FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR IMMEDIATE RELEASE PR-186-88

FDIC CHIEF OUTLINES BASIS FOR AVOIDING DEFAULTS BY MAJOR BANKS

Major U.S. banks have not been permitted to default on their obligations because of a number of assumptions made by federal authorities, FDIC Chairman L. William Seidman said today. In remarks to the Institute of International Bankers in Berlin, West Germany, Chairman Seidman described those assumptions as follows:

-- The banking system plays a vital role in the economy, not only by allocating credit and acting as a depository for funds, but also through its role at the center of the payment system.

-- Because of the need to protect the system as a whole, it has been necessary to protect the largest institutions to avoid a challenge to the system's overall integrity.

-- Allowing a major U.S. bank to default also could have destabilized the international financial system.

-- If the U.S. were to become the only industrialized nation to allow depositors and creditors of a multi-billion dollar bank to suffer loss, it could undermine the competitive position of U.S. institutions.

-- Paying off insured depositors in a major bank failure would prove very costly to the FDIC and involve hugh cash outlays. "There also is a real question of whether it is technically possible to close a giant

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institution without freezing insured as well as uninsured funds for a considerable period," Mr. Seidman noted.

Mr. Seidman observed that some people on the sidelines have argued that large institutions should be permitted to default. He pointed out, however, that "nobody really knows for sure what might happen if a major bank is allowed to default, and the opportunity to find out probably won't be accepted soon."

Chairman Seidman emphasized that the policy of protecting the depositors and creditors of major banks from loss does not extend to the owners or creditors of bank holding companies. He pointed out that the credit markets are recognizing this distinction and are requiring higher returns on holding company debt than on direct bank debt. "In our view," he concluded, "this represents a healthy and efficient development in our marketplace, and one that we hope the international community will support."

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FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR IMMEDIATE RELEASE PR-191-88 (10-10-88)

SEIDMAN REPORTS INSURANCE FUND REMAINS STRONG AFTER RECORD BANK FAILURES

The banking industry's deposit insurance fund remains strong and highly liquid despite record banking problems. "The FDIC fund is sound even after handling about the same amount of total banking assets from failed and assisted commercial banks in the last three years as the FDIC handled in its first 50 years," Federal Deposit Insurance Corporation Chairman L. William Seidman today told members of the American Bankers Association.

"Even though this year we will experience our first loss," Mr. Seidman reported, "the FDIC is solvent with a highly liquid net worth sufficient to handle our foreseeable problems." The insurance fund, he noted, has responded to more bank failures during the past three years than during the 30 years following World War II, including two of the most costly banking problems in the FDIC's history, First City and First Republic.

Mr. Seidman characterized preservation of the soundness of the insurance fund as the FDIC's "first, and most important goal." He attributed the fund's strong position to sound operation in the past and new approaches for resolving bank failures developed in the last three years.

The FDIC, he noted, improved its methods for selling failed banks by reducing its role in the liquidation of distressed assets and expanding opportunities for healthy banks to acquire problem loans. Refinement of its "loss assessment" techniques was a critical element in the FDIC's effort to develop failed bank sales approaches, Mr. Seidman said. These refinements are fully explained in a new FDIC publication, FDIC Banking Review, which is being release today, he added.

"The use of what we call whole bank transactions in nearly 60 percent of our failed bank cases has helped the FDIC minimize its cash outlays by as much as $3.5 billion," Mr. Seidman commented. Moreover, he noted the whole bank transaction has resulted in assets staying within the banking system. Mr. Seidman said this is producing significant savings in the FDIC's operating costs and cash outlays and has led to a gradual, managed reduction in the FDIC's liquidation staff of about 1,200 in the last 18 months.

Discussing other highlights of activities since 1985, Mr. Seidman commented on the exclusion of bank holding companies from the deposit insurance "safety net" and the publication of the FDIC's major study, Mandate For Change" which helped focus congressional debate on the key legislative issues in bank deregulation.

Mr. Seidman noted the FDIC staff will complete work next month on a major review of the deposit insurance system, including the problems facing the savings and loan industry. On insurance reform and other important issues, "predicting what Congress will do is beyond the capacity of even our brightest minds," Mr. Seidman commented. "One thing we know, the FDIC will be at the forefront of the battle to prevent the cost of the Federal Savings and Loan Insurance Corporation's insolvency being billed to the banking industry. I am looking forward to working with you all in the year ahead on this issue and others that are essential for the preservation of a safe and sound banking industry."

The FDIC is an independent agency of the U.S. Government and is administered by a three-member board consisting of Mr. Seidman, C.C. Hope, Jr., and Comptroller of the Currency Robert L. Clarke. The FDIC is not funded by tax dollars; rather, its operations are funded solely by premium payments from insured banks and income from the investment of those payments in U.S. Government securities.

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Remarks by

L. William Seidman
Chairman
Federal Deposit Insurance Corporation

Before

ABA Annual Convention
Honolulu, Hawaii
October 10, 1988

It gives me great pleasure to speak for the third time at the ABA annual convention.

I assume you keep inviting me back because you hope I'll finally get it right.

With the World Series approaching, it's hard to forget that it's three strikes and you're out.

And in the financial ballpark, it's important not to just hit the ball, but hit it well by getting ahead of the curve.

At the FDIC we have had one or two whiffs, but we have also hit a couple of Texas Leaguers, and a few home runs.

Given the challenges the FDIC has been facing, we hope you will judge it a satisfactory batting average.

Since you are in a sense our shareholders, it seems an appropriate time to "look at the record" as we come to the end of the term of the President who appointed me to this most interesting, if perhaps not the easiest, job in Washington.

Let's take a look at what we've achieved, and what still needs to be done.

First, we have preserved the financially sound position of our insurance fund. That's got to be good for extra bases in any ball game.

Despite record bank failures the FDIC fund remains strong and solvent. This is true even after handling about the same amount of banking assets from failing banks in the last three years as the FDIC handled in its first 50 years! This includes handling First Republic and First City, the first and third most costly bank problems in our history.

So I'm pleased to report that we expect the FDIC fund to end 1988 with a highly liquid net worth sufficient to handle our foreseeable problems. That's the case even though, as I said before, this year we will experience our first loss.

One of the reasons we are solvent and have $15 billion in cash and Treasury securities on hand today, is the result of our finding new methods to deal with bank failures.

The FDIC took its old tried and true "Purchase and Assumption" approach for handling bank failures, and developed an improved model.

The first "P&As" were used to sell the most attractive parts of failed banks to healthy banks. Unfortunately, this left the FDIC with the costly job of liquidating many loans and other assets, averaging almost 60 percent of each failed bank's total assets.

So there was room for improvement.

If the assets of failed banks could be kept in the private sector, our cost and cash outlays could be minimized.

To achieve that objective, the FDIC developed the "whole bank P&A." In these transactions, we ask qualified bidders how much assistance we need to provide for them to take all of a failed bank's good <u>and</u> bad assets, and we give all the bids a good look.

We accept the lowest viable bid if it constitutes the low cost approach to solving the problem.

We never could have made that cost determination, and consequently could not have introduced this approach, if we hadn't spent the last three years learning how to judge loss at a failed institution.

I'm pleased to announce that our new publication -- the "FDIC Banking Review" -- examines the different asset quality and regional variables we use to help estimate that loss. Our publication also contains the most in-depth explanation of the bidding process ever available. So now you don't have any more excuses for staying away from our bidding process! We invite you to come and look for bargains.

Our success rate in achieving whole bank and assistance transactions has soared from five percent in 1986, to almost 60 percent this year. That translates to about $3.5 billion less in cash tied up in liquidating assets -- not even counting First City and First Republic. And if First City and First Republic were handled the same as we handled Continental Illinois, we might have another $10 billion or so in assets in liquidation, and our cash might be an additional $3 to $4 billion lower.

<u>Our second hit was our newly developed ability to restrict the deposit insurance "safety net" to banks, and to withdraw it from holding companies.</u>

During these past three years, we put in place the necessary tools to treat banks and bank holding companies as separate entities. We asked for, and Congress granted us, the power to create bridge banks, which has been essential to achieving this result.

Too often it has been the regulators' practice to treat bank holding companies, and the banks they own as one -- in fact, in a manner that would make Siamese twins look like distant cousins. The FDIC's position has changed this practice.

We have made this an important goal because, if the "safety net" is not limited to banks, government support could extend anywhere holding companies are allowed to venture. In that case, ventures like new powers should and would certainly be restricted. The "safety net" is not intended for securities or insurance businesses.

Further, restricting the "safety net" brings with it an important protection for the insurance fund. We do not have to cover the costs of rescuing holding companies. In the First Republic case alone, our savings should exceed one billion dollars, and based on the holding company's projections in bankruptcy, it could be much more!

<u>Third, the publication of our blueprint for a brighter banking future -- "Mandate For Change"</u> -- was at least a single, and may lead to a score with your help.

Well before Congress started its effort on a banking bill, your FDIC had become a "player" in the banking restructuring ball game with its study.

Our study made the following points --

<u>It suggested streamlining bank regulation</u> by focusing supervision by bank regulators on the bank itself, not on its holding company or banking subsidiary.

<u>Further, it proposed attracting capital into banking</u> by eliminating the wall between commerce and banking.

<u>And, finally, it advocated giving banks a fair competitive position</u> by allowing banks new powers to be exercised through a separately capitalized affiliate or subsidiary.

A year ago, when "Mandate For Change" was released, these ideas were viewed by some as extreme. Some still hold that view.

So it's no surprise that all of this has not become current law.

But viewpoints embodied in the FDIC study have surfaced in the major banking debates on Capitol Hill and elsewhere.

What is happening in the real world indicates that the market-place may move us in the direction the study indicates, even if legislation does not. Sixty percent of the purchasers of sick thrifts are commercial outfits -- a big dent in the wall between commerce and finance. Because the "safety net" has been withdrawn from holding companies, banking is being financed directly, in many cases, instead of being financed through the holding company. The holding company is no longer being considered "a <u>bank</u>."

Moreover, new powers are arriving through new technology and state laws and regulations.

The real restructuring of banking is taking place in the marketplace.

<u>Fourth -- our home run</u> -- <u>we secured legislation that ensures the independence of the FDIC, a matter that has long been in question</u>.

Your help was vital in this effort. This independence gives us a great privilege and an even greater responsibility. We are meeting this responsibility with new and modern budgeting techniques, productivity standards, and comprehensive planning. The new law leaves us free to channel our energies into helping protect the safety and soundness of the banking industry, rather than defending ourselves in a bureaucratic turf battle.

<u>Fifth, we have made bank supervision the key to the future of deposit insurance. We're still at bat on this one</u>.

We have added an important principle to the rules of the game: "Deregulation requires more, not less, supervision." This was not a popular thought to some "deregulators" and bankers when first put forward.

It is now better understood. More and more people are accepting the view that banking can never be fully deregulated while there is federal deposit insurance available to the banks.

To help prevent future bank problems, we have expanded our programs to detect and deal with bank fraud with our list of "red flags," which help alert our examiners to problems that could affect bank safety and soundness. We have hired more examiners, refined our training program, increased the frequency of bank examinations, and expanded our use of off-site monitoring.

Our S.A.F.E. -- SAFE -- examination program (standing for "Supervisors' Annual Flexible Examination") provides that we meet each year with state regulators to create a coordinated program making maximum use of our combined resources.

Well, so much for our hits. Unfortunately, we haven't always made solid contact with the ball -- we have had some whiffs.

They include the fact that we are still behind in conducting compliance and safety and soundness examinations. We still have a long way to go in reducing the cost of fraud to the system. We still have billions of dollars of assets to liquidate. We have not yet found a way to control the kind of multi-billion dollar losses we have experienced in Texas.

It certainly has been an interesting and busy three years for me, and I want to thank you for your cooperation and support during this period.

<u>So what do we see ahead for the FDIC, whether its chairman be a Republican or a great Democrat like C. C. Hope</u>.

For the immediate future, we anticipate that the number of bank failures will top-off this year, and that we will see a sizable decline in the number of failed banks next year and a much lower amount of deposits to be dealt with. However, I must warn you we had a similar view in 1987 about 1988. Unfortunately we were wrong.

If new regions experience economic hardships, our optimistic view could change rapidly. In that regard, we are keeping a weather eye on real estate values, particularly in the Northeast and the Southeast, and hope you are, <u>too</u>.

Whatever the future holds, we are preparing for the worst while hoping for the best.

Thus, our Division of Bank Supervision plans to increase its examination staff to about 2300 within three years. In addition, with the possibility of new powers for banks, we hope to train a cadre of examiners who will focus on areas such as insurance and securities, foreign exchange, international banking, and other off-balance-sheet operations.

Our Division of Liquidation is preparing for the projected decline in the number of failed banks and in the volume of acquired assets. This is dictating a gradual, managed reduction in staffing, with a goal to reduce staffing from today's 3550 to under 2000 within three years. We are already down 1200 in the past 18 months even though we have had a record number of failures. We will move toward our goal of essentially getting out of the liquidation business.

The FDIC's Division of Accounting and Corporate Services is concentrating on building integrated systems and personnel structures that should have the flexibility to deal rapidly with any new economic environment.

And our people have been hard at work <u>all</u> year on a major review of the deposit insurance system, including the problems facing the S&L industry. Our study, "A Deposit Insurance System for the '90s and Beyond," will be completed late next month. In this regard, I compliment the ABA for its timely report on the S&L problem. It is a valuable contribution to solving a most serious problem.

As we look into our future, we find that our crystal ball is clouded by unpredictable congressional activity. Predicting what Congress will do is beyond the capacity of even our brightest minds.

So it is difficult to say too much about the road ahead because Congress may be setting our future "as we speak," as Willard the weather man puts it.

One thing we do know, <u>the FDIC will be in the forefront of the battle to prevent the cost of the FSLIC's insolvency being billed to the banking industry!</u>

We will use the lessons from today to help meet the needs of banks in the next decade, and beyond. We'll try to deal evenhandedly with small banks, compact and unit banks, southern and northern banks, and money center and independent banks.

It's not going to be an easy job, and unfortunately, you can't please all the people all the time.

But as has been said, "To escape criticism -- do nothing, say nothing, be nothing." That's a price we cannot afford to pay!

But I am confident that by working together, bankers and bank regulators can step up to the bat and achieve our most important shared goal -- a safe and healthy banking industry that brings excellent service to its community.

I'm pleased we have made it to the seventh inning stretch, and I look forward to working with you in the innings ahead to make certain we all win!

To conclude, let me tell you about a recent vote of confidence that shows we are a winning team. You've probably noticed that books predicting the collapse of the economy and banking system are currently more popular than ever.

Paul Erdman, in particular, has made a good living coming out with books entitled The Crash of 19 so and so every few years. Thus, I was interested in something contained in a recent interview with Mr. Erdman. I think it's encouraging to anyone concerned with the future of the United States banking system and our deposit insurance system. When Mr. Erdman was asked what he did with his own assets, he stated that he keeps his money where it is safe -- in insured bank certificates of deposit.

On that hopeful note, I'd like to thank you for the privilege of speaking to you in beautiful Hawaii, and I look forward to working with you in the future. Aloha!