More than 96 percent of all banks were profitable in the first half of 1997 and two-thirds reported higher earnings than in the same period of 1996. In the first half of 1997, commercial banks earned $29.1 billion, which is 14.2 percent higher than for the same period last year, resulting in an annualized ROA of 1.25 percent. The average ROA for all banks should surpass 1 percent -- an industry benchmark -- for the fifth year in a row, with two out of every three insured commercial banks having an ROA of 1 percent or higher. From the founding of the FDIC until 1993, the industry had never achieved an average ROA of above 1 percent.

As a consequence of these earnings, the industry's equity capital as a percentage of total assets is now at its highest level since 1941 -- 8.44 percent of industry assets. Ninety-eight percent of all commercial banks, representing more than 99 percent of total industry assets, meet or exceed the highest regulatory capital standards. With such strong levels of economic performance, it is not surprising that the number of banks on the FDIC's "Problem List" at the end of the second quarter of 1997 was 74 banks -- an all-time low -- with consolidated assets of $5 billion at mid-year. More than 12 months have passed since the last failure of an insured commercial bank. It has been more than 30 years since we had so long an interval between bank failures.

The continued prosperity of commercial banks results from a sustained period of favorable economic conditions and adjustments and innovations by banks. Economic growth has supported strong loan demand, while low and stable interest rates have helped banks maintain high net interest margins. As a result, net interest income growth has led to rising industry profits, although asset growth has decelerated and margins have receded somewhat from peak levels. The strong economy also has helped limit loan losses and reverse the accumulation of nonperforming assets in banks' portfolios. At the same time, through a greater emphasis on providing new financial products and services, such as mutual fund sales and management and brokerage services, banks have increased non-interest income steadily over the past several years. Finally, banks have been successful in controlling growth in overhead expenses and their operations have become more efficient.

One significant cost reduction for banks in 1996 and this year has been lower deposit insurance premiums. Since the recapitalization of the BIF in 1995, healthy banks have been required to pay minimal or no deposit insurance premiums, saving banks more than $5.5 billion annually on a pre-tax basis.

The Thrift Industry

There are two federal regulators for FDIC-insured savings institutions. The FDIC supervises 582 state-chartered savings banks. The Office of Thrift Supervision (OTS) oversees 1,270 state- and federally-chartered thrifts. These 1,852 institutions held assets of $1.0 trillion and insured deposits of $676 billion as of June 30, 1997.

Savings institutions, like commercial banks, have enjoyed strong earnings due to a healthy economy, improved asset quality and stable net interest margins. In the first half of 1997, savings institutions earned $4.7 billion, for an annualized ROA of 0.94 percent. Over 96 percent of savings institutions were profitable in the first half of 1997 and 38 percent had ROAs exceeding 1.00 percent. The industry's 1997 earnings represent a considerable improvement over 1996, when savings institutions earned $7.0 billion and the industry's ROA was 0.70 percent. Last year's earnings were reduced by a $3.5 billion one-time special assessment to capitalize the SAIF, which reduced after-tax earnings by an estimated $2.2 billion.

Today, the industry's equity capital ratio, 8.53 percent of assets, is at a 46-year high. Ninety-nine percent of the savings institutions currently meet the highest regulatory capital standards and just four institutions are undercapitalized. Only 29 institutions with $2.8 billion in assets are considered "problem" institutions, which is down from 35 institutions with $7 billion in assets at the beginning of the year. No savings institutions have failed since August of 1996.

Prospects for the Near Term

It appears that this period of unprecedented profitability is likely to continue, at least in the near term. The greatest potential threat to the status quo would be from a resurgence of asset-quality problems, but there are few signs that such a resurgence is imminent, either in the banking or the thrift industries. With the exception of credit-card loans, bank loan loss rates have not increased from cyclical low levels. Credit-card loans, which I will discuss in more detail later, now account for two-thirds of all loan charge-offs at commercial banks. Although there has been an increase in the net loan charge-off rate, the percentage of bank loans that are noncurrent -- either 90 days or more past due on scheduled payments or in nonaccrual status -- fell to 1 percent at midyear, the lowest level in the 16 years that we have collected noncurrent loan data.

Thrifts have seen significant improvement in asset quality in recent years. Net charge-off rates have declined in each of the last three years and through the first six months of this year. Noncurrent loans are at the lowest level in the eight years that noncurrent loan data has been collected for all savings institutions. An improvement in real estate markets in western states has been a major factor in improved asset quality for savings institutions. In a reversal from prior years, savings institutions in the western states now show noncurrent loan levels below the national average.

INDUSTRY CONSOLIDATION

Banks and thrifts are earning extraordinary profits amid dramatic changes in the financial marketplace. Recent legislation, regulatory initiatives, judicial decisions and technological advances have not only made it easier for banks and savings associations to expand, consolidate, switch charters, and acquire other institutions, but they have also blurred the lines that previously separated the banking, securities, and insurance industries. As a result, a wave of intra- and inter-industry mergers and acquisitions has begun to rearrange the financial services landscape. Pending deals and charter applications indicate that this trend will only accelerate.

The passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, for example, has resulted in a wave of mergers and acquisitions within the banking industry. During the first six months of 1997, a total of 325 commercial banks and 60 savings institutions were absorbed by mergers and acquisitions. Much of this activity is a result of multi-bank holding company consolidation. The number of subsidiary banks owned by the top 100 U.S. bank holding companies, for example, dropped by approximately 20 percent in the first half of 1997, driven mostly by consolidation of charters across state lines. Although consolidation of multi-bank holding company operations has been and continues to be significant, mergers and acquisitions for the purposes of expansion still predominate. Since enactment of the interstate banking law, approximately 44 percent of all commercial bank inter-state mergers and acquisitions (as measured by the percentage of the seller's assets) have represented expansions into new markets, while only 26 percent reflected within-market consolidations. The remaining 30 percent had both market expansion and within-market components.

Recent changes in banking laws and regulations also have made it easier for insured depository institutions to merge or make acquisitions across banking lines. An August 1996 change in the tax code, for example, virtually eliminated the costs of converting a savings institution to a commercial bank. Consequently, the banking industry has increasingly turned to savings institutions as a source of deposit growth. Since the beginning of the fourth quarter of 1996, 81 savings institutions with almost $55 billion in assets have been absorbed into the commercial banking industry. In addition, 22 savings institutions with $16.7 billion in assets converted to commercial bank charters.

How has all this merger activity affected the overall industry numbers? As of June 30, 1997, there were 11,160 FDIC-insured institutions -- 4,636 fewer than existed at the beginning of this decade. Of that number, 903 represent failed institutions that have been closed since 1990. Thus, we attribute the net decline of 3,733 institutions to industry consolidation. In contrast to the decline in the number of institutions, the number of bank and savings institution branches actually increased by 3,564 over the same period. To date, fears that industry consolidation would lead to widespread layoffs have been unfounded. Indeed, commercial bank and savings institution employment has been trending upward in recent quarters. In June 1997, the number of full-time employees was 1.76 million, the highest level in three years.

The banking industry has been consolidating while the barriers separating commercial banking from other financial service industries have been eroding. The combination of these two trends is likely to have a profound effect on the future structure of the industry. Since April of this year, for example, six of the nation's largest bank holding companies have bought securities firms. These acquisitions followed the Federal Reserve Board's decision to raise the amount of revenues that Section 20 securities subsidiaries of bank holding companies may earn from the underwriting of bank ineligible securities.

Similar deals are also becoming commonplace among and between insurers, brokerage firms, and thrifts. Just a few weeks ago, Travelers Group announced that it would buy the investment bank, Salomon Inc., in a deal valued at over $9 billion. Travelers, which already owns retail stock broker Smith Barney, also operates Travelers Life & Annuity, Primerica Financial Services, Travelers Property Casualty Corp. and Commercial Credit Company, and has an application pending for a federal thrift charter. Five other insurance companies also have recently applied to the Office of Thrift Supervision for thrift charters. Clearly, changes are underway in the financial services industries that are making distinctions between financial services providers less relevant. Banks and savings institutions appear financially well-prepared to adapt to the new marketplace.

POTENTIAL RISKS

As I have outlined previously, we are currently in the midst of the most profitable period for banking in the post-World War II era. As the deposit insurer, however, the FDIC must remain vigilant for possible problems that could disrupt this prosperity. Even now, banks' traditional businesses are coming under greater competitive pressure than ever before. Innovations in the capital markets, including the increasing securitization of previously illiquid assets, are reducing the yields available to banks from loans made to high-quality borrowers. Meanwhile an expanding array of options available to savers is increasing the cost and interest-rate sensitivity of bank liabilities.

In this highly competitive environment, some banks may take more risks to increase short-term profits. For example, some institutions may attempt to increase volumes on low-margin business that may or may not offer adequate risk-adjusted spreads; they may seek niches in higher-yielding, riskier businesses; or they may cut costs in ways that ultimately reduce their ability to manage risks. To sustain profits over the long term, banks must allow for the possibility of a decline in the economy and prudently balance risks and expected returns.

Developments in some segments of consumer lending, including credit card lending, subprime lending in general, and high LTV home-equity lending in particular, are noteworthy. Developments in the market for syndicated commercial loans, a resurgent commercial real estate market, the increased use of financial derivatives and the "Year 2000 Problem" also have attracted our attention. At present, the data do not suggest that a substantial increase in bank failures is likely due to these developments. Nevertheless, they warrant close scrutiny by both bankers and their regulators.

Credit Cards

Problems in the credit card business have been well publicized. Second-quarter 1997 earnings of credit card banks (defined as institutions with total loans greater than 50 percent of total assets and credit card loans greater than 50 percent of total loans) declined by $334 million from first-quarter levels. About one-third of this earnings decline was attributable to higher loan-loss provisions, reflecting rising charge-off rates on credit card loans. The remainder of the decline was due to accounting adjustments and other nonrecurring expenses.

The annualized net charge-off rate on commercial banks' credit card loans rose to 5.22 percent in the second quarter, up from 4.92 percent in the first quarter and 4.48 percent in the second quarter of 1996. As Chart 1 reveals, this is the highest quarterly charge-off rate on credit card loans in the 14 years that banks have reported this information. Losses on credit card loans accounted for two-thirds of all loan charge-offs taken by banks during the second quarter. Noncurrent credit card loans also are at or near all-time highs. Some analysts have suggested that charge-offs and delinquencies could be even higher were it not that consumers increasingly are consolidating credit card debt into home equity loans with lower monthly payment obligations.

One factor in the high rate of credit card losses is the continuing increase in consumer bankruptcies. Despite strong economic growth and a 25-year low in unemployment, annual personal bankruptcy filings in the U.S. have risen from around one per thousand U.S. citizens in the mid-1970s to over four per thousand in 1996. Over 1.1 million households filed for bankruptcy protection during 1996, a rise of 29 percent from the year before. Consumer bankruptcies continued to set new records in the second quarter of 1997, both for the quarter (353,000) and for the preceding twelve-month period (1.26 million). This trend is particularly alarming in that it is intensifying at a time when the economy is so strong. While new record levels are expected in the near term, the rate of growth in bankruptcy filings is expected to slow. VISA estimates that bankruptcy filings will grow 14.8 percent in 1998.

Consumer credit quality has deteriorated in step with the rise in bankruptcies. As evident in Chart 2, credit card charge-offs have closely tracked the growth in bankruptcies. According to many banks, bankruptcy accounts for about half of credit card charge-offs. Many bankers report that, increasingly, bankruptcy comes with no warning. Credit card accounts sometimes go from current status to bankruptcy and charge-off without the usual delinquency period. A recent article in the first quarter issue of the FDIC's new Regional Outlook publication discusses the causes of bankruptcy. A copy of the article is included as Attachment 1 in the Appendix.

Causes other than bankruptcy also have reduced credit card bank profits. Information technology and securitization have helped ease entry into this business, thus increasing competition and facilitating enormous growth in the supply of credit. Information technology, including credit-scoring models, has allowed lenders to segment customer

bases and match product terms with customer risk profiles, resulting in the proliferation of credit card offers. Securitization of credit card receivables has flourished, giving credit card lenders a relatively inexpensive and plentiful source of funds. Increased competition has produced balance transfer and "teaser rate" wars, which have resulted in downward pressure on yields, as Chart 3 reveals.

In the event of an economic downturn, losses from bankruptcy and credit card loans will probably increase. For example, the 1990-1991 recession was accompanied by increases in credit card charge-offs of about 54 percent. Similarly, given current record high consumer debt burden levels, an increase in interest rates could have an adverse effect on consumers' ability to service debt.

A related concern is the enormous size of the aggregate outstanding lines of credit now available to credit card borrowers. As of June 30, the amount of credit available, but not used, was $1.547 trillion. Should the economy begin to slow and unemployment begin to rise, borrowers may tap these lines to maintain lifestyles until their economic fortunes improve. However, in the interim, credit card banks that have extended these lines could be exposed to greater losses.

Nevertheless, it appears that most institutions that specialize in credit card lending have the financial strength to absorb further increases in credit losses and additional erosion of interest margins without jeopardizing their solvency. Card interest rates are based, in part, upon a bank's loss experience. Many major credit card banks have reported that they tightened credit standards in 1996. However, many industry analysts believe that charge-off rates may continue to rise this year before they begin to decline some time in 1998. In the meantime, developments in credit card lending warrant close monitoring by both bankers and their regulators.

To this end the FDIC has undertaken several initiatives. First, as part of a continuing program, the FDIC holds periodic round table meetings with selected credit card speciality banks. Participants assess emerging trends and risks in the retail credit industry and discuss managing these risks. Second, to evaluate credit card speciality banks, the FDIC has developed quarterly analytical reports containing data on the distinctive characteristics of these banks. The reports are used to monitor trends and to help prioritize on-site examination scheduling. Finally, the FDIC has developed specific procedures to examine credit card specialty banks as well as other banks with extensive credit card lending operations. A new examination manual that outlines these procedures and addresses the specific risks of the credit card industry was recently distributed to examiners. While we do not believe that recent developments in the credit card industry pose an immediate risk to the banking industry or the insurance fund, we will continue to monitor them.

Subprime Lending

Faced with strong competition and shrinking margins to high quality borrowers, many banks are pursuing subprime lending strategies. Subprime lending most commonly

refers to auto, home-equity, mortgage, and secured credit card loans to borrowers who have blemished or limited credit histories. Generally, the characteristics of a subprime borrower include a history of paying debts late, personal bankruptcy filings, or an insufficient credit record.

In the past, subprime lending was primarily the domain of a limited number of finance companies. The number of subprime lenders has surged in recent years as more companies have been attracted by significantly higher rates and fees earned on subprime loans. Large and small banks are now participating in credit card, auto, home-equity, and mortgage subprime lending, although the extent of involvement is difficult to quantify because subprime loans are not delineated in bank and thrift financial reports.

The lack of a standard definition for a "subprime" loan makes estimates of the extent of the market somewhat arbitrary. However, as reflected in Chart 4, some sources estimate that, during 1996, originations of subprime loans secured by residences, including both home-equity and mortgage loans, amounted to almost $150 billion. This compares to the estimated $800 billion in originations of conventional mortgages. Subprime auto loans have been estimated to range between $75 billion and $100 billion, or about 20 percent of total auto loans outstanding.

Increasing competition may compel some subprime lenders to compromise underwriting standards and lower pricing in order to protect market share. Financial difficulties reported by some major subprime auto lenders highlight these concerns. As recently as September 22, 1997, Standard & Poor's reported that U.S. issuers of securities backed by subprime auto loans sustained a two- to three-fold increase in losses. Reasons cited were bankruptcies, increased origination of lower quality loans, and lower auction recovery rates. Standard & Poor's also cited increased competition leading to relaxed underwriting guidelines, including higher advance rates and longer-term contracts.

Recent examinations revealed that a number of financial institutions involved in subprime lending had failed to properly assess and control the risks associated with this business. As with credit card lending, increased losses on subprime loans are occurring during relatively healthy economic conditions. The repayment capacity of subprime borrowers may be especially susceptible to downturns in the economy, which could exacerbate the already high level of delinquencies and defaults typically recorded on subprime loans.

The FDIC is concerned about the risks to insured institutions that fail to manage the risks inherent in subprime lending. In September 1997, a feature article in the FDIC's Regional Outlook, which the FDIC furnishes to its examiners and to all FDIC insured banks and thrifts, discussed some of the risks involved in subprime lending in more detail. A copy of the article is included as Attachment 2 in the Appendix. The FDIC also issued a Financial Institution Letter to all FDIC supervised institutions on May 2, 1997 warning of the risks associated with subprime lending. These risks include more frequent and earlier delinquencies and defaults, potential strains on underwriting and collection resources, and difficulties in estimating recovery values on repossessed

collateral. Bankers also were told to identify and understand the associated risks, design and implement effective corresponding controls and establish prudent limits before engaging in subprime lending or investing.

High Loan-to-Value Mortgages and Home-Equity Lending

Mortgage lending and home-equity lending have traditionally presented low credit risks for banks, particularly when interest rates are stable. To some extent, due to pricing pressures from increased competition, market participants have sought higher returns in the riskier sectors of these businesses. For example, as shown in Chart 5, the percentage of conventional mortgages with LTVs greater than 90 percent has grown dramatically. Recent growth in subprime residential lending also has attracted attention, as lenders that specialize in subprime home-equity loans and subprime mortgages are beginning to show some signs of stress. In April 1997, Moody's Investors Service lowered the rating on subordinated debt issued by a leading originator of subprime mortgage and home-equity loans because of the increasing level of delinquencies in the issuer's loan portfolio and the highly competitive environment for subprime home-equity loans.

Home-equity lending is a high-growth business for many banks. One in four banks increased their home-equity lines by more than 30 percent during the year ending mid-1997, as shown in Table 1. Debt consolidation apparently has become the most frequent reason for home-equity borrowing. Nonbanks that expanded their mortgage lending capacity during 1993 have been aggressively marketing to an increasing number of borrowers who desire to consolidate their growing debt burdens, some now offering loans in excess of collateral value (so-called 125 percent LTV programs). According to the Consumer Bankers' Association's 1996 Home-Equity Loan Study, debt consolidation accounted for 35 percent of home-equity lines of credit and 40 percent of closed-end loans. Prior to 1992, home improvement was the primary reason for home-equity borrowing. Unlike funds lent for home improvement, the proceeds of a debt consolidation loan do not enhance a lender's collateral value. Also, funds are extended to many who may be facing difficulties in meeting their existing consumer debt service.

Rapid growth in home-equity lending has been accompanied by signs of relaxed underwriting. Chart 6 shows the foreclosure rates for securitized closed-end loan pools originated in 1995 and 1996 versus 1994. While these data are based mostly on pools originated by nonbank subprime lenders, the sharp increase in delinquency rates for loan pools originated in 1995 and 1996 is worth noting. The third quarter issue of the FDIC's Regional Outlook contains an article that discusses trends in the home-equity securitized market. A copy of the article is found as Attachment 3 in the Appendix.

In our effort to monitor and control potential problems in high LTV and home-equity lending -- as well as in syndicated lending and commercial real estate lending, which I will discuss shortly -- the FDIC has implemented an ongoing underwriting standards survey that examiners complete at the conclusion of each safety and soundness examination. The survey assesses changes in the bank's underwriting standards and

compares these standards with those of other area banks. While our survey results show few weaknesses in the banks we directly supervise, as competition with nonbanks intensifies, any trends toward loosening underwriting standards will be closely monitored. In addition, Appendix A to Part 365 of the FDIC's Regulation on Real Estate Lending Standards sets forth specific guidance on real estate lending policies that banks should employ. For example, one section of Appendix A sets forth maximum loan-to-value limits for different types of real estate loans and specifies that loans exceeding such limitations should be reported to the institution's board of directors at least quarterly.

Syndicated Lending

Syndicated loans are large loans that are divided into smaller portions and sold to investors who then have a proportionate interest in the original underlying loan. As indicated in Chart 7, the current boom in syndications could result in an annual volume approaching one trillion dollars, more than double the level in 1993 and quadruple the level in 1991. While 40 percent of syndicated loans have been used to refinance existing debt, the amount of syndicated loans made to finance mergers and acquisitions is now comparable to the level in the 1980s.

Intense competition is transforming this sector, as investment banks are making notable inroads into a sector that traditionally has been dominated by banks. As part of a so-called "one-stop shopping" strategy, syndicated lending enables investment banks to offer a complete array of advisory services and financing capabilities.

As a result, spreads have narrowed significantly over the last three years, especially for some of the lowest-rated borrowers, though this decline in spreads has begun to level off. In some cases, loans to the highest-quality borrowers are reportedly being made primarily to preserve business relationships and are resulting in almost no risk-adjusted profit.

One concern is that a significant percentage of syndicated loans are being purchased by smaller banks, which, in some cases, may not be thoroughly reviewing the credit analysis. These smaller purchasing banks, however, may not enjoy the "relationship value" that, for the loan originator, may offset the narrow spreads. As mentioned earlier, for these and other reasons, the FDIC has implemented an underwriting standards survey to assess changes in a bank's underwriting standards and to compare these standards with those of other area banks. The FDIC will continue to monitor developments in syndicated lending closely.

Commercial Real Estate Lending

Given the significant losses to the insurance funds due to commercial real estate problems during the last banking crisis, the FDIC follows developments in real estate lending very closely. Banks are currently leading a resurgence in commercial real estate lending. About 28 percent of banks increased their total commercial real estate and

construction lending by more than 30 percent during the twelve months ending June 30, 1997, as set forth in Table 1, and about 23 percent of all banks with less than $1 billion in assets have total exposure in these two sectors of more than 200 percent of equity capital. High concentrations or rapid growth in a particular lending segment are not necessarily indicators of problems on the horizon. Nevertheless, any significant concentration of credit in a particular sector will be monitored closely.

Some analysts have expressed concerns about certain property types in particular locations. However, many metropolitan commercial real estate markets are seeing rising prices and rents and falling vacancy rates as the excess space created during the 1980s and early 1990s continues to be absorbed.

Further, there has been notable growth in the use of Commercial Mortgage-Backed Securities (CMBS) and Real Estate Investment Trusts (REITS) to finance the resurgence in commercial real estate. According to Commercial Mortgage Alert, outstanding CMBS reached $125 billion in 1996 on a record $30 billion of new issuance. Similarly, REITS have become a stronger force in real estate finance and have rapidly increased their market capitalization. These innovations can improve market efficiency by providing continuous pricing benchmarks through daily share price movements and thus enforce discipline upon developers and lenders, which may in turn help prevent excessive development and dampen the severity of real estate cycles. However, some analysts have argued that the appetite for REIT investments, combined with the premiums that the trusts can pay for properties, may push the price of commercial space beyond sustainable levels, thereby potentially amplifying cyclical swings in real estate values. Again, as with other innovations in the industry, we will monitor developments closely.

Financial Derivatives

Broadly defined, a financial derivative is a contract whose value depends on, or derives from, the value of an underlying asset, reference rate, or index. Financial derivatives are contracts which are principally designed to transfer price, interest rate and other market risks, without involving the actual holding or conveyance of balance sheet assets or liabilities.

Most risks inherent in financial derivative instruments are present in varying degrees in more traditional financial institution products and activities and can largely be assessed and evaluated in similar fashion. The complexity of financial derivatives is largely due to the manner in which these risks are combined. The difficulty in determining market values, the potential for increased leverage and the speed with which external market forces can affect value heighten the difficulty of accurately assessing the magnitude of these risks.

Despite their complexity, financial derivatives can be important risk-reducing tools. Nevertheless, their complexity, their enormous notional value and their concentration at a small number of banks merit close FDIC supervision to ensure that banks maintain

acceptable capital levels, suitable expertise and sufficient management controls for these activities. In an effort to ensure that examiners appropriately review an institution's use of derivatives, the FDIC issued an April 1994 Regional Directors Memorandum concerning derivatives in general and a follow-up Regional Directors Memorandum specifically on credit derivatives in August 1996.

Off-balance-sheet derivative contracts (futures, forwards, swaps and options) grew rapidly during the early 1990's. From the end of 1990 through the first quarter of 1995, the notional value of total outstanding derivative contracts rose from $6.8 trillion to $17.3 trillion, a compound annual rate of increase of 24.6 percent. During 1995, there was somewhat of a lull, with total contracts actually decreasing 4.4 percent in that year's fourth quarter. In 1996, however, the market rebounded with strong increases and, during the first half of 1997, the market experienced its strongest growth in several years with a 16.1 percent increase in off-balance-sheet derivatives contracts. Futures and forwards are the most prevalent type of contract at $9.1 trillion, followed by swaps at $8.7 trillion, and options at $5.4 trillion. The most commonly used contracts were interest rate contracts, followed by foreign exchange agreements.

Using the FDIC's definitions, in the five years prior to June 30, 1997, the notional amount of off-balance-sheet derivatives at commercial banks has increased by more than 175 percent, from $8.4 trillion to $23.3 trillion. Currently, 459 commercial banks, down from a peak of 679 in early 1993, hold at least some off-balance-sheet derivatives, but the seven largest dealer/traders account for 93 percent of all off-balance-sheet derivatives. Both the income and balance sheet results of banks' trading activities in off-balance-sheet derivatives exhibit considerable volatility. In the last eight quarters, trading gains and fee income attributable to these activities have ranged from as much as $2.4 billion to as little as $1.5 billion. The earnings impact of off-balance-sheet derivatives held for purposes other than trading has been mixed. For example, through the first six months of 1997, 417 banks indicated that these contracts had an effect on their income, suggesting that they were being used to hedge against interest rate risk. Of those 417 banks, 54 reported lower net interest income as a result of holding off-balance-sheet contracts, while 363 banks reported higher net interest income. Most banks -- approximately 8,849 -- do not have any off-balance-sheet financial derivatives; any interest rate risk management takes place on-balance-sheet.

The Year 2000 Problem

The financial institution industry is confronted with a unique challenge unrelated to the traditional risks associated with the industry. This challenge results from the method in which dates have been recorded in information technology systems and components. For decades, information technology platforms have represented the year as two digits, compared to the normal four digit format. On January 1, 2000, information technology systems that continue to use the two digit format will be unable to differentiate the year 2000 from the year 1900. This inability will cause mainframes, networks, personal computers, and other time-dependent technology to operate improperly. For example, the integrity of arithmetic calculations and date comparisons will be compromised.

The financial institution industry is especially exposed to Year 2000 issues because many of its services and products require calculations that are date-dependent. For example, mortgage amortization, interest calculation, check processing, wire transferring, and dividend payment functions require date references. Ultimately, should financial institutions be unable to deliver their products or services to customers, their business could be threatened.

The FDIC, in conjunction with the Federal Financial Institutions Examination Council (FFIEC), has issued an interagency statement that provides guidance on the activities insured financial institutions and data service providers need to undertake to ensure that all information technology systems and components are capable of recognizing dates in the Year 2000 and beyond. In addition, the interagency statement outlines the strategy that the banking regulators will use to ensure that Year 2000 issues are resolved.

The FDIC, along with other members of the FFIEC, is using a multi-step program to verify that insured financial institutions' information technology systems are Year 2000 compliant. The first part of the program, scheduled for completion by the end of 1997, assesses the current status of their Year 2000 planning efforts through an examiner questionnaire. This part of the program also includes an assessment of the status of multi-regional data processing servicers, other large independent servicers and the largest vendors of bank software. This assessment is particularly important to the FDIC, since many of the banks we supervise are smaller banks that are more dependent on servicers. Since March, the FDIC and state banking authorities have conducted Year 2000 surveys on approximately 4,800 FDIC-supervised financial institutions -- approximately 77 percent of FDIC-supervised institutions -- and 119 third-party servicers and software vendors -- approximately 81 percent of the servicers and vendors that the FDIC will assess. Other FFIEC members will assess other servicers and will share their assessments with the FDIC. The results indicate that institutions are generally aware of the Year 2000 problem. However, in some instances, senior management and outside directors do not fully understand the risk posed by this issue. The FDIC, in cooperation with the other federal banking regulatory agencies and state supervisory authorities, will continue its efforts to raise awareness of the seriousness of Year 2000 issues.

The results of the first phase of the multi-step program are being used to plan the next phase, on-site supervisory reviews. On-site supervisory reviews of third-party servicers and software vendors assessed by the FDIC are expected to be completed by the end of 1997. On-site supervisory reviews of FDIC supervised institutions are expected to be completed by mid-1998.

Insured financial institutions identified as having significant problems addressing Year 2000 issues will be supervised by FDIC examiners working closely with these institutions to mitigate these problems. Supervisory action, including formal enforcement action if warranted, may be taken if an institution fails to address this issue in a timely fashion. In addition, the FDIC is working with other federal regulators to develop an

outreach program that will communicate the regulators' issues and concerns regarding the Year 2000 problem to vendors or data service providers of insured financial institutions.

CONDITION OF THE INSURANCE FUNDS

The two deposit insurance funds managed by the FDIC reflect the condition of the banking and thrift industries. They are well capitalized and are well insulated against foreseeable losses. With low insurance losses, both funds are prospering even though, under our risk-based premium system, the best-rated banks and thrifts are not currently assessed for deposit insurance coverage.

The Bank Insurance Fund had a balance of $27.4 billion on June 30, 1997, which was 1.35 percent of estimated insured deposits. Since reaching the Designated Reserve Ratio of 1.25 percent in the second quarter of 1995, the BIF has continued to grow, both through investment earnings and through the recovery of reserves previously set aside for losses attributable to anticipated failures and assets in liquidation. Some institutions earlier projected as likely failures are no longer considered a threat to the fund. With only $26 million remaining in loss reserves as of June 30, 1997, however, comparable recoveries of reserves are unlikely in the near term. The fund also earned more than $700 million in interest income in the first half of 1997. Assessment revenue fell to just $13 million during that six-month period, compared to $37 million for the same period in 1996, as the percentage of the healthiest BIF members, which pay no premiums, rose to 95 percent.

Following the special assessment of $4.5 billion last fall to reach full capitalization, the Savings Association Insurance Fund is healthy. The $9.1 billion fund was 1.32 percent of estimated insured deposits on June 30. With minimal receivership activity, the fund is very liquid, and investment earnings totaled $262 million for the first six months of 1997. Despite an assessment base that is roughly one-third that of the BIF, SAIF assessment revenue was slightly higher for the first half of 1997, at $14 million, than that of the BIF due to a somewhat less favorable distribution of SAIF members in the risk-based assessment matrix. Nevertheless, nearly 90 percent of all SAIF members qualify for the best rating and pay zero premiums.

It has been more than one year since either fund experienced a failure. The near-term expectations for both funds remain favorable, but we do not -- and cannot prudently -- believe that current conditions will continue indefinitely. Steps to further strengthen the federal deposit insurance system should be taken now, when both funds are strong and insured institutions are prosperous. In particular, the BIF and the SAIF should be merged. The Deposit Insurance Funds Act of 1996 (the Funds Act), which capitalized the SAIF, recognized the need for a merger of the deposit insurance funds. The SAIF insures far fewer, and more geographically concentrated, institutions than does the BIF, and consequently faces greater long-term structural risks. A combined BIF and SAIF would have a larger membership and a broader distribution of geographic and product risks and would be stronger than the SAIF alone. With both funds fully capitalized and

their members healthy and profitable, the SAIF and BIF reserve ratios are very close to each other and should remain so throughout 1997. This means that a merger of the two funds would not result in a material dilution of either one. Under the Funds Act, Congress made the merger of the BIF and the SAIF contingent upon there being no savings associations, and we are hopeful that Congress will address fund merger issues in the context of enacting broader financial modernization legislation. However, regardless of what happens with comprehensive financial modernization legislation, I urge you to pass legislation that merges the two insurance funds, as contemplated by the Funds Act, while both funds are fully capitalized. Although we are not currently predicting losses to the funds, if either the banking or thrift industries were to encounter serious difficulties in the future and losses to the related funds resulted, merger of the two funds could become problematic.

SUMMARY OF THE FDIC'S STRATEGIC PLAN

As the Subcommittee has requested, let me now summarize the FDIC's Strategic Plan that was recently submitted to Congress pursuant to the Government Performance and Results Act of 1993 (the Results Act), which took effect this year. The FDIC strongly supports the Results Act. We are proud of our planning accomplishments over the past several years. While the Results Act applies the principles of sound business management to the Federal government, the FDIC has used strategic planning and performance measurement principles for years prior to the enactment of the Results Act.

The FDIC's Strategic Plan for 1997-2002 reflects our increasing emphasis on risk management. The Plan includes vision, values and mission statements that reflect our commitment to risk management, the safety and soundness of our banking system, fairness in the provision of financial services, and a positive environment for our employees to achieve our mission.

The Strategic Plan includes goals, objectives and strategies for the FDIC's three major program areas: Insurance; Supervision; and Policy, Regulation and Outreach. The Insurance program area comprises three functional areas identified as Risk Assessment; Resolution of Failing Institutions; and Receivership Management. This program area reflects the FDIC's role as deposit insurer in assessing potential risks to the insurance funds and proactively minimizing risks and costs to the insurance funds. In addition, the Insurance program area reflects the Corporation's role of minimizing costs to the funds through the orderly and "least costly" resolution of failed or failing institutions, and by effectively managing receivership operations.

The Supervision program area encompasses two functions identified as Risk Management-Safety and Soundness, and Risk Management-Compliance and Enforcement. The Supervision program area addresses the manner in which the FDIC fulfills its role of promoting the safety and soundness of insured depository institutions and fairness in the provision of financial services.

The Policy, Regulation, and Outreach program area comprises four functional areas: Consumer Affairs; Policy Leadership; Community Affairs and Outreach; and Outreach-Safety and Soundness. In addition to the Supervision program area, this program area describes how the FDIC fulfills its role of implementing statutes related to consumer protection, fair lending, and deposit insurance.

In addition, the FDIC's Strategic Plan addresses the resource strategies that will assist the FDIC in meeting its goals and objectives. In the staffing area, the FDIC is continuing to transfer staff from the failing institution resolution and liquidation areas into risk assessment, supervision, and compliance, in accordance with our increased emphasis on risk management. We also are pursuing technological initiatives that will improve examiners' ability to evaluate the financial condition of institutions and their compliance with fair lending and other laws. The Strategic Plan also includes annual performance measures that relate to the Plan's long-term goals and objectives.

While the Strategic Plan describes measures in general terms, the FDIC's Annual Performance Plan (which we referred to in prior years as our Corporate Business Plan) specifies performance goals or target levels for each measure. Performance is compared to these targets to determine achievement of our objectives. The FDIC's first Business Plan was developed in 1996 for calendar year 1997 and included performance targets for each of the FDIC's program and functional areas in the Strategic Plan. The 1998 Annual Performance Plan will set forth our target levels of performance for the year for each of the eight functions of the three major program areas in the Strategic Plan and include all of the elements required by the Results Act for Annual Performance Plans. We do not expect the performance measures or targets to change significantly over those that are in place in 1997.

The Strategic Plan outlines key external factors that could affect achievement of the FDIC's strategic goals. Examples of external factors are domestic or international economic developments, especially as they relate to the banking industry; the likely actions of Congress and other regulators of financial institutions; and the general business environment in which financial institutions operate.

With regard to program evaluation, the FDIC evaluates its program performance through a Quarterly Performance Reporting process. In May of this year, the FDIC initiated the reporting of our progress toward the performance targets established in the 1997 Business Plan. This report measures the FDIC's progress in meeting 27 performance targets in the FDIC's eight functional areas in the Strategic Plan and is reviewed quarterly by the FDIC's Operating Committee, which is comprised of the Chairman and officers of the Corporation. Beginning in 1998, the Quarterly Performance Report will be presented to the FDIC Board of Directors. This process holds managers accountable for achievement of their goals and provides feedback, which, in turn, allows us to revise goals, objectives and performance measures as appropriate. Work continues in this area as we move towards a more formalized program evaluation function in 1998.

The link between planning and budgeting is critical for the success of our planning process. The only programs that are funded through the FDIC budget are those that have been approved in the Strategic Plan or the Annual Performance Plan. Implementation of the Strategic Plan has resulted in cost savings throughout the FDIC since 1995, and those savings are projected to continue.

The FDIC continually consults with various stakeholders regarding our Strategic Plan. We inform these key groups of our strategic planning process and strategic initiatives on an ongoing basis through participation of Board members, Division and Office Directors and senior staff in outreach opportunities, speeches to industry trade groups, and participation in various community/consumer group activities. The Strategic Plan also was presented to and discussed with our Board of Directors at public meetings in April 1995 and April 1997. The Plan is also posted on our Internet site.

As required by the Results Act, the FDIC has been working closely with the other depository institution regulatory agencies to address programs that transcend the jurisdiction of each agency. In this connection, the FDIC is participating in an interagency working group to address and report on issues of mutual concern.

CONCLUSION

In conclusion, I am pleased to report that the condition of the banking and thrift industries is excellent. Record profits, accompanied by strong capital ratios and an absence of failures, make for a healthy industry. The FDIC sees no immediate threat to this situation. However, we will continue to closely monitor developments in the financial industry for potential problems, particularly in credit card lending, subprime lending, high loan-to-value ratio mortgages, syndicated lending, commercial real estate lending, derivatives and the Year 2000 issue, to ensure that institutions are prepared to respond if problems arise in the future.

Last Updated 6/25/1999