Oral Statement
by
Andrew C. Hove, Jr.
Chairman
Federal Deposit Insurance Corporation
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
October 21, 1997

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 industry and the deposit insurance funds.

I have a detailed written statement for the record. This morning I want to briefly describe where the industry stands today.

In short, commercial banks and savings institutions are experiencing a period of unprecedented prosperity.

Banks have enjoyed record earnings since 1993. In the first six months of this year, they earned $29.1 billion, which is 14.2 percent higher than for the same period last year.

If this pace is sustained in the second half, earnings will result in an annualized return on assets (ROA) of 1.25 percent, surpassing 1 percent for the fifth year in a row. In the sixty years from the founding of the FDIC in 1933 until 1993, the industry had never achieved an average ROA of above 1 percent.

As a consequence of these earnings in recent years, 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. About 98 percent of the banks meet or exceed the highest regulatory capital standard. As a result, only a handful of banks pay premiums for FDIC insurance. In addition, our problem list is down to 74 banks -- an all-time low -- and more than a year has passed since the last bank failure.

The good times for the banking industry have contributed greatly to building strong deposit insurance funds. As of June, 1997, the Bank Insurance Fund totaled $27.4 billion and the Savings Association Insurance Fund totaled $9.1 billion.

Turning to the future, 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.

The traditional business activities of banks, however, are coming under greater competitive pressure than ever before. Competition is narrowing yields from loans made to high quality borrowers. Meanwhile, an expanding array of options available to savers is increasing the cost of bank liabilities.

In this highly competitive environment, some banks may take more risks to increase short-term profits. To sustain profits over the long term, however, banks must allow for the possibility of a decline in the economy, and prudently balance risks and expected returns.

My written statement discusses several such areas of concern in detail. We point out that there are some areas where banks are expanding now, in good times, that could pose significant risks if the economy declines.

For the next few minutes, I would like to focus on one area where the Chairman has expressed concern: high loan-to-value (LTV) home-equity lending in general.

Four trends in the home lending area capture attention.

One, market participants have recently sought higher returns in the riskier sectors of the mortgage lending and home-equity lending businesses. As a result, the percentage of conventional mortgages with LTVs greater than 90 percent has grown dramatically.

Two, 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.

Three, 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 loan-to-value programs. Moreover, 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.

Four, rapid growth in home-equity lending has been accompanied by signs of relaxed underwriting. While the data we are looking at 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.

In our effort to monitor and control potential problems in high LTV and home-equity lending, the FDIC has implemented an ongoing underwriting standards survey, which examiners complete at the conclusion of each safety and soundness examination. The survey assesses changes in the bank's underwriting standards and compares those standards with those of other area banks. While our survey results show few weaknesses in the banks we directly supervise, any trends toward loosening underwriting standards will be closely monitored.

In addition, the FDIC's Regulation on Real Estate Lending Standards sets forth specific guidance on real estate lending policies that banks should employ. For example, we define maximum loan-to-value limits for different types of real estate loans and specify that loans exceeding such limitations should be reported to the institution's board of directors at least quarterly.

In conclusion, Mr. Chairman and members of the Subcommittee, I am pleased to say today that the condition of the banking industry 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 trends in the financial industry -- such as high loan-to-value mortgage lending -- for potential problems to ensure that institutions are prepared to respond if problems arise in the future.

Thank you -- I would be happy to answer your questions.

Last Updated 6/25/1999