TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

THE CONDITION OF THE BANKING INDUSTRY AND THE FDIC FUND

AND

THE SUPERVISORY AND ASSISTANCE ACTIVITIES OF THE FDIC

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
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Good afternoon, Mr. Chairman and members of the Committee. I am pleased to have the opportunity to testify today on the condition of the banking industry and the Federal Deposit Insurance Corporation fund, as well as on the supervisory and assistance activities of the FDIC.

In these challenging times, we believe the FDIC has functioned well and in full accord with Congressional intentions -- as embodied in the Federal Deposit Insurance Act -- with respect to the purpose, function and operations of the Corporation. In developing FDIC policies, we are guided by the following goals and principles:

- to maintain a safe and sound banking system and public confidence in that system;
- to enforce applicable laws, rules, and regulations governing banking;
- to reduce the cost to, and thus to preserve the financial viability of, the FDIC insurance fund;
- to emphasize private-sector resolution of banking problems;
- to enhance competition;
- to increase consumer services and protection; and
- to maintain the dual banking system.

With these guiding principles as background, our statement today details the FDIC's views and procedures regarding the changing role of deposit insurance, the status of the insurance fund, the condition of the banking industry, the role of bank supervision, the resolution of failed and failing banks, the need for additional legislation and deposit insurance reform.

THE CHANGING ROLE OF DEPOSIT INSURANCE

Deposit insurance was established some 55 years ago and today is at a watershed period. It was originally created as a reaction to severe problems the banking industry faced during the Depression. That beginning was not without controversy. Small depositors and small banks supported the plan, while larger institutions opposed anything that would help put smaller institutions on a more equal footing.

The role and form of deposit insurance as conceived in the 1930s have changed dramatically as the structure of the banking system has evolved. New competition, deregulation, disintermediation, new technologies and geographic expansion have combined to make banking a decidedly different business than it once was. Significant changes in the operation of the deposit insurance system have occurred, revealing stark differences from the original concept.

For example:

- Some small banks contend that the FDIC's use of the deposit insurance safety net gives unfair advantages to large institutions by not allowing the largest institutions to fail -- the "too-big-to-fail" doctrine. Granted, protection of depositors and creditors in large failing banks has distorted the system. However, no major industrial nation has allowed its largest banks to fail since the depression because the financial fallout is so difficult to predict. Moreover, the failure of a large bank likely would have significant international competitive ramifications. Thus, we now have an insurance system -- which was designed to help small banks compete with big banks -- that is criticized by some small banks as favoring big banks.

- Another example is that, the Federal Reserve System, traditionally considered the lender of last resort, has become the next-to-last-resort lender. The deposit insurance system has become the last resort for protecting failing banks and, thus, the stability of the system. For example, when First Republic went to the Fed window last winter, withdrawals increased because depositors and creditors were fully aware of the Federal Reserve's policy of requiring collateral for its liquidity lending. However, when the FDIC arranged a loan of $1 billion and stated unequivocally its intention to protect depositors and creditors, the run stopped. So the FDIC has become the back up source for insolvent banks that need to be protected. The creators of the fund could not have envisioned such a role for the FDIC.

- Third, the status of the holding company in the banking system has been drawn into question by recent FDIC policy. For example, when the FDIC assured that all depositors and other general creditors of the First Republic banks of Texas would be fully protected, such protection was NOT extended to the holding company's creditors or shareholders. This FDIC policy is critical when considering such issues as whether and what new activities should be permitted to holding companies and whether it is appropriate to apply the proposed risk-based capital standards to holding companies. Again, the current role of bank holding companies in the banking system was not envisioned under the original deposit insurance system.

Recent experience with deposit insurance -- in both the banking and thrift industries -- indicate that, while the FDIC continues to fulfill its mission, substantial improvements are necessary to the system. Improvements are necessary in order to:

- o contain potential insurance losses;
- o restrict the scope of the federal safety net;
- o improve supervision; and
- o provide more efficient and fairer handling of failed banks.

What started as a simple protection for small depositors (and small banks) has become, in the current environment, a major factor in the operation of the financial depository system. Federal deposit insurance, improperly controlled, has the potential to severely damage the entire financial system.

STATUS OF THE FUND

The financial condition of the FDIC remains strong despite recent record numbers 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. As announced previously, based on current estimates of loss in 1988 -- including the loss on First Republic and two other large banks in Texas -- we expect a modest decline in the net worth of the fund in 1988. Once those transactions are consummated, however, the main financial cost should be behind us and the insurance fund should begin to grow again in 1989.

The composition of the fund also is an important barometer of the fund's condition. At year-end 1987, nearly 87 percent of the fund balance, or $16.1 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 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.

CONDITION OF THE BANKING INDUSTRY

Overview

The condition of the banking industry and its future prospects are vitally dependent on the state of the economy and particular economic sectors and geographic areas. Consequently, some general observations on the economy seem appropriate.

In 1987 problems in the agricultural industry bottomed out and a slow, gradual improvement began. Continued improvement in that economic sector is expected to continue in 1988, barring serious problems resulting from the current Midwest drought. Nonetheless, the problems of agriculture and agricultural banks are not over. The upturn is slow and banks' performance normally lags the economy both on the way up and on the way down. However, even though problems still exist, the trend is in the right direction.

It is perhaps arguable whether problems in the energy sector bottomed out in 1987. So far this year energy problems do not appear any worse than last year, but certainly no one would describe that industry to be experiencing 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 to prevent oversupply. The FDIC is carefully arranging its property sales to ensure fair market value. 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, we have expressed 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 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.

Despite increased competition from all sectors of the financial community, severe regional economic problems, and an unprecedented pace of change in the industry, the banking system as a whole is sound and improving. 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.

Although the condition of the banking system is generally sound, 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. Historical data on failures and assistance transactions are provided by Tables 1, 2 and 3.

As of June 30, there have been 87 failures. In addition, there have been 15 assistance transactions which, inclusive of the First City*/ and First Republic transactions, involve approximately 146 banks. If the individual banks in First City and First Republic are not counted separately, the total number of failed- and assisted-bank transactions are 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 more than 200 failures and assistance transactions this year as well. Importantly, over 90 percent of the failures thus far in 1988 have been west of the Mississippi River, and banks in Texas alone have accounted for over 40 percent of those failures.

Although the trend is finally downward, the number of problem banks also is near the record level. Historical data on problem banks are contained in Table 4. As of May 31, there were 1,495 FDIC-insured problem banks with total deposits of $288 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 1,624 with deposits of $300 billion. Of the problem banks, approximately 433 are agricultural banks and 158 are energy banks. Eighty-

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*/Although not consummated until 1988, the cost of the First City transaction was fully reflected in our 1987 financial statements.

nine percent of the banks on the current problem list are west of the Mississippi River and 64 percent are in the six states of Colorado, Louisiana, Kansas, Minnesota, Oklahoma and Texas.

There is considerable turnover in the specific banks on the problem bank list -- a fact that sometimes goes unnoticed. Since the number of problem banks peaked in mid-1987, there have been 496 banks added to the problem bank list and 625 deleted from the list through May 31. Of the 625 deleted, 168 were the result of closings or receipt of FDIC assistance, 85 were the result of mergers and 372 were the result of improvements. The decline in the number of problem banks is attributed primarily 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 sectors of the economy now are experiencing relative prosperity, the differences among areas are much broader than in the past.

The areas west of the Mississippi River, with economies that are based on energy and agriculture, have pockets of severe recession or even depression. Most of the FDIC's problem banks today, and those anticipated for the rest of 1988, are located in these distressed regions. Many of the involved states have unit banking laws which tend to limit opportunities for diversification geographically and by economic sector. The statistics contained in our Quarterly Banking Profile (Appendix A) indicate problems by geographic area.

Key Indicators

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. Increases in the reserve for losses made by the large money-center banks for troubled loans to developing countries accounted for nearly all the growth in primary capital. 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. In fact, as of year-end 1987, only 115 banks -- with total assets of about $11 billion -- of the approximately 13,500 FDIC-insured commercial banks had primary capital ratios of three percent or below.

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-assets, or leverage, ratios 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 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. Imposing risk-based capital standards is an important initiative designed to reduce risk in the 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 that regulates holding companies.

Insofar as FDIC-insured savings banks are concerned, as of year-end 1987, all FDIC-insured savings banks reported positive net worths, even when their outstanding net worth certificates were not taken into account. This is an improvement over 1983 when five 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 five 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. Earnings are the lifeblood of any business and commercial banks in 1987 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 at 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. In fact, excluding loan loss provisions, only 695 banks in the United States -- with assets of $54 billion -- failed to generate sufficient earnings in 1987 to cover their operating expenses. Texas banks accounted for 60 percent of those assets.

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 far east of the Mississippi. Poor economic conditions in the energy States and Farm Belt are the primary contributor to the West's poor results.

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 thrift 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.

Notwithstanding regional banking problems, 1988 earnings prospects for the industry as a whole are very promising. We expect that for 1988 the commercial banking industry's aggregate income will exceed the previous historic high of $18.1 billion earned in 1985. Although the earnings will be dampened by continuing banking problems in the Southwest, those losses will be offset by improvements in other areas, especially by the collection of $1.6 billion of income foregone on Brazilian loans since early 1987.

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 non-performing 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.

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 intense. 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.

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, fourth-quarter deposits in 1987 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

Given the commitment of the federal government to the safety of insured deposits, it is clear that we must find ways of limiting or controlling the risks assumed by insured banks. Certainly market discipline has a role to play but it cannot be relied on exclusively or even substantially to protect the government's interest. We believe that interest must be protected primarily and directly through effective bank regulation and supervision with a decided emphasis on the flexibility of supervision.

Our experience in the Southwest to date has been instructive. From a supervisory standpoint, it is difficult to fault anyone for failing to anticipate the precipitous decline in oil prices and the effects that would have on the economy of the Southwest. It is hard to be an effective naysayer when everything is booming. On the other hand, it is also clear that in the euphoria of the oil boom many bankers failed to heed, and the regulators failed to adequately enforce, certain prudential lending standards that might have moderated the effects of the subsequent economic decline on individual banks.

These standards include risk diversification, cash flow and market analyses, sound collateral margins and the individual liability of borrowers with substantial net worth as additional support for indebtedness. Such standards are appropriate for all banks, including well-capitalized banks whose capital can be quickly dissipated in an economic downturn, particularly when the bank has concentrated its lending activities in one economic sector or geographic region.

Even though economic problems now are of greater importance than normal in explaining bank problems, management remains an important cause of most banks' difficulties. Deficiencies in bank management and policy exacerbate the natural tendency for banks to suffer from weaknesses in the economy. Wherever the circumstances warrant, the FDIC initiates formal enforcement actions. In 1987, we initiated 91 insurance termination proceedings, issued 107 cease-and-desist orders, and began 18 removal actions.

The downturn in the agricultural and energy industries has been so severe and protracted that today, in certain depressed areas of the country, some banks with good records 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.

Capital Forbearance and Loan Loss Deferral

The capital forbearance program adopted by the banking agencies is an example of the approach we believe has been useful and beneficial to both the FDIC and participating banks. This is a program for solvent banks with below expected capital and which have reasonable prospects for long-term viability. As of May 31, the FDIC has approved 155 applications for capital forbearance, while denying 68. There have been 30 banks that have been terminated from the capital forbearance program. Two of these institutions were removed because of improved financial condition and five others merged into healthier institutions. An additional six more of these banks failed and the remaining 17 were removed due to noncompliance with their capital plan.

Banks participating in the program outside the West and Southwest are improving. Many other banks in the program throughout the country also are making good progress. Restoring financial health does not occur overnight but we believe this program has been effective in accomplishing its purpose. We will be evaluating the program and measuring its results carefully in the future.

A somewhat similar program (loan-loss deferral) was authorized for agricultural banks by Congress last year. As of May 31, 66 banks have applied to the FDIC for the program, with 18 applications approved, 10 denied and 28 still under review. Nine banks were determined to be ineligible and one application was withdrawn. It is too early to determine the success of this program.

Fraud and Insider Abuse

Fraud and insider abuse are frequent elements 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. We estimate that 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 receive 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 FDIC supervision our <u>Pocket Guide for Directors</u>, a copy of which is attached as Appendix B. The <u>Guide</u> 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.

Examination and Examiners

One of the FDIC's primary goals has been to increase the level of onsite bank supervision by reducing the time intervals between onsite examinations. After evaluating our overall examination projections in terms of staff resources, operating procedures and the appropriate level of onsite examination, we have 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). Unfortunately, this 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 annual 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 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 1,900 field bank examiners. We intend to increase this number to about 2,100 by the end of 1988. Our examiner force had declined to only 1,389 in 1984 from the previous high of 1,760 examiners in 1978 when we had only 342 problem banks and 7 bank failures. In contrast, there are currently nearly 1,500 problem banks and the possibility of more than 200 failures this year. Once we reach our goal of 2,100 we will decide whether we should expand our force further.

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, however, before these new people are sufficiently trained to be able to carry a full load of examination responsibility. We also are building a new training center at Virginia Square, Virginia, to improve our ability to train our field forces.

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 the number of compliance examinations increased 97 percent during the past year.

A major innovation in our examination program has been the expanded use of automation and personal computers. We have developed automated examination reports that are 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 gauge more accurately overall time utilization and productivity trends.

FAILED- AND FAILING-BANK RESOLUTION

Alternatives

When a bank's failure is imminent, the FDIC must consider how it will discharge its obligations as both the insurer of the bank's deposits and the likely receiver of the failed bank. Although the response of the FDIC to each possible bank failure may be somewhat different, there are generally three categories of alternatives available. Generally the FDIC will make each alternative available to an interested investor.

First, direct financial assistance may be available to keep the bank from failing. This approach is available only if the Board of Directors of the FDIC finds that either the assistance required is less costly to the FDIC fund than any other alternatives available to the FDIC or that continued operation of the bank is essential to provide adequate banking service in the community.

Since assistance transactions are the product of negotiation, each has its own unique characteristics. The FDIC, however, imposes certain uniform requirements. The assistance required must be less than that required under other alternatives. In addition, the failing bank must provide all interested qualified investors an opportunity to present alternative assistance proposals. Generally, our philosophy is that the assistance provided should be no greater than the amount required to offset any deficiency between realizable asset values and liabilities. Furthermore, failing banks almost invariably have unrecognized losses to the extent they are capital deficient. For this reason, we require that new investors be found to recapitalize the bank and that the effect on existing shareholders be comparable to closing the bank. In cases involving widely held banks, existing shareholders may be left with a residual ownership interest -- such as one to two percent -- in order to induce a favorable shareholder vote. In other cases, shareholders are left with no ownership interest.

The tax consequences of FDIC assistance for the revitalized institution (as well as the extent to which tax attributes of the preassisted institution carry over) are issues that invariably arise during negotiations with new capital investors. Investors generally have not been able to work out the tax issues with the Internal Revenue Service until well <u>after</u> the assistance transaction with the FDIC has been negotiated. The uncertainty surrounding the tax consequences of assistance transactions is a real detriment to attracting new capital for troubled banks. Resolving tax issues beforehand -- ideally through a clear legislative mandate -- would be very useful. Thus, the FDIC has been actively pursuing clarification of these tax issues with the tax-writing committees of the Congress. We would appreciate any support this committee can provide in this area.

The second alternative available in addressing failing banks is a direct payoff of the insured deposits. In this situation the bank is closed and the FDIC is named receiver. The depositors are paid up to the $100,000 limit of

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insurance protection and the institution is liquidated. Depositors above the insurance limit are paid, to the extent possible, only after the failed bank's assets are liquidated. A variation of a direct payoff (called "an insured deposit transfer") is when insured deposits are transferred to another bank which acts as paying agent for the FDIC. A direct payoff is the least desirable, and usually most costly, alternative. It results in an interruption of vital banking services to the community served by the failed bank. In addition, because the failed bank's main office and branches are permanently closed, virtually all the failed bank's employees lose their jobs.

The third and most prevalent alternative is a "purchase-and-assumption" ("P&A") transaction. Under this alternative, which can be structured in several ways, a healthy bank assumes all the failed bank's deposit liabilities, including uninsured deposits, and agrees to acquire some or all of the failed bank's assets. The assuming bank receives an infusion of cash from the FDIC to make up the difference between the value of the assets and the liabilities assumed. The current FDIC policy is to try to arrange, wherever possible, so-called "whole bank" transactions where the assuming bank acquires all the assets of the failed bank, including the bad loans, with the minimum contribution from the FDIC.

A new temporary solution now available to the FDIC is a "bridge bank." In this case, the FDIC can operate the failed institution, for up to three years, until a buyer can be found.

The open-bank assistance transaction and the P&A have proven to be highly effective means of providing a cost-effective resolution for failing and failed banks, and have been used in the overwhelming majority of bank failures. They minimize disruption to depositors and the community generally, and maintain confidence in the system. These transactions, as well as being cost-effective, also generally protect all depositors, regardless of amount, and often general creditors as well.

Because of the benefits associated with these two means of dealing with failing and failed banks, the FDIC attempts to engage in such transactions wherever possible. In 1986, when a total of 145 banks either failed or were assisted, 98 P&A transactions were consummated and 7 open-bank assistance transactions were undertaken. In 1987 there were 133 P&As and 19 assistance transactions out of a total of 203 transactions. As of June 30, of a total of 102 failed or assisted banks, 66 were P&As -- including 38 "whole bank" transactions -- and 15 were open-bank assistance transactions. 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. However, uninsured deposits in these cases amounted to only a little over $80 million last year, or less than one percent of the total deposits of all banks that failed or received open-bank assistance.

Current Objectives

In light of the record numbers of bank failures over the past few years, we have been especially concerned with maintaining a 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's acquisition of as few bank assets as possible. Thus, as mentioned above, we are actively pursuing whole bank transactions whenever possible. 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, more recently and 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 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 settling outstanding claims whenever practical rather than pursuing protracted litigation. However, our policy and practice is to not "dump" assets for below-current appraised values.

As a result of these initiatives, the FDIC collected $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 that involved even greater record numbers in terms of dollars of failed assets involved.

The "Too-Big-to-Fail" Issue

As mentioned above, the "too-big-to-fail" matter is another important issue currently facing the FDIC in resolving the problems associated with failing and failed banks. It may be that governmental protection of the largest banks in the major industrialized countries is a premise which, in the United States, tends to be defined in terms of the extent of deposit insurance protection. In resolving several large failing bank cases we have deemed it unacceptable to fail to fully protect certain bank depositors and creditors because of the resultant economic costs and dislocations. Because the failure of banks over a certain size threatens the stability of a region -- or possibly the entire banking system -- it may be prudent to consider instead how to extend comparable protection to smaller institutions.

Appendix C provides some thoughts on various alternatives, all of which unfortunately have some undesirable side effects. The greatest threat to the sufficiency and viability of the deposit insurance fund is posed by the largest banks. 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 means that we are committed to providing open bank assistance or some variation of the purchase-and-assumption transaction as preferred alternatives. Use of these alternatives tends to minimize some of the perceived disparity of 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 fact, 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 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 their funds in the vast majority of cases. In fact in 1987, 72 percent of failed banks were handled by purchase-and-assumption transactions, assuring all depositors 100 percent of their funds.

First City and First Republic

Two failing bank cases, First City and First Republic (which is still pending), warrant special comment because of their recency, size, and the lessons they provide. They also demonstrate our commitment to promoting stability without extending the safety net to bank holding companies, bank managers and shareholders.

First City. The recapitalization of the subsidiary banks of First City Bancorporation, Houston, Texas, was consummated in mid-April, 1988 and involved approximately $970 million of FDIC assistance accompanied by approximately $500 million in new equity capital from private investors. The transaction was an open-bank assistance transaction and, accordingly, required the consent of common and preferred shareholders. As a condition of the FDIC assistance, and in order to insure viability of the recapitalized institution for the private investors, substantial concessions also were required from creditors of the First City holding company in accordance with our existing policy statement on open-bank assistance.

Because First City was an open-bank transaction, the concessions by the shareholders and creditors were voluntary. Any shareholder not wishing to participate in the restructuring could vote against the plan. Similarly, any creditor refusing to participate could refrain from tendering the debt security held by such creditor. Unlike the decisions involving shareholders, where the approval of the holders of two-thirds of the outstanding shares basically would bind all shareholders to the restructuring, the decisions of the debtholders were individual decisions. That is, each debtholder could make his or her own determination of whether or not to participate in the restructuring, unaffected by decisions of other debtholders.

The holders of approximately 67 percent of the outstanding debt voluntarily participated in the restructuring in which they received a cash payment of less than the face value of their debt obligation in exchange for the obligations. The holders of approximately 33 percent did not voluntarily exchange their indebtedness for cash, and thus continued to hold their debt. However, they did not receive a cash payment from First City of 100 cents on the dollar. They merely continue to hold their debt security under the preexisting terms.

In our view, participation in the debt concessions was substantial and sufficient for the private investors to inject $500 million of new equity into

First City. While certain individual creditors might have received greater benefit than if the insolvent First City banks had failed, it is our view that the aggregate concessions on the indebtedness comported with the guidelines contained in our policy statement. It is unclear what the creditors would have received in the event the insolvent First City banks actually had failed. As of March 31, 1988, of the 60 banks then in the First City system, 52 still had positive net worths and 56 had positive primary capital. Furthermore, the advantage of an open-bank transaction like First City is that the disruptions resulting from bank closings are avoided.

Another point also should be made clear. When originally announced, the recapitalization proposal contemplated that 90 percent of the debt would be exchanged for the cash payment, while 10 percent of the debt would remain outstanding on its original terms. The FDIC did not increase its financial commitment to the restructured First City when the ultimate debt concessions obtained were less than originally contemplated. This increased debt burden was assumed by the new investors, not the FDIC.

<u>First Republic</u>. On March 17, 1988, the FDIC announced an interim assistance plan for First RepublicBank Corporation, Dallas, Texas, involving a $1 billion loan to the two largest banks in the First Republic system. The announcement included an assurance to depositors and general creditors of the First Republic banks that in resolving the First Republic situation, bank depositors and banks creditors would be protected and that services to customers would not be interrupted. The FDIC specifically provided no assurance to creditors of the First Republic holding company or other non-banking subsidiaries. Further, these assurances related only to depositors and creditors other than

the First Republic banks themselves. That is, the inter-bank funding from one First Republic bank to another is not protected by the FDIC assurances.

In exchange for the assistance, the First Republic holding company guaranteed the $1 billion loan and collateralized that guarantee by pledging the shares of 30 of its bank subsidiaries. This loan was further guaranteed by each of the First Republic banks. First Republic also agreed to substantial restrictions on its operations, management, and policies.

At the time of the assistance, First Republic had total assets of $33 billion, was the largest bank holding company in Texas, and was the largest bank holding company outside New York, Chicago, and California. It is a major clearing bank, dependent to a substantial degree upon continued relationships with other banks, major corporate customers and others. Due primarily to major losses, First Republic suffered a severe erosion of confidence during the first quarter of 1988. As a result, it was losing not only deposits and other funding, but equally important, it was losing or was in danger of losing significant corporate and other banking relationships that would be difficult, it not impossible, to replace. The situation became so severe that First Republic requested the assistance package from the FDIC and was willing to pledge virtually its entire equity to the FDIC in exchange. The FDIC, in turn, determined that the assistance package was the most appropriate method of lessening the ultimate risk to the insurance fund posed by the situation.

The FDIC assured depositors and general creditors of the Republic banks that, as it acted to provide a long-term solution for the First Republic situation, the FDIC would arrange for a transaction that resulted in the depositors and creditors continuing to have deposits in and claims against an operating bank as a result of open-bank assistance transactions or a variation of one of its traditional purchase-and-assumption transactions.

It is important to understand the legal basis for the granting of such assurances. Section 13 of the Federal Deposit Insurance Act specifies the various alternatives available to the FDIC in assisting failing or failed banks. Among the alternatives are providing direct assistance to the banks to prevent their closing or providing assistance to another entity to facilitate the acquisition of the banks. Such alternatives generally have the effect of protecting depositors and other creditors of the banks. If any alternative other than paying off insured depositors and liquidating the assets of the failed bank is to be exercised, normally the cost of exercising such alternative must be no greater than the cost of liquidating the banks. However, the FDIC may also grant assistance in those instances where the failing bank is found to be essential to the community in which it operates. In our opinion, a determination of essentiality is available whenever severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, and the Board of Directors of the FDIC determines that the assistance will lessen the risks to the deposit insurance fund.

With respect to First Republic, the FDIC, in consultation with the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, determined that severe financial conditions existed that threatened the stability of a significant number of insured banks, as well as insured banks possessing significant financial resources. In making this determination, the

FDIC Board of Directors did not, and could not, extend deposit insurance coverage to all depositors and insured creditors. Instead, the Board committed itself to accomplishing a long-term resolution of the First Republic problem in a manner that would not result in loss to depositors or other general creditors of the bank. In providing such assurances to depositors and general creditors, the Board of Directors of the FDIC acted in order to lessen the risk posed to the insurance fund.

Clearly the size of the First Republic system, the multibank holding company situation so predominant in Texas, and the attendant intra- and inter-company funding relationships played an important role in assessing the risks to the deposit insurance fund. The Board examined and took into consideration the impact of the failure of First Republic on other bank holding companies located outside the state. In the view of the Board, the potential costs of allowing the lead bank of this major regional bank holding company to fail without taking into account the impact on the banking system would have been extremely shortsighted and imprudent, given the critical goal of preserving the insurance fund and the greater responsibilities of providing stability and confidence to the banking system generally.

At the time that a long-term solution is found for First Republic, the actual transaction (be it an open-bank assistance transaction or a purchase-and-assumption transaction) ultimately may be less expensive to the FDIC than the liquidation of the bank and paying off the insured deposits, and thus may satisfy the cost test provided in Section 13(c) of the FDI Act. Our preliminary analysis of First Republic and our general experience lead us to believe that this may be true. However, at the present time we are unable to make such calculations.

PROPOSED EMERGENCY CONSOLIDATION LEGISLATION

Multibank holding companies generally 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 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. Most multibank holding companies exist in states that have restricted branching. In most cases, the bank subsidiaries are commonly named and are commonly advertised. The bank subsidiaries support their lead bank to the same extent as if they were branches of that bank. For instance, individual "downstream" (or subsidiary) banks frequently deposit many times over their capital account in the lead bank and these amounts often are well over the $100,000 coverage limit. The subsidiary banks also may make unsecured loans to the lead bank. This captive funding is used by the lead bank to finance its lending activities.

This arrangement concentrates the bank holding company's assets in a single bank (usually the lead bank). If the lead bank's lending practices are inferior, the bank holding company effectively isolates its poor-quality assets in that bank. Moreover, the bank has the resources to make far more poor-quality loans than would be the case if the bank did not serve as the conduit for its affiliated banks' funds. When the lead bank's assets deteriorate sufficiently to threaten its solvency, the affiliated banks may withdraw their deposits--leaving the FDIC with the losses. 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 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. However, open-bank transactions require the consent of creditors and shareholders of the holding company. 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.

We are seeking legislation, that previously has been submitted to all members of this committee, to address these problems. This legislation would establish a special procedure for dealing with failing banks that belong to multibank 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 protect the public interest by ensuring that the banking assets of a holding company system are appropriately applied towards solving problems in a subsidiary bank prior to requiring the expenditure of FDIC funds. We hope this committee will adopt this measure.

DEPOSIT INSURANCE - A SYSTEM FOR THE 90s

Deposit insurance has successfully protected depositors and helped to maintain the stability of our banking system. Today, deposit insurance protects some $2.5 trillion of deposits held by large and small depositors in approximately 14,000 banks of all sizes, including 330 with deposits in excess of a billion dollars. Deposit insurance is now firmly entrenched as a part of our economic landscape and it is unlikely the public would countenance any serious diminution of the protection afforded.

Nevertheless, the deposit insurance scheme is facing serious new challenges to the sound operation of the system which must be addressed in order to assure its continued viability. That is why the FDIC is undertaking a complete review of deposit insurance and its role and operation in the current banking environment. Our study on this subject, "A Deposit Insurance System for the 90s", has been underway for several months. We expect to have the study completed by year-end and believe it will be a useful contribution to the future of the deposit insurance system.

Here are some of the fundamental questions to be answered in constructing a better deposit insurance system.

Can supervisory mechanisms control risk? This is key to the future of the system. If supervision doesn't work, the ability to borrow on the credit of the United States can be misused and abused. As we enter an environment providing banks with greater powers, how will supervision need to adapt to keep the system safe and sound? Are our present supervisory resources, personnel, examination procedures, offsite monitoring systems, and supervisory sanctions adequate? And, once problem banks have been identified, are our present regulatory powers sufficient to deal with institutions that pose a high risk to the insurance fund?

How can the market be used to control risk in today's environment? Is depositor discipline really alive and well despite insurance and big bank protection? Can we increase market discipline and thus promote safety by statutory and *de facto* deposit insurance coverage ceilings, changes in coverage to include only short-term deposits, or the introduction of private coinsurance? Should we control rates paid on insured deposits, or provide insurance only for individuals and not corporations?

How far should the "safety net" extend? The FDIC's treatment of certain large Texas banks demonstrates our present position that we will not extend the "safety net" to holding companies.

How can we improve the way we handle failing banks? Should large bank depositors be protected, and if so, by whom? How can we handle failed banks so as to treat large and small banks more equitably?

Should the FDIC operate more in the manner of a Reconstruction Finance Corporation ("RFC") of the 1930s? An RFC approach would involve loaning capital to banks that are still solvent but clearly in trouble. This approach might save us losses by preventing failures, but on the other hand this means greater government intrusion into the marketplace. Currently we have opposed the use of FDIC funds in this manner.

Do we price deposit insurance appropriately? Would a system of risk-related premiums do a better job than our current system of explicit and implicit pricing? Can we find a formula that will be mechanical, accurate and defensible? Should foreign deposits be subject to assessment?

Of course, no study of deposit insurance can avoid addressing the issue of a merger of the FDIC and FSLIC funds. We do not favor a merger under current conditions. If such a merger is mandated by Congress, we believe that an administrative merger might provide some cost savings.

While changes may be needed in view of the highly competitive and broad-based markets in which banks operate today, we should not lose sight of the success of deposit insurance to date and the essential soundness of the system now. Since the FDIC was founded, we have resolved over 1,300 failed or failing bank situations. Not one depositor has lost a penny of his or her insured deposits and the vast majority of all depositors have received all of their deposits, insured and uninsured. This result has been paid for by the use of premiums paid by the banks. This is a record of which we all can be justifiably proud.

Mr. Chairman, I would be pleased to respond at this time to any questions you or the other members of the Committee may have.

TABLE 1
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
6/30/88	86	$2,825,835	1	$ 590,700			87	$3,416,535
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	4,136,923
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

TABLE 2
OPEN BANK ASSISTANCE
FDIC INSURED FINANCIAL 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
6/30/88	11	$599,289	2	$1,285,107	2	$41,200,000	15	$43,084,396(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 74 banks of First RepublicBank Corporation and the 59 banks of First City Bancorp System as one institution each.

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

TABLE 3
CLOSED BANKS AND OPEN BANK ASSISTANCE BY FDIC
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
6/30/88	97	$3,425,124	3	$1,875,807	2	$41,200,000	102	$46,500,931(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 74 banks of First RepublicBank Corporation and the 59 banks of First City Bancorp System as one institution each.

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

TABLE 4
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
5/31/88	1,435	$ 60,330	38	$ 21,222	22	$206,362	1,495	$287,914
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.

APPENDIX A

The FDIC Quarterly Banking Profile

L. William Seidman, Chairman

First Quarter 1988

COMMERCIAL BANKING PERFORMANCE — FIRST QUARTER 1988

- ***First RepublicBank Losses Prevent Quarterly Earnings Record***
- ***Number of Unprofitable Banks Declines Modestly***
- ***Insolvencies Running at Same Rate as a Year Ago***
- ***Midwest Banks Show Greatest Improvement***

U.S. commercial banks earned $5.0 billion in the first quarter of 1988, compared to $5.3 billion in the first quarter of 1987. Earnings improved in all areas of the country except the Southwest. But for the $1.49 billion aggregate loss reported by First RepublicBank Corp. banks, first quarter results would have established a new quarterly earnings high. Nationwide, over half of all banks reported higher first quarter earnings in 1988 than a year ago, and the percentage of unprofitable banks fell to less than 13 percent from almost 15 percent in the first quarter last year.

Loan growth continued to be led by increases in real estate and consumer lending, as commercial loan growth remained sluggish. Real estate loans were $15.7 billion higher at the end of March than at year-end, accounting for 90 percent of aggregate asset growth in the quarter. The increase in real estate lending was distributed among construction and development and other commercial real estate loans (up $6.6 billion), home equity loans (up $1.6 billion), and 1-4 family residential mortgage loans (up $3.5 billion). Loans to individuals were up 6.8 percent from year-ago levels, but down $0.4 billion from year end.

Nonperforming assets were slightly below year-ago levels, but were up about $1 billion from year-end 1987, despite first quarter charge-offs of $5.0 billion. The industry's ratio of nonperforming assets to assets rose to 2.48 percent. The aggregate loan-loss allowance also was up nearly $1 billion in the first three months of 1988, to $50.3 billion, representing 78.8 percent of noncurrent loans and leases.

The industry's net interest income grew 5.9 percent over last year's first quarter, and noninterest income continued to grow strongly, up 17.3 percent. First quarter noninterest expenses were up 8.1 percent over last year. However, employment at commercial banks continued to decline, and the rate of growth in noninterest expense may subside as cost-cutting moves begin to take effect. Net nonrecurring gains contributed a single quarter record $165 million to the industry's bottom line in the first quarter.

The banking sector's equity capital base grew by $1.9 billion in the first quarter, after cash dividends of $3.3 billion. The industry's ratio of equity capital to assets rose slightly to 6.07 percent, up from 6.04 percent at year-end.

Chart A — Composition of Total Loans Outstanding March 31, 1988

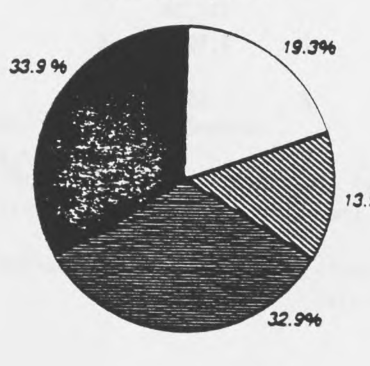
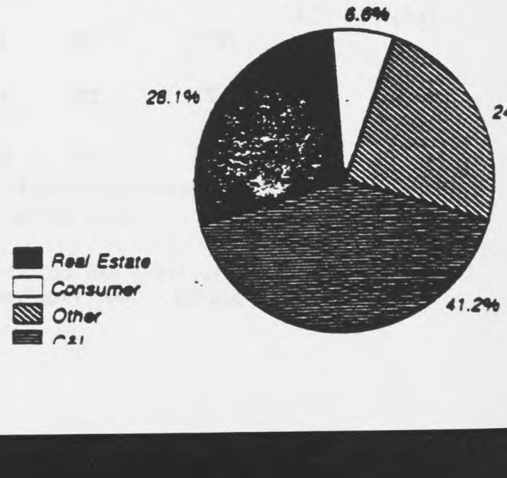


Chart B — Distribution of Noncurrent Loans March 31, 1988

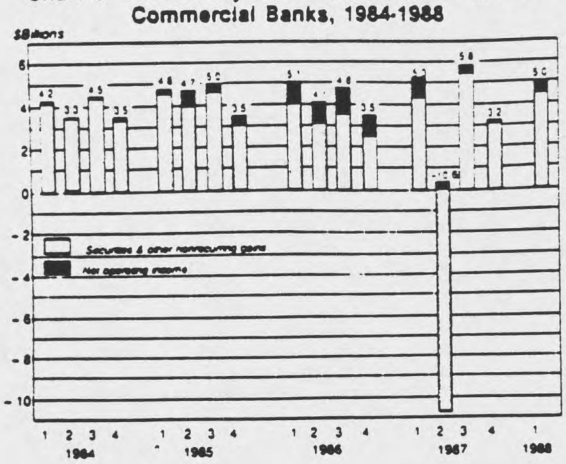


FDIC
Office of Research
& Strategic Planning

John Quinn
(202) [illegible]-3840

Ross Waldrop
(202) [illegible]

Chart C — Quarterly Net Income of FDIC-Insured Commercial Banks, 1984-1988



Fifty-four banks either failed or received FDIC assistance during the first quarter, the same number as in last year's first quarter. The number of "Problem" banks has continued to decline from its peak of over 1,600 institutions in the middle of 1987, reaching 1,491 at the end of March. Improvement was most pronounced among banks in the agricultural Midwest. In the Southwest, banks remain mired in asset-quality problems, mainly in real estate loans, and banks in that region account for a disproportionately large share of the "Problem Bank" list.

Southwest banks reported aggregate first quarter losses representing 2.4 percent of total assets, on an annualized basis; however, over 90 percent of these losses were concentrated in the subsidiaries of First RepublicBank Corp. While far from rosy, the picture of banking in the Southwest looks far less bleak when the First Republic banks are excluded.

Impact of the Southwest Region on First Quarter 1988 U.S. Banking Aggregates

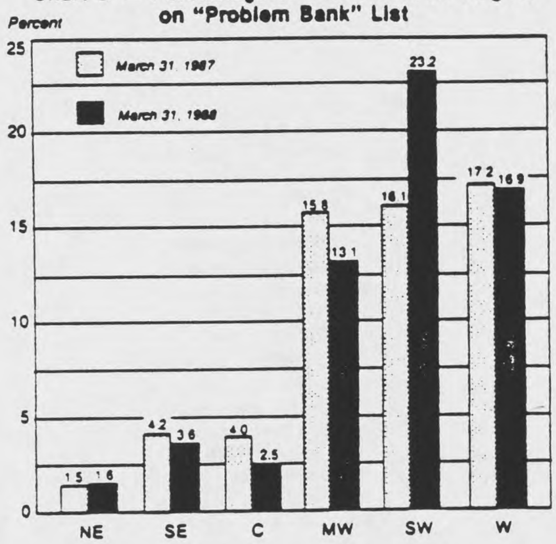
	Southwest Region with FRBC	Southwest Region excl. FRBC	Rest of the U.S.
Return on assets	-2.37%	-0.28%	0.97%
Net charge-offs to loans & leases	2.14	1.50	0.75
Nonperforming assets to assets	6.28	5.31	2.10
Equity capital to assets	5.43	6.20	6.13

Apart from First RepublicBank subsidiaries, the region's banks still registered an aggregate first quarter loss. During the quarter, 27 percent of the region's banks reported losses, and nonperforming assets reached disturbingly high levels. Southwest banks have boosted their loan-loss provisions, but reserves against noncurrent loans are still low, especially in comparison to other regions. Smaller banks in the Southwest have begun to show modest improvement, but it likely will take some time before banks benefit significantly from improving economic trends in that part of the country.

Improvement among Midwest banks is much more apparent. Aggregate profits increased 26 percent. The levels of nonperforming assets and loan-loss expense, as well as the number of banks losing money, all dropped significantly. The percentage of Midwest banks reporting first quarter losses fell from 13.5 percent a year ago to only 7.6 percent.

Improvement was also evident in the West. Nonperforming assets fell by 15 percent and net income jumped by 59 percent over last year's first quarter. While the percent of assets in nonperforming status (3.26%) and the percent of unprofitable banks (19.3%) remain relatively high, both showed improvement when compared to last year.

Chart D — Percentage of Banks in Each Region on "Problem Bank" List



Southeast and Central banks continued to exhibit strong performance in the first quarter. Earnings remained high and nonperforming assets remained low. Banks in the Northeast showed a dramatic 35 percent increase in earnings, yielding an aggregate return on equity of 17.4 percent. Nonperforming assets grew only 2 percent. Equity, however, was 3.5 percent lower than a year ago, reflecting the loss provisioning taken by the region's large banks last year.

Overall, the industry should continue to enjoy improved profitability through the rest of the year. Large banks will benefit from lower loss provisioning, and banks in the East will continue to benefit from a strong regional economy. Although it appears that the Southwest's economic problems have bottomed out, that region will continue to dominate 1988 banking news and numbers.

Table I. Selected Indicators, FDIC-Insured Commercial Banks

	1988*	1987*	1987	1986	1985	1984	1983
Return on assets	0.67%	0.72%	0.12%	0.63%	0.70%	0.65%	0.66%
Return on equity	11.00	11.39	2.00	9.94	11.31	10.73	10.70
Equity capital to assets	6.07	6.43	6.04	6.20	6.20	6.15	6.00
Primary capital ratio	7.74	7.57	7.89	7.22	6.91	6.91	6.59
Nonperforming assets to assets	2.48	2.61	2.46	1.94	1.87	1.97	1.97
Net charge-offs to loans	0.88	0.75	0.92	0.98	0.84	0.76	0.67
Asset growth rate	4.06	6.25	2.03	7.71	8.86	7.11	6.75
Net operating income growth	2.04	9.01	-85.27	-20.65	6.30	3.40	-3.69
Percentage of unprofitable banks	12.84	14.65	17.66	19.79	17.09	13.06	10.58
Number of problem banks	1,491	1,509	1,559	1,457	1,098	800	603
Number of failed/assisted banks	54	54	201	144	118	78	45

* — Through March 31; ratios annualized where appropriate

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

	Preliminary 1st Qtr 1988	4th Qtr 1987	1st Qtr 1987	% Change 87:1-88:1
Number of banks reporting	13,541	13,699	14,073	-3.8
Total employees (full-time equivalent)	1,531,367	1,554,994	1,555,220	-1.5
CONDITION DATA				
Total assets	$3,018,230	$3,000,914	$2,900,585	4.1
Real estate loans	615,571	599,904	532,184	15.7
Commercial & industrial loans	596,316	589,675	585,097	1.9
Loans to individuals	350,819	351,216	328,597	6.8
Farm loans	28,630	29,428	29,216	-2.0
Other loans and leases	257,898	259,062	263,822	-2.2
Total loans and leases	1,849,234	1,829,283	1,738,916	6.3
LESS: Reserve for losses	50,303	49,458	29,729	69.2
Net loans and leases	1,798,931	1,779,825	1,709,187	5.3
Temporary investments	471,707	461,199	450,081	4.8
Securities over 1 year	393,473	398,567	366,913	7.2
All other assets	354,119	373,323	374,424	-5.4
Total liabilities and capital	$3,018,230	$3,000,914	$2,900,585	4.1
Noninterest-bearing deposits	439,069	477,797	462,773	-5.1
Interest-bearing deposits	1,880,123	1,857,104	1,778,520	5.7
Other borrowed funds	393,922	381,447	348,464	13.0
Subordinated debt	17,474	17,592	17,282	1.1
All other liabilities	104,389	105,605	106,992	-2.4
Equity capital	183,253	181,389	186,554	-1.8
Primary capital	237,428	234,813	219,637	8.1
Nonperforming assets	74,890	73,905	75,582	-0.9
Loan commitments and letters of credit	802,308	794,698	752,650	6.6
Domestic office assets	2,585,406	2,575,379	2,477,493	4.4
Foreign office assets	432,824	425,535	423,092	2.3
Domestic office deposits	1,985,465	1,993,293	1,908,973	4.0
Foreign office deposits	333,727	341,608	332,320	0.4
Earning assets	2,664,111	2,627,591	2,528,161	5.5
Volatile liabilities	1,077,456	1,049,222	993,705	8.4

INCOME DATA	Full Year 1987	Full Year 1986	% Change	Preliminary 1st Qtr 1988	1st Qtr 1987	% Change
Total interest income	$244,891	$237,806	3.0	$64,147	58,428	9.8
Total interest expense	144,921	142,825	1.5	38,615	34,311	12.5
Net interest income	99,970	94,981	5.3	25,532	24,115	5.9
Provisions for loan losses	36,999	22,075	67.6	4,698	4,107	14.4
Total noninterest income	41,459	35,890	15.5	11,024	9,399	17.3
Total noninterest expense	97,053	90,247	7.5	25,030	23,144	8.1
Applicable income taxes	5,424	5,288	2.6	2,371	1,895	25.1
Net operating income	1,953	13,261	-85.3	4,457	4,368	2.0
Securities gains, net	1,445	3,950	-63.4	390	795	-50.9
Extraordinary gains, net	218	272	-29.9	165	89	85.4
Net income	3,616	17,483	-79.3	5,012	5,252	-4.6
Net charge-offs	16,360	16,550	-1.1	4,031	3,269	23.3
Net additions to capital stock	2,561	3,244	-21.1	129	40	222.5
Cash dividends on capital stock	10,648	9,228	15.4	3,295	2,334	41.2

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

		Asset Size Distribution				Geographic Distribution					
						EAST			WEST		
	All Banks	Less than $100 Million	$100-1,000 Million	$1-10 Billion	Greater than $10 Billion	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
CURRENT QUARTER											
Preliminary (The way it is . . .)											
Number of banks reporting	13,541	10,805	2,379	320	37	1,086	1,927	3,002	3,181	2,811	1,534
Total assets	$3,018.2	$391.2	$568.8	$933.5	$1,124.7	$1,203.9	$410.3	$477.4	$204.0	$274.7	$447.9
Total deposits	2,319.2	349.1	487.0	704.0	779.1	861.9	326.1	384.3	159.9	224.7	362.3
Net income *(in millions)*	5,012	731	998	1,725	1,558	2,831	1,031	1,335	541	-1,644	918
Percentage of banks losing money	12.8%	14.1%	8.1%	6.6%	2.7%	7.9%	11.3%	4.6%	7.6%	27.0%	19.3%
Performance ratios *(annualized)*											
Yield on earning assets	9.70%	9.59%	9.61%	9.63%	9.98%	9.99%	9.63%	9.33%	9.92%	9.20%	9.90%
Cost of funding earning assets	5.84	5.27	5.34	5.46	6.70	6.50	5.42	5.49	5.60	5.85	5.16
Net interest margin	3.86	4.32	4.27	4.17	3.28	3.49	4.21	3.84	4.32	3.35	4.74
Net noninterest expense to earning assets	2.12	2.79	2.65	2.33	1.43	1.63	2.44	1.98	2.07	3.00	2.80
Adjusted net operating income to assets	1.54	1.39	1.46	1.62	1.57	1.63	1.57	1.67	2.01	0.30	1.68
Net operating income to assets	0.59	0.69	0.64	0.68	0.47	0.87	0.94	1.08	1.02	-2.48	0.76
Return on assets	0.67	0.75	0.71	0.74	0.56	0.95	1.01	1.12	1.07	-2.37	0.83
Return on equity	11.00	8.71	9.67	12.04	12.64	17.39	14.75	16.88	14.34	-41.21	14.31
Net charge-offs to loans and leases	0.88	0.64	0.60	0.96	1.01	0.69	0.68	0.78	1.39	2.14	0.76
Loan loss provision to net charge-offs	116.58	127.47	147.84	101.16	117.71	91.51	84.08	75.87	81.45	222.15	105.36
Condition Ratios											
Loss allowance to:											
Loans and leases	2.72%	1.68%	1.66%	1.91%	4.24%	3.06%	1.33%	2.17%	2.13%	4.12%	3.11%
Noncurrent loans and leases	79.73	58.32	70.03	86.17	89.57	82.49	95.83	118.04	79.58	51.00	77.22
Nonperforming assets to assets	2.46	2.16	1.93	1.81	3.42	2.40	1.06	1.26	1.87	6.28	3.26
Equity capital ratio	6.07	8.72	7.31	6.19	4.41	5.52	6.94	6.74	7.43	5.43	5.76
Primary capital ratio	7.74	9.49	8.14	7.28	7.32	7.54	7.85	7.99	8.55	7.45	7.95
Net loans and leases to deposits	78.78	61.41	69.77	81.73	82.37	88.11	77.85	74.40	71.05	67.85	83.98
Growth Rates *(year-to-year)*											
Assets	4.1%	5.1%	10.2%	12.5%	3.1%	5.1%	9.0%	4.9%	-0.8%	-6.5%	1.6%
Equity capital	-1.8	3.7	8.1	10.0	-14.5	-3.5	10.4	0.4	1.4	-22.5	1.8
Net interest income	5.9	4.3	8.4	15.0	5.7	6.8	6.5	7.9	4.7	-7.3	5.7
Net income	-4.6	0.3	-15.7	-4.6	0.7	35.1	1.6	23.2	25.8	N/M	58.6
Nonperforming assets	-0.9	-0.5	18.3	20.5	-3.2	1.9	5.2	-14.9	-16.0	27.3	-14.7
Net charge-offs	23.3	-13.0	1.4	71.9	28.5	31.1	72.2	86.7	-1.3	30.3	-23.4
Loan loss provision	14.4	-14.5	24.8	37.0	21.9	-19.3	5.5	1.2	-29.1	165.9	-24.2
PRIOR FIRST QUARTERS											
(The way it was . . .)											
Return on assets . . . 1987	0.72%	0.72%	0.85%	0.84%	0.55%	0.73%	1.08%	0.95%	0.84%	0.10%	0.52%
. . . 1985	0.75	0.92	0.91	0.78	0.60	0.78	1.14	0.83	0.82	0.59	0.52
. . . 1983	0.78	1.24	0.93	0.67	0.54	0.72	1.03	0.79	1.14	1.09	0.40
Equity capital ratio . . . 1987	6.43	8.54	7.39	6.16	5.32	6.01	6.85	7.05	7.39	6.55	5.98
. . . 1985	6.29	8.65	7.25	5.95	4.92	5.65	6.83	6.91	7.82	7.00	5.67
. . . 1983	6.02	8.68	7.14	5.73	4.30	5.27	6.92	6.70	7.63	6.99	5.07
Nonperforming assets to assets . . . 1987	2.61	2.38	1.98	1.82	3.73	2.58	1.10	1.55	2.25	4.63	3.90
. . . 1985	2.09	2.08	1.65	1.74	2.67	1.84	1.12	1.73	2.32	2.48	3.34
. . . 1983	2.08	1.63	1.74	2.02	2.53	1.63	1.27	2.24	1.86	2.15	3.45
Net charge-offs to loans and leases . . . 1987	0.75	0.86	0.76	0.62	0.83	0.56	0.45	0.45	1.43	1.53	1.00
. . . 1985	0.58	0.72	0.50	0.54	0.60	0.37	0.35	0.48	1.08	0.93	0.82
. . . 1983	0.52	0.44	0.56	0.64	0.46	0.38	0.57	0.55	0.47	0.75	0.62

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

Table IV. 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
Number of banks reporting	13,699	10,927	1,884	536	268	74	10	1,081	1,924	3,053	3,232	2,873
Total assets	$3,000.9	$393.8	$304.0	$272.5	$589.5	$761.2	$679.9	$1,180.1	$406.8	$480.3	$208.6	$280.4
Total deposits	2,334.9	351.5	267.1	226.7	455.1	536.3	498.2	885.2	323.3	387.7	163.9	229.8
Net income *(in millions)*	3,616	2,120	2,337	1,725	3,058	5	-5,619	-1,535	3,590	2,029	1,377	-1,779
Percentage of banks losing money	17.7%	19.4%	9.4%	11.6%	12.3%	24.3%	90.0%	9.7%	8.4%	5.8%	12.6%	38.1%
Performance Ratios												
Yield on earning assets	9.54%	9.65%	9.59%	9.66%	9.62%	9.55%	9.99%	9.80%	9.74%	9.29%	10.02%	9.20%
Cost of funding earning assets	5.65	5.22	5.17	5.23	5.34	5.73	6.82	6.26	5.28	5.42	5.66	5.69
Net interest margin	3.89	4.43	4.41	4.43	4.27	3.82	3.17	3.54	4.46	3.87	4.36	3.51
Net noninterest expense to earning assets	2.17	2.86	2.66	2.64	2.38	1.98	1.51	1.74	2.52	2.16	2.03	2.57
Net operating income to assets	0.07	0.52	0.75	0.62	0.51	-0.05	-0.89	-0.22	0.91	0.40	0.68	-0.70
Return on assets	0.12	0.57	0.81	0.67	0.56	-0.00	-0.81	-0.13	0.96	0.44	0.70	-0.65
Return on equity	2.00	6.62	10.55	9.60	8.60	-0.01	-18.29	-2.37	13.96	6.51	9.39	-10.03
Net charge-offs to loans and leases	0.92	1.15	0.82	0.95	0.92	1.04	0.78	0.68	0.70	0.69	1.63	2.11
Condition Ratios												
Loss allowance to loans and leases	2.69%	1.64%	1.50%	1.60%	1.85%	2.92%	4.62%	3.15%	1.38%	2.24%	2.20%	3.09%
Nonperforming assets to assets	2.46	2.09	1.75	1.88	1.92	2.28	3.86	2.44	1.03	1.27	1.86	5.80
Loss allowance to noncurrent loans	78.00	61.53	68.59	70.68	75.36	88.06	78.72	83.33	100.17	117.92	80.85	41.20
Equity capital ratio	6.04	8.60	7.61	6.88	6.40	5.11	4.24	5.43	6.81	6.52	7.45	6.06
Primary capital ratio	7.81	9.42	8.42	7.75	7.41	7.12	7.75	7.51	7.52	7.78	8.57	7.54
Net loans and leases to assets	59.30	51.11	56.61	60.92	63.09	61.21	59.19	59.60	60.12	57.57	53.15	53.90
Net assets repriceable in one year or less to assets	-7.22	-9.39	-7.52	-7.40	-8.18	-8.01	-4.06	-6.07	-12.06	-4.60	-13.67	-11.27
Growth Rates *(year-to-year)*												
Assets	2.0%	4.0%	5.9%	7.7%	9.4%	8.4%	-1.8%	4.1%	6.6%	3.6%	1.0%	-7.1%
Earning assets	3.1	4.6	7.0	9.0	10.7	10.0	-1.3	5.1	7.6	4.3	1.5	-7.3
Loans and leases	4.1	6.9	10.4	12.0	14.9	9.3	-3.0	5.9	11.4	7.0	3.4	-8.3
Loss reserve	71.1	11.1	16.5	21.0	43.4	98.9	141.7	123.9	18.2	65.8	17.1	20.0
Net charge-offs	-1.1	-20.9	-10.4	16.1	24.4	40.6	-15.4	19.0	24.9	5.5	-22.2	-12.4
Nonperforming assets	29.0	0.6	9.2	20.3	41.8	58.5	49.7	64.6	15.4	1.2	-6.3	32.0
Deposits	2.3	4.1	5.4	6.1	9.1	9.0	0.2	4.7	6.0	4.5	1.6	-6.8
Equity capital	-0.5	4.2	8.7	8.6	11.5	0.8	-16.3	-2.7	10.5	-0.5	5.8	-12.0
Interest income	3.0	-1.2	3.3	6.0	11.3	11.6	3.8	10.2	5.1	1.3	-1.6	-11.3
Interest expense	1.5	-5.8	-1.3	1.6	7.4	11.2	6.3	11.7	1.4	-1.8	-4.6	-12.7
Net interest income	5.3	4.9	9.3	11.6	16.5	12.1	-1.1	7.7	9.9	6.2	2.6	-8.9
Loan loss provision	67.6	-23.1	-15.9	5.3	36.0	141.5	173.8	204.0	23.8	96.4	-19.1	17.2
Noninterest income	15.5	10.5	11.4	13.0	21.8	18.6	23.6	27.4	11.5	8.9	12.5	4.7
Noninterest expense	7.5	6.2	9.0	10.7	15.5	15.9	9.1	12.7	7.1	6.0	4.2	-0.1
Net operating income	-85.3	49.2	28.2	13.5	-5.9	N/M	N/M	N/M	10.4	-44.1	77.4	N/M
Net income	-79.3	11.4	10.8	-1.0	-14.0	N/M	N/M	N/M	0.4	-47.0	-1.6	N/M

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429 .

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FDIC-616

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.

Noncurrent Loans & Leases—the sum of loans past-due 90 days or more and loans in nonaccrual status.

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.

Volatile Liabilities—the sum of large denomination time deposits, foreign office deposits, federal funds purchased, and other borrowed money.

Requests for copies of and subscriptions to the FDIC Quarterly Banking Profile should be made through the FDIC's Office of Corporate Communications, 550 17th Street N.W., Washington, D.C. 20429; telephone (202) 898-6996.

APPENDIX B

Pocket Guide for Directors

Guidelines for Financial Institution Directors

FDIC

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. William Seidman
Chairman
Federal Deposit Insurance Corporation

Robert L. Clarke

C. C. Hope, Jr.

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

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.

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.

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

- 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 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, [illegible] expose themselves to serious civil and criminal liability, and may expose their institution to a greater than ordinary risk of loss.

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.

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.

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.