Testimony of
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On
Recent Bank Failures and Regulatory Initiatives
Before The
Committee on Banking and Financial Services
U.S. House Of Representatives
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Mr. Chairman, Congressman LaFalce, and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on recent bank failures and on recent FDIC initiatives with respect to troubled banks.

Several recent failures of insured institutions with unusually high losses have raised concerns among regulators and the Congress. In my testimony, I will first discuss the context of these failures. Then I will outline what we believe are the lessons of recent failures, and the initiatives that the FDIC has undertaken in response to these lessons -- specifically actions with respect to subprime lending, retained interests, fraud and risk-related premiums. Finally, I will discuss H.R. 3374, the Federal Deposit Insurance Corporation Examination Enhancement and Insurance Fund Protection Act, recently introduced by Chairman Leach.

Background

The banking industry has been extraordinarily profitable and healthy in recent years. In the third quarter of 1999, the latest quarter for which data are available, commercial banks earned $19.4 billion, a quarterly record. The average annualized return on assets (ROA) was 1.42 percent and the average annualized return on equity (ROE) was 16.62 percent, both also quarterly records. Early indications are that net income for the full year 1999 will be another annual record, making it the eighth consecutive year in which commercial banks have set an earnings record.

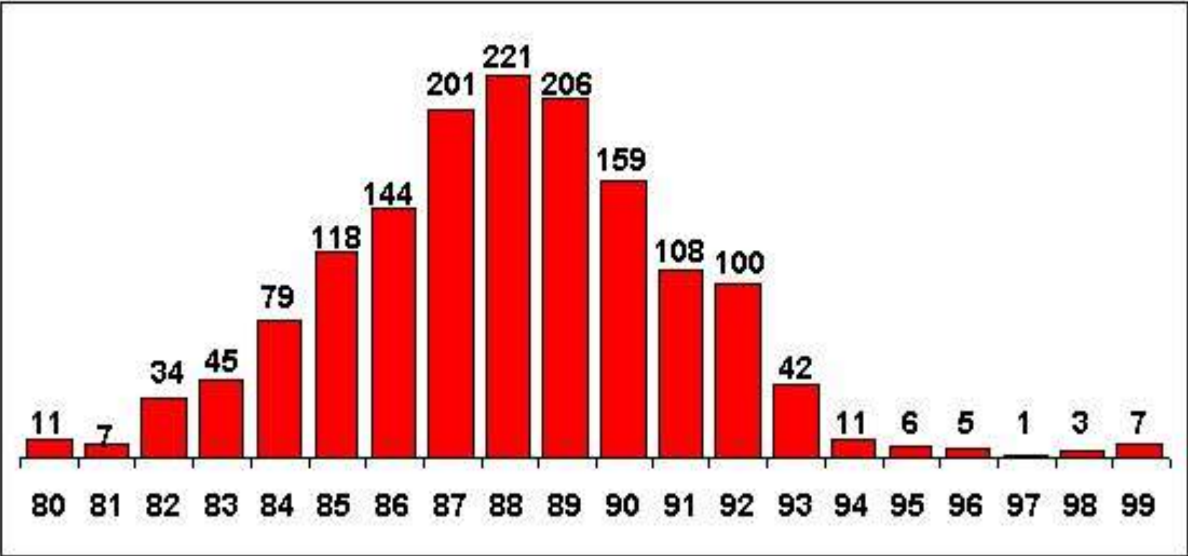
Savings institutions have shared the prosperity. After the devastating savings and loan crisis, the surviving savings institutions achieved net income of $6.7 billion in 1992. The trend since then has been upward, reaching $10.2 billion in 1998. Earnings for savings institutions

over the first nine months of 1999 were $8.4 billion, as compared to $8.2 billion over the same period the previous year. The average annualized ROA for the third quarter was 1.00 percent and the ROE was 11.8 percent.

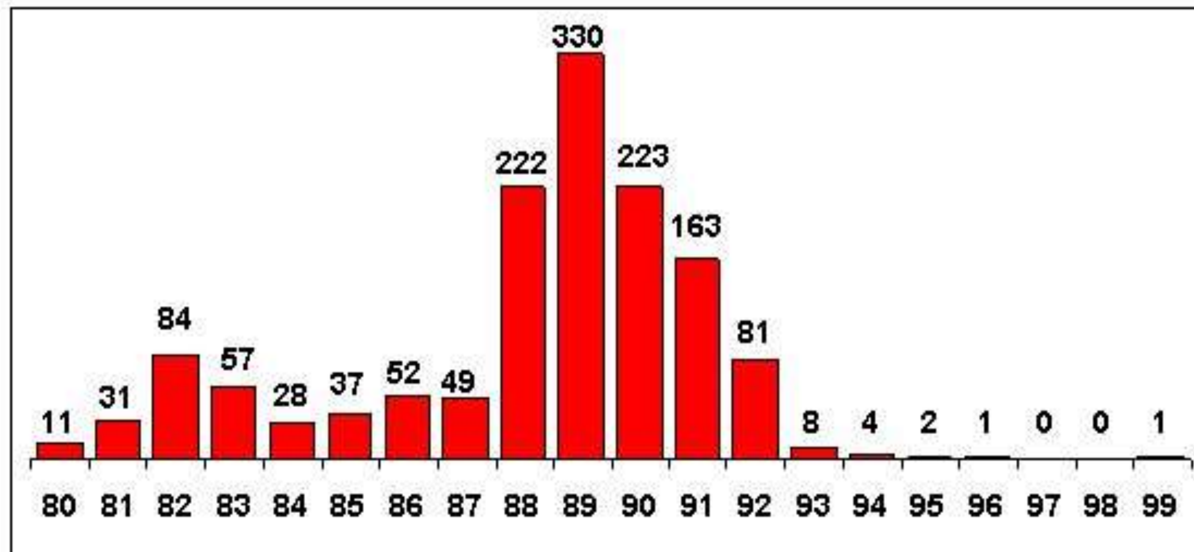
However, even in the best of times for the banking industry and for the economy as a whole, some individual financial institution failures are to be expected. Banks and savings institutions are in the business of managing risk, and not all will be successful. In fact, the very concept of risk implies occasional failures. While we want to minimize the effect of these failures on general economic activity, bank regulators have never striven for zero bank failures. We cannot eliminate all bank failures, however, we can seek to ensure that any problems that do occur do not become widespread and do not require taxpayer funds.

Reflecting the health of the banking industry and the economy in general, the number of bank and thrift failures in recent years has been very low by recent historical standards: eight in 1995, six in 1996, one in 1997, three in 1998, and eight in 1999. These failure rates were, of course, far smaller than those seen in the 1980s and early 1990s when the annual number of bank and thrift failures measured in the hundreds in some years. Current failure rates are more in line with those in earlier periods when the banking industry was generally healthy. In the period from 1946 to 1974, insured bank failures averaged slightly less than four per year. Below is a chart showing bank and thrift failures over the past twenty years.

BANK AND THRIFT FAILURES 1980-1999



Number of Failed Banks



Number of Failed Thrifts

Loss rates vary widely among bank failures, reflecting the particular characteristics of the individual institutions involved. For the most part, recent loss rates, defined as the loss to the deposit insurance fund as a percentage of the total assets of the failed bank, have been within the range experienced in earlier periods. Over the past 20 years, the average loss rate for the bank and thrift failures resolved by the FDIC has been 12 percent. For the eight bank and thrift failures that occurred in 1999, estimated losses to the FDIC are zero in two cases and less than 10 percent of assets in four other cases. On the other hand, for three failures -- two in 1999 and one in 1998 -- estimated loss rates are significantly above historical norms. The three institutions are BestBank in Boulder, Colorado (BestBank); First National Bank of Keystone in Keystone, West Virginia (Keystone); and Pacific Thrift and Loan Company in Woodland Hills, California (PTL).

Looking ahead, the FDIC prepares projections each quarter of the volume of assets in banks anticipated to fail. These projections are made on the basis of the most recent supervisory information, the results of financial and statistical models, and consideration of market trends. Estimating the timing and effect of a recession or severe financial turbulence on the FDIC's insurance losses is extraordinarily difficult. A severe downturn that causes a significant increase in banking losses is always possible, and we cannot rule out a future experience similar to the last recession. Moreover, recent bank failures underscore the potential for unanticipated, fraud-related losses to defy the statistical projections of the models. We cannot rule out the possibility that other significant fraud-related losses will occur. The FDIC staff continues to develop tools that may help us to better quantify fund exposure and to recognize early warning signals of potential high-loss scenarios, but predicting the future will always be difficult.

Based on the most recent information, and subject to the uncertainty described above, we project over the next two years a range of failed bank assets between $500 million and $2.5 billion for the Bank Insurance Fund (BIF), and a range of $200 million to $1.1 billion for the Savings Association Insurance Fund (SAIF). As stated above, over the past 20 years, the average loss rate for failures has been 12 percent.

It is important to note that these projections assume a continuation of current economic conditions. We are mindful that such conditions are unlikely to persist indefinitely. The U.S. economy has enjoyed a run of extraordinary prosperity driven in part by the absence of inflationary pressures and low interest rates supported by continued inflows of foreign capital to finance domestic business and household spending. Were this favorable confluence of events to reverse itself, the environment facing U.S. banks could rapidly become more challenging.

Recent Bank Failures

In addition to the failure of Best Bank in 1998, which is described in the Appendix, there have been four failures of FDIC-supervised, state non-member banks in 1999 and 2000.

Victory State Bank of Columbia, South Carolina, with total assets of $13.9 million, failed on March 26, 1999 after the FDIC appointed itself receiver under the statutory prompt corrective action provisions. The bank failed due to high operating expenses and weak underwriting. No loss to the Bank Insurance Fund is anticipated for Victory because of the premium received from the institution that assumed the deposits of the failing institution. Pacific Thrift and Loan Company of Woodland Hills, California, with total assets of $117.6 million, failed on November 19, 1999. The bank originated subprime loans for securitization and carried a substantial amount of retained interests as an asset on its books. As discussed in more detail in the Appendix to this statement, this asset is probably worthless because of losses and pre-payments on the underlying loans, with the result that a loss to the FDIC of approximately $50 million -- or roughly 40 percent of assets -- is projected. Golden City Commercial Bank, in New York City, with total assets of $89.3 million, failed on December 10, 1999 because of its unsafe and unsound condition. The bank and its CEO and founder were indicted on a variety of charges involving the use of apparently fraudulent loan applications and documents. We anticipate no loss to the fund from the failure of Golden City, again because of the premium received from the bank acquiring the failed institution. Most recently, Hartford-Carlisle Savings Bank of Carlisle, Iowa, with total assets of $113.8 million, failed on January 14, 2000. Hartford-Carlisle was declared insolvent after it was discovered that the CEO and controlling stockholder had apparently engaged in a scheme of extending nominee loans to obtain funds for personal use, including the purchase of stock in the bank. While we are currently evaluating the quality of the assets of the bank, we have estimated that the losses will be between $15 - $25 million or 10 to 20 percent of total assets of the bank.

As I stated earlier, the percentage and actual losses in three recent failures -- BestBank, Keystone, and PTL -- were unusually large. As discussed in the Appendix, these institutions exhibited some or all of the following characteristics: subprime lending and/or high loan-to-value lending without adequate prudential standards, apparent fraud, and/or large holdings of retained interests (sometimes referred to as

residuals) with questionable valuations. Since the FDIC is engaged in a number of litigation and enforcement actions, with more expected, our discussion is in general terms.

Lessons Learned and FDIC Initiatives

BestBank, Keystone and PTL each had particular characteristics that contributed to proportionately large losses to the deposit insurance fund. All three had concentrations of subprime loans. Fraud contributed significantly to losses in two cases, and residual interests in the other. The FDIC has learned a number of lessons from these failures which should help us mitigate similar losses in the future.

Subprime Lending

A common element in some recent failures was extensive activity in subprime lending. Subprime lending can be -- and indeed, has been -- an activity beneficial to borrowers with blemished or limited credit histories and can be an acceptable activity for insured institutions, provided that the institution has in place proper safeguards, including adequate capital to meet unanticipated losses. Most banks active in subprime lending appear, in fact, to have such safeguards. However, a minority does not. As abundantly borne out by recent failures, subprime lending without sufficient capital and other safeguards -- especially when coupled with fraudulent or questionable accounting practices -- can cause enormous losses for the FDIC.

Subprime lending can meet the credit needs of a broad spectrum of borrowers in a safe and sound manner if: (1) risks are effectively managed through proper underwriting standards and attention to servicing; (2) loans are priced on the basis of risk; (3) allowances for loan losses cover the credit losses embedded in the portfolios; and (4) capital levels reflect the additional risks inherent in this activity. Because these safeguards are not always maintained, a disproportionate number of institutions that engage in subprime lending are problem institutions. The FDIC estimates that approximately 140 insured institutions have significant exposures in the subprime lending business. These subprime lenders represent just over one percent of all insured institutions, yet they account for nearly 20 percent of all problem institutions -- those with CAMELS ratings of "4" or "5". Ninety-five percent of all insured institutions are rated CAMELS "1" or "2", while only 70 percent of the identified subprime lenders are so rated. While not necessarily the proximate cause of the failure, 6 of the 11 banks that have failed over the past 18 months had significant subprime lending portfolios.

In order to assure that subprime lending is backed by sufficient capital, the FDIC has developed a draft proposal that addresses four issues: (1) concentration of subprime risk; (2) definition of subprime lending; (3) exclusion of the many types of community lending and flexible lending programs from the subprime definition; and (4) level of capitalization for subprime portfolios. We presented the draft proposal to the other federal banking agencies on December 8, 1999, and the proposal is currently being discussed with the other agencies.

We believe that appropriate action can be taken with respect to the relatively few banks that operate with inadequate safeguards, and that action will not appreciably reduce the availability of credit to low- or moderate- income borrowers. Indeed, we believe that our efforts will strengthen the ability of prudently managed banks to serve the subprime market in the long run. After all, a bank that does not hold adequate capital in relation to the risks it takes is not a dependable, long-term source of such credit.

The FDIC's proposal to increase the capital requirement on concentrations of subprime loans recognizes that subprime lending is an activity that can be beneficial to borrowers with poor or limited credit histories and is an acceptable activity for insured institutions if that lending is carried out with appropriate safeguards. The proposal focuses only on banks that have significant concentrations of subprime loans or operate a subprime lending program, rather than attempting to address issues with individual loans. Under the proposal, banks that have significant subprime portfolios will be expected to manage them through a clearly defined, carefully planned, and properly controlled program that addresses the portfolio's inherent risks. A distinct line of business in the bank that involves a concentration of over 25 percent of Tier 1 capital in subprime lending will trigger the capitalization requirements of the proposal.

The proposal also offers a more explicit definition of subprime lending than currently exists in regulatory guidance. For purposes of the proposal, subprime lending includes separate lending programs that involve a significantly higher risk of default and higher interest rates or fees than traditional bank lending. The proposal would place the responsibility on the bank to identify and segregate its subprime portfolio and allows the supervisor to use the institution's grading criteria wherever possible. Although banks would be given flexibility to determine the status of their portfolio, underwriting that deviated from specified standards would have to be fully explained and justified. In the case of a bank making significant quantities of subprime loans outside a clearly defined program, the supervisor would normally conclude that the bank was simply making lower quality loans without appropriate controls. The bank would be rated and supervised accordingly.

The FDIC's proposed definition, however, also distinguishes subprime lending from the many forms of community development lending and flexible lending programs that have proven to be safe and sound, even while exhibiting atypical underwriting standards. Our intent to specifically exclude these types of loans is clearly stated in the proposal, and we are working with the other agencies to ensure that the final definition reflects that fact. Community development loans are excluded in the definition because the incremental risk associated with using non-traditional underwriting factors in these cases is typically mitigated by public or private credit enhancements. These enhancements include direct repayment guarantees through government and private programs, income or expense enhancements (such as guaranteed income, lease guarantees and tax credits), and collateral and equity cushions such as subordinated financing and secondary market programs. In addition, banks can mitigate risk through partnerships with community development organizations and agencies. These groups can provide applicant screening and referral services, assist in loan servicing, and provide ongoing homeownership, small business and small farm counseling services to borrowers.

In addition, the FDIC's subprime definition generally excludes loans to first time homebuyers, emerging small businesses or other first time borrowers, or loans based on the borrower's "character" as known to the bank through a long-time customer relationship. These exclusions

from the definition of subprime lending in the proposal recognize that there are types of loans that may have some of the characteristics of subprime lending but safely and soundly serve a significant public purpose in helping to meet community interests.

Finally, the FDIC's subprime proposal would require an institution to maintain additional capital only when subprime loans represent a significant concentration of the bank's capital, and only against those specific assets. Having identified a portfolio of subprime loans and established appropriate controls, an institution would be required to maintain sufficient capital to support the unusual risks undertaken in the process of generating potentially profitable, but highly variable income. The simple premise of the proposal is that an institution with a concentration of subprime loans should have sufficient capital to protect against unanticipated losses, and that the risk of loss is borne by the institution, rather than the deposit insurance fund.

Interestingly, nonbank subprime lenders generally hold capital significantly in excess of that generally required and held by FDIC-insured subprime lending specialists. Market forces dictate those higher capitalization levels. Investors in nonbank providers of subprime consumer loans have demanded a level of capital adequate to ensure the safety and profitability of their investment. In 1998, the common equity capital ratio for nonbank subprime consumer lenders was 22.5 percent as compared with 10.3 percent for banks engaged in similar activities. Yet despite the high levels of capital generally held by these nonbank subprime lenders, the riskiness of their business strategy is evidenced by the financial difficulties many have faced recently. Over the past two years, 13 of 51 publicly traded subprime lenders have declared bankruptcy. In addition, 9 were delisted from the stock exchange due to financial difficulties.

The FDIC has seen several applications of new banks that wish to engage in subprime lending as a significant line of business. New bank applicants have recognized the advantages of being able to conduct subprime lending business through an insured bank, which carries a cheaper cost of funds - with lower capital requirements - than is demanded for the same kind of business activity of nonbanks by the investment capital markets. That disparity creates an arbitrage opportunity that has resulted in a greater portion of subprime lending being undertaken in insured banks, transferring the risk from private investors to the deposit insurance funds.

The FDIC has attempted to craft a proposal that is flexible enough to permit subprime lending activities with appropriate controls, but without shifting the risk from the institution and its shareholders to the deposit insurance funds. At the same time, we have taken great care to avoid harming flexible lending programs, community lending or similar CRA-related loans. Because we recognize that crafting a standard for subprime lending is difficult, we have shared our proposal with our fellow regulators and asked for their assistance in this effort. We anticipate that the interagency participation and ultimately public comment on the proposal will produce a superior standard that will serve the public well.

The FDIC has already required that some individual banks under its supervision hold additional capital commensurate with their subprime lending exposures. The amount of capital expected of these banks has been determined on a case-by-case basis with the cooperation of bank management. Only a few banks have been required to raise additional capital, largely because many banks' capital levels already

exceed regulatory minimums. The FDIC also is requiring additional capital for newly formed banks or those undergoing a change of control that plan a subprime lending program.

In addition to our subprime proposal, the FDIC has:

1. spearheaded interagency efforts to issue guidance to the industry that provide risk management standards that should be present prior to engaging in subprime lending activities,

2. refined our off-site monitoring procedures to better identify which institutions have significant involvement in subprime lending activities, and

3. enhanced our examination procedures and training materials to assist examiners in their assessment of these institutions.

The FDIC also wants to add subprime lending information to the quarterly Commercial Bank Call Report and Thrift Financial Reports. The extent of subprime lending is difficult to track because there is no asset category for subprime lending on these quarterly reports. FDIC estimates of insured-institution involvement in this activity are derived from examination reports, but the quality of the information varies considerably and quickly becomes stale. A staff working group of the Federal Financial Institutions Examination Council has unanimously recommended that subprime-related line items be added to the banking agencies' quarterly reports beginning in March 2001. The FDIC strongly supports this recommendation.

Retained Interests

Retained interests generated from the securitization of high-risk assets (for example, subprime and high loan-to-value loans) pose significant valuation and liquidity concerns. If the valuations turn out to be overly optimistic or anticipated cash flows do not materialize, as we found in the failure of PTL, the safety and soundness of a bank or thrift may be threatened. This risk is particularly acute in institutions with excessive concentrations of these assets in relation to capital.

The valuation and liquidity problems stem from the very nature of the retained interest asset. In transactions involving the securitization and sale of subprime loans, the selling institution often retains the right to receive a portion of the cash flows expected from the loans, which is generally referred to as the retained interest. These retained interests are often pledged as credit enhancements that provide protection to the investors that acquire the securities resulting from the securitization of the subprime loans. Under these types of structures, the retained interest holder's right to receive cash flows is generally a deeply subordinated position relative to the rights of the other security holders.

Recent examinations have revealed that some institutions are not properly valuing the interests retained from the sale of assets. Under generally accepted accounting principles (GAAP), the fair value of these expected future cash flows are recorded on balance sheets as

assets in the form of interest-only strips receivable, spread accounts, or other retained interests. The best evidence of fair value is a quoted market price in an active market. In the absence of quoted market prices, accounting rules allow a fair value to be estimated. An estimate of fair value should be fully documented, based on reasonable and current assumptions, and regularly analyzed for any subsequent value impairment. The key assumptions in all valuation analyses include default rates, loss severity factors, prepayment or payment rates, and discount rates. If a best estimate of fair value is not practicable, the retained interest should be recorded at zero in financial and regulatory reports. However, even when initial internal valuations are reasonable, unforeseen market events that affect default, payment, and discount rates can dramatically change the fair value of the asset.

The banking agencies issued supervisory guidance concerning retained interests to banks on December 13, 1999. That guidance requires bank management, under the direction of its board of directors, to develop and implement policies that limit the type and amount of retained interests that may be booked as an asset and count toward equity capital. This interagency guidance also states that any securitization-related retained interest must be supported by objectively verifiable documentation of the interest's fair market value, utilizing reasonable, conservative valuation assumptions.

Given the valuation problems associated with the securitization of high-risk assets, the federal banking agencies are working on a proposal to limit the amount of retained interest that can be recognized when computing an institution's regulatory capital. In the interim, the agencies are reviewing affected institutions on a case-by-case basis and, in appropriate circumstances, may require institutions to hold additional capital commensurate with their risk exposure.

Fraud

Another element in some recent bank failures, including some of the most costly failures, has been apparently fraudulent activity by bank managers or directors. Fraud appears to have played a role in the failure of BestBank, Keystone, Golden City Commercial Bank and Hartford-Carlisle Savings Bank. From a supervisory standpoint, fraudulent activity is by its nature harder to detect than is conduct that is unsafe or unwise. Because fraud is both purposeful and harder to detect, it can -- and frequently does -- significantly raise the cost of a bank failure.

Recently, we have seen a few bankers try to recoup their personal losses -- resulting from the deteriorating condition of their bank -- through illegal activities. In other cases, the same internal weaknesses that lead to credit and other operating losses have provided opportunities for dishonest and illegal activities. Fraud is particularly difficult to detect when there is collusion among various parties in the bank or between bank management and outside servicing contractors. Such collusion subverts the internal controls that are established to mitigate the danger of fraud.

In this regard, outsourcing -- contracting with third party suppliers for certain services -- helped to conceal apparently fraudulent activities in the BestBank case, including misrepresentation of the true delinquency status of the credit-card portfolio. This resulted in a delay in the

detection and early resolution of growing credit problems. It took an on-site review of the records at the bank service provider, coupled with a full-scope examination of BestBank, to uncover these problems and allow bank examiners to identify significant losses in the subprime credit-card portfolio.

As a factor in bank failures, fraud is most noticeable during periods of general prosperity, such as the present period, when failures and losses accompanying business recessions are absent. An FDIC study of the 67 failures that occurred during the 1960-74 period of general prosperity concluded that 57 were caused by self-serving loans to bank management or friends of management, defalcations or embezzlement by bank personnel, and various fraudulent manipulations by bank officials.

On the other hand, fraud-related failures are a relatively small proportion of the total number of failures in periods of widespread banking problems when recession-related failures increase. A 1988 study by the Office of Comptroller of the Currency indicated that fraud was a significant contributing factor in only 11 percent of national bank failures in 1979-87.

There are three levels of protection against fraud -- bank management, external auditors, and examiners. Bank management is the first line of defense against fraud. Management has the responsibility of establishing internal controls to mitigate the danger of fraud. The banks' independent auditors have a responsibility to perform appropriate tests to verify the existence of assets and to determine if the bank has the appropriate controls in place to prevent fraud. In the BestBank and Keystone cases, the banks had received clean audit reports despite the existence of the apparently ongoing fraudulent conditions that contributed to the failures.

Bank examiners also have a role to play in the prevention and detection of fraud through their responsibility to assess a bank's internal control system. Examiners' assessment of the internal control system may indicate weaknesses that provide opportunities for fraud. Examiners also need to be alert to possible indications of fraud and undertake reasonable steps, which may include directly verifying the assets located in the bank or service company.

A recent memorandum to FDIC examiners reemphasized that they must investigate any information leading to suspicions of fraud. We stressed that examiners give these investigations the highest priority, using whatever resources necessary. Examiners are to contact our Regional Fraud Specialists if they suspect fraud. These specialists have access to a database of Suspicious Activities Reports and other resources that would aid in an investigation. In senior management meetings and in more formal communications, we have also emphasized that examinations require a thorough assessment of internal control systems, and have listed particular warning signs or "red flags" that indicate a heightened potential for fraud.

The FDIC has also found that reviewing external auditor's work papers can be helpful in determining the severity of a bank's problems. Therefore, the FDIC plans to issue guidance directing examiners when and how to review external audit work papers of banks with more

than $500 million in assets. The memorandum will also direct examiners to conduct such reviews in all troubled or problem banks with under $500 million in assets.

The FDIC recognizes the need for on-site review of unaffiliated service provider records with respect to services performed for insured depository institutions. The relevant records of such third-party service providers may be reviewed pursuant to authority contained in section 10(c) of the Federal Deposit Insurance Act, as well as section 7(c) of the Bank Service Company Act. Furthermore, the FDIC recognizes that institutions that have significant holdings of highly liquid securitizable loans that are held off-site by third parties present unique operational and internal-control risks. The FDIC has identified approximately 130 FDIC-insured institutions that currently have such highly liquid assets, retained interests, or operational and internal control weaknesses. Each FDIC region is pursuing supervisory strategies for each of these identified institutions so that the unique risks are properly assessed and any identified weaknesses are adequately resolved.

Risk-Related Premiums

The FDIC is continually assessing ways to ensure that the risk-based premium system is adequately addressing risks inherent in the banking industry. The FDIC recently has implemented risk-related premium enhancements to provide a more flexible, forward-looking pricing system that keeps pace with new and emerging risks. The enhancements are intended to identify institutions with atypically high risk profiles among those in the best-rated premium category, and to determine whether there are unresolved supervisory concerns regarding the risk-management practices of these institutions. Where such concerns are present, the institutions will be notified that they may pay higher premiums if the concerns are not adequately addressed prior to the next assessment period.

Much like institutions that failed in the 1980s, a review of institutions that experienced significant problems in 1998 and early 1999 revealed a number of common characteristics including: rapid growth (often centered in potentially risky, high-yielding lending areas), significant concentrations in high-risk assets, and recent changes in business activities. These potentially risky traits, when accompanied by inadequate management systems and controls, can lead to a deteriorating financial condition even when economic conditions are favorable.

For more than a year, the FDIC has worked with the other bank regulatory agencies to develop off-site screens to identify atypical institutions in the best-rated premium category with extreme combinations of these risk characteristics. Back-testing of the screens resulted in flagging a number of recent bank failures and near-failures that were not identified by other systems used to trigger reviews in connection with determining premiums. The FDIC has implemented the screens, along with procedures for reviewing the risk-management practices of flagged institutions, and will charge higher premiums if deficiencies are not corrected within a reasonable period of time.

The FDIC will work with the other bank regulatory agencies on an ongoing basis to modify the screens and procedures as necessary to ensure that new and emerging risks to the insurance funds are considered in the review process for assigning deposit insurance

premiums. An interagency group has been established to carry out this function and to ensure that premiums better reflect all relevant information from the supervisory process.

H.R. 3374, the Federal Deposit Insurance Corporation Examination Enhancement and Insurance Fund Protection Act

The FDIC appreciates the concerns of Chairman Leach in introducing H.R. 3374, and supports passage of this legislation. H.R. 3374 would give the Chairman of the FDIC, rather than the FDIC Board, the authority to authorize a special examination of an insured institution when such action is necessary to determine the condition of the institution for insurance purposes.

Congress granted the FDIC authority to perform special examinations in 1950. Over the years, the FDIC Board of Directors has adopted various policies governing special examinations. For example, in 1983 the Board authorized a Cooperative Examination Program, under which FDIC personnel automatically would be invited to participate in examinations of national banks currently rated CAMEL "4" or "5" and selected other banks. That policy was rescinded in 1993 when the FDIC Board adopted a policy wherein all recommendations for a concurrent or special examination were required to go to the Board for approval.

Under the current policy, which was adopted in 1995, the FDIC supervisory staff have been delegated the authority to request to participate in examinations of national banks, state member banks, or OTS-supervised thrifts. In the vast majority of cases, FDIC requests to participate in examination activities have been quickly honored at the regional staff level. If agreement on participation cannot be reached, the request for special examination authority is developed into a Board case and brought before the FDIC Board of Directors for their consideration and decision. In all cases since 1995, the agencies have reached an agreement while the Board case was being developed - in one case, agreement was not reached until immediately prior to Board consideration. Thus, the Board has not been asked to approve any cases under the existing policy. However, this process can result in delay.

While cooperation between the regulatory agencies has been generally quite good, in the case of Keystone, coordination between the Office of the Comptroller of the Currency and the FDIC was not optimal. There were some delays and interagency friction, although there is no reason to believe this had any effect on the ultimate outcome. While some regulatory tensions may be healthy and in any event, inevitable, both Comptroller Hawke and I have taken steps to improve the situation. Both of us have instituted procedures whereby we, and the entire FDIC Board, are immediately informed of these types of interagency disagreements. I am confident that future Keystone-type incidents will not occur on the watch of this present FDIC Board.

While I believe the new procedures we have implemented will be effective -- long-term, this issue has bedeviled the regulators. The policies and procedures regarding FDIC involvement have changed repeatedly over the decades. The matter has never been settled with

any finality. Adoption of H.R. 3374 would expedite the initiation of special examinations in those situations where they are most needed and would bring closure to this long-standing issue.

This statutory change also would be in keeping with the fact that the FDIC has responsibilities that go beyond its role as supervisor of state nonmember banks. The FDIC insures the deposits of all insured banks and thrifts, including those it does not directly supervise. As of September 30, 1999, the FDIC was the primary federal regulator for 5,773 banks and thrift institutions that represented 56 percent of the total number of FDIC-insured institutions. Yet, the total assets of institutions supervised by the FDIC represented only 19 percent of the total assets of all banks and thrifts insured by the FDIC. Thus, most of the risk to the deposit insurance funds comes from institutions the FDIC does not directly supervise.

The FDIC needs to be in a position to expeditiously examine institutions that pose higher risk profiles to the insurance funds and H.R. 3374 would accomplish this objective. Consistent with the FDIC's past practice, H.R. 3374 requires the FDIC to cooperate with other bank regulators in exercising its special examination authority and to minimize any disruptive or burdensome effects on the institution being examined.

The FDIC also strongly supports the information sharing provisions of H.R. 3374. Those provisions would require the FDIC to have access to information "in as prompt a manner as is practicable" and directs the federal banking agencies to establish procedures for providing the FDIC with such additional information as may be needed for insurance purposes. As noted earlier, the FDIC has responsibilities distinct from individual bank supervision including management of the insurance funds, least-cost resolution of failing institutions, and maximizing the value of failing banks' receivership assets, that require access to information.

The changing banking industry will challenge regulators to consistently improve coordination and cooperation to ensure effective supervision. H.R. 3374 will assist the FDIC in this effort. In particular, the FDIC, in its capacity as insurer, must be assured access to information necessary to assess risk to the insurance fund that may be inherent in an insured institution directly or through transactions with affiliates. H.R. 3374 facilitates FDIC access to additional information it might need for insurance purposes from other banking agencies. Increased cooperation in ensuring the timely exchange of information among all functional regulators will be increasingly important as the financial services industry evolves.

Looking to the future, the FDIC believes it will need to place increased emphasis in two areas. First, we believe the FDIC will need to find ways to incorporate the results of the risk evaluations being conducted internally by the largest banks in our evaluation of risks to the insurance funds. As these banks increase in size and complexity, evaluating the risks posed by these institutions, the correlation among such risks, and the adequacy of the deposit insurance funds, will increasingly require an understanding of these banks' own views of the risks they are facing. Examples of such information include results of the bank's stress testing analysis, the underlying assumptions of such analysis, the timeliness and quality of the bank's internal credit ratings, and information about the largest credit exposures.

Second, from the perspective of enhancing information flows, the FDIC will need to expand current agreements and understandings with the primary federal regulators about when FDIC contact with bank management, or a role in examinations, is appropriate. The FDIC believes that there are instances where the most cost-effective, timely, and practical approach for the FDIC to understand what may be a highly complex, or rapidly changing, situation involves some level of participation in examinations or attendance at meetings between the primary regulator and bank management. Where the bank's financial condition is rapidly deteriorating, and its failure may occur, such participation or attendance may be crucial to the FDIC's ability to efficiently manage the resolution of the bank, to protect depositors, and to maintain public confidence.

The FDIC does not envision the use of its special exam authority as duplicating the primary regulator's efforts, but as a way of rapidly gaining a firsthand understanding of significant risks facing the bank and the insurance fund or, where failure may occur, of information critical to the resolution. As a practical matter, such instances would be limited to the largest banks that make up the bulk of the FDIC's insurance risk, and some smaller banks with highly atypical or problematic risk profiles. The FDIC shares information on the resolution of particular banks with the primary regulator in order to enhance the ongoing exchange of information. The FDIC staff is exploring both of these areas with its counterparts at the other federal bank and thrift regulatory agencies.

Conclusion

The FDIC shares this Committee's concerns about the size of the losses in some recent bank failures that have occurred even in our current favorable economic environment. Although there will inevitably be failures in the banking industry, even in good times, our goal is to ensure stability in the banking system, protect depositors and minimize losses. We are carefully studying recent bank failures, identifying trends and initiating action where necessary. Our recent initiatives regarding subprime lending, retained interest valuation, fraud detection and risk-related premiums are key efforts to address important issues in the industry. These initiatives, along with the passage of H.R. 3374, will enable the FDIC and other bank regulators to proceed in a unified, coordinated effort to ensure the health of a rapidly changing banking industry.

APPENDIX

RECENT BANK FAILURES WITH EXCEPTIONALLY HIGH LOSSES TO THE

FDIC

As noted in the preceding statement, three insured institutions failed in 1998 and 1999 with unusually high losses to the FDIC. These were BestBank in Boulder, Colorado; First National Bank of Keystone in Keystone, West Virginia; and Pacific Thrift and Loan Company in Woodland Hills, California. This appendix describes the activities of these institutions that led to their failure and to the large losses

incurred by the FDIC. Each of these institutions exhibited some or all of the following characteristics: subprime lending, apparent fraud, and large holdings of retained interests.

BestBank

BestBank's activities were marked by apparent fraud, deceptive lending practices, and subprime lending without proper standards. As of November 1999, the FDIC had estimated losses from the failure that total $232 million on an asset base of $318 million, a 73 percent loss rate. When the FDIC was appointed receiver of the bank in July 1998, the vast majority of the bank's accounts were delinquent.

The principal assets of BestBank were credit-card receivables originated by Century Financial Group. Century and entities related to Century's principals performed all normal credit-card functions, from collection of all payments, customer service issues, collection on delinquent accounts, reporting, and calculation of payments due BestBank and Century from cardholder payments. Century specialized in marketing travel club memberships to people with low incomes, no credit history, or bad credit histories. The marketing was conducted by a Century related-entity, All Around Travel Club, referred to as AATC. AATC would offer individuals with no or poor credit histories an opportunity to obtain a BestBank Visa card with a $600 credit limit as part of the purchase of a travel club membership in the AATC. The cost of the travel club was $498, which was immediately charged to the BestBank Visa along with the $45 credit card annual fee for a total of $543, leaving the cardholder with only $57 of available credit. However, a person purchasing the travel membership received little of real value. The membership entitled the member to a discounted Bahamas cruise (the main enticement) operated by another related entity of the owners of Century, known as New SeaEscapes. However, the member had to provide his or her own travel arrangements to Florida for the trip. If the member wanted to take another person, full fare was charged. The $543 in travel club membership and other fees that were charged to the BestBank credit card were then split between BestBank, Century and their various related entities.

These subprime credit card receivables were extremely risky. Aggressive marketing techniques were used to issue cards to individuals with no or checkered credit histories. The FDIC has found that some of the cardholders were in nursing homes, and many other holders stated that they just received the card in the mail without requesting the card or hearing about the travel club. Once the cardholder discovered that he or she had purchased a travel club membership that had little value, the individual may have decided to try to cancel the credit card or may have decided not to make payments. The level of cancellations and delinquencies in the AATC credit card program were extremely high. BestBank entered into an agreement with Century wherein Century agreed to purchase all delinquent accounts from BestBank.

We believe that Century concealed delinquent accounts by apparently falsifying payment records, making delinquent accounts appear current. We suspect that Century used a portion of the proceeds that it received from new originations to make payments on delinquent accounts. As more and more accounts became delinquent, Century had to originate more new accounts to service the growing mountain of bad accounts, a classic Ponzi scheme.

The credit card portfolio grew at a rapid rate, particularly in the last months of the bank's existence, with thousands of new cardholders being enrolled in the program and an increasing number of improper credits being applied to the delinquent accounts. In fact, over 350,000 accounts, approximately 74 percent of the active AATC accounts, received these false credits in the last six months prior to the bank's closing in July 1998. As a result of the rapid growth in new cards and the apparent scheme to conceal delinquent accounts, BestBank carried in excess of $179 million in credit card receivables that were misstated and misrepresented as current by the improper credits posted by Century.

When the concealment of the delinquent accounts was discovered in mid-1998, regulators determined that Century did not have sufficient capital to perform on the guarantee and the bank was closed. Because the credit cards were unsecured, recoveries on the delinquent accounts were extremely small. Additionally, in view of the high delinquency rates and the possibility of fraud even in connection with the current accounts, the FDIC in 1999 decided to write off the remaining balance.

First National Bank of Keystone (Keystone)

Keystone exhibited apparent fraud, subprime and high loan-to-value lending without prudential standards, and large holdings of retained interests with questionable values. Keystone is projected to be the tenth-largest dollar loss in FDIC history. The current estimate is that the loss to the BIF will be between $750 million and $850 million, 70-80 percent of total assets.

The loss appears to stem from two different sources. The largest portion of the loss, approximately $500 million, seems to be due to improperly recorded assets that did not belong to Keystone, with the result that there may be few assets to recover. The FDIC is tracing the cash and investigating other entries on the bank's books in an attempt to increase its recoveries or determine the validity of assets.

The remainder of the Keystone loss is expected to stem from little or no recovery value in the $380 million in retained interests in subprime and high loan-to-value loans it had securitized. Subprime and high loan-to-value ratio loans usually have high interest rates relative to prime loans. When the loans are securitized, portions of the securities often have "credit enhancements." These are designed to reduce the risk to the purchaser of the security and lower the required interest rate on the security. For instance, if a pool of subprime loans has an interest rate of 12 percent and the credit-enhanced portion of the security has an 8 percent rate, there will be "excess interest" of 4 percent for that portion of the securitization. This excess interest is generally used to pay for servicing and other fees and to fund the credit enhancement reserve. Any leftover cash flow goes to the residual holder. During the life of the securitization, how much money actually accrues to the residual holder depends on the performance of the underlying loans. If there are low levels of defaults and pre-payments, the residual can have substantial value. If there are high default rates, particularly in the earlier years, and high levels of prepayments, the residual may be significantly reduced in value or become worthless.

Most securitizations by Keystone had two types of credit enhancements: a Federal Housing Administration insurance co-payment that would absorb up to 10 percent of losses of the entire securitization and private insurance that absorbed additional losses. If the default

rates were such that the private insurer began to absorb losses, the insurer was entitled to excess interest payments up to the amount of its loss. The FDIC has engaged an investment banking firm to value the retained interest; however, given the very large default rates and losses in the loans underlying the securitization, we expect the loss to be between $340 million and $370 million on the $380 million of retained interest.

Pacific Thrift and Loan (PTL)

Pacific Thrift and Loan, with $118 million in assets, exhibited the following characteristics: subprime lending and retained interest. PTL originated subprime first and second mortgages, sold those loans to its parent, and split the cash flow resulting from the securitization of the loans with its parent. PTL had on its books approximately $50 million in retained interest assets on which the FDIC estimates recoveries will be zero, yielding a total loss rate of approximately 40 percent.

PTL originated subprime loans and sold the loans to its parent who sold the loans to firms that subsequently securitized the loans. Inter-company agreements relating to securitizations determined the priority of claims of various participants on future cash flows and therefore the value of each participant's claim. The loans were expected to generate substantial interest payments over and above those needed to support the cash flows to the security holders. The firms that securitized the assets agreed to share a portion of the retained interest with PTL's parent, which in turn executed an agreement to share this interest with PTL. However, there was a problem for PTL with this arrangement. The retained interest asset on the books of PTL did not generate any payments in the early years of the securitization; thus PTL experienced trouble generating sufficient operating income to pay its expenses. In order to generate cash flow, PTL's parent borrowed up to 75 percent of the estimated value of the retained interest from the investment firms and passed the funds to PTL. The borrowings were to be repaid from the excess interest due to PTL and its parent. This arrangement reduced the likelihood that PTL would receive any interest.

To illustrate this transaction, imagine that PTL had estimated that its portion of the retained interest was worth $10 million and it had booked that amount as an asset. It received from its parent $7.5 million and reduced the retained interest asset to $2.5 million (25 percent of the original amount).

The value of the remaining 25 percent retained interest that had not been pledged against borrowings was extremely tenuous due to the fact that PTL stood sixth in line for any payments from the securitization. Payments went first to scheduled principal and interest, second to fund delinquencies and defaults, third for monthly fees and servicing, fourth to fund required reserve balances, fifth to payments on the borrowings of PTL against the advance on the retained interests loan and finally, if any payments remained, to PTL. If almost any loss or prepayment assumption used in the valuation of the retained interests turned out to be too optimistic, the institution's retained interest would probably be greatly reduced in value or become worthless.

From the records received from the servicer of the securitization, it appears that the pre-payments and losses in the underlying loans so exceed those assumed in the valuation of the retained interests that there is little or no chance of receiving any payments. In this regard, FASB 125 requires periodic revaluation, taking into account differences between actual and assumed performance. In the case of PTL, the approximately $50 million in retained interests the bank reported on its books are probably worthless.

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