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TESTIMONY OF

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ON

THE FINANCIAL CONDITION OF FDIC-INSURED INSTITUTIONS

BEFORE THE

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

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Good morning, Mr. Chairman and members of the Committee. I am pleased to present the Federal Deposit Insurance Corporation's views on the condition of the banking industry and its insurance fund. At your request, the regulators already have submitted, through the Federal Reserve Board, a variety of statistics. My testimony today will provide an overview of the financial condition of FDIC-insured banks and respond to the specific questions raised in your letter.

First let me suggest a perspective for my remarks. The business media ordinarily focus on banking problems -- as does, in fact, my own testimony today. That is only natural as most of our time is spent dealing with those problems. However, the real news is that, despite increased competition from all sectors of the financial community, severe economic problems in parts of our country, and an unprecedented pace of change in the industry, the banking system as a whole is sound and is getting sounder. Given a reasonable ability for the system to evolve and adapt through a prudent restructuring of the financial services industry, that assessment should continue to be true over the long run.

GENERAL ECONOMIC CONDITIONS

I would like to preface my discussion of the financial condition of the banking system with some general observations on the economy.

In last year's testimony we suggested that agricultural problems had bottomed out and that slow gradual improvement could be anticipated for 1987. That

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turned out to be the case and improvement in that sector is expected to continue in 1988. Despite this improvement, the problems of agriculture and agricultural banks are not over. The upturn is slow and banks' performance normally lag the economy both on the way up and on the way down. However, even though problems are still there, the trend is in the right direction.

We also indicated last year that the energy economy had apparently reached bottom, but the ripple effect had not yet run its course through the rest of the local economy. Therefore, banks could expect more problems. It is perhaps arguable whether or not the energy sector had indeed bottomed out. It does not appear any worse than last year, but certainly no one would describe it as in a robust recovery. There is no doubt that the ripple effect, particularly in the real estate markets, continues to cause serious problems for banks. Office vacancy rates in energy-centered areas are among the highest in the nation. A large volume of property is being withheld from the market, though not by the FDIC, to prevent oversupply. Hopefully, property value declines are nearing an end. Even in that event, the adverse effect on the economy and on banks in these areas will continue for some time.

Last year we also expressed some concern over the aggregate levels of debt outstanding, especially consumer debt, with much of it owed to commercial banks. While we are still concerned, the rate of increase in this debt has been reduced, thus decreasing the probability that it will become a major banking problem.

Another area of concern is interest rates, particularly the effect a rise in rates would have upon the thrift industry. Many of these institutions already

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are having problems with asset quality. If interest rates increase, the resulting impact on thrift earnings may well exacerbate the financial difficulties of that industry. Fortunately, interest rate risk in the banking industry is not large at this time.

FINANCIAL CONDITION OF THE INDUSTRY

Capital -- Aggregate primary capital of all insured commercial banks grew from $214 billion at year-end 1986 to $234 billion at year-end 1987, a 9.4 percent increase. However, nearly all the growth in primary capital occurred in the reserve for losses component which resulted from the loss provisions made by the large money center banks for troubled loans to developing countries. This new reserving provided adequate, if not comfortable, reserves against developing country loan risk. Smaller banks continue to have higher capital to asset ratios than larger banks. The Southwest Region, dominated by the energy industry and once comprised of banks with some of the strongest capital ratios, experienced sizable declines in capital during 1987, and now exhibits some of the weakest capital ratios.

The growth in capital outpaced the less than two percent growth in assets during 1987. The industry as a whole currently has an adequate level of capital. However, a continued growth in capital is necessary to maintain that position, especially if asset growth returns to higher levels.

Current minimum capital rules set substantially similar capital requirements for all banks, regardless of asset size or the identity of the bank's primary Federal supervisory authority. These capital-to-asset, or leverage, ratios

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continue to serve as useful tools in assessing capital adequacy, especially for banks that are not particularly active in off-balance sheet activity. However, the FDIC believes there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banking organizations. While a risk-based system may require certain individual institutions to increase capital, these increases will help to further stabilize and strengthen the banking system.

The FDIC recently joined the OCC and Federal Reserve in issuing for comment a risk-based capital proposal based on an internationally agreed outline. This proposal is part of an ongoing effort by the bank regulatory authorities, both in the United States and in foreign countries, to encourage the establishment and convergence of international capital standards that would apply to all international banking organizations.

The FDIC proposal would apply to all State nonmember banks, regardless of size. However, we are considering ways to minimize the impact on smaller banks by exempting them from unnecessary and cumbersome reporting requirements. Our present estimate is that few smaller banks would be required to increase capital as a result of applying the proposed risk-based standards. At this time, the proposal would not replace or eliminate our existing capital maintenance regulations, which require minimum levels of primary capital and total capital as a percent of total assets. However, once the risk-based capital framework is fully implemented, the FDIC, in conjunction with the other Federal banking agencies, will consider whether the existing regulatory leverage ratios should be left in place. If the agencies decide to retain a

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leverage requirement, the FDIC also will consider whether the definition of capital for leverage purposes should be revised to conform to the definition of capital used for risk-based capital purposes.

The proposed risk-based capital framework sets forth: (1) a definition of capital for risk-based capital purposes; (2) a system for calculating risk-weighted assets by assigning risk weights to balance sheet assets and off-balance sheet items; and (3) a schedule, including transitional arrangements, for achieving a minimum supervisory target ratio of capital to risk-weighted assets.

The risk-based capital ratio focuses principally on broad categories of credit risk. However, the ratio does not take into account many other factors that can affect a banking organization's financial condition. These other factors include overall interest rate risk exposure; liquidity, funding and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; the level and severity of problem and adversely classified assets; and management's overall ability to monitor and control other financial and operating risks. For this reason, the final supervisory judgment on a banking organization's capital adequacy may differ significantly from the conclusions that might be drawn solely from the organization's minimum risk-based capital ratio.

The risk-based capital framework would apply to all international banking organizations. The ratios in the proposal have been established with a view toward maintaining a safe and sound banking system rather than achieving

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the lowest common denominator. There are competitive equity concerns in light of the fact that investment banks, savings and loan associations and nonbank financial intermediaries would not be subject to the risk-based capital framework. However, efforts will continue to eliminate or minimize competitive inequities among financial institutions of all types, to the extent that such action is consistent with a safe and sound banking system.

An important question with respect to international capital standards is whether they should apply only to banks (as they do in foreign countries), or to banks <u>and</u> bank holding companies as proposed in the United States. This is a difficult question since the United States is the only country which regulates holding companies. It is our view that competitive equity would be served by <u>not</u> subjecting holding companies to the new risk-based capital requirements.

A risk-based capital framework will not be finalized until after the Federal banking agencies have consulted further with banking regulators from other countries and carefully evaluated the public comments received in response to the current proposal.

Some of what appears as new equity in banks is the result of double-leveraging by holding companies. Double-leverage has been a potential cause for concern for several years. Thus, the FDIC analyzes double-leverage on a case-by-case basis during the examination of individual banks. Double-leverage occurs when the parent company incurs debt and uses the proceeds to purchase equity in its bank or nonbank subsidiaries. Since the normal practice is to service this debt through dividends from the subsidiaries, excessive debt service

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requirements of the parent can be a threat to the banks in the holding company. There have been a number of examples of bank holding company leveraging that have weakened the banks in the system.

Double leverage is an important issue in the pending legislation to restructure the financial services industry. If there is to be an effective firewall, we must be able to protect the bank from its holding company and holding company creditors. The FDIC emphasized this position in the recent statement of protection regarding First Republic of Dallas, Texas. All depositors and other general creditors of First Republic's banks are fully protected, but the FDIC made it clear that these guarantees DO NOT extend to the holding company creditors or shareholders. Furthermore, the assistance the FDIC provided First Republic was guaranteed by the holding company and its affiliate banks, and was collateralized by a pledge of certain assets of the holding company. The holding company banks were not allowed to pay dividends to service <u>holding company</u> debt.

Many multi-bank holding companies coordinate their banks' activities so closely that the bank holding company system effectively operates as a single banking enterprise. Yet when a bank within the system fails, the FDIC must deal with that bank as if it were independent. In effect, the FDIC must act as if there is no connection between the failed bank and the rest of the system unless it can take some action to prevent this result.

Some bank holding companies and their creditors have seen a way to turn this situation to their advantage. By concentrating poorer assets in a single bank, and then letting that bank fail, the bank holding company can shift the

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cost of those assets -- the loss it would otherwise be forced to realize -- to the FDIC. This technique amounts to a misuse of the FDIC's resources, which can do substantial harm to the Federal safety net for depositors.

Recent experience also has shown that creditors and shareholders can impose unwarranted costs on the Federal safety net in other ways as well. In some cases, the FDIC arranges open-bank assistance transactions which avoid the disruption that bank failures inflict on communities. Open bank transactions may require the consent of creditors and shareholders of the holding company. However, in some situations creditors and shareholders have sought to "hold up" the transaction in an attempt to receive greater consideration than that to which they would have been entitled if the bank had failed. This imposes added costs on the Federal safety net.

We are seeking legislation that would allow us to meet this challenge. In fact, a draft legislative proposal was circulated to the members of this Committee last week. (A copy of the draft statutory language and an explanation is contained in Appendix B.) The proposal would establish a special emergency procedure to deal with failing banks that belong to multi-bank holding companies. The procedure would allow the FDIC -- in conjunction with the Federal Reserve and the banks' primary regulators -- to require the consolidation of a failing bank with other banks in the holding company. It is designed to improve the asset quality of a failing bank within a multi-bank system without affecting the health of the system as a whole.

We also would like to report on the status of capital in FDIC-insured savings banks. As of year-end 1987, all FDIC-insured savings banks reported positive net worths, even when their outstanding net worth certificates were not taken

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into account. This is an improvement over 1983 when 5 institutions with $11.5 billion in total assets reported negative net worths when their net worth certificates were not counted. Capital levels in savings banks have increased over the last 5 years due to improved earnings performance and conversions to a stock form of ownership. From 1982 to 1985, net worth certificates totaling $710 million were issued to 29 savings banks that were experiencing severe losses due to interest rate mismatches. At year-end 1987, three banks had remaining net worth certificates outstanding aggregating $315 million.

Earnings -- In 1987 commercial banks had their worst year for profitability since the Great Depression. Commercial banks earned $3.7 billion, down nearly 80 percent from $17.5 billion earned in 1986. Their return on assets of 0.12 percent and return on equity of 2.02 percent were the lowest levels since 1934. A soaring loan loss provision, over 67 percent higher than 1986, fully accounted for the industry's year-to-year drop in earnings. Loan loss provisions attributable to the international operations of U.S. banks were $20.6 billion, $18 billion higher than a year earlier. Absent the extraordinary reserving for LDC loans, net income would have been roughly equal to the 1986 level.

Earnings performance ratios for commercial banks have not been consistent among asset size groups or geographic locations. The largest banks reported poor earnings for 1987 due to their sizable loss provisions for international credits. After the large money center banks are excluded, the results for those banks west of the Mississippi River are poorer than those east of the Mississippi. Poor economic conditions in the energy States and Farm Belt are the primary contributor to the West's poor results.

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The Southwest Region is a major area of earnings weakness. The region's banking sector is operating at a loss, with 36 percent of the banks in the region unprofitable for 1987 and the return on assets a negative 0.64 percent. A persistent high level of problem assets, despite high levels of charge-offs, points to a continuation of this problem for the region. The region's earnings also are depressed by the effect of the lowest net interest margin in the country. The region's well-publicized S&L and economic problems influence the banks' cost of funds which, coupled with a weak loan demand and high levels of nonperforming assets, compresses the net interest margin.

There have been a variety of developments in recent years that make satisfactory earnings for the banking system as a whole more difficult to achieve. Among these are poor economic conditions in certain areas of the country, the tendency of the largest most creditworthy customers to access the credit markets directly, and intensified competition from nontraditional banking business. However, the outlook for the immediate future is cautiously optimistic.

Banks continue to be creative in developing new products and services to increase their sources of income. Significant fee income is being generated by letters of credit and swaps, markets which continue to grow dramatically. Fee income from securities underwriting and other services is growing and would provide additional sources of income should these markets be opened to banks. The FDIC believes the banking system can provide new services and that new bank powers will provide new opportunities for profit in a safe and sound manner. Of course, proper controls and appropriate surveillance by the regulators will be necessary.

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Assets -- Nonperforming assets at year-end 1987 are highest in the largest 25 banks and in the Southwest Region with 3.46 and 4.18 percent, respectively, of their total assets in nonperforming status. Insured commercial banks as a group have 2.11 percent of their total assets in nonperforming status as of year-end 1987. Problem assets (i.e., assets subject to adverse classification by the regulators) reflect trends and concentrations similar to nonperforming assets, with problem assets being 1.16 percent of total assets in the largest 25 category and 1.95 percent of total assets in the Southwest Region. All insured commercial banks had 0.91 percent of total assets classified as problem assets at both year-end 1987 and 1986.

We believe that the asset quality problems have for the most part been identified and steps are being taken to reduce banks' risk exposure. However, recovery will be slow. There are further losses to be recognized in these acknowledged problem areas and the high levels of problem assets will remain until the economic conditions are markedly improved.

Bank exposure to LDCs continues to decline as a percentage of capital. During 1987, most major U.S. banks significantly increased their bad debt reserves against loans to lesser developed countries. The money-center banks have reserves against approximately 25-30 percent of their non-trade LDC exposures. The large regional banks took additional reserves or charge-offs and now have reserves covering approximately 50 percent of their non-trade LDC exposures. Based on the use of 25 percent of export income to service debt, this level of reserving appears reasonable for present conditions.

These increased bad debt reserves severely depressed earnings but had no major ramifications on the U.S. financial system. The large reserves probably have

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served to enhance the flexibility banks have in dealing with LDC debt. In that regard, the Mexico/U.S. Treasury backed bond swap was less successful then originally envisaged, but it hopefully will lead to other innovative approaches under the "menu of options" to deal with the situation. Perhaps the major effect of the reserve action is that it has bolstered the perception that the LDC problem is concentrated, more than ever, in a handful of the largest U.S. banking companies.

Asset growth, which was less than two percent during 1987, showed the smallest annual increase in almost 40 years. Banks experienced shrinkage in those loan categories suffering quality problems, i.e., agricultural, energy, commercial real estate, and international. These shrinkages were essentially offset by growth in home equity loans, which stood at $33 billion at year-end, and other consumer lending. Banks continue to strive to expand lending in these new areas. However, competition remains heavy. Banks realize the possible adverse affects of heavy concentrations of assets. Most strive to minimize this risk while continuing to serve their customers' legitimate credit needs.

New products and services are being developed to help spread this risk and to take advantage of commercial banks' strengths. "Securitization" is one such practice which allows banks to emphasize one of their strengths -- being an efficient originator of loans. Securitization activities, initially used in the mortgage banking area, are now expanding into other markets. They provide banks with additional sources of revenue without the capital requirements and costs associated with the warehousing of loans. Securitization also allows diversification of portfolio by region and thus helps to avoid concentration problems such as those currently being experienced in the Southwest.

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Liquidity -- During the latter part of 1987 banks enjoyed a large inflow of deposits at lower interest rates. This resulted partially from the October stock market decline. Up until that time, banking sector deposits had increased at a steady, albeit slow, pace. However, 1987 fourth quarter deposits grew at an annualized rate of 11.7 percent.

Overall, sources of banks' funds appear stable and liquidity is adequate. However, in the Southwest Region, institutions with sizable amounts of uninsured deposits are vulnerable to sudden deposit outflows. As evidenced by First Republic, funding sources can be influenced by poor operating results and uncertain conditions. This demonstrates that market discipline by depositors and creditors still exists despite insurers actions to protect all depositors in large institutions. However, we believe that the potential trouble spots have been identified and the FDIC has shown it is willing and able to be a stabilizing influence when the need arises.

The FDIC was generally satisfied with the banking system's support of the securities market during the October stock market decline. We believe the banks' response was consistent with safe and sound banking practices and they were able to assist in providing liquidity where needed. This support can be shown by a fourth quarter surge in loan demand.

BANK SUPERVISION

Our supervisory efforts continue to be directed toward maintaining the safety and soundness of the banking system and protecting the insurance fund against unnecessary loss. In addition to supervising directly on the federal level

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some 8,000 insured state nonmember banks, we monitor the condition of approximately 6,000 national and state member banks and cooperate with the other federal and state regulatory authorities in their efforts to assure the safe and sound operation of these insured banks.

One of the FDIC's primary goals has been to increase the level of onsite supervision by reducing the time intervals between onsite examinations. After evaluating our overall examination projections in terms of staff resources, operative procedures and the appropriate level of onsite examination, we decided to move toward more frequent examinations. Our goal now is to have an onsite examination every 24 months for well-rated institutions (those rated 1 or 2) and an onsite examination every 12 months for problem and near problem institutions (those rated 3, 4 or 5). Obviously such a goal cannot be accomplished overnight, but we have made considerable progress. Currently, we are averaging once every 34 months for satisfactory banks, once every 23 months for marginal banks and about once every 19 months for problem banks.

We recently have initiated a new program for coordinating FDIC supervision with state supervision -- known as the Supervisors Annual Flexible Examination (SAFE) Program. Under this program the FDIC sets <u>annual</u> plans for supervisory activities with state authorities. It is a flexible program that emphasizes results. Basically, we envision treating many examinations conducted by state examiners as our own. These state exams would be placed on our examination cycle database, and would be counted as examinations by the FDIC for purposes of tracking adherence to our examination schedule guidelines. Where state examinations are accepted as our own, FDIC presence in these banks for full-scope examinations would be delayed -- possibly for up to an additional

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two years for 1 and 2-rated banks, and an additional one year for 3-rated banks. In the case of 3-rated banks, our presence would depend on trends in the individual banks.

At year-end 1987, the FDIC employed roughly 1900 field bank examiners. We intend to increase this number to about 2100 by the end of 1988. Our examiner force had declined to only 1389 in 1984 from the previous high of 1760 examiners in 1978 when we had only 342 problem banks and 7 bank failures. In contrast, there are currently over 1,500 problem banks and a possibility of up to 200 failures this year. Once we reach our goal of 2,100 we will decide whether we should expand our force further or remain at that level.

We have changed our recruiting methods and standards since deciding in 1985 and 1986 to increase the field staff by 30 percent. By improving our recruitment techniques and hiring the best possible candidates, we were able to hire 421 new trainee examiners in 1987 with a collective college grade point average of 3.4 out of a possible 4.0. It will be some time before these new people are sufficiently trained to be able to carry a full load of responsibility. We are building a new training center at Virginia Square, Virginia, to improve our ability to train our field forces as well as those employed by the states.

Even though we are not at our goal for examination frequency, the expanded work force has enabled us to complete more examinations in 1987 than in 1986. The number of safety and soundness examinations increased 14 percent and compliance examinations increased 60 percent during the past year. The need for effective supervision becomes even more critical as banks obtain expanded

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powers and undertake to engage in various nontraditional activities. Effective supervision also is a necessity in limiting the federal insurance safety net to banks and not allowing it to expand to bank holding companies.

A major innovation in our examination program has been the expanded use of automation and personal computers. We developed an automated examination report that is now utilized for all safety and soundness, trust, compliance and EDP examinations. Additionally, several specialty programs are available to assist our examiners with tasks ranging from APR calculations in consumer compliance examinations to analyses of capital adequacy. Personal computers have given our field staff immediate access to the data on the Corporation's mainframe computer and the tools to present current data in typewritten or graphic form. The automated report also provides the means to more accurately gauge overall time utilization and productivity trends.

FAILED AND PROBLEM BANKS

The condition of the banking system is generally sound although there continue to be areas of strain. Bank failures are at record levels. In 1987, 184 FDIC-insured banks failed and another 19 received financial assistance to avert failure, including 11 in the BancTexas group. Unfortunately, we have been setting new records each year, and this year is not expected to be an exception. As of April 30, there have been 59 failures and 13 assistance transactions which, inclusive of the First City and First Republic transactions, involve approximately 140 banks. This rate is about on a par with last year's but with more assistance transactions in the current mix. If the current pace continues, we can anticipate about 200 failures and assistance

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transactions this year as well. It should be noted that almost 90 percent of these failures were west of the Mississippi River and banks in Texas alone accounted for over 30 percent of all bank failures so far this year.

Although the trend is finally downward, the number of problem banks also is near the record level. As of April 30, 1988, there were 1505 FDIC-insured problem banks with total deposits of $289 billion, down from 1,575 as of year-end 1987 but still over the year-end 1986 number of 1484. In mid 1987, the number of problem banks peaked at 1624 with deposits of $300 billion. Of the problem banks, approximately 500 are agricultural banks and 158 are energy banks. Eighty nine percent of the banks on the current problem list are west of the Mississippi River and over 61 percent are in the 6 states of Colorado, Louisiana, Kansas, Minnesota, Oklahoma and Texas.

It is important to note that there is considerable turnover in the specific banks on the problem bank list. Since the number of problem banks peaked in mid-1987 there have been 461 banks added to the problem bank list and 580 deleted from the list through April 30 of this year. Of the 580 deleted, 155 were the result of closings or receipt of FDIC assistance, 79 were the result of mergers and 346 were the result of improvements. The decline in the number of problem banks is primarily attributed to two factors, gradual improvement in the agricultural areas of the country and merger activity, particularly in Texas. We expect the number of problem banks to decline slowly although problems will continue to be severe in those areas dependent on the energy sector.

The pattern of increases and decreases in the number of problem banks correlates with economic conditions. While much of the country and most

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sectors of the economy now are experiencing relative prosperity, the differences among areas are much wider than has been experienced historically. The areas west of the Mississippi River, with economies that are importantly based on energy, have pockets of severe recession or even depression. Most of the FDIC's problem banks today, and for the rest of 1988, are located in these distressed regions. The statistics contained in our Quarterly Banking Profile (Appendix A) indicate clearly the problems by geographic area.

Deficiencies in bank management and policy exacerbate the natural tendency for banks to suffer from weaknesses in the economy. Historically, inept or abusive management has been a primary cause of problem banks and this remains true today. Management's underwriting standards and credit judgments must remain prudent even when the economy is strong so that the impact of inevitable economic downturns is moderated.

Even though economic problems now are of greater importance than normal in explaining bank problems, management remains an important cause of most banks' difficulties. We do not hesitate to use our formal enforcement powers when circumstances warrant. In 1987, we initiated 91 insurance removal proceedings under Section 8(a) of the Federal Deposit Insurance Act, 130 cease and desist actions under Section 8(b) and 22 removal actions under Section 8(e). Numbers of these actions are down modestly from 1986 except in the case of Section 8(a) actions, which are higher due to including national and state member banks most of which are in the Southwest.

The downturn in agriculture and energy has been so severe and protracted that today, in these depressed areas of the country, many banks with good records

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and acceptable management are having financial difficulties. As regulators, we are using new approaches in supervising these institutions. We believe that formal enforcement actions -- while very useful and appropriate in many situations -- are counterproductive in those cases where management is acceptable, the bank's problems are the result of adverse market conditions, and the prospects for recovery are good, given a reasonable economic cycle. The FDIC seeks to work cooperatively with the management of such banks in a joint effort to restore the financial stability of their banks.

Our Capital Forbearance program is an example of the approach which we believe has been useful and beneficial to both the FDIC and participating banks. As of April 30, 1988, the FDIC has approved 154 applications for capital forbearance, while denying 68. Of the 126 banks in the FDIC's capital forebearance program on March 31, 1988, 57 improved their primary capital ratio since being approved. There have been 27 banks which have been terminated from the capital forebearance program. Two of these institutions were removed because of improved financial condition and four others merged into healthier institutions. Six more of these banks failed and the remaining 15 were removed due to noncompliance with the capital plan.

Banks participating in the program outside the west and southwest are improving. Many banks in the program throughout the country also are making good progress. Restoring financial health does not occur overnight but we believe that this program is a sound approach, which is doing the job it was designed to do. We will be evaluating the program and measuring its results carefully in the future.

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A somewhat similar program (loan loss deferral) was authorized for agricultural banks by Congress last year. It is too early to determine the success of this program. However, as of April 30, 1988, 62 banks have applied for the program, with 15 applications approved, 10 denied and the remainder still under review.

With regard to the role of fraud and insider abuse in bank failures, we believe that such misconduct contributed significantly to about one-third of the bank failures in 1986, 1987 and so far in 1988. Outright criminal conduct was responsible for 12 percent to 15 percent of bank failures. For example, from January 1985 through 1987, 98 of the 354 banks that failed were cited by examiners as having at least some element of fraud or insider abuse. Those 98 failed banks had assets of $2.7 billion and cost the FDIC nearly $676 million. Our experience since 1985, however, suggests a somewhat lessened impact of fraud and abuse compared to the late 1970s and early 1980s.

The FDIC recognized a need to strengthen efforts to deal with fraud and abuse and has taken several major steps since 1984 to improve the situation. We published a list of time tested "Red Flags" and other warning signs of fraud and abuse to be used as an aid to examiners and auditors. We designated some 60 examiners as bank fraud specialists to be given specialized training in bank fraud and insider abuse. Later this year, an intensive, highly specialized training session will be held for these examiners. It will focus on criminal motivation, early detection and investigative techniques. Other training courses for examiners and liquidators have been developed or improved.

We have published guidelines for banks to use in setting up or revising their codes of conduct and, earlier this year, we mailed to all of the banks under

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our supervision our Pocket Guide for Directors, a copy of which is attached as Appendix C. The Guide provides directors with practical guidance in meeting their duties and responsibilities.

These initiatives with respect to the bank fraud problem will help contain this ever-present problem by fostering public confidence and deterring future abuses.

FAILING BANK RESOLUTION AND LIQUIDATION ACTIVITIES

The FDIC is constantly seeking innovative ways of efficiently resolving failing bank cases and meeting our deposit insurance commitments. In light of the record number of bank failures over the past few years, we have been especially concerned that we maintain our sound cash position. This objective requires the prompt resolution of failing bank cases in a manner that minimizes our costs and cash outlays and results in the FDIC acquiring as few bank assets as possible. Thus, we are actively pursuing, whenever possible, whole bank transactions where the new owners of a failing or failed bank recapitalize the bank and assume all or substantially all its assets with the smallest possible contribution from the FDIC. This approach permits us to realize maximum value on the assets of the failed or failing bank, with only minimal disruption to existing borrower and depositor relationships and the community at large. In addition, as part of our SAFE cooperative program with state regulators we have arranged to give purchasers up to four weeks to examine a failing bank and decide whether they want to purchase it on an open or closed basis.

In keeping with our desire to conserve cash while maximizing our recoveries on acquired assets, we have developed new initiatives to obtain maximum net

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present value from liquidation assets in the shortest possible time. These initiatives include an aggressive marketing program -- including bulk sales -- designed to move loans and other assets back into the private sector; a stepped up management review of assets in litigation and large dollar assets; and an increased emphasis on seeking settlement on outstanding claims whenever practical rather than pursuing protracted litigation. However, we do not "dump" assets below current appraised values.

As a result of these initiatives, we were able to collect $2.4 billion by liquidating assets from failed banks last year, a 38 percent increase over the $1.7 billion collected in 1986. These efforts have enabled us to hold our inventory of managed assets from failed banks steady at about $11 billion despite a record number of bank failures with even greater record numbers in terms of dollars of failed assets involved.

With regard to the "too big to fail" problem, we suggest that the answer depends in part on how one defines the "problem." It may be that governmental protection of the largest banks in different countries is a premise which, in the United States, tends to be defined in terms of the extent of deposit insurance protection. Certainly, our experience to date in resolving several large failing bank cases suggests that the costs and dislocations of failing to fully protect certain bank depositors and creditors appear unacceptable. Since this appears to us to be the case with regard to banks over a certain size -- that is, depositor losses in such banks threaten the stability of a region or possibly the entire banking system -- then we must seek instead to consider how to extend comparable protection to smaller institutions.

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Appendix D provides some thoughts on various alternatives, all of which unfortunately have some undesirable side effects. Certainly the greatest threat to the sufficiency and viability of the deposit insurance fund is posed by the largest banks that might be considered "too large to fail." If depositors in these banks are to be fully protected, there would seem to be relatively little more cost to the fund in extending that protection to smaller banks as well. However, this would further reduce the market's ability to discipline the system and thus could further increase the burden of government supervision. As yet, we have found no alternative which satisfies the criteria of providing a level playing field between larger and smaller banks, maintains what is left of depositor discipline and protects our system when big banks fail.

As a matter of policy, and consistent with statutory criteria, we are attempting to resolve smaller failing bank cases in a manner that protects all depositors whenever possible. This approach tends to minimize some of the perceived disparate treatment between large and small banks. By attempting to extend full protection to depositors of smaller banks we also tend to reap the full benefits of stability to the banking system that such an approach entails. In a relatively small number of cases, however, we have no choice under current law but to pay off insured depositors up to the statutory maximum. The losses of uninsured depositors in these cases amounted to only a little more than $80 million last year, or less than .99 percent of the total deposits of all failed banks and banks receiving open bank assistance.

When considered as a whole, our treatment of large and small failing banks is in most important respects remarkably similar. In virtually all cases, equity

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holders and subordinated creditors are substantially wiped out or suffer severe losses and senior management and directors are replaced. Bank depositors and creditors receive ALL of their funds in the vast majority of cases. In fact in 1987, 72 percent of the failed bank's were handled by purchase and assumption transactions which assured all depositors 100 percent of their funds.

ADEQUACY OF THE FUND

The financial condition of the FDIC remains strong and stable despite a record number of bank failures and assistance transactions, including the second largest in our history in 1987. At year-end 1987, the insurance fund's net worth was $18.3 billion, a modest increase of roughly $50 million over the previous year. Based on current estimates of loss in 1988, including the loss on First Republic of Dallas, Texas, we may experience a small decrease in the net worth of the fund in 1988.

The composition of the fund is as important as the balance. At year end 1987, nearly 91 percent of the fund balance, or $16.6 billion, was represented by cash and liquid U.S. Treasury Securities. The amount of these liquid assets declined by only about $500 million in 1987 even though record demands were made upon our fund.

The preservation of our cash is largely the result of the innovation in handling failures which we mentioned previously. The flexibility and capacity represented by what is essentially cash is one reason we are confident that the FDIC fund remains adequate to handle any foreseeable problems in the banking system.

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Even though the fund is strong and stable, it is not increasing at a rate commensurate with the growth in deposits. In 1986 the ratio of reserves to insured deposits dropped from 1.20 percent to 1.12 percent. This decline continued in 1987 to 1.10 percent. Until the number or size of bank failures declines from present historically high levels, it is difficult to foresee the ratio of insurance reserves to insured deposits increasing. Indeed, a further decline in 1988 is anticipated largely due to the continued economic problems west of the Mississippi.

FDIC - FSLIC

While we believe that the FDIC fund is sufficient to deal with problems in the banking system as we see them today, we do not have the financial capacity to function as insurer of commercial banks, and restore the solvency of the Federal Savings and Loan Insurance Corporation as well. If additional funds are required by the FSLIC in the future, we believe they should be supplied without endangering the financial condition and capacity of the FDIC. We do not believe a merger of the funds is desirable under current conditions. Despite this view, we are studying various suggestions with respect to a merger in the event the Congress decides such action is required. In addition, we have offered whatever assistance we can to the FSLIC in terms of administration, asset liquidation, developing supervisory policies and procedures, training or other operational assistance.

Although there are some problems in the banking industry, there is no inventory of operating FDIC-insured insolvent banks. The fund is adequate, and commercial bank problems -- outside recognized troubled areas -- appear to

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be stabilized or on the decline. With new products banks could further improve their safety and soundness.

We believe that addressing the FSLIC problem should entail an overview of the workings of the entire federal deposit insurance system. This issue is of great importance. Accordingly, we have formed a group of knowledgeable people from both within and outside the FDIC to study, and make recommendations in, this area. We have asked for input from all interested parties. We expect our study -- "A Federal Deposit Insurance System for the 90s" -- will be completed before year-end.

CONCLUSION

The banking industry is experiencing a stressful period of evolution. There are serious problems and challenges for banks, bankers the regulators and especially for the establishment of appropriate public policy by the Congress. The questions and problems are not easily answered but they can be managed. Mistakes may occur, but correcting and learning from mistakes is often better than inaction. Actions taken now will shape the health and worldwide competitiveness of U.S. banking into the next century. We look forward to cooperating with the Congress in whatever way possible to insure that the industry remains the safe and sound backbone of the U.S. economic system and a capable competitor in world markets.

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TABLE 1
Number and total deposits of troubled (CAMEL rating of 4 and 5 and pre-CAMEL equivalents) institutions

TOTAL NUMBER OF FDIC-INSURED PROBLEM COMMERCIAL BANKS AND THRIFTS AND AGGREGATE TOTAL DEPOSITS BY YEAR (000,000 omitted)

Year-End	0 - $300 Million		$300 - 1,000 Million		Over $1 Billion		Total	
	#	Total Deposits	#	Total Deposits	#	Total Deposits	#	Total Deposits
4/30/88	1,444	$ 60,651	39	$ 21,789	22	$206,413	1,505	$288,853
1987	1,509	63,743	42	22,461	24	196,246	1,575	282,450
1986	1,412	55,289	46	24,348	26	191,683	1,484	271,320
1985	1,069	41,317	41	23,217	30	132,593	1,140	197,127
1984	778	31,031	38	20,129	32	134,949	848	186,109
1983	591	26,838	31	16,513	20	85,740	642	129,081
1982	332	12,759	21	10,119	16	34,460	369	57,338
1981	197	5,659	15	9,423	11	27,482	223	42,564
1980	206	4,599	7	4,860	4	12,185	217	21,644
1979	274	6,995	11	6,559	2	6,763	287	20,317
1978	322	8,404	14	7,668	6	48,069	342	64,142
1977	348	10,036	13	7,307	7	44,561	368	61,904
1976	361	11,286	10	6,037	8	41,830	379	59,153
1975	303	7,641	7	3,955	2	6,517	312	18,113
1974	177	4,525	5	3,116	1	1,420	183	9,061
1973	154	2,806	2	1,499	0	0	156	4,305
1972	189	3,141	3	2,192	0	0	192	5,333
1971	239	3,504	2	1,453	0	0	241	4,957
1970	251	3,613	0	0	1	1,076	252	4,689

Source: FDIC Problem Bank List.

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TABLE 2
CLOSED BANKS
FDIC INSURED INSTITUTIONS
BY SIZE (000 omitted)

Year-End	0 - $300 Million #	0 - $300 Million Total Assets	$300 - 1,000 Million #	$300 - 1,000 Million Total Assets	Over $1 Billion #	Over $1 Billion Total Assets	Total #	Total Total Assets
4/30/88	58	$2,010,411	1	$ 590,700			59	$2,601,111
1987	181	5,644,359	3	1,277,618			184	6,921,977
1986	136	4,787,971	1	561,013	1	$1,616,816	138	6,965,800
1985	116	2,851,969					116	2,851,969
1984	77	2,371,211	1	391,800			78	2,763,011
1983	43	1,954,397	1	778,434	1	1,404,092	45	4,136,92[illegible]
1982	31	749,647	2	1,497,159			33	2,246,806
1981	7	103,626					7	103,626
1980	10	236,164					10	236,164
1979	10	132,988					10	132,988
1978	6	281,495	1	712,540			7	994,035
1977	6	232,612					6	232,612
1976	15	627,186	1	412,107			16	1,039,293
1975	13	419,950					13	419,950
1974	3	166,934			1	3,655,662	4	3,822,596
1973	5	43,807			1	1,265,868	6	1,309,675
1972	1	22,054					1	22,054
1971	6	196,520					6	196,520
1970	7	62,147					7	62,147

Source: FDIC Annual Reports

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TABLE 3
OPEN BANK ASSISTANCE
FDIC INSURED FINANCIAL INSTITUTIONS
BY SIZE (000 omitted)

Year-End	0 - $300 Million		$300 - 1,000 Million		Over $1 Billion		Total	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
4/30/88	9	$514,193	2	$1,285,107	2	$41,200,000	13	$42,999,300(A)
1987	7	122,580			2	2,428,518	9	2,551,098(B)
1986	6	220,694	1	500,000			7	720,694
1985	2	197,879	1	413,948	1	5,277,472	4	5,889,299
1984			1	513,400	1	35,900,000	2	36,413,400
1983	2	390,000			1	2,500,000	3	2,890,000
1982	2	205,203	4	2,642,682	3	6,537,724	9	9,385,609
1981			1	899,029	2	3,856,405	3	4,755,434
1980					1	5,500,000	1	5,500,000
1979								
1978								
1977								
1976			1	305,000			1	350,000
1975								
1974								
1973								
1972					1	1,300,000	1	1,300,000
1971	1	9,300					1	9,300
1970								

Source: FDIC Annual Reports

(A) Includes the 70 banks of First RepublicBank Corporation and the 52 banks of First City Bancorp System as one institution each.

(B) Includes the 11 banks of BancTexas System as one institution.

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TABLE 4
CLOSED BANKS AND OPEN BANK ASSISTANCE BY FDIC
FDIC INSURED INSTITUTIONS
BY SIZE (000 omitted)

Year-End	0 - $300 Million		$300 - 1,000 Million		Over $1 Billion		Total	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
4/30/88	67	$2,524,604	3	$1,875,807	2	$41,200,000	72	$45,600,411(A)
1987	188	$5,766,939	3	$1,277,618	2	2,428,518	193	9,473,075(B)
1986	142	5,008,665	2	1,061,013	1	1,616,816	145	7,686,494
1985	118	3,049,848	1	413,948	1	5,277,472	120	8,741,268
1984	77	2,371,211	2	905,200	1	35,900,000	80	39,176,411
1983	45	2,344,397	1	778,434	2	3,904,092	48	7,026,923
1982	33	954,850	6	4,139,841	3	6,537,724	42	11,632,415
1981	7	103,626	1	899,029	2	3,856,405	10	4,859,060
1980	10	236,164			1	5,500,000	11	5,736,164
1979	10	132,988					10	132,988
1978	6	281,495	1	712,540			7	994,035
1977	6	232,612					6	232,612
1976	15	627,186	2	762,107			17	1,389,293
1975	13	419,950					13	419,950
1974	3	166,934			1	3,655,662	4	3,822,596
1973	5	43,807			1	1,265,868	6	1,309,675
1972	1	22,054			1	1,300,000	2	1,322,054
1971	7	205,820					7	205,820
1970	7	62,147					7	62,147

Source: FDIC Annual Reports

(A) Includes the 70 banks of First RepublicBank Corporation and the 52 banks of First City Bancorp System as one institution each.

(B) Includes the 11 banks of BancTexas System as one institution.

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The FDIC Quarterly Banking Profile

APPENDIX A

L. William Seidman, Chairman

Fourth Quarter 1987

COMMERCIAL BANKING PERFORMANCE — FOURTH QUARTER, 1987

- ***U.S. BANKS POST LOWEST RETURNS SINCE THE GREAT DEPRESSION***
- ***1987'S EXTRAORDINARY LOAN LOSS PROVISIONS ACCOUNT FOR DROP IN PROFITS***
- ***MIDWESTERN BANKS SHOW SIGNIFICANT IMPROVEMENT***
- ***SOUTHWESTERN BANKS SUFFER LARGE LOSSES***
- ***FOURTH QUARTER OPERATING INCOME UP SHARPLY FROM YEAR-EARLIER LEVELS***
- ***NUMBER OF BANKS ON PROBLEM LIST DECLINES — FIRST TIME SINCE 1981***
- ***SIGNIFICANT IMPROVEMENT IN INDUSTRY PERFORMANCE EXPECTED IN 1988***

Commercial banks earned $3.7 billion in 1987, down nearly 80 percent from the $17.5 billion earned in 1986, in their worst year for profitability since the Great Depression. Their return on assets of 0.13 percent and return on equity of 2.56 percent were the lowest levels since 1934. These results had been anticipated since the second quarter, when the nation's largest banks began setting aside sizable reserves for troubled loans to developing countries (LDCs). The soaring loan-loss provisions, over 67 percent higher than in 1986, fully accounted for the banking industry's year-to-year drop in earnings. Loan-loss provisions attributable to the international operations of U.S. banks were $20.6 billion, $18 billion higher than a year ago. Absent the extraordinary reserving for LDC loans, aggregate loan loss provisions would have declined $3 billion from a year ago, and net income would have been roughly equal to 1986's level.

Chart A — Returns on Assets and Equity at Insured Commercial Banks 1935—1987

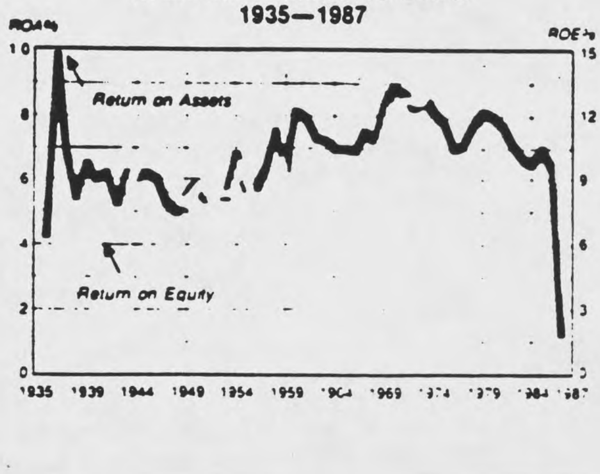
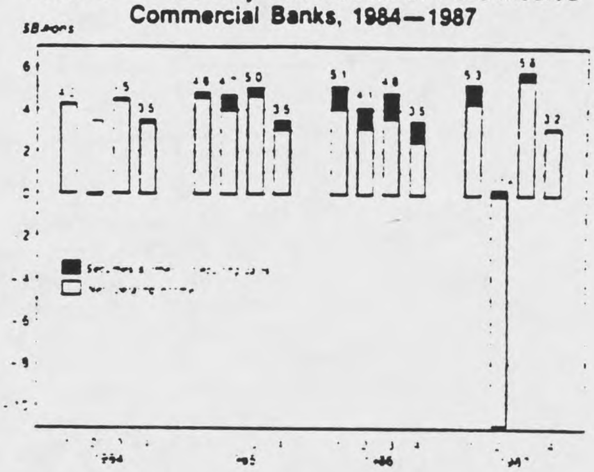


Chart B — Quarterly Net Income of FDIC-Insured Commercial Banks, 1984—1987



The loan-loss provisions had the positive effect of raising the aggregate allowance for loan and lease losses 71 percent. At year-end, the ratio of the loss allowance to loans stood at 2.70 percent, compared to 1.65 percent at the end of 1986. The ratio of equity capital to assets fell by 16 basis points to 6.05 percent, while the ratio of primary capital (which includes the loss allowance) to assets increased by 47 basis points to 7.69 percent. Nonperforming assets were up 29 percent from a year ago, largely due to the impaired status of LDC loans, ending the year at 2.56 percent of total assets. Most of the growth in nonperforming assets took place in the first quarter of the year; nonperforming assets shrank by $1.5 billion in the fourth quarter. The possibility that some nonaccruing LDC loans may return to accrual status in 1988 increases the potential for further reductions.

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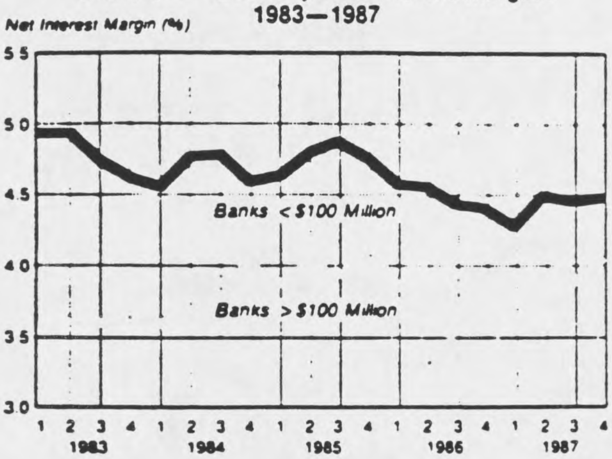
Fourth quarter operating income was $3.2 billion, up over 25 percent from the fourth quarter of 1986, despite loan loss provisions of $7.7 billion that were nearly 12 percent higher than the year-ago period. Interest margins, which narrowed for the full year, improved slightly during the second half of the year. They were especially strengthened in the fourth quarter in the wake of the October stock market decline, as banks enjoyed a large inflow of deposits and interest rates fell. Banking sector deposits, up only 2.2 percent for the year, grew at an annualized rate of 11.7 percent in the fourth quarter. The events of Black Monday also triggered a surge in loan demand as financial services firms sought to maintain liquidity. The largest banks were the greatest beneficiaries of the flight to quality; they also experienced a marked increase in noninterest income in the fourth quarter, especially from foreign exchange operations.

Chart C — Quarterly Net Interest Margins 1983—1987



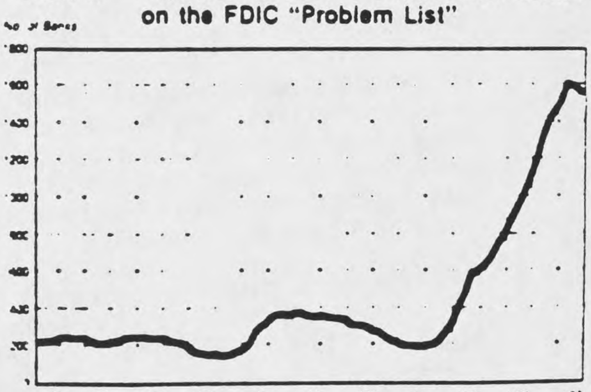
Asset growth was less than two percent during 1987, the smallest annual increase since 1948, and commercial loans were down two percent from year-earlier levels. The four percent growth in total loans was driven by increased real estate and consumer lending. Real estate loans outstanding at year-end actually exceeded banks' commercial loans by $10 billion, reflecting the restructuring of banks' traditional operations in the face of increased competition. Much of the increase in real estate lending was in the form of home equity loans, which stood at nearly $33 billion at year-end.

The outlook for 1988 is cautiously optimistic. Barring any new shocks, loan loss provisioning should be lower than usual this year, and profitability at money-center and regional banks will be much improved. The effectiveness of banks' efforts to expand noninterest income sources and curb operating expense growth will be an important determinant of profitability. Community banks showed improved results in 1987, with return on assets up 43 basis points at banks smaller than $100 million, and 22 basis points for banks in the $100-to-300 million range. Unaffected by overseas loan problems, both of these size groups, representing 93.5 percent of all banks, saw charge-offs and loss provisions decrease by 10 to 25 percent from year-earlier levels. Smaller banks outside the Southwest should continue to show strong or improving earnings in 1988.

The Southwest will continue to be a major source of earnings weakness. The levels of problem banks and failures remain high and the region's banking sector continues to operate at a loss. For the full year, 36 percent of the banks in the region were unprofitable and return on equity was a negative 11.81 percent. Persistent growth of nonperforming assets, despite high levels of loan charge-offs, points to more of the same this year. In contrast, the worst of the problems experienced by banks in the Midwest are behind them, and they can be expected to return soon to more traditional levels of profitability. The number of Midwest bank failures was down slightly, from 48 to 40, but the number of unprofitable banks was almost cut in half. Loan charge-offs declined 22 percent compared to 1986, while at the same time, asset quality improved, as nonperforming assets fell 6.5 percent. Midwestern banks showed the greatest improvement over 1986 results, with a 78 percent increase in net operating income on a year-to-year basis.

The results for the Northeast and, to a lesser extent, the Central and West regions, were dominated by the loan-loss provisioning at the big money-center banks. Actions by the largest banks overshadowed generally strong performance by banks in the Central region. Loan loss provisions were almost twice 1986 levels, halving net income, but actual loan losses grew by only five percent. The Central region had the lowest proportions of both failed and unprofitable banks, and the second highest rate of loan growth. The Southeast enjoyed the strongest loan demand of the six regions, as loans grew 11.3 percent and assets by 6.5 percent. That demand, combined with strong net interest margins, yielded a regional-high return on assets of 0.93 percent.

Chart D — Number of Insured Commercial Banks on the FDIC "Problem List"



The number of banks with full-year earnings losses fell 15 percent to 2,366 in 1987, while the number of "Problem" banks leveled off, after peaking at mid-year. On the whole, the number of banks on the "Problem List" increased by 102, 7.0 percent higher at the end of 1987 than 1986. This increase was the lowest, both in number of net additions and in percentage terms, since 1981. The outlook for 1988 is for fewer troubled institutions, but the number of failures is not expected to be significantly lower than 1987's record. Industry profits for 1988 should be close to the $17.5 billion earned in 1986, as banks return to a more normal pattern of operations.

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Table I. Aggregate Condition and Income Data, FDIC-Insured Commercial Banks
(dollar figures in millions)

	Preliminary 4th Qtr 1987	3rd Qtr 1987	4th Qtr 1986	% Change 86 4-87 4
Number of banks reporting	13.654	13.851	14.200	-3.8
Total employees (full-time equivalent)	1,554.885	1.554.142	1.563.057	-0.5
CONDITION DATA				
Total Assets	$2.998.428	$2.942.652	$2.941,082	1.9
Real estate loans	599.135	579.046	515.365	16.3
Commercial & industrial loans	588.971	580.375	600.878	-2.0
Loans to individuals	350.361	341.829	335.698	4.4
Farm loans	29,317	31.066	31,607	-7.2
Other loans and leases	259.909	265,778	273.102	-4.8
Total loans and leases	1,827,693	1,798.094	1.756.650	4.0
LESS: Reserve for losses	49.429	47,407	28.903	71.0
Net loans and leases	1,778.264	1,750.687	1,727,747	2.9
Temporary investments	450.623	446.390	463.627	-2.8
Securities over 1 year	396.452	387.372	357.523	10.9
All other assets	373.089	358.203	392.185	-4.9
Total liabilities and capital	$2.998.428	$2.942.652	$2.941,082	1.9
Noninterest-bearing deposits	479.073	450.361	532.347	-10.0
Interest-bearing deposits	1,853.600	1,816.254	1,751,121	5.9
Other borrowed funds	361.351	367,418	358.964	0.7
Subordinated debt	17.586	17.528	16.993	3.5
All other liabilities	105.554	110.675	99.411	6.2
Equity capital	181.264	180.416	182.246	-0.5
Primary Capital	234.471	231.492	214.304	9.4
Nonperforming assets	74.390	75.914	57.667	29.0
Loan commitments and letters of credit	792.136	773.589	751.859	5.4
Domestic office assets	2.572.769	2.519.010	2.532.352	1.6
Foreign office assets	425.649	423.642	408.730	4.1
Domestic office deposits	1.991,066	1.922.217	1,969.673	1.1
Foreign office deposits	341.607	344.398	313.795	8.9
Earning Assets	2.625.339	2.584.449	2.548.897	3.0

INCOME DATA	Preliminary Full Year 1987	Full Year 1986	% Change	Preliminary 4th Qtr 1987	4th Qtr 1986	% Change
Total interest income	$244.695	$237.806	2.9	$64.270	57.865	11.1
Total interest expense	144.810	142.824	1.4	38.392	33.593	14.3
Net interest income	99.885	94.982	5.2	25.878	24.272	6.6
Provisions for loan losses	36.965	22.075	67.5	7.725	6.924	11.6
Total noninterest income	41,490	35.890	15.6	12.070	9.852	22.5
Total noninterest expense	96.933	90.247	7.4	25.691	24.196	6.2
Applicable income taxes	5.425	5.288	2.6	1.381	494	179.6
Net operating income	2.052	13.262	-84.5	3.151	2.510	25.5
Securities gains, net	1,436	3,950	-63.6	42	961	-95.6
Extraordinary gains, net	219	274	-20.1	38	61	-37.7
Net Income	3,707	17,486	-78.8	3.231	3.532	-8.5
Net charge-offs	15.901	16.550	-3.9	5.253	5.448	-3.6
Net additions to capital stock	2.506	3.244	-22.7	1.392	2.251	-38.2
Cash dividends on capital stock	10.620	9.228	15.1	3.650	3.245	12.5

Table II. Selected Indicators, FDIC-Insured Commercial Banks

	1981	1982	1983	1984	1985	1986	1987
Return on assets	0.78%	0.71%	0.66%	0.65%	0.70%	0.64%	0.13%
Return on equity	13.08	12.11	10.70	10.73	11.31	10.18	2.56
Equity capital to assets	5.83	5.87	6.00	6.15	6.20	6.21	6.05
Primary capital ratio	6.39	6.47	6.59	6.91	6.91	7.22	7.69
Nonperforming assets to assets	N/A	1.85	1.97	1.97	1.87	1.95	2.46
Net charge-offs to loans	0.37	0.56	0.67	0.76	0.84	0.99	0.89
Asset growth rate	9.36	8.12	6.75	7.11	8.86	7.62	1.95
Net operating income growth	7.60	-0.62	-3.69	3.40	6.30	-16.20	-84.53
Number of unprofitable banks	741	1.196	1.530	1.891	2.453	2.784	2.366
Number of problem banks	196	326	603	800	1.098	1.457	1.559
Number of failed/assisted banks	7	34	45	78	118	144	201

N/A — Not available

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Table III. Preliminary Fourth Quarter 1987 Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution						Geographic Distribution				
								EAST			WEST	
	All Banks	Less than $100 Million	$100-300 Million	$300-1,000 Million	$1-5 Billion	Greater than $5 Billion	Ten Largest Banks	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region
Number of banks reporting	13,654	10,891	1,876	535	268	74	10	1,079	1,916	3,042	3,230	2,860
Total assets	$2,998.4	$392.6	$302.8	$272.2	$589.6	$761.3	$679.9	$1,179.7	$406.5	$479.7	$208.4	$279.9
Total deposits	2,332.7	350.5	266.1	226.4	455.1	536.4	498.2	865.0	323.2	387.1	163.7	229.3
% total banks	100.0%	79.8%	13.7%	3.9%	2.0%	0.5%	0.1%	7.9%	14.0%	22.3%	23.7%	20.9%
Asset share (%)	100.0	13.1	10.1	9.1	19.6	25.4	22.7	39.3	13.6	16.0	7.0	9.3
Deposit share (%)	100.0	15.0	11.4	9.7	19.5	23.0	21.4	37.1	13.9	16.6	7.0	9.8
Number of unprofitable banks	3,478	3,055	287	78	35	21	2	160	418	395	746	1,288
Number of failed/assisted banks	50	46	2	2	0	0	0	1	0	1	14	26
Performance ratios *(annualized)*												
Yield on earning assets	9.86%	9.83%	9.84%	10.11%	10.46%	10.18%	10.48%	10.17%	9.79%	9.44%	9.83%	8.93%
Cost of funding earning assets	5.89	5.34	5.35	5.58	5.92	6.23	7.14	6.53	5.45	5.56	5.56	5.61
Net interest margin	3.97	4.49	4.49	4.53	4.54	3.95	3.34	3.64	4.34	3.88	4.27	3.32
Net noninterest expense to earning assets	2.09	3.12	2.76	2.72	2.47	2.01	1.08	1.52	2.45	2.06	2.02	2.73
Net operating income to assets	0.42	0.24	0.62	0.51	0.40	-0.20	1.04	0.57	0.78	0.48	0.77	-1.08
Return on assets	0.43	0.23	0.63	0.53	0.41	-0.19	1.07	0.61	0.80	0.48	0.74	-1.12
Return on equity	7.14	2.65	8.15	7.56	6.32	-3.68	25.98	11.27	11.58	7.33	9.89	-18.02
Net charge-offs to loans and leases	1.15	1.55	1.16	1.21	1.32	1.75	0.39	0.71	1.14	1.10	1.99	2.43
Condition Ratios												
Loss allowance to loans and leases	2.70%	1.63%	1.50%	1.60%	1.85%	2.93%	4.65%	3.15%	1.38%	2.24%	2.21%	3.09%
Nonperforming assets to assets	2.48	2.09	1.75	1.87	1.93	2.28	3.88	2.44	1.04	1.27	1.87	5.80
Equity capital ratio	6.05	8.61	7.62	6.88	6.41	5.11	4.24	5.43	6.81	6.53	7.46	6.07
Primary capital ratio	7.69	9.36	8.35	7.69	7.36	7.01	7.55	7.51	7.53	7.80	8.58	7.55
Net loans and leases to assets	59.31	51.10	56.61	60.91	63.08	61.21	59.19	59.61	60.14	57.56	53.15	53.90
Net assets repriceable in one year or less to assets	-7.26	-9.46	-7.73	-7.43	-8.21	-8.01	-4.06	-6.05	-12.11	-4.60	-13.67	-11.39
Growth Rates *(year-to-year)*												
Assets	1.9%	4.0%	5.9%	7.7%	9.4%	8.4%	-1.8%	4.1%	6.5%	3.5%	1.0%	-7.3%
Earning assets	3.0	4.6	7.0	9.0	10.7	10.0	-1.3	5.1	7.6	4.1	1.4	-7.4
Loans and leases	4.0	6.9	10.4	12.0	14.9	9.3	-3.0	5.9	11.3	6.9	3.3	-8.4
Loss reserve	71.0	10.7	16.6	21.0	43.5	98.8	140.7	123.8	18.0	65.6	16.9	19.7
Net charge-offs	-3.6	-33.4	-21.0	-1.4	42.9	113.4	-62.3	2.8	44.5	23.7	-13.4	-32.2
Nonperforming assets	29.0	0.4	9.5	19.7	41.7	58.3	49.6	64.5	15.7	0.9	-6.5	31.5
Deposits	2.2	4.1	5.4	6.1	9.1	9.0	0.2	4.7	5.9	4.3	1.5	-7.0
Equity capital	-0.5	4.2	8.8	8.6	11.7	0.8	-16.3	-2.7	10.3	-0.5	5.7	-12.1
Interest income	11.1	4.3	9.0	11.5	25.4	24.9	14.6	19.9	11.6	9.0	4.5	-4.9
Interest expense	14.3	2.4	8.1	13.1	28.2	31.5	21.3	27.1	13.6	10.1	3.7	-4.4
Net interest income	6.6	6.6	10.1	9.5	22.0	15.6	2.4	8.8	9.2	7.6	5.5	-5.6
Loan loss expense	11.6	-37.1	-32.2	-2.5	39.2	157.0	-28.0	42.6	14.1	75.5	-28.9	-32.2
Noninterest income	22.5	4.8	6.6	8.8	36.8	23.8	45.2	44.3	15.5	20.8	-5.7	1.3
Noninterest expense	6.2	4.7	6.4	9.5	22.5	18.5	8.0	13.3	4.5	4.4	0.3	-0.1
Net operating income	25.5	N/M	163.9	26.2	-10.8	N/M	126.3	-3.0	33.9	-17.1	83.3	N/M
Net income	-8.5	N/M	75.2	-0.4	-29.3	N/M	89.5	-13.4	3.7	-28.5	26.7	N/M

REGIONS: Northeast — Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont

Southeast — Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia

Central — Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin

Midwest — Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota

Southwest — Arkansas, Louisiana, New Mexico, Oklahoma, Texas

West — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Pacific Islands, Utah, Washington, Wyoming

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Table IV. Preliminary Full-Year 1987 Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution						Geographic Distribution					
								EAST			WEST		
	All Banks	Less than $100 Million	$100-300 Million	$300-1,000 Million	$1-5 Billion	Greater than $5 Billion	Ten Largest Banks	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
Number of unprofitable banks	2,366	2,070	174	62	33	18	9	104	230	184	412	1,038	398
Number of failed/assisted banks	201	186	12	3	0	0	0	3	6	7	40	116	33
Performance ratios													
Yield on earning assets	9.53%	9.65%	9.59%	9.66%	9.62%	9.55%	9.99%	9.75%	9.54%	9.19%	9.65%	8.70%	9.83%
Cost of funding earning assets	5.64	5.22	5.17	5.23	5.34	5.73	6.82	6.23	5.17	5.36	5.45	5.38	5.10
Net interest margin	3.89	4.43	4.41	4.43	4.28	3.82	3.17	3.52	4.37	3.83	4.20	3.32	4.73
Net noninterest expense to earning assets	2.16	2.86	2.66	2.63	2.37	1.98	1.51	1.74	2.48	2.13	1.95	2.43	2.93
Net operating income to assets	0.07	0.53	0.75	0.62	0.53	-0.05	-0.89	-0.22	0.88	0.41	0.66	-0.66	-0.05
Return on assets	0.13	0.58	0.81	0.67	0.57	-0.00	-0.81	-0.13	0.93	0.45	0.68	-0.61	-0.01
Return on equity	2.56	6.70	10.61	9.59	8.77	-0.01	-18.29	-2.96	17.16	8.28	11.48	-11.81	-0.32
Net charge-offs to loans and leases	0.89	1.14	0.81	0.95	0.92	1.04	0.67	0.61	0.69	0.68	1.57	1.99	1.08
Growth Rates *(year-to-year)*													
Net charge-offs	-3.9%	-21.2%	-10.8%	16.1%	24.4%	40.6%	-26.9%	7.5%	24.8%	5.2%	-22.4%	-12.8%	-11.3%
Interest income	2.9	-1.2	3.3	6.0	11.3	11.6	3.8	10.2	5.1	1.2	-1.6	-11.5	-2.6
Interest expense	1.4	-5.7	-1.3	1.6	7.4	11.2	6.3	11.6	1.4	-1.9	-4.7	-12.9	-8.3
Net interest income	5.2	4.9	9.3	11.6	16.6	12.1	-1.1	7.7	9.8	6.0	2.6	-9.1	4.4
Loan loss expense	67.5	-23.8	-16.1	5.3	35.7	141.5	173.8	203.7	23.6	96.1	-19.2	-17.6	42.9
Noninterest income	15.6	10.5	11.5	13.0	22.9	18.7	23.6	27.3	11.5	10.1	12.4	4.5	2.0
Noninterest expense	7.4	6.2	9.0	10.7	15.5	15.9	9.1	12.6	7.0	5.8	4.1	-0.4	4.3
Net operating income	-84.5	51.0	28.5	13.6	-3.7	N/M	N/M	N/M	10.6	-42.3	77.6	N/M	N/M
Net income	-78.8	12.6	11.3	-0.9	-12.1	N/M	N/M	N/M	0.5	-45.5	-1.4	N/M	N/M

NOTES TO USERS

COMPUTATION METHODOLOGY FOR PERFORMANCE AND CONDITION RATIOS

All income figures used in calculating performance ratios represent amounts for that period, annualized (multiplied by the number of periods in a year).

All asset and liability figures used in calculating performance ratios represent average amounts for the period (beginning-of-period amount plus end-of-period amount plus any periods in between, divided by the total number of periods).

All asset and liability figures used in calculating the condition ratios represent amounts as of the end of the quarter.

DEFINITIONS

"Problem" Banks—Federal regulators assign to each financial institution a uniform composite rating, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" banks are those institutions with financial, operational or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either "4" or "5".

Earning Assets—all loans and other investments that earn interest, dividend or fee income.

Yield on Earning Assets—total interest, dividend and fee income earned on loans and investments as a percentage of average earning assets.

Cost of Funding Earning Assets—total interest expense paid on deposits and other borrowed money as a percentage of average earning assets.

Net Interest Margin—the difference between the yield on earning assets and the cost of funding them, i.e., the profit margin a bank earns on its loans and investments.

Net Noninterest Expense—total noninterest expense, excluding the expense of providing for loan losses, less total noninterest income. A measure of banks' overhead costs.

Net Operating Income—income after taxes and before gains (or losses) from securities transactions and from nonrecurring items. The profit earned on banks' regular banking business.

Return on Assets—net income (including securities transactions and nonrecurring items) as a percentage of average total assets. The basic yardstick of bank profitability.

Return on Equity—net income as a percentage of average total equity capital.

Net Charge-offs—total loans and leases charged off (removed from balance sheet because of uncollectibility) during the quarter, less amounts recovered on loans and leases previously charged off.

Nonperforming Assets—the sum of loans past-due 90 days or more, loans in nonaccrual status and noninvestment real estate owned other than bank premises.

Primary Capital—total equity capital plus the allowance for loan and lease losses plus minority interests in consolidated subsidiaries plus qualifying mandatory convertible debt (cannot exceed 20 percent of total primary capital), less intangible assets except purchased mortgage servicing rights.

Net Loans and Leases—total loans and leases less unearned income and the allowance for loan and lease losses.

Net Assets Repriceable in One Year or Less—all assets with interest rates that are repriceable in one year or less plus assets with remaining maturity of one year or less, minus all liabilities that are repriced or due to mature within one year of the reporting date. A positive value indicates that banks' income from assets is more sensitive to movements in interest rates than is the expense of their liabilities, and vice-versa for a negative value.

Temporary Investments—the sum of interest-bearing balances due from depository institutions, federal funds sold and resold, trading-account assets and investment securities with remaining maturities of one year or less.

Loan Loss Expense—the quarterly addition to the loan loss reserve that will keep the balance of the reserve adequate to absorb the quarter's anticipated loan losses.

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DRAFT--MAY 11, 1988

EMERGENCY CONSOLIDATIONS

Analysis

Many bank holding companies coordinate their banks' activities so closely that the bank holding company system effectively operates as a single banking enterprise. Yet when a bank within the system fails, the FDIC must deal with such bank individually. In effect, the FDIC must act as if there is no connection between the failed bank and the rest of the system.

Some bank holding companies and their creditors have seen a way to turn this situation to their advantage. By concentrating poorer assets in a single bank, and then letting that bank fail, the bank holding company can shift the cost of those assets--the loss it would otherwise be forced to realize on them--to the FDIC. This technique amounts to a misuse of the FDIC's resources, which can do substantial harm to the Federal safety net for depositors.

Recent experience has also shown that creditors and shareholders can interfere with the Federal safety net in other ways as well. In many cases it is in the best interest of the local community and of the banking system for the FDIC to arrange open-bank assistance transactions. These transactions are designed to avoid the disruption that a bank failure would inflict on a community. Open-bank transactions may require the consent of creditors and shareholders of the holding company, however. In a number of cases the creditors and shareholders have delayed these transactions in an attempt to receive greater consideration than they would have been entitled to if the bank had failed. These creditors and shareholders have imposed added costs on the Federal safety net because of the FDIC's desire to prevent the closing of the bank.

The bill seeks to address these problems by establishing a special procedure to deal with failing banks that belong to multi-bank holding companies. The procedure is designed to improve the asset quality of a failing bank within a multi-bank system without affecting the health of the system as a whole.

The process begins when a bank's charterer--State or Federal--notifies the FDIC that a bank is in danger of failing, and asks the FDIC to start the process. The FDIC then decides whether the special procedure will reduce the risk to the FDIC fund, or alternatively, whether local economic conditions are such that resort to the special procedure is justified. If so, the FDIC may then certify to the Federal Reserve Board that it is necessary for the Board to exercise the new special powers made available under the bill.

Upon making the certification, the FDIC may specify one of the following new powers for the Board to exercise:

- --The Board can order the holding company to transfer the stock of one or more of its healthy banks to the failing bank;
- --The Board can order the company to merge one or more of its banks into the failing bank;
- --The Board can order the company to merge the failing bank into one or more of its healthy banks; and/or

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--The Board may order the company to provide such assets or services to the failing bank as may be needed for the bank to continue to conduct its normal business operations--e.g., bank buildings or data processing services.

The FDIC's recommendation may specify that the Board may exercise some or all of these powers. The Board may only exercise the powers that the FDIC has specified. On the other hand, the FDIC cannot compel the Board to take the action that the FDIC has recommended.

The Board must make a reasonable effort to see that the transaction does not involve the transfer of more assets to the failing bank than the bank needs to regain its health, taking into account the circumstances of the case. The FDIC may recommend a transaction, and the Board may order it, even if the assets so transferred to the failing bank are not sufficient to restore the bank to solvency.

Before the FDIC may make any recommendation to the Board, the FDIC must provide advance notice of the proposed transaction to every charterer--State and Federal--of every bank that would be involved. Each charterer has 48 hours to object to the recommendation. If any charterer objects within that time, the FDIC may only issue the recommendation if the FDIC's board of directors acts unanimously.

The Board has complete control over the specifics of any transaction that it orders pursuant to the FDIC's recommendation. The Board controls the procedures and scheduling.

No party may challenge an order issued by the Board or any action required by the Board in connection with any such transaction. Anyone who may be harmed by a Board-ordered action can take advantage of the bill's compensation provisions, but may not prevent the transaction from going forward.

No private contract can prevent or interfere with a Board-ordered transaction. Conversely, if a court declines to enforce a private contract because doing so would interfere with such a transaction, the court's action will not disturb the contract rights of the parties as among themselves.

Anyone who believes that a Board-ordered transaction has diminished the value of any valid and enforceable debt the bank holding company or any subsidiary bank might owe him, or of any equity interest he may own in the bank holding company or in any subsidiary bank, can apply to the Board within thirty days and ask the Board to appraise the debt or the equity interest. The Board must determine the value of any such debt or equity. Then, if the person tenders the debt or equity to the FDIC, the FDIC must buy it at the appraised value. This procedure provides full compensation for anyone whose property rights may be harmed by a Board-ordered transaction. It is the only procedure available to claimants for seeking such compensation.

The appraisal-and-tender rights created by this Act are only available to independent owners of the debt or equity of the bank holding company or of an

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affiliated bank. The bank holding company itself and its affiliates are not given any such rights.

The appraisal-and-tender rights apply to any debt and any equity, but only to debt or equity that someone holds on or before the effective date of this Act. Anyone who acquires debt or equity after that date does not have appraisal-and-tender rights. There are two exceptions to the cut-off. A person who is owed money for goods or services that the bank holding company or bank has procured in the ordinary course of business may tender the debt to the FDIC no matter when the debt was incurred. In addition, a person who owns shares in a subsidiary bank may tender them to the FDIC no matter when he acquired them. This latter provision protects someone who has bought a minority share in an independent bank, and who continues to hold that share after the majority owners have sold their shares to a bank holding company.

A resulting bank may keep any branches or other offices it acquires as a result of a Board-ordered merger.

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DRAFT--MAY 16, 1988

EMERGENCY CONSOLIDATIONS

SEC. ___. EMERGENCY CONSOLIDATIONS.--Section 5 of the Bank Holding Company Act of 1956 is amended by inserting new subsections (g) and (h) at the end thereof reading as follows:

"(g) EMERGENCY CONSOLIDATIONS; PREEMPTION OF STATE AND FEDERAL LAWS.--Notwithstanding any other provision of this Act, or of Federal or State bankruptcy laws, or of any other Federal or State law or of the constitution of any State, or of any contract or other instrument or security--

"(1) CONSOLIDATIONS REQUIRED.--Upon certifying to the Board that it is necessary for the Board to exercise the powers made available by this subsection (g), the Corporation may recommend that the Board:

"(A) Order a bank holding company to cause any or all of its affiliated banks to be reorganized as subsidiaries of a bank specified in subparagraph (11)(A);

"(B) Order a bank holding company to cause any or all of its subsidiary banks located in the same State as a bank specified in subparagraph (11)(A) to merge with, or to purchase the assets and assume the liabilities of, such bank;

"(C) Order a bank holding company to cause a bank specified in subparagraph (11)(A) to merge with, or to purchase the assets and assume the liabilities of, any or all of the bank holding company's other subsidiary banks that are located in the same State as such bank;

"(D) Order a bank holding company to contribute or transfer or provide to a bank specified in subparagraph (11)(A), or to require any of its subsidiaries to contribute or transfer or provide to any such bank, such assets or services as are customarily utilized by a bank in the conduct of its business or operations; or

"(E) Order a bank holding company to take any combination of actions specified in paragraphs (A) through (D).

"(2) BOARD POWERS.--

"(A) AUTHORITY.--

"(i) The Board shall have authority to compel any bank holding company to consummate a transaction recommended by the Corporation under paragraph (1). The Board may require the bank holding company and any subsidiary thereof to take such action in connection with any such transaction as the Board may deem necessary or appropriate.

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"(ii) Upon a determination that an emergency no longer exists, the Board may order any bank holding company subsidiaries which were reorganized as subsidiaries of a bank under subparagraph (A) of paragraph (1) to be organized as direct subsidiaries of the bank holding company. In no event shall the Board order such a restructuring to occur in less than thirty days from the date of its order.

"(B) PROCEDURES.--Any action required by the Board under subparagraph (A) shall be consummated in accordance with such procedures and schedules as the Board may prescribe. Except as provided in clause (ii) of subparagraph (A), any transaction ordered by the Board, and any action required by the Board in connection with any such transaction, shall be consummated immediately if the Board so orders.

"(C) JUDICIAL REVIEW.--No order issued by the Board under this paragraph (2), and no action required by the Board under this paragraph (2), shall be subject to review by any court.

"(3) CONSULTATION.--

"(i) REQUIRED.--Before making any recommendation under paragraph (1), the Corporation shall consult the relevant supervisor of any bank involved in the recommended transaction.

"(ii) NOTICE.--The Corporation shall provide the relevant supervisor a reasonable opportunity, and in no event less than forty-eight hours, to object to the Corporation's recommendation.

"(iii) RIGHT TO OBJECT.--If the relevant supervisor objects during such period, the Corporation may make a recommendation under paragraph (1) only by a unanimous vote of its Board of Directors.

"(4) OFFICES ACQUIRED IN CONSOLIDATIONS.--Any office operated as a branch or home office by a bank involved in a transaction ordered by the Board under paragraph (2) may be operated as a branch or home office by any bank that acquires it pursuant to such transaction.

"(5) APPLICATION OF CERTAIN LAWS.--

"(A) BANK HOLDING COMPANY ACT.--

"(i) SECTION 2.--So long as a bank that is ordered under paragraph (2) to acquire affiliates as subsidiaries remains itself a subsidiary of a bank holding company, the term 'bank holding company' as defined in subsection 2(a) of this Act shall not include a bank if such bank would otherwise be deemed to be a bank holding company solely because it holds stock in the shares of another bank or banks, and has acquired such stock pursuant to the action required by the Board.

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"(ii) SECTION 3.--No action required by the Board under paragraph (2) shall require an application to or approval by the Board under Section 3 of this Act.

"(B) NATIONAL BANKING ACT.--No action required by the Board under paragraph (2) shall be subject to the requirements of the National Banking Act specified in Section 20 of Public Law 86-230.

"(C) FEDERAL DEPOSIT INSURANCE ACT.--No action required by the Board under paragraph (2) shall be subject to the requirements of section 13(f) or of section 18(c) of the Federal Deposit Insurance Act.

"(D) HART-SCOTT-RODINO ACT.--No action required by the Board under paragraph (2) shall be subject to the requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

"(6) PRIVATE PARTIES INELIGIBLE TO PREVENT CONSOLIDATION.--

(A) LIMITATION ON RIGHTS OF PRIVATE PARTIES.--No court shall give effect to any rights or powers conferred on any person, whether such rights or powers are conferred by State or Federal statute or by the articles or by-laws of the bank holding company or of any subsidiary thereof or by any debt or equity security of any such bank holding company or subsidiary thereof or by any other contract or other instrument or otherwise, and any provision of any such statute or security or article or by-law or contract or instrument shall be void, insofar as giving effect to any such rights or powers would impair the ability of the bank holding company or of any subsidiary bank:

"(i) to take any action required by the Board under paragraph (2), or

"(ii) as part of a transaction ordered by the Board under paragraph (2), to pledge, sell or otherwise transfer securities or assets of the bank holding company or of any subsidiary bank to the Corporation in connection with a transaction authorized by Section 13 of the Federal Deposit Insurance Act.

"(B) REFUSAL TO ENFORCE RIGHTS NOT OCCASION OF DEFAULT OR OTHER IMPOSITION OF PENALTY OR GROUND FOR ASSERTION OF DERIVATIVE RIGHTS.--The failure of a court to give effect to any rights or powers under subparagraph (A) shall not constitute an event of default or occasion of imposition of any penalty. No consequent effect of such failure to enforce the rights or duties of any person shall constitute an event of default or occasion of imposition of any penalty. No person may assert any rights or powers, whether such rights or powers are conferred by State or Federal statute or by the articles or by-laws of the bank holding company or of any subsidiary thereof or by any debt or equity security of any such bank holding company or subsidiary thereof or by any other contract or other instrument or otherwise, if such person would be unable to assert such rights or powers but for the failure of the court to give effect to rights or powers under subparagraph (A).

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"(C) NO OTHER CONSENTS NECESSARY.--Except as provided in this subsection (g), any action required by the Board under paragraph (2) shall be consummated without the necessity of notice to, approval from, or consent of shareholders, creditors, parties to contracts, lessors, insurers, or any other persons or governmental authorities.

"(7) RIGHT OF APPRAISAL.--

"(A) DEBTS OF BANK HOLDING COMPANIES AND OF AFFILIATED BANKS.--Any creditor of a bank holding company subject to an order issued by the Board under paragraph (2), and any creditor of a bank directly involved in a transaction in connection with such order, may apply to the Board for an appraisal of the value of any valid and enforceable debt owed to such creditor: provided, that neither the bank holding company nor any affiliate thereof, other than a person who is an affiliate solely because such person holds shares for investment purposes in such bank holding company or affiliate thereof, may file an application to the Board under this subparagraph (A).

"(B) SHAREHOLDERS IN BANK HOLDING COMPANIES.--Any person holding shares in a bank holding company subject to an order issued by the Board under paragraph (2) may apply to the Board for an appraisal of the value of such shares: provided, that no affiliate of such bank holding company, other than a person who is an affiliate solely because such person holds shares for investment purposes in such bank holding company, may file an application to the Board under this subparagraph (B).

"(C) SHAREHOLDERS IN AFFILIATED BANKS.--Any person holding shares in a bank directly involved in a transaction in connection with an order issued by the Board under paragraph (2) may apply to the Board for an appraisal of the value of such shares: provided, that no affiliate of such bank, other than a person who is an affiliate solely because such person holds shares for investment purposes in such bank, may file an application to the Board under this subparagraph (C).

"(8) TIME LIMITS.--

"(A) LIMIT RELATED TO TIME OF CONSUMMATION OF THE TRANSACTION.--No application under paragraph (7) may be made more than thirty days after the date of consummation of the transaction ordered by the Board under paragraph (2).

"(B) LIMIT RELATED TO TIME OF ACQUISITION OF THE DEBT OR SHARE.--No application under subparagraph (A) or subparagraph (B) of paragraph (7) may be made based on a debt or share acquired by the applicant on or after [the effective date of this Act]: provided, that this subparagraph (B) shall not apply to a person making application based on a debt owed for goods or services procured by the bank holding company or bank in the ordinary course of business.

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"(9) BOARD APPRAISALS.--

"(A) BOARD AUTHORIZED TO MAKE APPRAISALS.--Whenever a person files an application with the Board under paragraph (7), the Board shall determine the value of any debt or share based upon an appraisal. The appraisal shall be final and binding on all parties.

"(B) BASIS FOR APPRAISAL.--The value of any debt or share shall be based upon the value it would have had if every bank specified in subparagraph (11)(A) had been closed on the date of the order issued by the Board under paragraph (2), with the Corporation paying all insured deposits, the assets liquidated, and the resulting funds applied toward satisfying all other valid and enforceable liabilities of such bank, with the remainder, if any, allocated to the shareholders of such bank. Any determination of value also shall include consideration of any consequential effects resulting from such closing that would have occurred to other subsidiaries of the bank holding company.

"(C) RULEMAKING AUTHORITY.--The Board shall promulgate rules providing the procedures for making applications and appraisals under this subparagraph (9).

"(D) STANDARD OF REVIEW FOR APPRAISALS.--Any person obtaining an appraisal from the Board and disagreeing with the appraisal so established may seek review of the appraisal in accordance with the provisions of section 9 of this Act: <u>provided</u>, that no appraisal of any debt or share shall be set aside unless the Board has acted arbitrarily and capriciously in setting the value of such debt or share.

"(10) FDIC COMPENSATION.--

"(A) TENDER BY APPLICANT.--No later than twenty days after completion of an appraisal under subparagraph (9)(A) and review of any challenge thereto, an applicant may tender to the Corporation any debt or share so appraised. An applicant may accomplish the tender by surrendering the debt instrument or share to the Corporation or by providing such other evidence of the debt or ownership interest as the Corporation may reasonably require.

"(B) FDIC COMPENSATION AUTHORIZED; SUBROGATION.--Upon tender of any debt or share under subparagraph (A), the Corporation is authorized and directed to acquire any such debt or share from the applicant and to compensate the applicant promptly in the amount determined by the Board under paragraph (9). Upon providing compensation to any person under this subparagraph (B), the Corporation shall be subrogated to all rights of such person arising out of such debt or share to the extent of such compensation.

"(C) RULEMAKING AUTHORITY.--The Corporation is authorized and directed to promulgate rules providing procedures for receipt and payment under the provisions of this paragraph (10).

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"(D) FDIC COMPENSATION AS SOLE REMEDY.--The procedure established by this paragraph (10) shall be the sole means by which any person may seek compensation for any loss occasioned by an action ordered by the Board under paragraph (2).

"(11) STANDARD FOR CERTIFICATION.--The Corporation may certify that it is necessary for the Board to exercise the powers made available by this subsection (g) only if:

"(A) BANK IN DANGER OF CLOSING.--The chartering authority for an insured bank has notified the Corporation that the bank is in danger of closing, as defined in Section 13(f)(8) of the Federal Deposit Insurance Act, and

"(B) REDUCTION OF RISK TO FDIC FUND.--The Corporation has determined, in its sole discretion, either:

"(i) That such action will lessen the risk to the Federal Deposit Insurance fund, or

"(ii) That severe financial conditions exist which threaten the stability of a significant number of insured banks in the community where the bank specified in subparagraph (A) is located or is making loans or is doing business, or the stability of insured banks possessing significant financial resources in any such community.

"(12) BOARD ACTION TO BE LIMITED IN KEEPING WITH NEEDS OF SITUATION.--In exercising the authority conferred under this subsection (g), the Board shall make a reasonable effort to assure that any transfer of assets or securities to a bank specified in subparagraph (11)(A), and any transfer of assets or securities in connection with a merger involving a bank specified in subparagraph (11)(A), shall not exceed an amount that is reasonably necessary to provide adequate capitalization to such bank or any successor thereto.

"(13) DEFINITIONS.--For the purpose of this subsection (g):

"(A) FDIC.--The term 'Corporation' means the Federal Deposit Insurance Corporation.

"(B) RELEVANT SUPERVISOR.--

"(i) COMPTROLLER OF THE CURRENCY.--In the case of a national bank, the term 'relevant supervisor' means the Office of the Comptroller of the Currency.

"(ii) STATE BANK SUPERVISOR.--In the case of a State-chartered bank, the term 'relevant supervisor' means the State bank supervisor of any such bank.

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"(h)(1) CERTAIN RESTRICTIONS PROHIBITED.--No provision of any contract entered into by a bank holding company or subsidiary thereof on or after [the effective date of this Act] shall be effective if:

"(A) it prohibits or restricts in any manner the sale, transfer, pledge or conveyance by a bank holding company or a bank subsidiary of a bank holding company of shares or assets of a subsidiary bank or prohibits the subsidiary bank from selling, transferring, pledging or conveying any or all of its shares, assets or liabilities to any entity other than the holding company; and

"(B) such sale, transfer, pledge or conveyance takes place in conjunction with or as a part of assistance provided by the Corporation under section 13(c) of the Federal Deposit Insurance Act and the Corporation requests such sale, transfer, pledge or conveyance as a part of such assistance.

"(2) COMPLIANCE WITH FDIC REQUEST NOT OCCASION OF DEFAULT OR OTHER IMPOSITION OF PENALTY.--Any compliance with such a request of the Corporation shall not constitute a default or event of default under such contract, and shall not give rise to the imposition of rights of acceleration, damages, or otherwise.

"(3) DEFINITION.--For the purpose of this subsection (h) the term 'Corporation' means the Federal Deposit Insurance Corporation.

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Pocket Guide for Directors

Guidelines for Financial Institution Directors

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Financial Institution Directors

Change in the financial marketplace has created a more competitive and challenging environment for all financial institutions. As a consequence of this change, the role of the financial institution board member has grown in importance and complexity.

This Pocket Guide has been developed by the Federal Deposit Insurance Corporation to provide directors of financial institutions with accessible and practical guidance in meeting their duties and responsibilities in a changing environment. These guidelines have been endorsed by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Home Loan Bank Board.

We hope this Pocket Guide will help to make the director's job one that can be approached with clarity, assurance and effectiveness. If you are helped in meeting these goals, then the larger goal of maintaining confidence in the safety and soundness of our financial system will also be achieved.

Sincerely,

L. Wm. Seidman

L. William Seidman
Chairman
Federal Deposit Insurance Corporation

Robert L. Clarke — C. C. Hope, Jr.

FEDERAL DEPOSIT INSURANCE CORPORATION
Washington, D.C.
February, 1988

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General Guidelines

A financial institution's board of directors oversees the conduct of the institution's business. The board of directors should:

- select and retain competent management;
- establish, with management, the institution's long and short term business objectives, and adopt operating policies to achieve these objectives in a legal and sound manner;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the institution's business performance; and
- ensure that the institution helps to meet its community's credit needs.

These responsibilities are governed by a complex framework of federal and state law and regulation. The guidelines do not modify the legal framework in any way and are not intended to cover every conceivable situation that may confront an insured institution. Rather, they are intended only to offer general assistance to directors in meeting their responsibilities. Underlying these guidelines is the assumption that directors are making an honest effort to deal fairly with their institutions and to comply with all applicable laws and regulations, and follow sound practices.

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Maintain Independence

The first step both the board and individual directors should take is to establish and maintain the board's independence. Effective corporate governance requires a high level of cooperation between an institution's board and its management. Nevertheless, a director's duty to oversee the conduct of the institution's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Critical evaluation of issues before the board is essential. Directors who routinely approve management decisions without exercising their own informed judgment are not serving their institutions, their stockholders, or their communities adequately.

Keep Informed

Directors must keep themselves informed of the activities and condition of their institution and of the environment in which it operates. They should attend board and assigned committee meetings regularly, and should be careful to review closely all meeting materials, auditor's findings and recommendations, and supervisory communications. Directors also should stay abreast of general industry trends and any statutory and regulatory developments pertinent to their institution. Directors should work with management to develop a program to keep members informed. Periodic briefings by management, counsel, auditors or other consultants might be helpful, and more formal director education seminars should be considered.

The pace of change in the nature of financial institutions today makes it particularly important that directors commit adequate time in order to be informed participants in the affairs of their institution.

Ensure Qualified Management

The board of directors is responsible for ensuring that day-to-day operations of the institution are in the hands of qualified management. If the board becomes dissatisfied with the performance of the chief executive officer or senior management, it should address the matter directly. If hiring a new chief executive officer is necessary, the board should act quickly to find a qualified replacement. Ability, integrity, and experience are the most important qualifications for a chief executive officer.

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Supervise Management

Supervision is the broadest of the board's duties and the most difficult to describe, as its scope varies according to the circumstances of each case. Consequently, the following suggestions should be viewed as general.

Establish Policies. The board of directors should ensure that all significant activities are covered by clearly communicated written policies which can be readily understood by all employees. All policies should be monitored to ensure that they conform with changes in laws and regulations, economic conditions, and the institution's circumstances. Specific policies should cover at a *minimum:*

- loans, including internal loan review procedures
- investments
- asset-liability/funds management
- profit planning and budget
- capital planning
- internal controls
- compliance activities
- audit program
- conflicts of interest
- code of ethics

These policies should be formulated to further the institution's business plan in a manner consistent with safe and sound practices. They should contain procedures, including a system of internal controls, designed to foster sound practices, to comply with laws and regulations, and to protect the institution against external crimes and internal fraud and abuse.

Monitor implementation. The board's policies should establish mechanisms for providing the board the information needed to monitor the institution's operations. In most cases, these mechanisms will include management reports to the board. These reports should be carefully framed to present information in a form meaningful to the board. The appropriate level of detail and frequency of individual reports will vary with the circumstances of each institution. Reports generally will include information such as the following:

- the income and expenses of the institution
- capital outlays and adequacy
- loans and investments made
- past due and negotiated loans and investments

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- problem loans, their present status and workout programs
- allowance for possible loan loss
- concentrations of credit
- losses and recoveries on sales, collection, or other dispositions of assets
- funding activities and the management of interest rate risk
- performance in all of the above areas compared to *past* performance as well as to *peer groups'* performance
- all insider transactions that benefit, *directly or indirectly*, controlling shareholders, directors, officers, employees, or their related interests
- activities undertaken to ensure compliance with applicable laws (including among others, lending limits, consumer requirements, and the Bank Secrecy Act) and any significant compliance problems
- any extraordinary development likely to impact the integrity, safety, or profitability of the institution

Reports should be provided far enough in advance of board meetings to allow for meaningful review. Management should be asked to respond to any questions raised by the reports.

Experience has shown that certain aspects of lending are responsible for a great number of the problems experienced by troubled institutions. The importance of policies and reports that reflect on loan documentation, performance, and review cannot be overstated.

Provide for independent reviews. The board also should establish a mechanism for independent third party review and testing of compliance with board policies and procedures, applicable laws and regulations, and accuracy of information provided by management. This might be accomplished by an internal auditor reporting directly to the board, or by an examining committee of the board itself. In addition, a comprehensive annual audit by a CPA is desirable. It is highly recommended that such an audit include a review of asset quality. The board should review the auditors' findings with management and should monitor management's efforts to resolve any identified problems.

In order to discharge its general oversight responsibilities, the board or its audit committee should have direct responsibility for hiring, firing, and evaluating the institution's auditors, and

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should have access to the institution's regular corporate counsel and staff as required. In some situations, outside directors may wish to consider employing independent counsel, accountants or other experts, at the institution's expense, to advise them on special problems arising in the exercise of their oversight function. Such situations might include the need to develop appropriate responses to problems in important areas of the institution's performance or operations.

Heed supervisory reports. Board members should personally review any reports of examination or other supervisory activity, and any other correspondence from the institution's supervisors. Any findings and recommendations should be reviewed carefully. Progress in addressing identified problems should be tracked. Directors should discuss issues of concern with the examiners.

Avoid Preferential Transactions

Avoid all preferential transactions involving insiders or their related interests. Financial transactions with insiders must be beyond reproach. They must be in full compliance with laws and regulations concerning such transactions, and be judged according to the same objective criteria used in transactions with ordinary customers. The basis for such decisions must be fully documented. Directors and officers who permit preferential treatment of insiders breach their responsibilities, can expose themselves to serious civil and criminal liability, and may expose their institution to a greater than ordinary risk of loss.

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Copies of this publication, ***Pocket Guide for Directors*** *— Guidelines for Financial Institution Directors*, are available from the Office of Corporate Communications, Federal Deposit Insurance Corporation, 550 Seventeenth Street, NW, Washington, D.C. 20429, or through the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency.

A more detailed discussion of a director's role and responsibilities is available in the Office of the Comptroller of the Currency's new book, ***The Director's Book*** *— The Role of a National Bank Director*, which is available from the Communications Division, Office of the Comptroller of the Currency, Washington, D.C. 20219.

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INEQUITIES IN THE DEPOSIT INSURANCE SYSTEM

There always has been some degree of inequity in the deposit insurance treatment of large and small failing banks. Specifically, there has been a tendency to handle large failing banks in a manner that protects uninsured depositors and other general creditors from loss while smaller failing banks are more frequently subject to a statutory payoff, thus uninsured creditors are exposed to loss.

In recent years, the FDIC has occasionally placed a de facto "guarantee" on the liabilities of certain institutions (more accurately, the FDIC has made a commitment to handle the bank(s) in a manner that would not result in losses to general creditors). This action has been taken in situations where there is a perceived threat to the stability of the banking system. This "guarantee" has been limited to three cases: Continental Illinois in 1984; First City and First Republic in 1988.

The FDIC is well aware of the competitive distortions that result from taking an action that permits an institution to issue liabilities "guaranteed" by the U.S. Government. Thus, such action has not been taken lightly.

A variety of suggestions have been made that are designed to ameliorate the distortions associated with an outright guarantee. While each of the suggestions is intended to achieve equity, each also would have some negative impacts. The following is a brief summary of the pros and cons of each proposal.

- Depositor Discipline. The ability of the FDIC to provide more protection than the statutory limit would be restricted. This suggestion would remove inequity between large and small banks. However, it could lead to an unacceptable level of instability in the banking system.

- Raise Insurance Premiums for Large Banks. Premiums would be based on total liabilities that fall in the same creditor class as deposits. This suggestion would bring the insurance cost for large institutions more in line with de facto coverage, thus reducing inequities. However, these added costs may overly restrict large banks' ability to compete in global markets. Larger banks may respond by shifting business to noninsured subsidiaries, thereby reducing premium income.

- Provide 100 Percent Deposit Insurance To All Banks. This would be the most straightforward way of providing all depositors with the same treatment regardless of the size of their bank. The cost to the FDIC fund would be negligible (at least in the short run) because most depositors are already protected. Furthermore, it would be easier to handle failures because there would be no need to compute insured deposits on payoff; an entire deposit base could be transferred easily, leaving behind creditors and contingent claims.

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A full insurance approach, however, would completely eliminate depositor discipline and might raise longer-term insurance costs. It also would remove incentives for spreading deposits to smaller banks to maximize insurance coverage.

- Modified 100 Percent Deposit Insurance Coverage. This suggestion would not extend 100% coverage to certain deposits such as negotiable time deposits. Only transaction accounts and consumer and local business-type time deposits would get full coverage.

  Such an approach would reduce big bank/small bank inequity without completely eliminating depositor discipline. It does reduce depositor discipline, and it doesn't eliminate big bank/small bank inequities. Therefore, this suggestion represents only a partial solution.

- Limit Business Activities of Banks Operating Under 100 Percent Guarantee. This approach would require that rates on deposits be kept below market rates; business solicitation (letters of credit, etc.) would be restricted to existing customer base.

  If used, it would minimize damage to bank competitors. However, some customers might still be attracted by the insurance guarantee without added solicitation. Moreover, this suggestion does not resolve the big bank/small bank equity issue.

- Restrict the Full Insurance Guarantee to Existing Deposit Accounts. This suggestion would not permit a bank to use an insurance "guarantee" to attract new business, therefore minimizing damage to bank competitors. However, it would limit the ability of a bank to replace outflows with new deposits. It also would create massive recordkeeping problems for the bank, and for the FDIC if the bank is ultimately paid off. Furthermore, it may lead to market confusion over what is, and what is not, insured. It does not resolve the small bank/large bank equity issue.

- Extend Guarantee to Other Banks in State. Providing a full insurance guarantee to all banks operating in the same state would preserve intrastate equity. However, inequities would remain with respect to out-of-state competitors. Furthermore, banks within the state operating with 100% insurance might raise new supervisory issues.

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