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FDIC FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

ANTICIPATING ADVERSITY AND MANAGING CHANGE

An address by

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I am particularly pleased to have an opportunity to meet with you this morning. A variety of economic and competitive forces are testing bankers and bank regulators as they have not been tested for 50 years. While it would be a grave mistake to underestimate the complexity and severity of the many challenges confronting us, it would be an equally serious mistake to underestimate the resilience of the system and our ability to respond to these challenges.

Despite all of the concern expressed during the past year about the thrifts, troubled foreign loans, the real estate slump, declining energy prices, corporate and individual bankruptcies, declining farm income, high and volatile interest rates, deregulation, and intense competitive pressures, the banking system remains strong and secure. Although we do not expect the problems facing the industry to disappear anytime soon, we are confident about the future.

I want to spend the brief time I have with you today talking about the condition of the banking system, some of the steps we are taking at the federal level to better prepare the bank regulatory system for the future, and some additional measures that need to be considered in the near term.

I. CONDITION OF THE BANKING SYSTEM

A. Economic Environment. Any consideration of the condition of the banking system must begin with the economic environment, for banks, by their very nature, mirror the economy. The economy has been mired in a slump for the better part of the past four years with sectors such as housing and autos experiencing severe difficulties. Interest rates have been extraordinarily high and volatile throughout the period.

Unemployment is currently slightly above 10%, a post-war record. The bankruptcy rate is almost double the rate in 1975, though by no means coming close to the levels experienced during the 1930s. Corporate liquidity is strained. Real farm income is at its lowest level since the early 1960s.

The economic problems of the United States and other industrialized nations have been quickly and severely reflected in the economies of the less developed countries. At a time when record interest rates have significantly increased borrowing costs, these countries have experienced reduced demand and lower prices for their exports, making it difficult to fund external debts. Moreover, the cost of acquiring dollars needed to repay loans has risen. These pressures have exacerbated the risks associated with international lending.

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Although chargeoffs on foreign loans of U.S. banks have not been substantial so far, there is a growing concern about exposure in this area. We believe that prudent public and private behavior should forestall serious international defaults, but the problems will linger for some time to come.

B. Bank Loan Losses and Earnings. In view of the weaknesses in the U.S. and world economy, it is not surprising that loan losses are up at banks. They nevertheless remain at tolerable levels. During the first half of this year, for example, net loan chargeoffs at commercial banks amounted, on an annualized basis, to just over $4 billion, or .35% of loans. The percentage figure was in line with 1980 and 1981 and was substantially below the .56% figure reported in 1975 and 1976.

Chargeoffs tend to be heavier in the second half of the year, and loan losses normally peak a year or more after the cyclical low point. Thus, even if the economy has bottomed out, we should expect increases in loan losses through 1983.

Despite enormous interest rate swings and dramatic increases in the cost of retail deposits, banks have enjoyed good earnings. Annualized earnings during the first half of 1982 were up about 3% from 1981, and as a percentage of assets they remained almost constant. But, consistent with a more volatile, deregulated environment, we are seeing more variability in performance among banks.

C. Problem Banks and Bank Failures. The number of banks on our problem list has risen from about 220 at the beginning of this year to about 320 today, and we expect the number to continue rising through next year. The current number remains below the 385 banks on the list in 1976.

There is a great deal of turnover on the problem bank list. The typical bank remains on the list for about a year before its condition has improved sufficiently to warrant its removal.

The failure rate is also up significantly. So far this year, there have been 35 bank failures including eight mutual savings banks. The post-war peak had been 16 banks in 1976.

Historically, a large percentage of bank failures have involved elements of fraud, self-dealing, extreme concentrations of credit, or outright incompetence. These factors were just as important in commercial bank failures this year. In a weak economy and competitive banking environment, the process of natural selection can hardly be avoided.

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Thus, we should not be surprised by this year's failures. Nor should we be surprised if the number of failures increases in 1983. Past experience suggests it might. While a stronger economy should bring the number of failures down after next year, we do not expect a return to the "normal" five-to-ten failures a year. Deregulation carries with it greater freedom to make mistakes, and some of those mistakes will no doubt be serious enough to cause failure.

The FDIC was an extremely busy place during the past 12 months. Bank failures and the thrift problems required considerable time and energy. We faced many tense, pressure-packed moments. Around-the-clock weekend sessions were commonplace. But the problems were contained -- the system worked.

Of necessity, we did some things differently. Commercial bank failures have typically been handled through purchase and assumption transactions where the bank is closed and its liabilities assumed by another bank with FDIC assistance. In two recent cases -- Abilene National and Oklahoma National -- we provided assistance in connection with commercial banks that were not closed but were on the brink of failure. Because the banks remained open, some going-concern value was preserved and the cost to the FDIC was reduced. Both situations involved stock loan foreclosures, so we were able to assist the mergers without bailing out stockholders. At a time when our field resources have been heavily taxed, we were also able to avoid liquidation activities and conserve staff. Finally, the mergers were accomplished with minimal adverse public reaction or inconvenience.

In July, the $500 million Penn Square National Bank was closed, and a Deposit Insurance National Bank was created to facilitate an orderly payoff of insured deposits. The largest previous FDIC payoff was less than $100 million. Penn Square has received considerable media attention and has had an impact on CD and other markets. Handling Penn Square the way we did involved some risks. Why, then, did we not go the more common deposit assumption route?

Under our statute, we cannot assist a deposit assumption transaction unless we believe it would be less expensive than a deposit payoff. Due to an enormous volume of loan participations, outstanding letters of credit and loan commitments, and other possible contingent claims, for which the FDIC might have been held responsible in a deposit assumption transaction, we could not meet the statutory cost test. Although we deeply regret the financial losses suffered by others as a result of Penn Square, our decision, based on the cost-test, was not a close call.

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There was another persuasive argument in favor of a payoff. Any reasonably astute observer would have concluded that, despite overwhelming cost considerations and the existence of massive abuses, the FDIC was unwilling to pay off a $500 million bank. Whatever market discipline exists in banking today would have been substantially eroded by a deposit assumption transaction.

One of our greatest challenges during the past 12 months has been in handling the failure of 11 FDIC-insured, failing mutual savings banks. Their assets totalled nearly $15 billion. Like other thrifts, these institutions were caught in a squeeze between rapidly escalating short-term liability costs and a long-term, fixed-rate bond and mortgage portfolio. Some large mutuals suffered annualized losses amounting to nearly 400 basis points on assets. Surplus accounts accumulated over a 150-year period were wiped out in just two years.

The transactions we put together in merging the failing savings banks were varied and complicated. In the larger transactions, the FDIC agreed to make future payments related to the cost of funds and the yields on the acquired assets. We accepted this interest rate risk for several reasons: we felt we could better afford to take the risk than the acquiring institutions; by making the transactions less risky to acquiring institutions we encouraged them to bid more aggressively and reduce our costs; and we hoped interest rates would decline. While a considerable part of our cash outlays will be in the future, we projected these future outlays based on the then-existing rate environment, discounted the outlays to present values, and created a loss reserve for the entire amount.

On this basis, we estimated our losses on the 11 savings bank mergers at almost $1.7 billion. The price tag was high -- nearly six times the FDIC's aggregate losses during the past 50 years. However, any other solution would have been at least as expensive and some would have been substantially more costly. We estimated, for example, that deposit payoffs in these 11 mutuals would have cost $4.3 billion.

Under our statute, we are required to rebate 60% of the premiums banks pay to us after deducting our current losses and operating expenses. The heavy losses incurred on the savings bank mergers substantially reduced the rebate last year and will probably eliminate it for this year. We are no more pleased than you about this turn of events. But we take satisfaction in the knowledge that we maintained public confidence in the financial system through a series of sound mergers arranged at the lowest possible cost.

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Commercial bankers, as usual, have been supportive of our efforts. I can count on both hands the number of letters we have received complaining about the reduction in the assessment rebate.

If the recent declines in interest rates are maintained, both the number of additional savings banks requiring assistance and the cost of assisting them will be greatly reduced. Our cost estimates will also be decreased on the mergers already consummated. Toward the end of this year, we will likely reduce our reserve for losses on the 11 previous savings bank mergers by about $350 million. This will reduce or eliminate any loss carry-forward and enhance the prospects for a more substantial assessment rebate next year.

D. The Insurance Fund. Despite the extraordinary losses charged against the Federal Deposit Insurance Fund during the past year, the Fund continues to grow and remains strong and liquid. At the beginning of last year, the Fund stood at $11 billion. It currently totals nearly $13 billion after absorbing the full impact of 45 failures since the beginning of 1981.

Our gross income this year from bank assessments and interest on our investment portfolio will be nearly $2.5 billion. The portfolio is invested entirely in U.S. Treasury securities with an average maturity of 2 years, 8 months. We will have a positive cash flow this year, including maturing investments, in the neighborhood of $7 billion.

The FDIC has the right to borrow up to $3 billion at any time from the U.S. Treasury. We have never utilized this authority and do not foresee ever doing so, but it is available should the need arise.

II. THE CHALLENGES AHEAD

At the FDIC, we believe our principal task in the years ahead is to help the banking industry cope with deregulation, an uncertain economy, and increased competitive pressures. Banks must be unshackled from unnecessary regulations and burdensome procedures, subjected to more skillful monitoring and supervision, exposed to greater marketplace discipline, and given the tools they need to compete successfully in the evolving financial services marketplace.

A. Regulatory Reform and Simplification. The FDIC is reviewing every regulation under which it operates to determine whether the regulation can be eliminated or simplified. While we have had some success in these endeavors, we have

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been held back by the statutory provisions we are bound to uphold. We have encouraged Congress to review a number of laws -- notably, Truth-in-Lending and FIRA -- with an eye toward genuine reform. In the meantime, we are attempting to use a measure of common sense in enforcing the laws and are helping bankers to better understand their obligations through FDIC-sponsored seminars.

We have devoted considerable effort to simplifying and speeding our applications procedures. Our application forms have been substantially shortened. We have encouraged the states to join with us in adopting common forms. We have strongly encouraged simultaneous filing, investigation, and processing of state and FDIC applications. Greatly expedited branch application procedures are out for public comment. Finally, our regional offices have been delegated substantial additional authority to approve applications.

B. Examination Procedures. In the examinations area, we are faced with two challenges. In a deregulated, rapidly changing environment, the traditional on-site, full-scope exam once every 18 months is no longer sufficient. Moreover, our personnel resources are focused disproportionately on the smaller banks where our exposure is limited. We are addressing these problems on several fronts. The divided exam program has permitted us to space out our examinations of smaller, nonproblem banks. The new Call Report information will permit us to improve our off-site monitoring capabilities. Limited-purpose or directed-scope exams will be utilized more extensively. Finally, we are currently experimenting with on-line computer links to several banks in our Philadelphia region. We believe these measures will result in more effective supervision, save millions of dollars annually, and reduce the overall burden on the banks we regulate.

C. Marketplace Discipline. Most banks are well-managed and soundly operated. Unavoidably, in a universe of 15,000, some are not. If banking is to be kept independent and conducted prudently in a deregulated environment, we must find ways to expose banks to a greater degree of marketplace discipline. For the marketplace to function, it must have information to enable depositors and other creditors to select the soundest institutions. This is why we have decided to make public the new Call Report information on nonperforming loans and interest-rate sensitivity. We know this decision concerns some bankers. But the vast majority of banks are in good condition, and we are convinced they have nothing to fear -- indeed, have much to gain -- from more complete disclosure.

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Another ingredient essential to the proper functioning of the marketplace is the risk of loss. While there are a number of advantages to deposit assumption transactions involving failing banks, they have the major disadvantage, under current law, of making all general creditors whole and thereby eroding marketplace discipline. We are considering the desirability of a statutory change to permit deposit assumptions without providing a complete bailout for larger creditors. If we recommend this change, we might at the same time recommend an increase in the $100,000 deposit insurance limit. We also have under review the question of risk-related insurance premiums.

D. New Competitive Tools. Banks are facing relentless competitive pressures from all directions. I have no doubt about your ability to meet these challenges if you are given the tools you need to do the job.

First and foremost, we must authorize a truly competitive short-term instrument to permit you to recapture business lost to the money-market funds and others. With the passage of the Depository Institutions Act of 1982, we expect the DIDC to take this action promptly. This could be costly to some of you in the shortrun, as passbook funds shift, but the account is essential to the maintenance of your position in the evolving financial-services marketplace.

We are disappointed, as are you, that the new law does not rectify other inequities in the existing statutory framework. Many of your new competitors are able to offer a broader array of financial services, and they operate under a less burdensome regulatory scheme. Moreover, interest margins at banks are coming under increasing pressure, and new sources of income must be made available. We feel strongly that in its next session Congress must address such questions as greater participation by banks in securities, real estate, and insurance activities. Moreover, we are convinced that the present five-agency system of regulation for depository institutions at the federal level must be reformed. Finally, serious consideration should be given to either imposing equivalent reserves on money-market funds and other nonbank competitors or permitting the payment of interest on bank reserves.

III. CONCLUSION

Before I close today, I want to express appreciation for your support of the Depository Institutions Act of 1982. While, the law does not contain all that you want and need to compete successfully in the years ahead, it is an essential first step toward our ultimate objective of a stronger, more rational financial system. It ends the thrift differential

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and provides a competitive short-term instrument, gives limited due-on-sale relief, reforms the National Banking Act and Section 23A of the Federal Reserve Act, modifies FIRA, expands the powers of bank service corporations, and grants modest relief on reserve requirements. Moreover, the law contains important, long-sought new tools to enable the FDIC to bring about an orderly resolution of problem situations.

In supporting the legislation, you took the long view and evidenced your faith in the legislative and regulatory process. I believe your faith has not been misplaced.

These are interesting times indeed to be involved in banking and bank regulation. There are problems on the horizon, but none that we, working together, cannot handle.

Our greatest challenge is to anticipate adversity and manage change. Some banks will not, and they will fall by the wayside. Most will, and their future will be brighter than ever. I pledge to you that the FDIC is doing, and will continue to do, everything in its power to ease and facilitate the transition and maintain a sound banking system.

Thank you.

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