Speech

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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[Banking changes and the role of the FDIC].

An address by

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I am honored to appear before you and to have this opportunity to discuss the changing nature of banking in the United States and the role of the Federal Deposit Insurance Corporation in maintaining stability. I have been privileged to have served as Chairman of the FDIC since 1981, a time of turbulence and challenge for both the banking industry and bank regulators.

The financial services sector in the United States and many other nations is in a period of dramatic change. Technological innovation, the development of new financial products and the elimination of outmoded regulations, such as deposit interest rate controls, are resulting in intensified competition among financial institutions. During the past decade the economic environment has been inhospitable, characterized by accelerating inflation, high and volatile interest rates, two back-to-back recessions and deflation in certain sectors such as energy and agriculture.

The United States has one of the most decentralized financial systems in the world. There are approximately 15,000 commercial banks and another 25,000 savings associations and credit unions operating throughout the country. The bank regulatory structure is also decentralized and consists of several complementary, but sometimes overlapping, levels. We have a "dual" or state/federal bank chartering system, subject to a tripartite federal regulatory structure composed of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation.

This structure evolved more or less haphazardly over many decades in response to various financial crises. Primary among the philosophies which have shaped our current system were a strong tradition of independent bank ownership, respect for the rights of individual states and a fear of concentrations of financial power. Permit me to reflect for a moment upon the evolution of our system in order to give you a better perspective of our current trends.

The Evolution of Bank Regulation in the United States

In the 1700s there were several early attempts to establish a national banking system for the purpose of financing a newly formed federal government and to foster economic growth. Bank chartering and bank regulation, however, remained the domain of the individual state governments until the 1860s. In 1863, partially to finance the American Civil War and partially to provide for a stable national currency, a new system of federally chartered banks was created to coexist with state-chartered institutions. This marked the beginning of our dual banking system.

Both state and federal regulation increased over the remainder of the century, but financial panics and bank "runs" continued at all too frequent intervals. While the National

Banking Act had established the first nationwide currency, it did not provide for the orderly conversion between demand deposits and currency. Widespread deposit withdrawals often led to the disorderly liquidation of bank assets. There was no mechanism for providing temporary liquidity or cash reserves to the banking system, resulting in rapid deposit outflows, a drop in the nation's money supply and contractions of commercial activity.

In 1913, in an attempt to correct this problem, the Congress created a central banking authority. As a compromise with those who feared central control over banking, the Federal Reserve System was decentralized into 12 regional banks. While membership was required for all national banks, it was voluntary for state-chartered institutions. Additionally, the Comptroller of the Currency and the Federal Reserve were granted authority to supervise and to examine member banks. The new system had the power to rediscount the eligible paper of member banks, to hold the reserves of its members and to make purchases and sales of U.S. Government securities. Nevertheless, financial stability remained an elusive goal.

In the 1930s the Great Depression threw our economy into financial chaos. Deposit runs caused thousands of banks and savings institutions to close and there was another serious contraction in the money supply. Many depositors lost their life savings, and home foreclosures were widespread. In this turmoil a bank "holiday" was declared, and Congress established the federal deposit insurance system.

The Current Role of the FDIC

The FDIC has two primary functions. One is the supervision and regulation of banks in order to promote safe and sound banking practices. The other is to insure bank deposits and to act as receiver of failed institutions in order to maintain public confidence and alleviate the disruptive consequences of bank closings.

I would emphasize that it is not the FDIC's role to prevent bank failures. Inefficient and inept banking practices should not be supported. Our objective is to assure that bank failures remain independent, isolated events and do not become widespread so as to imperil stability in the system.

In the role of supervisor and regulator, the FDIC is one of the three federal bank regulatory authorities, together with the Comptroller of the Currency and the Federal Reserve. The FDIC has direct supervisory responsibility for approximately 9,000 state-chartered commerical banks and savings institutions which are not members of the Federal Reserve System. Additionally, in its role as insurer of deposits in almost 15,000 state and federally chartered depository institutions, it has a very real interest in the financial condition and supervision of all insured institutions. The FDIC is empowered to examine all insured banks and, when appropriate, the FDIC works with the primary regulator to deal with the problems of weakened or troubled institutions, regardless of charter.

We have available a number of different supervisory tools to accomplish our task. First, all insured banks are subject to periodic bank examination by a corps of highly trained examiners who seek to identify problems and weaknesses which could, if neglected, lead to failure. This effort is complemented by periodic data reporting requirements and by an offsite monitoring and surveillance system to detect adverse trends in the intervals between onsite examinations. Once weaknesses are identified, preventive measures are quickly taken to avert the possibility of a bank failure.

Our findings of pending difficulty or weakness are first discussed with bank management in an attempt to obtain timely corrective action. If this is not forthcoming, the FDIC has a number of enforcement actions available which can be tailored to the perceived severity of the situation. For example, "cease-and-desist" orders can be issued in order to prevent unsafe practices. Management officials can be removed from the bank or fines assessed. If a bank persists in following unsound practices, its deposit insurance can be terminated.

Dealing with Bank Failures

There are three principal options available to the FDIC in dealing with bank failures. The first is to arrange a merger with another bank. The FDIC acquires all of the troubled assets of the failed bank for cash and then sells the "clean" bank through a sealed bid process. The transaction ordinarily occurs over a weekend so there is no disruption of banking services. All depositors and other general creditors are made whole, though stockholders and subordinated creditors usually lose most of their investment. The FDIC is left with the task of collecting on the acquired troubled loans, a process that normally requires several years to complete.

In about 20 percent of the cases it is not possible to arrange a merger, either because the FDIC receives no bids for the failed bank or because the failed bank has a large volume of off-balance-sheet or contingent claims for which the FDIC cannot prudently assume responsibility. In these cases, the FDIC moves swiftly to pay insured depositors up to the $100,000 insurance limit. We have a good record of timely action, generally commencing the insured deposit payoff within a couple of days following a bank closing. Deposits in excess of the FDIC insurance limit and other bank creditors share pro rata in the proceeds realized from the subsequent liquidation of the bank's assets. Historically, actual losses sustained by uninsured bank creditors are relatively small, but these creditors may experience a time delay of up to several years before receiving the bulk of their funds.

A third option is for the FDIC to make loans to or purchase assets from an insured institution in danger of closing. These powers are seldom used, but they have proven to be extremely important in a few recent situations.

By far the most well-publicized use of these powers involved Continental Illinois National Bank in mid-1984. Continental's home state of Illinois did not allow for branch banking, which limited the bank's ability to attract deposits in its local market. When in the mid-to-late 1970s the bank launched an aggressive lending strategy, much of this growth had to be funded in the domestic and international money markets. To enhance profitability, the bank relied heavily on short-term funding. It is safe to say that the bank's funding strategy soon reached a level of imprudence in terms of both volume and maturity structure.

Continental had been a large purchaser of poor quality energy loans from Penn Square Bank, an Oklahoma bank which failed in July 1982. When Penn Square Bank failed, Continental immediately began to experience some funding problems. As time passed the funding situation stabilized, although the bank was forced to pay higher rates and maturities were shortened further.

In early 1984, apprehension began to grow about the bank's level of nonperforming assets (both from energy loans and from other segments of its portfolio) and the quality of its earnings. This finally culminated in an uninsured funding "run."

By May 1984, the funding crisis became so severe that the three federal bank regulatory agencies and major United States banks assembled a multibillion dollar "interim" financial assistance package to stabilize the situation. The package had to be fashioned quickly to provide the time needed to arrange a more orderly, permanent solution to the bank's problems. A part of this program included an announcement that all depositors and general creditors would be protected. This was not an unprecedented move as we had provided this same assurance in connection with interim assistance packages to three other banks during the previous three years. The interim package provided temporary relief, and we embarked upon negotiations to find a suitable permanent solution to the bank's problems. Several offers were received from interested parties, but they were judged to be too costly to the FDIC.

On July 26, 1984, we announced a permanent aid package for Continental Illinois involving a $1 billion capital infusion from the FDIC and the purchase by the FDIC of several billion dollars of the bank's troubled loans. We replaced the bank's top management with an internationally acclaimed management team, and we are in the process of changing the board of directors. The aid program was structured to protect the bank's depositors and other creditors against loss, but not its shareholders.

While our actions have been criticized by some, most observers believe we did what was necessary to avert a national, and even international, banking crisis. The bank is returning to health faster than we dared hope just a few months ago, and I believe that in the final analysis the FDIC will suffer modest losses or may even profit from the transaction.

The past several years have indeed been challenging for the FDIC. During its first 47 years, the FDIC handled fewer than 600 bank failures with total assets of $9 billion at an aggregate cost of $500 million. During the past four years, we have handled nearly 200 bank failures with assets totalling over $27 billion at a cost of nearly $4 billion -- and those figures exclude Continental Illinois! Despite all this, our deposit insurance fund is stronger than ever. For example, since the beginning of 1981, after absorbing record losses, the FDIC fund has grown dramatically from $11 billion to over $17 billion.

The Need for Continued Reform

Though we have weathered well the storm of the past several years, much remains to be done as we continue along the path toward a less regulated, more market-oriented financial system in the United States.

We have deregulated deposit interest rates. The benefits to bank and thrift customers have been enormous, but the costs to depository institutions have been substantial. It is essential that we move swiftly to expand the range of financial services our banks and thrifts are permitted to offer. Bills are pending in Congress to eliminate the outmoded, 50-year-old barriers that separate the banking, securities, insurance and real estate industries. If enacted, these reforms will afford American consumers and businesses a broader range of convenient financial services at more competitive prices and will greatly strengthen our financial system. At the same time, the debate over regional and even nationwide banking is intensifying and fundamental reforms may be close at hand.

As we move forward, bank supervision must be improved. The agencies are mounting major efforts to improve examiner training and performance and are investing millions of dollars in offsite monitoring techniques. Bank capital ratios have been raised substantially in the past few years and even higher ratios are in the offing. The use of formal enforcement actions against banks and their officers and directors has increased manyfold over the past several years and this trend will continue.

We are also seeking to enlist the support of the marketplace in our efforts to create a stronger, more disciplined banking system. Public disclosure of the financial condition and practices of banks has been enhanced in recent years and these efforts will continue. The objective is to encourage deposits to flow to the vast majority of banks that are well-managed rather than to the high-risk banks that tend to pay the highest rates.

Finally, proposals are pending to reform the operation of our deposit insurance system and to streamline our antiquated regulatory system. One of the reforms in the deposit insurance area would be to charge individual banks a premium for insurance based on an objective evaluation of risk rather than the current flat-rate assessment. In the regulatory arena, a task force headed by Vice President Bush has recommended a realignment of the agencies to reduce overlapping responsibilities and better target our resources.

I am convinced we will make substantial progress on these fundamental reforms in the months and years ahead. I am equally convinced that the result will be a more competitive and responsive and far stronger financial system than America has ever known.

Conclusion

I have covered a lot of material very quickly today, and I am sure I have left you with many questions, which I will be pleased to address in the time remaining. Let me conclude by thanking you for this opportunity to meet with such a distinguished group of leaders from government and industry.

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