TESTIMONY OF

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ON

THE CONDITION OF THE BANK INSURANCE SYSTEM

BEFORE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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Mr. Chairman and members of the Committee, I appreciate the opportunity to testify today on the condition of the deposit insurance system. Our testimony focuses primarily on the bank insurance system. In your letter of invitation to today's hearing, Mr. Chairman, you asked that the FDIC address several specific questions. I intend to do so shortly. First, however, I would like to address a matter of some concern to us at the FDIC.

Recently, there have been assertions that regulators are holding back in acting on troubled banks until after the elections. This is simply not the case. In fact, the FDIC has resolved institutions with over $5 billion in assets in October alone. The fewer than expected closures of banks thus far in 1992 have been due to low interest rates and the ability of some troubled banks to improve their financial condition.

As we testified before this Committee last June and have documented in our publication <u>The FDIC Quarterly Banking Profile</u>, low interest rates resulted in record earnings for the banking industry in the first two quarters of 1992. In order to build capital, banks have retained a larger share of those earnings than in the past. In addition, many banks have attracted new capital from the markets. In fact, the prospect of sustained higher earnings, the trend toward consolidation, and incentives in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) resulted in a $16.7 billion increase in the total equity capital of commercial banks in the first half of 1992. This is over twice as much as the equity capital raised during the same period of 1991. The banking industry's average equity capital-to-assets ratio now stands at 7.23 percent, the highest level since 1966.

This is not to say that the banking industry's problems are behind us. It must be noted that the number and assets of failed banks are and will remain for some time at or near historically high levels. For many banks, the low rates have merely provided a temporary reprieve. Large inventories of troubled loans, particularly real estate loans, remain on the books of these institutions. Even if interest rates remain low, these difficulties are likely to result eventually in a number of additional failures. Low interest rates may cure some of the potential failures, but many of them will not be cured. Moreover, if rates turn upward, the rate of failures could accelerate significantly.

Will there be a "December surprise"? It will not be a "December surprise," but a December dictate directed by the FDICIA. Beginning on December 19, 1992, FDICIA dictates that institutions with below two percent capital must be dealt with severely, including closing those institutions as well as others that are not viable. The FDIC plans to use these new powers precisely as we understand the statute intended.

The point is, the regulators have not been reining in their bank closure activities. The reduced level of bank failures has been due primarily to low interest rates and the ability of certain weak banks to improve their financial condition.

Bank Closings in 1992

Although the FDIC has resolved fewer failed banks in 1992 than anticipated before the decrease in interest rates, the FDIC has been far from idle during 1992. The FDIC has resolved a large number of failed banks. As of the week of October 16, 85 banks with total assets of approximately $29 billion have been resolved in 1992, an extremely high number by historical standards. The FDIC currently believes that between 100 and 120 banks with approximately $37 billion in assets will fail for all of calendar year 1992. The cost of resolutions in 1992 is expected to be between $4 to $5 billion, which compares with 1992 assessment revenue of $5.8 billion.

Recent resolutions include aggressive, innovative efforts by the FDIC to reduce the costs to the Bank Insurance Fund. For example, assisted acquisitions of the failed First Constitution Bank in Connecticut and the failed Howard Savings Bank in New Jersey were arranged before the banks' book capital was totally depleted or franchise values had substantially deteriorated. The transactions included loss-sharing provisions between the FDIC and the acquiring banks that were designed to give the acquirers incentives to reduce losses on troubled loans.

The FDIC has been busy implementing and preparing to implement the many provisions of FDICIA. One aspect of FDICIA that recently has been the focus of considerable interest regarding the number of failures over the near term is the effect of the prompt corrective action provisions (§131) and other powers (§133), which go into effect on December 19, 1992. We do not believe that these provisions will of themselves cause a significant increase in the number of bank failures. Undoubtedly, the new law will accelerate the closing dates for some institutions. However, the statute provides that banks that are viable and have realistic short-term plans to recapitalize will be allowed to do so.

FDICIA's prompt corrective action provisions set forth specific capital categories, which FDICIA requires to become effective on December 19, 1992. The FDIC's regulations apply primarily to FDIC-supervised state-chartered banks and FDIC-supervised U.S. branches of foreign banks. The Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision have adopted parallel rules for the institutions they supervise. Portions of the FDIC rule also apply to all insured depository institutions that are deemed to be "critically undercapitalized."

The five capital categories defined in the statute and regulations are: well capitalized; adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized. The categories are based primarily on combinations of several measures of capital. The existence of certain supervisory orders and a bank's CAMEL rating are additional factors. In addition, the "downgrading" of institutions in an unsafe or unsound condition or engaging in unsafe or unsound practices may occur.

Preliminary estimates of the number of institutions that will be in each category for BIF-insured institutions, based on the latest publicly available Call Report data, dated June 30, 1992, and not adjusted for supervisory "downgrades," are as follows:

Category	Institutions	Assets (bil)
Well capitalized	11,237 (93.0%)	$2,375.9 (64.9%)
Adequately capitalized	553 (4.6%)	1,186.5 (32.4%)
Undercapitalized	148 (1.2%)	52.3 (1.4%)
Significantly undercapitalized	55 (0.5%)	20.8 (0.6%)
Critically undercapitalized[1]	60 (0.5%)	25.3 (0.7%)

The total number of institutions in the three under-capitalized categories is 263. It is interesting to note that if Call Report data from just six months earlier--year-end 1991--are

1 Of these, 14 banks, with $6.7 billion in assets, were closed between June 30 and October 16, 1992.

examined, the number of institutions falling in the three undercapitalized categories was substantially higher, 432. The drop in the number of institutions in the undercapitalized categories reinforces a point made earlier--relative capital levels in the banking industry have improved. Thus, one of the intended results of FDICIA may be coming about: a stronger, better capitalized banking industry.

As the table above shows, as of June 30, 60 banks with $25 billion in assets met the numerical requirements for critically undercapitalized institutions. It is important to note that these numbers will change between June 30 and December 19. Many factors -- sales of assets or infusions of additional capital, for example -- can change a bank's capital ratio and consequently, its capital category. Some of the critically undercapitalized institutions, and we cannot yet know how many, will be recapitalized during the next few months. Other banks will be downgraded because the June 30 numbers do not reflect downgrades by the regulators based on CAMEL ratings, supervisory orders, or unsafe or unsound practices. Of the 60 critically undercapitalized banks, 14 banks, with $6.7 billion in assets, already have been closed since June 30. For those added or remaining banks that are not viable and that cannot be recapitalized, the December date will cause them to fail sooner than they would under current rules.

<u>Implementation of the Prompt Corrective Action Rule</u>

In September 1992, the federal bank regulatory agencies approved final rules implementing the prompt corrective action provisions of FDICIA which become effective on December 19, 1992, as required by the statute. The FDIC is working closely with the other banking regulators to implement these complex provisions so that policies and procedures are in place before the effective date to ensure an orderly process.

The FDIC currently is notifying undercapitalized FDIC-supervised institutions prior to December of their initial capital category and of the requirements and restrictions under the statute. The FDIC will request that the undercapitalized, significantly undercapitalized or critically undercapitalized institutions supervised by the FDIC file a written capital restoration plan with the FDIC within 45 days of the effective date of the rule.

If any institution believes that the capital category to which it has been assigned is incorrect, it will be urged to notify the FDIC as soon as possible. Institutions will have an opportunity to inform the FDIC of any events, such as a recent stock sale that may have occurred since the filing of their Call Report, which would place them in another capital category.

The FDIC also is working closely with the other agencies to ensure that a notification letter is provided to all critically undercapitalized institutions for which the FDIC is not the primary regulator, including a description of the institutions' responsibilities for notifying the FDIC of certain actions. Under FDICIA, any critically undercapitalized insured depository institution is prohibited from taking certain actions without the FDIC's prior written approval, such as paying excessive compensation or bonuses, entering into any material transaction other than in the usual course of business, or making any material change in accounting methods.

Other steps being taken to implement the prompt corrective action provisions prior to December include the issuance of guidance to field examiners and regional supervisory staff. The new supervisory powers also are being discussed with our senior managers at a series of meetings.

We are consulting with the primary federal and state regulators to determine viability of critically undercapitalized institutions on a case-by-case basis prior to December 19. It is still too soon to say how many of the 60 banks that reported tangible equity capital of two percent or less -- and which have not already closed -- will be closed or placed in conservatorship in the first weeks after December 19. We expect there will be some that qualify and those will be handled in an orderly progression.

The FDIC also is taking steps to implement section 133 of FDICIA which expands the grounds for appointment of a receiver and also becomes effective on December 19, 1992. Prior to December 19, the FDIC cannot appoint itself receiver or conservator and the authority to close an insured depository institution rests solely with the chartering authority. Section 133 of FDICIA, among other things, grants the FDIC the authority to appoint itself receiver or conservator in certain situations and where there is a risk of loss to the insurance fund.

Under the prompt corrective action provisions, the primary federal banking agency can appoint the FDIC as receiver when an institution becomes critically undercapitalized. In fact, the agency needs the concurrence of the FDIC if that agency does not do so within 90 days. Section 133 of FDICIA also expands the grounds for appointment of a receiver or conservator by the primary federal regulator. As a result, a troubled institution conceivably could meet one or more of these grounds, even though its tangible equity is greater than two percent. Because the premature closure of an otherwise viable institution would not be in accordance with the purpose of the least cost test of FDICIA, the regulators must make a determination of viability on a case-by-case basis.

The FDIC is in the process of identifying the group of institutions with tangible equity capital greater than two percent that nevertheless meet one or more grounds for appointment of a conservator or receiver under section 133 and are not considered viable. The FDIC will consult with the primary federal and state regulators before making final determinations. Our legal staff is drafting the documents necessary to invoke each of these powers. We also are formulating guidance for senior supervisory officials for implementation of the powers.

We will not use either prompt corrective action or section 133 to close institutions that are viable or that have a short-term plan with a high probability of success. Prompt corrective action allows the regulatory agency to resolve institutions that are not viable and that otherwise would fail at a later date.

Future Bank Closings

Projecting bank failures with any precision is an extremely difficult task. As the time horizon of the projection increases from weeks to months to years, the reliability of the results rapidly declines. Interest rates, real estate markets, and the general condition of the economy all are factors in the number of failures. Attached to my testimony as Attachment 1 is a table comparing projections by various authorities (and individual economists), including the FDIC itself, of losses to the Bank Insurance Fund from bank failures. The disparities in the projections--the forecasted negative impacts to the BIF range from an optimistic $15 billion to a pessimistic $95 billion--underscore the uncertainties in the forecasting business.

For 1993, our current thinking is that approximately 100 to 125 banks will fail. On September 15, 1992, the FDIC adopted, as required by FDICIA, a 15-year recapitalization schedule for the Bank Insurance Fund. Estimates for failed bank assets are $76 billion for 1993 and approximately $268 billion for the entire period 1992-1996. We see no reason at this time to change these estimates, but we plan to revisit them as events unfold.

Applying a 17 percent cost ratio to the $76 billion in failed bank assets mentioned above, the cost of failures in 1993 is expected to be approximately $13 billion. As mentioned earlier, failures this year are expected to cost no more than $5 billion. The bulk of the costs associated with these failures have already been reserved for by the FDIC.

In forecasting the cost to the Bank Insurance Fund of failures expected over the near term, the FDIC incorporated in the BIF recapitalization schedule a 17 percent resolution cost-to-assets ratio for failed institutions. The 17 percent ratio was based on 1986-1990 data and may prove to be overly cautious. The very preliminary resolution cost-to-assets estimate for failed banks in 1991 is approximately 11 percent.

As a general matter, the FDICIA prompt corrective action and other early resolution provisions scheduled to go into effect at year-end should result in troubled banks being resolved at less cost to the deposit insurance system. The recent early resolutions of First Constitution Bank and Howard Savings Bank are examples of the FDIC's commitment to pursue cost-saving bank resolution strategies. Consequently, the costs of bank failures over time should be reduced.

Future Condition of the Deposit Insurance System

Finally, as for the future condition of the deposit insurance system, it will depend in large measure on the future health of the banking industry. The future health of the industry will in turn be affected by the extent of improvement in real estate markets, by the movement of interest rates, and in general by the degree of growth in the nation's economy.

Banks still have significant exposure to real estate markets. Recovery appears to be underway in some regions of the country, but significant problems remain. High vacancy rates for commercial office space indicate that there is considerable excess capacity to be eliminated before much new construction will be undertaken. Moreover, the real estate problems in parts of California appear to have a long way to go before improvement is seen.

Regarding interest rates, the steep yield curve produced by the much sharper drop in short-term rates than in long-term rates--coupled with the general move toward higher quality assets--has led many banks to fund longer-term investment securities, such as Treasury bonds, with shorter-term deposits. The number of banks holding concentrations in longer-term investment securities is increasing. As of June 30, 1992, over 1,200 banks had invested at least 20 percent of their assets in investment securities with maturities of five or more years. In aggregate, these banks hold more than nine percent of the industry's assets. A rise in rates generally would devalue these portfolios of debt securities. If short-term rates rose faster than long-term rates, net interest margins would be detrimentally affected.

In addition, banks have increased their off-balance-sheet activities and their investments in highly sophisticated derivative products, such as collateralized mortgage obligations, in recent years. It is important that banks understand the risks of these instruments as certain of the risks become more apparent during periods of changing interest rates. We also are concerned about the impact of changing interest rates on the value of purchased and excess mortgage servicing rights which represent a significant asset category for some banks and especially for thrifts. Finally, a rise in rates could negatively impact the economic recovery, causing problems among bank borrowers. The FDIC has been developing specialized expertise to more carefully monitor and supervise these activities and is working on regulations to incorporate interest-rate risk in the risk-based capital standards.

One specific matter concerning the condition of the deposit insurance system, specifically the Savings Association Insurance Fund (SAIF), should be highlighted. As Chairman William Taylor noted in testimony before the House Banking Committee in July, considerable uncertainty exists regarding the adequacy of the funding of the SAIF. On October 1, 1993, the FDIC assumes responsibility for resolving failing thrifts, using the resources of the SAIF. The SAIF may be inadequately funded initially. A related cause for concern is that the $30 billion Treasury borrowing authority given to the FDIC in FDICIA is supposed to cover losses not just to the BIF but also to the SAIF. Furthermore, rebuilding SAIF's reserve ratio to the statutorily mandated level of 1.25 percent of deposits will depend upon a number of uncertainties, including the economic environment and the long-term competitiveness of the thrift industry.

Conclusion

In conclusion, I would like to emphasize again that the regulators have not been neglecting their responsibilities regarding troubled banks. Lower interest rates are largely responsible for the banking industry's improved condition over the past year. Consequently, failure rates have been lower than we expected a year ago. However, we are not suggesting that the industry's problems are behind us. Troubled assets at commercial banks, while somewhat improved, remain at historically high levels. Moreover, if the current favorable interest-rate environment changes, we fully expect that failure rates will accelerate significantly.

I would like to add that we have been working diligently to implement the provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991. We are preparing to implement significant provisions of FDICIA which become effective beginning in December of this year. FDICIA provides the regulators with the tools necessary to take more aggressive supervisory actions and to close institutions earlier.

We hope that our estimates of future bank failures are overly pessimistic. And we hope that FDICIA will encourage troubled banks to attempt to improve their condition earlier and will help reduce the costs of failed bank resolutions.

Attachment 1

Selected Estimates of Costs of Bank Failures
to the Bank Insurance Fund

Author	Estimate ($ billion)	Date Released
CBO	15-32	September 1990
Barth et al.	31-43	December 1990
FDIC	16-25	March 1991
CBO	40	April 1991
Bank of America	28-51	July 1991
GAO	30	August 1991
FDIC	39-48	October 1991
OMB	72	January 1992
CBO	43	April 1992
Barth	36-63	April 1992
Ely	15-20	April 1992
Kane	53	April 1992
Litan	30-50	April 1992
FDIC	46*	September 1992
Vaughan & Hill	31-95	October 1992

* Dollar figure as published in the BIF recapitalization schedule in September 1992 for the period 1992-1996.

Source: FDIC and News Release entitled "2,000 U.S. Banks Found to Be Dying or Near Death," issued by The Washington Post Company Briefing Books, dated October 5, 1992.