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Statement on

Condition of the Banking System

and

Report of the General Accounting Office

Presented to

Committee on Banking, Housing and Urban Affairs
United States Senate

by

Robert E. Barnett, Chairman
Federal Deposit Insurance Corporation

March 11, 1977

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I am pleased that the Committee is holding this type of review of the condition of the banking system, and I hope that this will be a regular part of the Congressional oversight of the banking industry and the banking supervisory agencies. Regular routine disclosure and discussion of information concerning the banking industry is in the public interest.

General health of the banking industry; standards appropriate for judging its health.

Let me first state my belief that the banking industry is in reasonably sound condition, certainly in much better condition than it was during the past year or two. The statistical trends in the industry over the past year seem to reflect movements toward stability, increased capital ratios, better liquidity, declining loan losses (although they remained high in 1976) and higher earnings. Nonstatistical items, such as management experience, also have improved. The industry is in an appropriate position to recover from the remaining ill effects of the problems of the early 1970s.

This is a significant achievement if the developments of the past number of years are listed: Over the last 15 years, banks have chosen to operate in a riskier manner; At the same time, the U.S. and world economies have become riskier places in which to do business; Over the last 5 years or so, there have been some very unfavorable economic developments which had serious effects

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because of the riskier structure of the economic system; As a result of these unfortunate events, the greater risk in the economic environment and the greater risk inherent in their own financial structure and operations, the banking system underwent a severe shock; The banking system was hit hard by the confluence of these forces in the 1973-74 period, and this resulted in severe problems for a number of banks, including some large banks; Despite all of this, the banking industry and the financial system were basically sound and stable, and this enabled the industry to weather the storm. Let me go back and consider these points in order.

Over the last 10-15 years the banking system has become a riskier one as banks, particularly the larger banks, have operated in a more aggressive manner. Since the early 1960s, many banks, and particularly the large banks, abandoned their traditional conservatism and began to strive for more rapid growth of assets, deposits and net income. Large banks began pressing at the legal boundaries of allowable activities for banks. Beginning in the mid-1960s, national banks were allowed to expand their activities into fields which, to many observers, involved more than the traditional degree of risk for commercial banks. Whether such activities are inherently riskier, or riskier only in their newness to bank managers is a problem I must leave to others to resolve. Suffice it to say that at least in the short run, they are riskier. These included such activities as direct-lease financing, underwriting of

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revenue bonds, and expanded foreign operations. I am not suggesting that banks should not be in these activities. One could make the argument, I believe, that such increased riskiness is healthy, desirable for the nation's economy, and competitively responsible. Nevertheless, these activities are examples of the general trend toward increased aggressiveness and increased willingness to bear risk on the part of the banking system in general, and large banks in particular.

The bank holding company movement is another such development. It allowed banks to get into areas somewhat different from their traditional activities; again, not necessarily inappropriate, but activities at least generally perceived to involve a greater degree of risk.

Beginning at about the same time, larger banks began to advocate and practice the concept of liability management. This involved a change from the traditional balance sheet requirement of adequate liquidity of assets to a willingness to go into the money market and buy liquidity if needed, regardless of prevailing rates.

Most of the traditional financial measures of bank aggressiveness and riskiness show these trends. In 1960, for example, banks with deposits of between $5-10 million had an average loan-deposit ratio of 46 percent, whereas banks with deposits over $500 million had a loan-deposit ratio of 56 percent. Both size categories of banks showed significant increases in this ratio over the last 15

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years, but the increase has been more dramatic for the large banks. Their loan-deposit ratio at the end of 1974 was 79 percent as compared with 63 percent for the smaller banks. This came about as a result of a very large increase in the volume of business loans (including commercial real estate loans) in the early 1970s. In addition to the loan-deposit ratio, the capital-asset ratio showed the same trends. The capital-to-asset ratio of both size categories of banks was nearly the same in 1965, and averaged for all banks, about 8 percent. Since that time the small banks have maintained their capital ratio at about 8 1/2 percent, while the large banks' ratio has declined to under 7 percent, causing the average of all banks to drop to about 7 percent. While one can argue the merits of these or other ratios as measures of risk, for whatever they are worth, they do exhibit a change in traditional ratios of risk measurement, with a much greater change on the part of the larger banks than the smaller ones.

One of the areas in which large banks have moved with great vigor in recent years has been the international area. Approximately 140 American banks, or one percent by number of American banks, have foreign branches, compared with only 27 in 1968. These banks, while small in number, account for nearly half of total U. S. bank deposits, and the assets of their foreign operations amount to about 30 percent of their total assets. Part of this operation involved a much greater role for American banks in lending to foreign businesses

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and governments. Operation outside the country in which a corporation is originally established is not necessarily riskier than domestic operations. But for most American banks engaging in this activity during the 1960s and 1970s, it was at least a new venture, and new ventures are almost necessarily riskier than those in which one has built up a solid base of experience. Not surprisingly, a number of American banks have incurred losses in their foreign operations. Again, none of these losses have been sufficient by themselves to result in a bank failure, although the international operations of Franklin National Bank greatly added to its other problems.

Related to the move into new types of activities, and new geographical areas for banking activity, has been a change in orientation of American banks. Performance began to be a more important consideration, as did growth. Banks became more concerned about their immediate profit picture and the price of their stock. In several cases, banks took on activities, loans or commitments that seemed to have the promise of immediate profitability or favorable stock market reaction.

Part of this was associated, at least in the United States, with a new breed of banker -- younger and more aggressive. Not only did youth itself tend to make for more aggressiveness, but we began to see rising to positions of responsibility bankers who had not had direct personal banking experience during the depression of the 1930s. One can take that argument only so far, however, since some of the

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industry leaders during this period were individuals who were personally familiar with the depression.

It is generally acknowledged that the state of the world economy has become riskier in recent years. There are several forces at work here. The long-run world inflationary trend is one aspect of it. Another is the replacement of the system of relatively fixed exchange rates that has prevailed for most of the post-World War II period by a system of more-or-less freely fluctuating exchange rates. A world of fluctuating exchange rates is a riskier one in which to do business. In fact, the means by which business firms have minimized their exchange risks have been their utilization of banks to take on the exchange risks. On the domestic scene, over the last 20 years corporations have restructured their balance sheets on a rather massive scale, substituting debt for equity and increasing their leverage. Not only did the financial structure of the firms that banks lend to become riskier, but at the same time corporate profits were weak, so that the corporations have found themselves more dependent on external financing for both their long-term and short-term financing needs.

Once both the banking system and the economy arrived in this riskier position, the world was beset by an extraordinary combination of crises. First the world energy crisis precipitated by the OPEC Cartel -- the embargo and the huge increase in the price of oil. This produced a massive shift in the balance of payments of the U. S. and

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other countries requiring the financing of resulting deficits and reinvestment of the OPEC surpluses. One result was the serious threat to the status of multi-billion dollar oil tanker loans. Another was to generate questions about the economic outlook of less developed countries who were, in fact, the hardest hit by the increase in oil prices.

These developments, along with such developments as wide swings in commodity prices, not only helped produce inflation at a record rate, but led to a recession deeper than any downturn since the 1930s. The inflation and recession combined with what appears to be a peaking of another of the periodic cycles of real estate speculation in the U.S. to produce massive deterioration of the real estate market, generating huge loan losses. A separate crisis in municipal credit was triggered by New York City's near default. In the midst of all this, we had the failure of what had been the twentieth largest bank in the United States and many news stories about the regulatory agencies' list of problem banks.

One observer of the banking scene put it this way:

> "some time after 1965, the halcyon age apparently ended. Rising inflation was the harbinger, but certainly not the sole cause or symptom, of heightened economic instability. This was a period of collapse of the Bretton-Woods Agreement and disappearing anchovies, of social unrest in America and widespread drought abroad. An American president was shamed into resignation and traditional allies grew restive as former adversaries were embraced under the guise of detente. In addition, petroleum producers established a potentially disastrous precedent for other primary materials producers in effectively cartelizing the

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industry. In short, the period after 1965, and particularly after 1970, was one in which numerous seemingly unrelated shocks buffeted the economic system. Quite expectedly, the system lurched to and fro, while stabilization policy-makers sought to administer offsetting shocks."*

As a result of all of this, we saw 16 bank failures in 1976, the largest number in nearly 25 years, following closely the 13 the previous year. The number of banks on our problem list, which includes national banks and state member banks, as well as non-member banks, increased from 156 on January 1, 1974, to 349 on January 1, 1976. We usually expect the number of our problem banks to level off and decline after some time lag during the recovery period for the economy. The time lag was much greater in the case of the 1973-74 recession, and during 1976, the number of banks on the problem list actually increased, rising to 373 by early summer of 1976 and fluctuating around that number since that time. As of January 1, 1977, we had 379 banks on the problem list, and as of March 8, 1977, we had 384. It is significant, however, that the number of banks in our serious problem categories has declined substantially from a high of 128 in the spring of 1976 to 115 at the present time, and that the number of banks that were not on our problem list was always about 14,500 throughout this period. Similarly, although 16 insured banks failed, nearly 98 percent

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* Stuart Greenbaum, Professor of Finance, Northwestern University, "Economic Instability and Commercial Banking." Compendium of Major Issues in Bank Regulation, Senate Banking Committee, May 1975.

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of all deposits were immediately available because of successful purchase and assumption transactions, and over 98 percent were available in all cases within three days. As has been pointed out frequently in the past year, because of these successful purchase and assumption transactions, bank failures generally are no longer the disastrous events in a community that they once were. (See the FDIC 1976 Annual Report, a copy of which is attached hereto.)

With all that bad news as background, we can look at more recent developments with some optimism. Nineteen seventy-six was a good year for the banking system in terms of earnings and improvement in financial conditions. Bank liquidity positions improved dramatically with substantial increases in holdings of government securities (holdings were up $17 billion, following a $30 billion increase in 1975). While banks might have preferred that loan demand were stronger, we must recognize that lack of demand has led to an improvement of the liquidity position of the banking system. The liquidity position was also improved by the continued displacement of volatile money market sources of funds with stable savings type deposits. (Large CDs dropped by $19 billion and consumer savings-type deposits increased $58 billion.) The reduction in interest costs allowed an increase in earnings despite the relatively slack loan demand. The capital position of the banking industry also improved during 1976, as the growth rate of capital, through retention of earnings, was higher than the modest growth

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rate of loans. (Total capital accounts were up 8.5 percent and loans were up 5 percent.)

Bankers necessarily have learned something from their experiences of the last few years. Activities that were new to many of them in the 1960s are more familiar now that they have lived with them through bad times as well as good. Bankers' attitudes toward risk and appropriate loan policy have benefitted from this experience. The real estate developer with a great idea will sit down with a loan officer more experienced and more skeptical than a few years ago.

Bank loan problems still exist. Since a major element of problem loans for banks over the last few years has been real estate loans, loans that take a long time to work out, the volume of underperforming loans and classified loans is still high. (Complete figures are not available, but the ratio of classified loans to capital appears to be up slightly in 1976.) But net loan losses in 1976, while high, were less than the record levels of 1975. (Complete figures are not yet available, but the trend clearly is down.) All in all, it does seem fair to say that the banking system has turned the corner and its condition is improving. A key factor in its continuing recovery will be the cost of carrying problem assets until their disposition and whether the opportunity cost of missed investments will exceed or fall short of ultimate recovery values. Thus, although some banks are not yet clear of the serious financial problems that surfaced during the 1973-74 recession, the industry as

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a whole continues to experience steady improvement in both balance sheet liquidity and capital strength in early 1977. We might note that no bank has closed because of financial difficulties so far in 1977. By this date last year, we had seen four bank failures.

It is perhaps unfortunate that the initial disclosure of the numbers of banks on our problem list came at a time when the numbers were larger than they had been previously. Nevertheless, the periodic dissemination of such information is useful and appropriate public information. Confidential information concerning the condition of an individual bank that arises from the examination process should remain confidential. But aggregate information that relates to the health of the banking system as a whole is appropriately a part of the public record. It remains our intention to make such periodic disclosure of aggregate information from our problem list in regular forums such as periodic Congressional hearings on the condition of the banking industry.

Implicit in what I have said up to this point is that the Corporation believes that appropriate standards for judging the health of the banking industry include the following:

-- earnings
-- capital
-- loan losses
-- liquidity
-- management
-- number and size of banks on the problem list
-- classified assets
-- failed banks

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In addition, the Corporation refers to other standards that are more difficult to apply. For example, without question public confidence in the banking system is important to the health of the banking industry. To measure confidence is somewhat difficult, but we do see signs that public confidence in the system is present. There is no evidence that money is bypassing the banking system; deposits are growing rapidly. There were no major runs on banks during the past year even though there were a large number of bank failures, considerable publicity about banks in trouble, and intensive scrutiny by Congress and state legislators of banking structure, powers, and functions. All of this suggests that public confidence is high.

In addition, we believe that relatively free entry and intra-industry competition are appropriate standards for measuring the health of the banking industry. Again, this is difficult to measure statistically, but we do have some numbers that suggest that desirable markets are subject to competition from different institutions. For example, the Corporation approved 116 applications for Federal deposit insurance in 1976 for state-chartered nonmember banks. Likewise, 609 applications for new branches and 254 applications for limited branch facilities were approved, and 116 notifications of unmanned remote service facilities.

Finally, it is important to the health of the banking industry that a viable dual banking system operate. We think 1976 saw the continued aggressive participation in the banking industry by state

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legislators and supervisors, as well as Congress and the Federal supervisors. The dual banking system seems to have been viable during 1976, and that should contribute to the health of the industry.

There may be other standards which the Corporation applies which would be appropriate, but these seem to be the ones that are the most obvious.

The FDIC monitoring systems.

In my earlier statements on the improved condition of the banking industry, I mentioned the evidence of improvement in ratios of capital to assets for commercial and mutual savings banks, larger ratios of U. S. Government securities to total assets, increased earnings between 1975 and 1976, etc. Such measures were mentioned to highlight the recovery of banks generally from the pressures of the 1973-75 recession.

It is important to note that the FDIC has begun to use similar measures to determine the condition of the individual banks we supervise. In the development of our monitoring systems over the past few years, we have observed that in many instances, developing problems in individual banks were foreshadowed by a demonstration of a lack of ability on their part to keep up with their peers. In comparing banks with known serious problems with banks which we felt were in sound condition, our researchers noted that sometimes there were distinct differences in the size of certain ratios derived from the balance sheet and income statement. Differences, moreover, did not always develop overnight but

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sometimes over a period of years. Now this is not a revolutionary concept; our supervisory force has been utilizing balance sheet and income data for years to assist in the evaluation of banks. What is new is that, with the help of the computer, the Corporation has put the "early warning" analysis on a more formal basis.

Take for example, the various ratios of capital to assets we supplied the Committee. These are average ratios for insured non-member commercial banks. One series consists of average ratios for all such banks, another consists of average ratios for those particular banks which FDIC thinks warrant the designation "problem banks."

	June 1976	
	All	Problem
Equity capital to total deposits	8.7	6.3
Equity capital to total assets	7.8	5.7
Total capital to total assets	8.2	6.7
Total capital to risk assets	11.1	8.2
Total capital to total liabilities	8.9	7.2
Debt capital to total capital	5.2	14.2

For June 1976, every single average ratio of equity and total capital in problem banks is lower than the average for all insured commercial banks. The ratio of debt capital to total capital is significantly larger for problem banks than that for all banks.

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These ratios then become part of the criteria the FDIC uses in its monitoring system. We now flag for further analysis any bank that has a much lower capital ratio than that of other banks.

Similar research has been done on other ratios and, as a result, we flag any bank with a much higher ratio of loans to deposits than that of most other banks, a much higher ratio of operating expenses to operating earnings, an unusually large increase in amount of time deposits, etc. Once the outliers or mavericks have been flagged, the deviant ratios are reviewed over the past three years to see if a condition in some particular part of their operation has been developing. If there is a condition that our examiner force does not already know about, an examination is quickly scheduled. We have found no substitute for an on-site examination to determine the actual condition of the bank.

It has not been easy to gain the acceptance of these early warning systems by the examination force. The system itself has been generally usable for the past two or three years, but it is only during 1976 that a general acceptance of it has been achieved in the Corporation.

Specific standards about which comment has been requested.

The Committee has specifically requested comment about the Corporation's standards for determining capital adequacy, liquidity requirements, and management competence. Attached for reference

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are appropriate Corporation bulletins or memoranda which articulate our standards for those three areas. While it is difficult to summarize these statements, let me make a brief comment on each:

Capital Adequacy -- Attached are the sections from the Manual of Examination Policies dealing with capital and applications for deposit insurance, and a copy of a 11-6-73 speech by former Chairman Frank Wille on "Capital Adequacy", a speech which has received wide distribution and continues to be an important document on the subject.

It remains the position of the FDIC that capital adequacy must be measured for each bank individually since banks are sufficiently dissimilar as to the quality and nature of their assets, the relative competency of their managements, and the relative stability of the economic environment in which they operate. The only practicable generalization is that the capital of any given bank should be sufficient to support the volume, type, and nature of the business presently conducted, provide for the possibilities of loss inherent therein, and permit the bank to continue to meet the reasonable credit requirements of the area served. The monitoring system I have referred to above places capital in a framework with other measures and permits a more objective evaluation than has been possible before. Specific numerical standards for a capital ratio are avoided because, while they are a benchmark of industry practice and custom, they are a mere starting point in determining whether or not adequate capital protection is present. The components of the capital accounts are another factor

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to be considered. In the case of a new bank applying for deposit insurance, the FDIC has adopted a guideline which calls for that initial amount of capital which is estimated will be necessay to result in at least a 10 percent ratio of capital to assets three years after organization.

Liquidity -- Attached is a copy of a 7-22-76 memorandum to all regional directors (copies were furnished to examiners) which deals with new examination report pages on liquidity analysis. Also attached is a copy of the section from the Manual of Examination Policies dealing with liabilities and the draft of a proposed section on liquidity which is under staff consideration.

The liquidity needs of a bank are a result of that individual bank's mix of assets and liabilities and therefore requires an analysis of asset quality and structure, trend and distribution of liabilities, earnings trend and capital adequacy. Local and national economic conditions also have an impact. Management's ability to make asset selections consistent with anticipated and potential liquidity demands, while at the same time conducting affairs in a sound, profitable manner, is a major consideration in the evaluation of a bank's future prospects. Until recently the Corporation's examiners had evaluated the adequacy of a bank's liquidity provisions in a rather subjective manner, but in mid-1976 a quantitative analysis became a part of each examination and it is believed that benchmark ratios which can signal the need for further investigation will soon be determined. However, we believe that no one

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ratio can ever be considered a norm for all banks. The increased use of liability management concepts has led to a closer look at the credit side of the balance sheet, while at the same time not losing sight of the asset side. Any analysis of liquidity must necessarily be concerned with the structure, character and trend of deposits, seasonal fluctuations in deposits and loans; amount of primary and secondary reserves; quality and maturity of the loan portfolio; quality and maturity spacing of the securities portfolio; and the volume of secured liabilities. Consideration must be given the bank's borrowing record and its ability to borrow additional sums, to the adequacy of its capital, and to its earnings record, which impacts significantly on its ability to market additional capital. Each of these areas is normally reviewed during an examination and, combined, they reflect a bank's liquidity position and provide subjective evidence of bank management's attitude, practices, and policies for liquidity management.

Management Competence -- Attached are sections from the Manual of Examination Policies dealing with management and that part of the supervisory section where management is rated.

The quality of management is perhaps the single most important element in the successful operation of a bank. The board of directors is the source of all authority and responsibility and therefore a significant degree of our attention is focused on the ability and participation of the directors. The formulation of policies and procedures to assure adherence to such policies is a paramount function of the directors.

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Their characteristics should include knowledge of the duties and responsibilities of their office, a genuine interest in performing those duties and responsibilities to the best of their ability, the capability of recognizing and avoiding potential conflicts of interest, sound business judgment and experience, familiarity with the community the bank serves and economic conditions generally, and an independence in approach to problem solving and decision making. Personal integrity is fundamental. Many of the duties and restrictions on a bank director are specifically set by law.

It makes sense to repeat at this point the cliche that directors direct and managers manage. To have a viable, productive bank that serves the community well the board of directors must employ and retain active, day-to-day officers of competence and integrity. The competence of executive management is reflected in its general and technical ability, its experience and capacity and general attitude and character; by the general condition and performance of the bank; by the bank's attendance to the reasonable and legitimate credit needs of the community; and by its ability to meet reasonable competition.

Changes in examination, supervision and regulation during the year; comparison with old standards.

There have been many changes in examination, supervision and regulation during 1976. Permit me to limit this section to a

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discussion of those which seem to be the most significant for purposes of examination and supervision:

1. Examination priorities, frequency, and scope.
2. Liquidity analysis.
3. Relationship with bank Boards of Directors.
4. Enforcement actions.

For continuity, please refer to the previous section relating to Corporation definitions of standards relating to capital adequacy and liquidity.

Examination priorities, frequency and scope -- With respect to item 1, we have put into effect a policy delineated in General Memorandum #1, in which top priority is accorded the examination of banks with known supervisory or financial problems. Attached is a copy of that Memorandum. These banks will receive a full-scale examination at least once every 12 months.

For banks with no known supervisory or financial problems and which have assets of less than $100 million, a modified examination is permitted for alternate examinations provided the banks meet criteria indicating satisfactory management, adequate capital, acceptable fidelity coverage, suitable earnings, and adequate internal routine and controls. Banks which appear as exceptions on the FDIC's monitoring program and which are not already known to have supervisory or financial problems would, of course, not be candidates for a modified examination. The modified examination emphasizes management policy and performance;

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the evaluation of asset quality, distribution and liquidity; capital adequacy; and compliance with laws and regulations.

Banks with assets of $100 million or more that do not present supervisory or financial problems will continue to receive a full-scale examination during each 18-month period. But the examination is designed to make full use of the bank's own reporting capabilities and generally is tailored now to the size and the complexity of the bank more than was the case before.

Focusing the examiner's attention on particular banks and modifying the scope and techniques are the culmination of a gradual change from former standards geared toward examining all banks at similar intervals and in a similar manner.

I earlier mentioned our increased use of monitoring or "early warning" systems. To emphasize our commitment to this approach, we added to our regional offices in 1976 the manpower which permits our regional directors to assign specific personnel to monitor the output of that system.

Liquidity analysis -- In the past, while examiners were charged with comparisons of the maturities and interest rates of various asset and liability categories, the FDIC had no firmly established procedures or criteria for the measurement of liquidity. However, the liquidity problems of 1973-1975 prompted development and implementation in July 1976 of a 3-part procedure which we believe will be of significant

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value in the advance detection of liquidity problems and the marshalling of corrective efforts.

The first schedule of the liquidity analysis is essentially a ratio of net liquid assets to net current liabilities and is computed at each regular examination. As a guide to examiners and pending further experience, a 20 percent "benchmark" ratio was established. When the ratio falls below the benchmark, further analysis using a cash flow projection schedule is required. When a negative cash flow is projected using this second schedule, or if the examiner considers the total available funds to be insufficient, further evaluation and review with bank management is necessary, and a series of questions is provided in the corrective measures (third) schedule as a guide for the examiner in seeking corrective actions by bank management for indicated liquidity problems. Although FDIC does not prescribe any number or ratio as a standard, the new procedures for liquidity analysis are more formal. Copies of all schedules are attached.

Relationship with bank boards of directors -- The FDIC is stepping up the frequency of meetings of examiners with boards of directors, and is pursuing other courses aimed at making directors more aware of their responsibilities with respect to the operations of the bank. For example, the FDIC has adopted a regulation under which the board of directors of each bank is required to review and vote on every insider transaction involving assets having a fair market value greater than a specified amount, that amount varying with the size

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of the bank. Although examiners have continually devoted attention to insider transactions, this new regulation tends to standardize the procedures to be followed.

Formal enforcement actions -- Over the last few years, the Corporation has moved to more frequent initiation of formal actions, generally cease-and-desist orders issued pursuant to Section 8(b) of the FDI Act. There were 41 cease-and-desist proceedings initiated in 1976, compared with 8 in 1975 and only 7 as recently as 1971. This change of policy reflects a shift from reliance on persuasion to reliance both on persuasion and on formalized efforts toward correction where necessary.

Comments on the GAO report.

Attached for the Committee's analysis is a detailed critique prepared by the FDIC staff in response to specific items covered by the GAO report. My comments will be more general than that critique.

To begin with, I would like to point out that in comparing the supervisory procedures of the three Federal bank regulatory agencies, it must be borne in mind that the day-to-day relationship which the FDIC has with state banking supervisors is extremely important in our supervisory effort. Unlike the Comptroller of the Currency, but like the Federal Reserve Board, we supervise banks who are operating under 54 state and territory laws, as well as the Federal

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Deposit Insurance Act. Those banks are chartered by 54 different state and territorial supervisory authorities and the manner of supervising those banks at the Federal level differs as a result from state to state. It is also important to realize that the FDIC is the sole Federal regulator for the entire mutual savings bank industry, a $100 billion industry. While we appreciate that the GAO report is directed only to commercial banks, it is essential to take into account the FDIC's activities with respect to the mutual savings bank industry in order to understand its supervisory effort.

As to flexibility in examination techniques, we wholeheartedly concur with the GAO in the need for such flexibility. As a result of a continuing study going back a number of years, we amended in early November of 1976 the basic memorandum which governs our examination policy. This amended General Memorandum No. 1, which I mentioned earlier in this testimony, is quite consistent with the thrust of the GAO report and we believe that a full discussion of it should have been included in that report. We like to think that the philosophy outlined in this memorandum, which we have tested during the past few years by experimenting in different FDIC regions, is the best philosophy for the FDIC to pursue in the examination of nonmember banks. Since it is so central to our operations, and since it is a relatively new statement of a flexible examination policy, we would have liked to have had the benefit of the GAO's in-depth comments about it.

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We also agree, as the report recommends, that more administrative enforcement proceedings should be undertaken in the supervisory process by the Federal regulators. We have attempted to pursue that policy, particularly since late spring and early summer of 1976, and have requested from the Congress additional supervisory powers.

In this connection, the GAO report notes the large number of violations of law found during a typical examination. We were pleased, however, to note that the GAO pointed out that some of the laws and regulations are complex and that some of the violations were of a technical nature that would in no way affect the soundness of a bank. It is the experience of our Division of Bank Supervision that the major portion of violations of laws set forth in reports of examination does not affect the soundness and safety of a bank. All violations of laws or regulations are a matter of concern, of course, but it is the particular responsibility of the bank regulator to consider each violation in terms of whether it was intentional or willful, the consequences flowing from it, the likelihood of continued violation, and other similar matters, and then to take the appropriate corrective action.

The report implicitly suggests that FDIC examiners should be criticizing loan policies before bad loans are made. We certainly agree that a closer review of loan policies is important, and criticism of such policies in advance of their implementation should be made where the written policies will obviously lead to an unsafe or unsound condition for the bank or to violations of law. Most written loan

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policies will be written in such a way, however, that a reasonable examiner will find it difficult to find something significant in them to criticize. We believe that the written policies themselves are not the problem -- it is rather the implementation of these policies.

The GAO also recommends that the Federal bank regulatory agencies develop greater uniformity and cooperation with respect to:

a. Standards of examination procedures.

b. Uniform classification of shared National credits.

c. Uniformity in approach to monitoring and examining for compliance with consumer credit laws.

d. Uniform criteria for identifying problem banks.

e. Uniform examiner training.

In some of these areas we have already achieved uniformity with the other Federal agencies or are in the process of working out details with a goal of achieving uniformity.

We are now participating in the program initiated by the Office of the Comptroller of the Currency for the review of shared national credits. Although the number of such credits found in banks which we supervise is relatively small, we have directed our examiners to apply the classifications arrived at by the interagency examining team for all banks we examine which share such credits. This constitutes a significant step in interagency cooperation in the examination process. We are developing plans to enlarge on this concept

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by providing for joint interagency review of shared national credits in which a state nonmember bank is the lead bank.

With respect to examiner training, we have reached tentative agreement with both the Comptroller's Office and the Federal Reserve to explore the feasiblity of a joint training center for examiners. The FDIC has outgrown its training center because of an increase in the number of examiners and an increase in the curriculum required for each examiner. It seems a propitious time to discuss a joint facility, and to that end I sent letters to both Chairman Burns and Comptroller Bloom inviting them to join us in the development of a joint facility. Both responded favorably to the idea and our staffs are now at work on the idea.

In a more advanced stage are plans for an interagency consolidation of consumer protection schools. Although not finally approved, plans are being formulated to hold the first session this June at the present FDIC Training Center in Rosslyn, Virginia. Examiners and other personnel involved in bank supervision from the FDIC, the Office of the Comptroller of the Currency, and the Federal Reserve System would participate and instructors would likewise be drawn from the three participating agencies. Included in the curriculum would be Truth in Lending, anti-discrimination laws and the Real Estate Settlement Procedures Act. In addition, training will be provided in the areas of consumer complaint procedures and consumer education. This effort, although not

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representing a complete consolidation of existing consumer regulation training, is an experimental step which may lead to eventual consolidation.

In order to promote coordination and to provide a vehicle for the interchange of ideas and policies, the Interagency Coordinating Committee has established a top level staff subcommittee made up of the senior examination staff officials of the FDIC, the Comptroller's Office, the Federal Reserve, and the Federal Home Loan Bank Board to coordinate matters relating to bank examination and supervision. The function of this Committee, which will meet on a continuing, periodic basis, is to provide a clearinghouse for ideas, policies and procedures in the area of examination and supervision.

Uniformity may not always be practical, or serve the best interests of the public. Some divergence among the agencies in their approaches to problems may result in innovations which may later be adopted by the other agencies. This is especially true in newly emerging areas of regulatory concern such as consumer legislation, EFTS and bank securities regulation. This divergence is beneficial and is assisted by a commitment from all the agencies to review their own procedures and to adopt alternative approaches which other agencies have found to be successful in solving problems effectively and efficiently. The Interagency Coordinating Subcommittee, referred to previously, evidences our commitment to this principle.

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The need to develop common criteria for determining problem banks, for example, is not obvious and may not be appropriate. Our experience is that the accurate designation of a problem bank does not lend itself to the application of simple mechanical formulas that can be universally applied. While we do apply certain screening devices as initial tests, we believe the actual designation of a bank as a problem should only be imposed on a case-by-case basis after a comprehensive, in-depth analysis of the entire bank. We also believe it is appropriate for the FDIC, as insurer, to view what constitutes a problem situation from a somewhat different perspective than the other two Federal regulatory agencies, namely from the standpoint of undue risk to the insurance fund.

The differences in perspective and responsibility make uniform criteria for designation of problem status impractical; the division of supervisory authority over various classes of banks makes uniform criteria unnecessary. The fact that the Corporation places a national or state member bank on its problem list generally results in no different supervisory attention accorded that bank by its respective supervisor -- in almost all cases that bank is already a matter of supervisory concern to the appropriate agency. It does not, except in the most unusual and severe cases, result in FDIC examiners examining the bank or imposing any conflicting supervisory directions on the bank. While some have suggested that the Corporation should use its statutory authority to examine national and state member banks,

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the legislative history of the FDI Act makes it quite clear that such authority was granted the Corporation only if it were to be used exceedingly sparingly. The fact that the FDIC might have some what different banks on its problem list than the Comptroller or the Federal Reserve does not, then, confuse the bankers or the public and lead them to believe that their bank may be a problem to one Federal agency but not to another.

Undoubtedly, there is merit to the proposition that problems common to the three agencies should be resolved through closer coordination and cooperation. There is, as I have pointed out, a substantial flow of information between and coordination among the agencies at the present time. If, however, there is any merit to the concept of separate Federal supervisory agencies, and to a dual banking system with state and Federal supervision of banks, among those benefits would seem to be the opportunity to try different approaches and to have a diversity of examination and supervisory procedures, thereby enhancing the possibility of useful innovation and improvement in bank examination and supervision.

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