Speeches

TESTIMONY OF

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CHAIRMAN
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WASHINGTON, D. C.

ON

THE CONDITION OF THE COMMERCIAL BANKING INDUSTRY

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
UNITED STATES SENATE

10:00 A.M.
OCTOBER 25, 1989
ROOM 538, DIRKSEN SENATE OFFICE BUILDING

SUMMARY OF FDIC STATEMENT

The banking industry is relatively healthy and improving, even though the level of bank failures in the Southwest is still far too high. We have continuing concerns regarding credit to developing countries and loans to finance highly leveraged transactions. All in all, however, we think bank failures will decline in 1990 and see nothing on the horizon raising any significant threat to the Bank Insurance Fund.

The weakest regional economies have been improving, particularly in the Midwest, where the agricultural recovery has led to a strong performance by banks in that region. The Southwest is, and will remain through 1990, the region with the highest levels of problem and failed banks.

Banks in the Northeast recently have shown a declining trend in asset-quality indicators. The softening real estate market and continuing problems in loans to developing countries (which affect only the largest banks) have been primarily responsible for a rise in nonperforming assets for three consecutive quarters. However, we do not see these difficulties developing into anything requiring significant FDIC financial assistance

In 1988, the FDIC handled 200 bank failures and provided financial assistance for the resolution of 21 additional institutions. Even though the number of bank failures has remained high during 1989, with 170 failures as of October 13, provisions for losses are down significantly. For the first six months of 1989, net income for the Bank Insurance Fund was $171 million and we expect it to break even for the full year and to increase in 1990.

Capital levels in commercial banks are adequate and improving, but certainly not excessive at this time of increasing risks to the system. In the first half of 1989, commercial banks increased their equity capital by $9.8 billion and have attained an equity capital-to-assets ratio of 6.44 percent and a primary capital-to-assets ratio of 7.99 percent. This is not to say that some banks are not sorely in need of additional capital. The supervisors are working closely with those banks to overcome the problem.

The Comptroller of the Currency has suggested a change to the leverage capital standard which has been in place for several years. Our analysis indicates that the Comptroller's current proposal would reduce the required minimum amount of capital in the banking system by at least $8 billion, as compared with a risk-based capital requirement supplemented with a six percent total capital requirement. Now is not the time to be reducing capital standards. The banking business is an increasingly volatile one and well known concerns remain in areas such as interest rate risk, concentrations, real estate volatility and loans to lesser developed countries.

Good morning, Mr. Chairman and members of the Committee. We are pleased to report today on the condition of the commercial banking industry. We also will be reporting on the condition of the Bank Insurance Fund and the status of supervision as the Federal Deposit Insurance Corporation begins to implement the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

The banking industry is relatively healthy and improving, even though the level of bank failures in the Southwest is still far too high. We have continuing concerns regarding credit to developing countries and loans to finance highly leveraged transactions. All in all, however, we think bank failures will decline in 1990 and see nothing on the horizon raising any significant threat to the Bank Insurance Fund.

The three banking agencies earlier have provided you with a book of statistics on bank performance and condition, problem bank levels and trends, bank failures and assistance transactions (updated numbers for closed banks and open bank assistance by FDIC as of September 30, 1989 are included as Attachment A), number and experience level of examiners, and examination hours by CAMEL rating. We also have attached to this testimony our most recent Quarterly Banking Profile, which provides current statistics on commercial banking results.

<u>The Economy and the Condition of the Banking Industry</u>

The overall financial condition of the banking industry is closely tied to national and regional economic conditions. Lately, national economic conditions have been favorable, with relatively low inflation and interest rates, and moderate economic growth. The weakest regional economies have been improving, particularly in the Midwest, where the agricultural recovery has led to a strong performance by banks in that region. The Southwest economy has shown signs of recovery, but this has not yet translated into significantly improved bank performance. Most failed banks in 1988 and so far in 1989 were located in Texas, Oklahoma or Louisiana. Texas alone accounted for more than one-half of all bank failures last year; this year, Texas has accounted for two-thirds of all failures. The Southwest is and will remain the region with the highest levels of problem and failed banks, at least through 1990, but we expect overall bank performance to show improvement next year.

In contrast, banks in the Northeast recently have shown a declining trend in asset-quality indicators. A softening real estate market has boosted the level of nonperforming real estate loans. These loans and the continuing problems in loans to developing countries (which affect only the largest banks) have been primarily responsible for a rise in nonperforming assets for three consecutive quarters. These problem areas are expected to adversely impact this region's bank earnings in the second half of 1989. While some of the problems in the Northeast are now receiving public notice, we do not see these difficulties developing into anything requiring significant FDIC financial assistance.

The Northeast also is the location of most of the Bank Insurance Fund's ("BIF") insured savings banks. Since mid-1987, BIF-insured savings banks have experienced lower earnings attributable to shrinking net interest margins and rising loan-loss expenses.

Nonperforming assets of savings banks at the end of the second quarter were more than twice as high as a year earlier. Most of the problem assets were in real estate loans, which comprise the majority of state-chartered savings bank assets. As of September 30, 1989, 15 BIF-insured savings banks were on the "Problem List," representing only three percent of the industry; in contrast, nine percent of commercial banks were on the "Problem List" on that date. The number of BIF-insured savings bank failures has not exceeded two in any year since 1983. In view of the trend toward higher problem levels in real estate lending in the Northeastern United States, we expect some deterioration in these numbers in 1990.

Status of the Bank Insurance Fund (BIF) and Bank Failures and Assistance Transactions

Financial institution failures and open-bank assistance transactions were at record levels in 1988 in size, number and cost to the Insurance Fund. The FDIC handled 200 bank failures and provided financial assistance for the resolution of 21 additional institutions. Included in these numbers were the failure of First RepublicBank in Dallas and the assistance of Houston-based First City Bancorporation. Also included in the FDIC's 1988 operating losses was the commitment of funds to handle MCorp of Dallas, Texas American Bancshares of Fort Worth, and National Bancshares Corporation of San Antonio (all of which are being resolved during this year). In total, provisions for insurance-related losses in 1988 were $6.3 billion. As a result, the net worth of the Insurance Fund declined more than $4 billion, from $18.3 billion to $14.1 billion at year-end 1988.

Even though the number of bank failures has remained high during 1989, with 170 failures as of October 13, provisions for losses are down significantly. For the first six months of 1989, net income for the Bank Insurance Fund was $171 million and we expect it to about break even for the full year and to increase in 1990. Moreover, we expect the number of failures to begin to decline and for this trend to continue into 1990. The number of problem banks has been dropping for over two years, from a high of 1,624 in mid-1987 to 1,166 as of September 30, 1989, and this favorable trend is beginning to show up in the failed-bank numbers.

Not only has the Fund been adequate to handle the bank problems of the past few years, but liquidity has been maintained despite record insurance-related outlays. At year-end 1988, nearly 74 percent of the Fund's total assets, or $16.5 billion, was in the form of cash or U.S. Treasury securities and this level has been maintained during 1989. New approaches to dealing with bank failures and aggressive management of assets held for liquidation have been responsible.

Several provisions in FIRREA provide the FDIC with additional flexibility to help ensure that the Bank Insurance Fund can effectively address future problems in the industry. Insurance premiums will increase to 12 basis points of assessable deposits in 1990, and to 15 basis points in 1991. We estimate that with a modest four percent annual growth rate in assessable deposits, assessment income will be about $3 billion in 1990 and $3.9 billion in 1991. This compares to $1.8 billion in 1988 and a projected $1.9 billion in 1989. In addition, the FDIC has the flexibility to increase these rates based upon the experience of the Fund. The FDIC will continue to earn interest on the portfolio of U.S. Treasury securities held in the Fund. Interest income for 1988 amounted to $1.4 billion and a similar amount is projected for 1989. The increased statutory assessment rates and the flexibility to change those rates should allow the Bank Insurance Fund to attain and then maintain the 1.25 percent target ratio of the Fund to insured deposits.

The FDIC ended 1988 with 106,000 assets in liquidation with a book value of $9.3 billion. The assets were acquired from failed and assisted institutions. This was a significant decline from the past three years when at year-end 1987 we held 178,000 assets with a book value of $11.3 billion; at year-end 1986 we held 192,000 assets with a book value of $10.9 billion; and, in 1985, we held 180,000 assets with a book value of $9.6 billion. This reduction can be attributed to the success of our "whole bank" purchase and assumption program where the acquirer purchases most of the assets of the failed bank.

With respect to the assets retained by the FDIC, strong marketing and asset management has resulted in significant asset sales at or near current appraised values. Our policy is that every asset is for sale at the appraised market price. Getting these assets back into the private sector at market prices is the first step in helping troubled regional economies recover.

Our testimony now will focus on the seven specific questions raised in the Committee's letter of invitation.

1. Are you satisfied that commercial banks and their holding companies have enough capital to protect the public interest and avoid a future crisis at the Bank Insurance Fund?

Capital levels in commercial banks are adequate and improving, but certainly not excessive at this time of increasing risks to the system. We agree with Chairman Greenspan's recent remarks before the American Bankers Association regarding the role of capital. He emphasized that banks do not need exceptionally low capital ratios to produce an acceptable return on equity and that strong capital ratios do not preclude strong returns.

In the first half of this year, commercial banks increased their equity capital by $9.8 billion and have attained an equity capital-to-assets ratio of 6.44 percent and a primary capital-to-assets ratio of 7.99 percent. These are the highest industry-wide capital ratios in recent years. Large banks in particular have steadily increased their equity capital as a percentage of total assets, aided by strong earnings and prompted by new risk-based capital requirements.

That is not to say that some banks are not sorely in need of additional capital. The supervisors are working closely with those banks to overcome the problem, where possible. As of September 30, 1989, the Bank Insurance Fund's problem bank list contained 1,166 institutions representing slightly less than $200 billion in deposits. Most, if not all, of these banks are deemed to have inadequate capital.

Fortunately, most problem banks are rehabilitated, usually with close supervisory guidance. For example, in 1988, only about one third of the 680 banks that were removed from the problem list were removed as a result of failure or FDIC financial assistance.

Now is not the time to be reducing capital standards. The banking business is an increasingly volatile one and well known concerns remain in areas such as interest rate risk, concentrations, real estate volatility and loans to lesser developed countries.

The Comptroller of the Currency has suggested a change to the leverage capital standard which has been in place for several years. While important parts of the Comptroller's initiative have merit and my support, the issue ultimately boils down to, "Now is not the time to lower capital requirements." Our analysis indicates that the Comptroller's current proposal would reduce the required minimum amount of capital in the banking system by at least $8 billion, as compared with a risk-based capital requirement supplemented with a six percent total capital requirement. While most of the largest U.S. banks will be subject to a risk-based capital requirement that will be higher for them than a leverage ratio (as of the risk-based capital phase-in dates of year-end 1990 and 1992), the vast majority of U.S. banks will continue to be governed by the six percent leverage ratio which is uniformly in place at all three banking agencies. Lowering the leverage ratio to just three percent core capital with no additional requirement will allow many financial institutions which currently exceed the six percent ratio to suddenly have large amounts of "excess capital" available to fund growth and/or reduce capital through dividends or in other ways. We estimate that almost 10,000 banks would be able to reduce their equity capital under the Comptroller's proposal, as compared with a six-percent total capital requirement.

As the insurer of the industry, we would regard that as being an undesirable effect. Thus, we believe the three percent core leverage test must be supplemented with a total capital requirement which could include secondary forms of capital such as those allowed under the current leverage framework. We support limiting or eliminating the allowance for loan losses in this calculation.

Common capital standards among the three Federal banking agencies have been beneficial to the industry as well as the insurance fund. We believe that acceptable common standards must be adopted before the risk-based standards first begin to apply at year-end 1990.

2. Are you confident that earnings reported for the banking industry reflect the true earnings performance of the industry?

Commercial banks' net income totalled $14.3 billion for the first six months of 1989, the most ever earned in a six-month period. This record level of earnings is attributable to the performance of the largest banks which have seen a dramatic rise in earnings due to improved net interest income, strong gains in noninterest income, and reduced loan loss expenses.

However, increasing problems in real estate loans in soft markets and continuing problems with loans to lesser developed countries are expected to be main factors influencing bank earnings in the second half of 1989 and beyond. At the end of June, the banking industry's loss reserves totalled just over $45 billion, an amount equal to 62.6 percent of its nonperforming assets.

Recently published earnings reports indicate that some of the largest commercial banks added several billion dollars to their loan-loss reserves in the third quarter. These additions will raise the industry's reserves above the previous record level of $50.3 billion reported in the first quarter of 1988. This boosting of reserves will be accomplished at the expense of industry earnings for the third quarter, and may produce a net drop in commercial banks' combined equity capital. In this respect, the large banks' additions to loss reserves are similar in nature, albeit much smaller in scale, to their $15-billion reserve boost in the second quarter of 1987. That boost, too, was made in response to perceived changes in the value of the banks' loans to developing countries. It represented a restructuring of their balance sheets, and resulted in a more accurate portrayal of their net worths. The latest additions to reserves will mean that subsequent reported earnings will more closely represent banks' "true" earnings performance. Our concerns regarding LDC lending and investments in real estate are discussed below.

In summary, bank earnings appear adequate to provide for the foreseeable losses in the banking industry and provide the support needed for capital growth.

3. <u>Do you have any concerns about the portfolio composition (particularly investments in real estate, LBOs and LDC lending) of banks and their holding companies?</u>

It is a supervisor's job to worry about all the risks that banks take on, including those arising from how they structure their balance sheet. As such, this is an area which receives a lot of our attention through off-site monitoring, special reviews and, of course, the regular examination process. The three areas raised in this question, along with interest rate risk, are matters of some concern in regards to banks' portfolio composition.

<u>Lesser Developed Countries (LDC) Debt</u>. The regulatory agencies have required that specific reserves be established against certain exposures to LDC debt. The agencies also have required increased capital in several banks involved in international lending. These requirements are regularly reviewed by an interagency committee composed of specially trained examiners. Because all the major U.S. banks have been able to reduce their relative exposures to LDC debt through increased capital and reserve levels, reductions, and write-offs, the risks to the banking system have been reduced significantly even though protracted problems in the LDC arena continue.

We believe that decisions on reserving for losses should be determined by each individual borrower's debt service capacity. For those banks intending to dispose of LDC loans, higher reserves could be appropriate, based on secondary market values. Thus, we applaud the conservative, extra provisions recently made by some banks. Future actions in this area will depend upon the results of current negotiations now underway with debtor countries.

It should be noted that all the money-center banks would continue to be solvent even if they wrote down to current secondary-market levels all their exposures to the six major LDC countries.

Real Estate. Domestic real estate loans is the fastest growing item on commercial banks' balance sheets, increasing to a total of $720 billion in outstandings as of June 30, 1989, or 36.2 percent of total loans. This amount is 12.8 percent higher than the same time last year. This growth has been most pronounced in the largest institutions.

This rapid growth gives us some concern, as would a similar rapid growth in any other asset category. Rapid growth is usually accompanied by a decrease in credit quality, and indeed we have begun to notice an increase in nonperforming real estate assets, including repossessed real estate, principally in the Northeast. It should be pointed out, however, that the Southwest banks still have the highest percentage of nonperforming assets, principally in real estate, with a rate that is over twice as high as the Northeast's.

We are monitoring the level and quality of real estate portfolios closely. While we foresee some unfavorable trends in real estate asset losses and charge-offs, the extent of these problems are not great enough to cause uncontrollable losses or substantial declines in earnings on an industry-wide basis. some states permit bank investment in real estate. In all banks the dividing line between a loan with an "equity kicker" and a direct investment can be blurred. We believe banking institutions can safely and profitably invest in real estate, but that it generally should be done through non-bank subsidiaries and affiliates. We continue to seek regulatory means to create such a requirement.

Leveraged Buyout Financing (LBOs). LBOs or the more encompassing term "highly leveraged transactions" (HLTs) (which also includes recapitalization and acquisition financing) are a concern because of the volume and rapid growth of such transactions in the banking industry, especially at the largest institutions. Banks currently have invested over $175 billion in HLT loans. We must point out though that the originating banks generally do not keep all HLT loans in their portfolios. Instead, they sell participations to others without recourse and retain only a small percentage of a transaction.

We are taking special supervisory action by monitoring banks' participation in HLTs very closely. We believe that to date, banks have managed their HLT financing risks acceptably. Of course, rising interest rates or an economic downturn could increase these risks, but we do not now see any serious threats to the banking industry.

4. <u>Are you satisfied that bank examinations are being carried out in an effective and timely fashion?</u>

Today's banking environment demands that we identify emerging trends and potential areas of risk and pinpoint individual banks with symptoms of higher than normal risk. The traditional methods of conducting on-site examinations based on fixed examination cycles have given way to more continuous methods of supervision. Our current program uses on-site examinations and visitations complemented with off-site monitoring, exchanges of information with other regulators (state and federal), and the use of supervisory guidelines, policy statements, and rules and regulations.

Our experience in recent years has indicated the need to increase the level and frequency of on-site supervision. As a result, in July of last year we revised our statement of goals regarding examination priorities. Our goal is to have an on-site examination every 24 months for well-rated institutions (those rated 1 or 2) and one every 12 months for problem and near-problem institutions (those rated 3, 4, or 5). The intervals for those rated 1, 2, or 3 can be extended if an acceptable state examination is conducted.

In 1988, we conducted 4,019 on-site safety-and-soundness examinations compared to 3,653 in 1987 and 3,194 in 1986. We expect to complete more than 4,100 examinations during 1989. We had expected to do considerably more than 4,100 this year, but had to revise that goal due to our involvement as conservator for insolvent thrifts. Even with that additional role, we will still exceed last year's examination tally.

As of June 30, 1989, over 90 percent of the 4- and 5-rated state nonmember banks had undergone an FDIC examination, visitation, or state examination within the preceding twelve-month period. The others are monitored closely, already have supervisory corrective action in place and, in most cases, have been examined within the last two years.

Also, as of June 30, 1989, only two percent of all 1- and 2-rated state nonmember banks have not had an FDIC or acceptable state examination or visit within the last three years. This percentage has been declining for some time now and we expect this trend to continue.

We have increased examiner hours spent on examinations of state nonmember banks from 1.3 million hours in 1985 to over 2.2 million hours in 1988. Most of this increase has been on banks rated 1 and 2, from 532,000 hours to over 1.2 million hours. In addition, those banks rated 3, 4, and 5 receive considerable review and processing by regional office and Washington office staff.

5. <u>What is your record with regard to initiating and accomplishing your goals for enforcement actions?</u>

The FDIC seeks corrective action from all institutions presenting supervisory concerns. Depending on the seriousness of the problem and the willingness and ability of management to effect correction, we may use an informal Memorandum of Understanding or we may proceed with formal action pursuant to Section 8 of the FDI Act. Attachment B describes the various types of enforcement powers available to the FDIC. It also includes a brief review of the circumstances which generally have led to the use of such actions.

During the period January, 1984 through March 31, 1989, 2,072 state nonmember banks had been considered "Problem Banks" and another 1,905 state nonmember banks were rated a composite 3 and considered a supervisory concern, although their possible failure was considered to be only a remote possibility. Seventy-four percent or 2,953 institutions were subject to some form of FDIC enforcement action. In most cases, the close supervisory attention afforded these institutions led to their rehabilitation. Only 448 or 11 percent of those banks failed or required FDIC financial assistance. Forty-four percent or 1,762 institutions improved their condition or merged with a stronger institution, and 1,767 or 44 percent remained in the "problem bank" (4- or 5-rated) or 3-rated categories. Attachment C provides a summary of the "problem bank" performance.

Enforcement actions, both as to type and scope, are tailored to the particulars of each problem situation. Our goal is to obtain correction using the most appropriate degree of intrusion. The FDIC believes that its enforcement actions are effective, especially in cases where bank management is cooperative and desirous of working together with the regulators to restore their institution to financial stability. The Capital Forbearance Program and the use of Agricultural Loan Loss Deferral are examples of this approach which have proven both useful and beneficial to the FDIC and participating banks. The basic goals and philosophy of these programs have long been used by the FDIC in our enforcement program.

However, whenever fraud, mismanagement, or insider abuse is present, the FDIC has not, and will not, hesitate to use its enforcement powers to the fullest. The new powers granted to us in FIRREA will allow us to increase our enforcement actions in such cases, especially in regards to individuals. We believe that fraud losses and unjust gains to insiders should be restored to institutions and to the federal deposit insurance funds wherever possible. The FDIC is working with the Department of Justice to convince judges to order restitution to the insurance funds when losses are attributed to dishonest insiders or customers. We think restitution orders should be sought and granted as a matter of course to minimize the cost of criminal acts to the insurance funds and to prevent offenders from enjoying their ill-gotten gains.

6. <u>What is your forecast of the condition of the banking industry for the next year?</u>

Generally, we see the condition of the banking industry improving during the next year. The declining trend in the number of problem banks should continue and we expect the number of failed banks to decline from the record levels of 1988 and 1989, both in size and number. The Southwest will continue to be the region of the country with most of the problems, although all of the largest commercial bank problems in that region have been restructured. We expect overall bank performance in that region to show a slight improvement next year, but recovery will be slow due to that region's overbuilt real estate markets. Banks in the Northeast probably will show some declining trends due to problem real estate loans in that area's regional banks and also due to the fact that most of the large banks which are involved in LDC lending are located in that area of the country.

It has been suggested by others that the banking industry is much weaker than our analysis indicates. The analysis prepared by Mr. Litan and Mr. Brumbaugh and presented by Mr. Litan before this Committee concludes that ten percent of the industry's assets are in institutions that have less than a three percent capital ratio. However, our recent analysis is that less than one-half of a percent have less than a three percent capital ratio. Our response to their statement is provided as Attachment D.

7. <u>What is your plan of action for remedying any concerns you have?</u>

With respect to the adequacy and liquidity of the Bank Insurance Fund, we plan to continue to pursue "whole bank" purchase-and-assumption transactions whenever possible and to continue aggressive marketing of assets held for liquidation. The increase in premiums will allow the Fund to grow and substantial progress should be made toward the 1.25 percent target reserves-to-insured deposits ratio.

We will continue to stress a strong supervisory approach as one of our major responsibilities. We are the primary federal supervisor for over 8,000 state nonmember commercial and savings banks with over $900 billion in assets. In addition, we monitor the condition of approximately 5,500 national and state member banks and approximately 2,900 savings and loans, and cooperate with the other federal and state regulatory authorities in their efforts to ensure the safe and sound operation of these insured institutions. A major goal of the FDIC's supervisory program is to control risk and to anticipate problems to the extent possible. The concerns mentioned above will continue to receive special close supervisory attention and we are prepared to take whatever corrective enforcement action may be necessary if bank management is not otherwise responsive.

This supervisory program will need to be as effective and timely as possible. We intend to increase the number of examiners to about 2,400 by the end of 1989 and to hire even more during 1990. This will allow us to conduct even more examinations. We are building a new training facility and are committed to the maintenance of a well trained examiner force. In 1989 we expect to spend $11.2 million on examiner training, an amount equal to almost 10 percent of total examiner compensation. We think that this is money well spent.

It is imperative that the FDIC attract and retain the most qualified individuals to be examiners. We are studying salary levels, benefits and programs intended to enhance job satisfaction in order to retain as many of our highly trained and qualified examiners as possible. Further, we are able to hire very good talent due to an expedited hiring procedure available with respect to college students who have a 3.5 grade point average or who are in the top ten percent of their class. This year alone we hired 325 examiners under this expedited procedure. We are exploring with the U.S. Office of Personnel Management the possibility of lowering the 3.5 GPA minimum in order to increase the number of candidates available to us under this program.

Also, as noted, we intend to pursue bank fraud, mismanagement and insider abuse wherever found and to take all appropriate supervisory action against both individuals and institutions. We are working closely with law enforcement authorities to see that these matters are pursued to the fullest extent possible.

Thrift Supervision

FIRREA has assigned the FDIC substantial responsibilities for the supervision of some 2,900 savings associations. In addition to deposit insurance and general backup enforcement responsibilities, the FDIC also has responsibility for overseeing several important thrift activities -- such as the exercise of nontraditional powers, the holding of junk bonds and the acquisition of brokered funds.

In order to assure that these responsibilities are fully and properly addressed, we expect to have an FDIC on-site presence, either a full scale examination and/or targeted visit(s), in every insured savings association by the end of 1990. Our approach will emphasize coordination and close working relationships with the Office of Thrift Supervision and state regulators with the goal being timely and effective supervision of savings and loans and the avoidance of duplication of effort on the part of the various regulatory agencies.

We will fulfill our new thrift industry responsibilities, but only with extraordinary efforts and some start-up strains. We also intend to meet those responsibilities without material impact on our supervisory role on the commercial bank side.

That concludes my prepared remarks. I would be happy to respond to any questions at this time.

The FDIC
Quarterly Banking Profile

L. William Seidman, Chairman

Second Quarter 1989

COMMERCIAL BANKING PERFORMANCE —SECOND QUARTER 1989

- ***Bank Earnings Remain Strong — First-Half Earnings Highest Ever***
- ***Banks Boost Net Worth Ratio to Pre-1987 Level***
- ***Asset Quality Problems Move East***
- ***Southwest Banks Register Loss, But Turnaround May Be Imminent***
- ***Number of Problem Banks Reaches Lowest Level in Three Years***

Commercial banks earned $7 billion in the second quarter, down from the $7.3 billion earned in the first quarter, but 30.7 percent above the $5.4 billion earned in the second quarter of 1988. For the first six months of 1989, industry net income totalled $14.3 billion, the most ever earned in a six-month period. Equity capital increased by $9.8 billion during that period, with $4.6 billion added during the second quarter. Asset quality showed some overall improvement, as nonperforming assets ended the first half below the level of a year ago, but regional trends were mixed. In a reversal of recent experience, nonperforming asset levels fell in the three regions west of the Mississippi River, and rose in the three eastern regions.

Continuing improvement in net interest income, strong gains in noninterest income, and reduced loan-loss expenses were key factors in the record earnings results. Earning assets were only 4.8 percent higher than a year earlier. Growth was led by real-estate loans, up 12.8 percent from a year ago, and consumer loans, up 6.0 percent. Funding shifted slightly from deposits, up 4.1 percent year-to-year, to nondeposit liabilities, up 7.1 percent. With interest rates mostly stable during the second quarter, smaller banks were able to increase their net interest margins over first-quarter levels. Larger banks' margins remained essentially unchanged.

Banks' aggregate loan-loss reserves have declined in each quarter after peaking in the first quarter of 1988. Large banks in particular have steadily increased their equity capital as a percentage of total assets, aided by strong earnings and prompted by new risk-based capital requirements. Because of this, the growth in the industry's equity capital has more than offset a decline in loss reserves, so that the cushion of equity and reserves has increa relative to nonperforming assets.

Chart A — Quarterly Net Income of FDIC-Insured Banks, 1985—1989

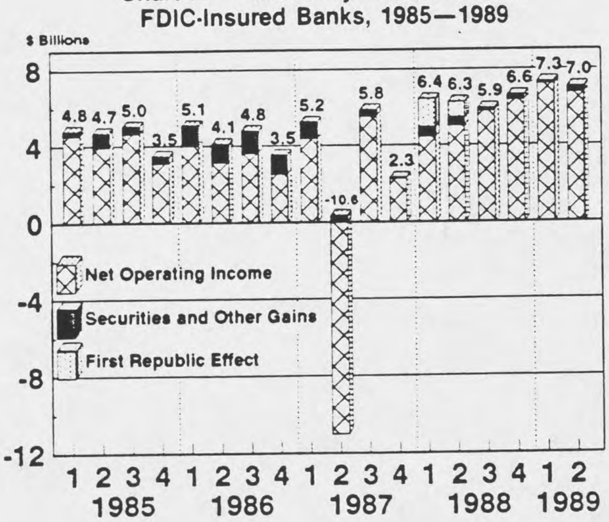
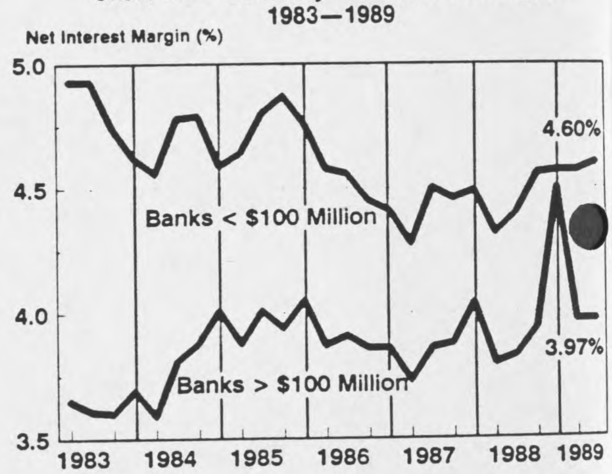


Chart B — Quarterly Net Interest Margins 1983—1989



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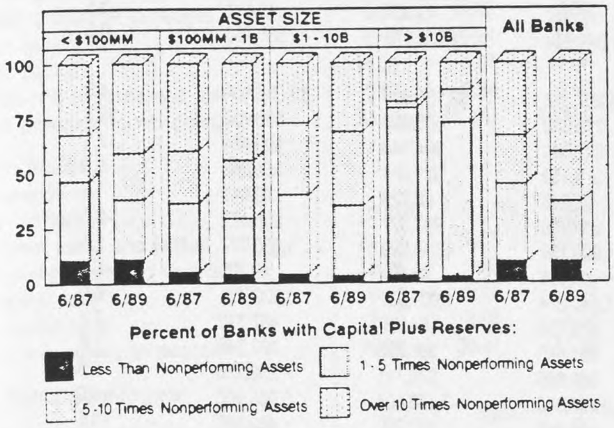
The increase in nonperforming assets in the eastern regions has come from troubled loans to developing countries and real estate. The 20 percent write-down of loans to Argentina that was mandated in the second quarter was the main reason that banks in the Northeast and Central regions had a higher quarterly charge-off rate than in the second quarter of 1988. Banks in the other four regions had lower charge-off rates than a year earlier. The decline in asset quality has been greatest in the Northeast region, with banks in the Central and Southeast regions reporting only slight increases in the percentage of nonperforming assets. The Northeast was the only region to show a year-to-year increase in the proportion of banks losing money.

Chart C — Distribution of Banks by Problem Asset Coverage Levels and Asset Size June 1987 & June 1989

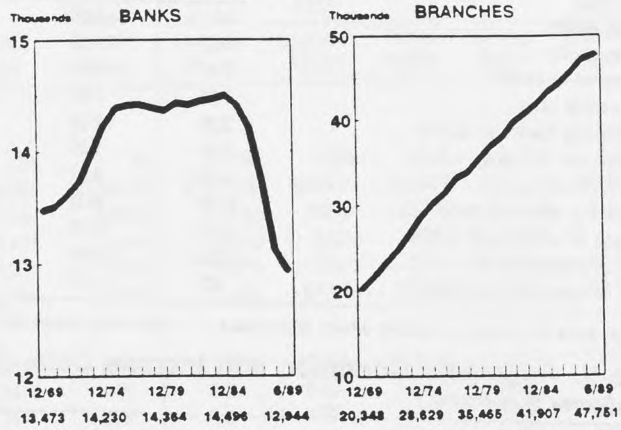


Recent trends in Southwest bank performance suggest that the prolonged deterioration of that region's banking sector may have finally ended. The improvement in asset-quality indicators in the Southwest region is especially encouraging, even though much of the improvement is attributable to FDIC intervention in failure and assistance transactions in recent years. Second-quarter net charge-offs were almost two-thirds lower than a year earlier, and nonperforming assets declined by 27.6 percent. The percentage of banks with earnings losses has been declining in recent quarters. Southwest banks still have the highest percentage of nonperforming assets, more than twice the national average, as well as the highest percentage of banks on the FDIC's "Problem List."

The number of commercial banks fell during the quarter, as the industry continues the consolidation process begun in 1985. The 12,944 banks operating at the end of June was a record low since the creation of the FDIC in 1934. A continued high rate of bank failures, a lower rate of new bank charters, and conversion of multibank holding company subsidiaries into branches have contributed to reducing the number of commercial banks. Despite this shrinkage, the total number of banking offices has continued to grow.

In the first six months of 1989, 101 banks failed or received assistance to avert failure, the same

Chart D — Numbers of FDIC-Insured Commercial Banks & Branches, 1969—1989



number as in the first half of 1988. For the second half of 1989, the failure rate is expected to moderate, with the average asset size of failed institutions well below the average for failed banks in 1988. This expectation is based on the continuing decline in the number of "problem" banks since midyear 1987. The 1,256 commercial banks on the "Problem List" is the fewest since June 1986.

The outlook for bank performance in the remainder of 1989 is clouded by uncertainties as to the earnings impact of the recently completed Mexican debt restructuring. The outlook for other developing-country loans remains problematic. The continuing rapid expansion of domestic real-estate loan portfolios, in the face of rising nonperforming rates in some areas, may portend more losses ahead. The recent economic climate, characterized by positive economic growth and low interest-rate levels, has been largely favorable for asset quality. Any adverse changes in these conditions could exacerbate current asset problems and trigger losses, especially in commercial credits extended in highly-leveraged transactions. At this point it is uncertain whether full-year earnings will exceed the all-time record of $25.1 billion earned last year.

Chart E — Percent of Banks on "Problem List" by Region, June 1987 & June 1989

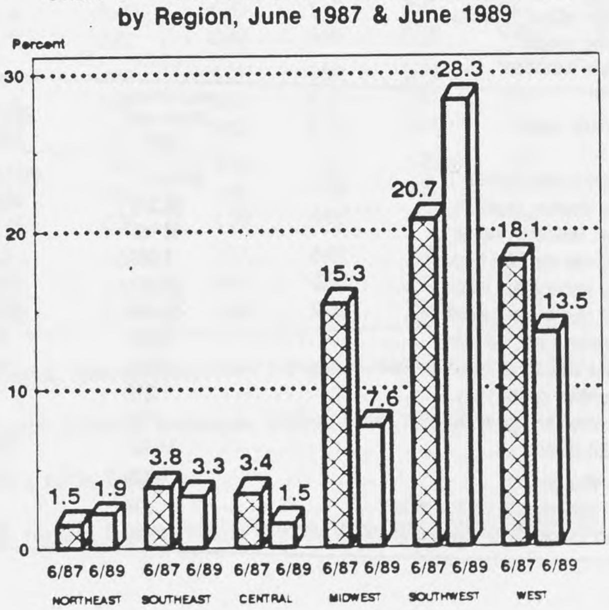


Table I. Selected Indicators, FDIC-Insured Commercial Banks

	1989*	1988*	1988	1987	1986	1985	1984
Return on assets	0.91%	0.69%	0.83%	0.12%	0.63%	0.70%	0.65%
Return on equity	14.22	11.35	13.37	2.00	9.94	11.31	10.73
Equity capital to assets	6.44	6.15	6.28	6.04	6.20	6.20	6.15
Primary capital ratio	7.99	7.86	7.85	7.70	7.22	6.91	6.91
Nonperforming assets to assets	2.25	2.39	2.14	2.46	1.94	1.87	1.97
Net charge-offs to loans	0.87	1.00	0.99	0.92	0.98	0.84	0.76
Asset growth rate	4.95	4.92	5.68	2.03	7.71	8.86	7.11
Net operating income growth	47.98	N/M	1666.92	-85.27	-20.65	6.30	3.40
Percentage of unprofitable banks	9.72	13.46	14.44	17.66	19.79	17.09	13.06
Number of problem banks	1,256	1,455	1,394	1,559	1,457	1,098	800
Number of failed/assisted banks	101	101	221	201	144	118	78

*Through June 30; ratios annualized where appropriate. N/M—Not meaningful

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

	Preliminary 2nd Qtr 1989	1st Qtr 1989	2nd Qtr 1988	%Change 88:2-89:2
Number of banks reporting	12,944	13,003	13,411	-3.5
Total employees (full-time equivalent)	1,544,594	1,526,179	1,536,763	0.5
CONDITION DATA				
Total assets	$3,207,318	$3,150,604	$3,055,956	4.9
Real estate loans	719,640	695,032	638,107	12.8
Commercial & industrial loans	612,341	604,348	599,454	2.1
Loans to individuals	379,152	371,494	358,255	5.8
Farm loans	31,048	28,729	30,617	1.6
Other loans and leases	246,958	247,327	256,422	-3.7
Total loans and leases	1,989,139	1,946,929	1,883,077	5.6
LESS: Reserve for losses	45,065	45,891	49,305	-8.6
Net loans and leases	1,944,074	1,901,037	1,833,771	6.0
Temporary investments	478,735	484,320	467,712	2.4
Securities over 1 year	394,640	386,505	387,746	1.8
All other assets	389,869	378,741	366,728	6.3
Total liabilities and capital	3,207,318	3,150,604	3,055,956	4.9
Noninterest-bearing deposits	455,846	440,200	463,096	-1.6
Interest-bearing deposits	1,997,018	1,988,462	1,893,216	5.5
Other borrowed funds	420,674	399,338	391,125	7.6
Subordinated debt	17,684	17,350	17,206	2.8
All other liabilities	109,568	103,339	103,438	5.9
Equity capital	206,527	201,916	187,875	9.9
Primary capital	255,227	251,671	240,967	5.9
Nonperforming assets	72,052	69,503	72,901	-1.2
Loan commitments and letters of credit	849,830	837,726	813,634	4.4
Domestic office assets	2,788,717	2,736,044	2,638,775	5.7
Foreign office assets	418,601	414,560	417,181	0.3
Domestic office deposits	2,129,554	2,103,810	2,027,190	5.0
Foreign office deposits	323,311	324,852	329,122	-1.8
Earning assets	2,817,449	2,771,863	2,689,228	4.8
Volatile liabilities	1,138,678	1,116,099	1,070,636	6.4

INCOME DATA	Preliminary First Half 1989	First Half 1988	%Change	Preliminary 2nd Qtr 1989	2nd Qtr 1988	% Change
Total interest income	$155,511	$129,450	20.1	$80,177	$65,751	21.9
Total interest expense	99,326	78,095	27.2	51,945	39,722	30.8
Net interest income	56,185	51,355	9.4	28,232	26,029	8.5
Provision for loan losses	7,983	9,203	-13.3	4,383	4,589	-4.5
Total noninterest income	24,544	22,144	10.8	12,829	11,131	15.3
Total noninterest expense	52,850	50,090	5.5	26,977	25,218	7.0
Applicable income taxes	5,965	4,791	24.5	2,981	2,424	23.0
Net operating income	13,932	9,415	48.0	6,720	4,930	36.3
Securities gains, net	212	534	-60.3	161	142	13.0
Extraordinary gains, net	178	436	-59.1	148	306	-51.8
Net income	14,322	10,385	37.9	7,028	5,378	30.7
Net charge-offs	8,529	9,298	-8.3	5,053	5,305	-4.8
Net additions to capital stock	314	347	-9.4	114	144	-20.5
Cash dividends on capital stock	6,675	6,086	9.7	3,504	2,906	20.6

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

		Asset Size Distribution				Geographic Distribution					
						EAST			WEST		
	All Banks	Less than $100 Million	$100 Million to $1 Billion	$1-10 Billion	Greater than $10 Billion	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
FIRST HALF *Preliminary* *(The way it is . . .)*											
Number of banks reporting	12,944	10,081	2,487	336	40	1,094	1,958	2,884	3,064	2,446	1,498
Total assets	$3,207.32	$371.76	$588.54	$1,042.66	$1,204.35	$1,275.86	$457.76	$519.79	$207.44	$258.05	$488.42
Total deposits	2,452.86	329.09	503.67	773.54	846.57	913.65	362.54	413.37	164.39	216.41	382.51
Net income *(in millions)*	14,322	1,668	2,808	4,401	5,445	5,515	2,224	2,768	1,150	84	2,580
Percentage of banks losing money	9.7%	11.0%	5.3%	5.9%	2.5%	8.8%	9.5%	3.4%	4.6%	21.8%	13.7%
Percentage of banks with earnings gains	64.9%	62.6%	73.1%	72.3%	65.0%	71.2%	67.1%	68.0%	59.5%	59.0%	72.0%
Performance Ratios *(annualized)*											
Yield on earning assets	11.25%	10.49%	10.79%	11.05%	11.91%	11.89%	10.80%	10.61%	10.92%	10.15%	11.39%
Cost of funding earning assets	7.18	5.90	6.15	6.74	8.55	8.28	6.53	6.61	6.43	6.59	6.15
Net interest margin	4.06	4.59	4.64	4.31	3.36	3.61	4.27	4.00	4.49	3.56	5.24
Net noninterest expense to earning assets	2.05	2.75	2.63	2.21	1.36	1.67	2.37	2.03	2.03	2.31	2.63
Net operating cash flow to assets	1.77	1.68	1.81	1.86	1.70	1.69	1.69	1.76	2.21	1.06	2.25
Net operating income to assets	0.88	0.88	0.96	0.84	0.89	0.87	0.97	1.08	1.10	0.03	1.00
Return on assets	0.91	0.91	0.97	0.86	0.92	0.88	0.99	1.09	1.13	0.07	1.08
Return on equity	14.22	10.07	12.98	13.66	17.99	14.61	14.18	15.89	14.68	1.12	17.85
Net charge-offs to loans and leases	0.87	0.64	0.62	0.87	1.05	0.90	0.46	0.67	0.93	1.77	0.95
Loan loss provision to net charge-offs	93.59	123.10	123.09	119.07	61.03	74.51	138.57	92.65	117.96	98.29	106.61
Condition Ratios											
Loss allowance to:											
Loans and leases	2.27%	1.67%	1.57%	1.73%	3.26%	2.64%	1.32%	1.89%	1.96%	2.56%	2.54%
Noncurrent loans and leases	74.19	72.27	75.52	85.75	69.56	68.97	96.28	99.15	94.56	44.66	83.50
Nonperforming assets to assets	2.25	1.92	1.77	1.58	3.16	2.52	1.12	1.29	1.59	4.75	2.57
Equity capital ratio	6.44	9.08	7.55	6.35	5.16	6.06	7.02	6.89	7.82	5.84	6.15
Primary capital ratio	7.99	9.96	8.53	7.51	7.53	7.90	7.88	8.16	9.02	7.07	8.18
Net loans and leases to deposits	79.26	59.41	71.50	86.77	84.73	84.97	78.76	74.34	73.09	59.63	85.15
Growth Rates *(year-to-year)*											
Assets	4.9%	5.8%	9.5%	11.1%	4.1%	4.6%	9.5%	6.8%	0.8%	-4.7%	7.5%
Equity capital	9.9	5.3	9.3	12.0	14.3	11.7	9.7	8.7	4.7	2.8	14.0
Net interest income	9.4	11.9	16.9	15.2	6.6	8.1	10.3	10.1	4.4	-1.2	17.2
Net income	37.9	22.3	18.8	10.4	1.5	-3.9	9.1	6.8	7.0	N/M	49.5
Nonperforming assets	-1.2	3.3	16.4	24.6	3.1	13.0	15.3	13.2	-8.6	-27.6	-7.4
Net charge-offs	-8.3	1.7	17.9	-7.2	16.2	45.8	-17.6	-3.3	-29.5	-53.6	-6.4
Loan loss provision	-13.3	2.6	17.8	30.5	5.9	12.6	13.3	16.8	-2.7	-63.9	23.4
PRIOR FIRST HALVES *(The way it was . . .)*											
Return on assets 1988	0.69%	0.72%	0.78%	0.69%	0.64%	0.96%	0.99%	1.09%	1.06%	-2.08%	0.77%
1986	0.68	0.75	0.85	0.75	0.49	0.80	1.10	0.93	0.77	-0.08	0.26
1984	0.63	0.97	0.92	0.73	0.22	0.63	0.99	0.25	0.93	0.82	0.47
Equity capital ratio 1988	6.15	8.78	7.35	6.20	4.58	5.67	7.01	6.76	7.53	5.41	5.80
1986	6.33	8.65	7.23	6.16	5.03	5.83	6.80	7.02	7.53	6.92	5.57
1984	6.07	8.66	7.16	5.82	4.41	5.39	6.79	6.45	7.65	7.01	5.38
Nonperforming assets to assets 1988	2.39	2.07	1.81	1.72	3.36	2.33	1.07	1.21	1.75	6.26	2.99
1986	2.03	2.37	1.90	1.59	2.33	1.59	1.03	1.52	2.44	3.57	3.16
1984	1.70	0.66	0.84	1.46	2.86	1.70	0.66	1.79	1.10	1.52	2.69
Net charge-offs to loans and leases 1988	1.00	0.75	0.74	1.16	1.06	0.65	0.62	0.75	1.40	3.40	1.09
1986	0.84	1.16	0.78	0.80	0.81	0.57	0.50	0.60	1.81	1.53	1.12
1984	0.61	0.59	0.48	0.56	0.72	0.33	0.32	1.00	0.69	0.93	0.77

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. Second Quarter Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution				Geographic Distribution					
						EAST			WEST		
	All Banks	Less than $100 Million	$100 Million to $1 Billion	$1-10 Billion	Greater than $10 Billion	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
SECOND QUARTER *Preliminary* *(The way it is . . .)*											
Number of banks reporting	12,944	10,081	2,487	336	40	1,094	1,958	2,884	3,064	2,446	1,498
Net income	7,028	801	1,401	2,036	2,790	2,786	1,132	1,381	541	-34	1,222
Percentage of banks losing money	10.4%	11.8%	5.6%	6.3%	5.0%	9.3%	10.3%	3.8%	5.5%	22.4%	14.5%
Percentage of banks with earnings gains	61.9%	59.6%	69.9%	72.3%	62.5%	64.7%	62.1%	65.4%	57.7%	57.6%	68.4%
Performance Ratios *(annualized)*											
Yield on earning assets	11.49%	10.66%	10.99%	11.29%	12.20%	12.16%	10.95%	10.83%	11.28%	10.45%	11.60%
Cost of funding earning assets	7.45	6.05	6.34	6.98	8.89	8.59	6.71	6.83	6.72	6.93	6.37
Net interest margin	4.05	4.60	4.65	4.31	3.31	3.58	4.23	4.01	4.56	3.51	5.23
Net noninterest expense to earning assets	2.03	2.74	2.63	2.20	1.33	1.68	2.33	1.95	2.15	2.28	2.57
Net operating cash flow to assets	1.77	1.69	1.82	1.87	1.69	1.66	1.70	1.84	2.16	1.05	2.28
Net operating income to assets	0.85	0.84	0.95	0.77	0.87	0.83	0.97	1.08	1.05	-0.11	0.95
Return on assets	0.89	0.87	0.96	0.79	0.93	0.88	1.00	1.08	1.07	-0.05	1.02
Return on equity	13.78	9.58	12.78	12.45	18.20	14.58	14.26	15.64	13.60	-0.91	16.58
Net charge-offs to loans and leases	1.03	0.74	0.68	0.94	1.36	1.19	0.51	0.74	0.92	1.92	1.04
Loan loss provision to net charge-offs	86.75	118.68	116.96	127.50	48.95	59.54	132.08	93.65	118.08	106.28	113.69
Growth Rates *(year-to-year)*											
Net interest income	8.5	10.5	15.0	14.3	5.8	7.0	9.5	9.2	4.6	-2.1	16.0
Net income	30.7	20.2	20.5	2.8	2.8	-5.6	13.9	8.8	-1.8	N/M	49.7
Net charge-offs	-4.8	3.2	5.1	-14.7	46.8	102.1	-2.0	9.4	-32.0	-64.2	-20.4
Loan loss provision	-4.5	4.6	9.6	31.9	6.5	18.3	3.0	32.3	-9.8	-52.9	30.3
PRIOR SECOND QUARTERS *(The way it was . . .)*											
Return on assets . . . 1988	0.71%	0.67%	0.75%	0.67%	0.74%	0.97%	0.96%	1.06%	1.08%	-1.79%	0.73%
. . . 1986	0.60	0.63	0.80	0.80	0.32	0.77	1.09	0.90	0.77	-0.15	-0.04
. . . 1984	0.56	1.00	0.94	0.74	-0.02	0.61	1.04	-0.25	0.94	0.84	0.54
Net charge-offs to loans and leases . 1988	1.14	0.89	0.93	1.38	1.10	0.63	0.57	0.73	1.41	4.75	[illegible]
. . . 1986	0.97	1.45	0.94	0.86	0.92	0.64	0.56	0.66	2.06	1.93	1.28
. . . 1984	0.77	0.69	0.63	0.72	0.93	0.41	0.37	1.48	0.89	0.97	0.94

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.

Net Operating Cash Flow—pre-tax net operating income before the provision for loan and lease losses; a measurement of banks' cash flow, net of interest and overhead expenses, from regular operations. Previously referred to as "adjusted net operating income".

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.

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.

TABLE 1
CLOSED BANKS AND OPEN BANK ASSISTANCE BY FDIC
FDIC INSURED INSTITUTIONS
BY SIZE (000 Omitted)

Year-End	0 - $300 Million		$300 - $1,000 Million		Over $1 Billion		Total	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
9-30-89	149	$8,760,154	11	$6,069,582	3	$11,988,038	163	$26,817,774
1988	205	10,249,691	10	6,089,863	6	37,482,000	221	53,821,554
1987	198	6,497,955	4	1,739,120	1	1,236,000	203	9,473,075
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

Attachment A

TABLE 4
CLOSED BANKS AND OPEN BANK ASSISTANCE BY FDIC
FDIC INSURED INSTITUTIONS
BY REGIONS (000 Omitted)

Year-End	NORTHEAST #	NORTHEAST Total Assets	SOUTHEAST #	SOUTHEAST Total Assets	CENTRAL #	CENTRAL Total Assets	MIDWEST #	MIDWEST Total Assets	SOUTHWEST #	SOUTHWEST Total Assets	WEST #	WEST Total Assets
9-30-89	3	$1,304,975	4	$45,878			8	$84,002	136	$24,323,894	12	$1,059,025
1988	2	630,665	3	749,856	7	$ 164,110	29	525,484	157	49,909,066	23	1,842,373
1987	5	2,015,091	6	293,322	7	160,795	40	603,194	110	5,042,844	35	1,357,829
1986	1	31,785	7	916,960	5	83,395	48	1,111,849	54	4,790,073	30	752,432
1985	4	5,878,941	9	291,368	4	60,243	50	902,512	31	913,844	22	694,360
1984	2	912,066	16	575,892	10	36,149,902	22	316,185	14	593,534	16	628,832
1983	4	2,686,460	13	1,735,776	7	222,858	5	97,984	5	1,539,623	14	744,222
1982	8	8,130,668	7	360,994	7	122,018	4	1,078,399	13	1,217,570	3	722,766
1981	3	4,755,434	1	7,621	2	73,060					4	22,945
1980	2	5,505,732	4	115,084	1	8,794	4	106,554				
1979	1	12,681	4	74,742	2	24,809	1	5,038	1	10,659	1	5,059
1978	2	721,892	3	18,851	2	253,292						
1977	2	194,569	1	24,223			1	5,509	2	8,311		
1976	6	640,558	2	452,182	1	507			5	233,382	3	62,664
1975	2	26,285	1	18,049	4	330,875	2	10,474	3	28,610	1	5,657
1974	1	3,655,662	1	147,137	1	16,295	1	3,502				

Attachment A

Generally, the Corporation's authority for formal enforcement actions emanates from Section 8 of the Federal Deposit Insurance Act. These include termination of deposit insurance, issuance of cease and desist actions (including immediate temporary actions), suspension or removal of a bank officer or director, or prohibition of participation by others in bank affairs when certain criteria can be established. The initiation of formal actions is based upon findings of practices or conditions deemed unsafe or unsound (undesirable, unacceptable and/or objectionable) and/or violations of law, regulation, condition or order.

The circumstances which lead to the taking of formal enforcement actions can include unsatisfactory management, inadequate capital, failure to recognize or charge off losses, inadequate loan valuation reserve, unsatisfactory loan administration, large volume of subquality assets, operating losses or inadequate earnings, unwarranted dividends or other insider payments, poor liquidity, lacking or insufficient corporate planning, failure to file or inaccurate reports, and/or violations of laws and regulations. Actions may require institutions to cease unsatisfactory practices, take affirmative action to correct deficiencies, and/or achieve and maintain certain acceptable levels in the future. Civil money penalties are assessed to punish the violator and to deter future violations. They may be issued for violations of several laws and are initiated if the violation is found to be willful, flagrant, or otherwise evidence bad faith on the part of the bank or individual(s), and/or if violations have not been corrected or represent repeat-type violations. [redacted]

Memorandums of understanding or FDIC Resolutions with a bank's board of directors are considered for near-problem banks and are used by the FDIC as a means of applying informal action to institutions of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. They may also be utilized in otherwise deteriorated situations where, because of strong commitment for correction on the part of a competent board and management, more formal action is foregone. Contents of a resolution memorandum are uniquely fashioned to address the specific problems of an individual institution.

The Capital Forbearance Policy is for solvent and viable banks with concentrations in weak economic sectors that are experiencing a severe, unexpected and protracted downturn. These banks have had their capital deficiency caused by external problems in the economy that are beyond management's control. Situations are such that these banks are not able to raise additional needed capital. The FDIC is not enforcing capital standards on the banks approved into this program. These banks have provided an acceptable plan for capital restoration, have competent management, and file annual progress reports.

Each of the FDIC's Regional Offices has front-line responsibility to identify and recommend institutions or individuals for formal or informal enforcement actions (most commonly through examination or visitation reports). The senior staff meets directly with an institution's board of directors to delineate deficiencies and seek appropriate corrective measures. The Regional Office staff will monitor and follow up on compliance with provisions of formal or informal enforcement actions through reviewing progress reports required to be submitted at specified intervals by the institution and first-hand appraisals by Corporation field examiners at subsequent examinations and visitations.

ADMINISTRATIVE ACTIONS

The Board of Directors of the FDIC uses a broad array of enforcement powers, including:

Section 8(a) - Termination of Insurance - The most severe sanction available to the FDIC is the termination of a bank's insurance (national banks, Federal savings banks and many state banks are not permitted to operate without federal deposit insurance). Insurance termination may be used where the FDIC determines that a bank is in an unsafe or unsound condition or has violated a law or regulation. In practice, insurance termination is generally reserved for banks whose financial condition has seriously deteriorated and other efforts to obtain correction have failed.

Section 8(b) - Cease and Desist Proceedings - Permits the FDIC to order an insured bank and its directors, officers, employees, and agents to cease and desist from certain practices and violations and take affirmative action to correct the condition resulting therefrom.

Section 8(c) - Temporary Cease and Desist Proceedings - Provides that the FDIC may issue a Temporary Cease and Desist Order whenever the FDIC determines the violation or threatened violations or unsafe or unsound practices are likely to cause insolvency or substantial dissipation of assets or earnings of the bank, seriously weaken the condition of the bank, or otherwise seriously prejudice the interests of the depositors prior to the completion of action under Section 8(b).

Section 8(e) - Removal Procedures - Gives the FDIC the power to remove any director, officer, or other person participating in the conduct of the affairs of a bank for certain conduct evidencing personal dishonesty and posing a threat to the bank or its depositors.

Section 8(g) - Suspension Procedures - Permits the FDIC to suspend any director, officer, or other person participating in the conduct of the affairs of a bank if such person is indicted for a felony involving personal dishonesty or breach of trust.

Section 8(p) - Termination of Insurance - Permits the FDIC to terminate the insurance of an insured banking organization that is not engaged in the business of receiving deposits, other than trust funds.

Civil Money Penalties - Fines assessed by the FDIC on banks, bank officers, directors, and/or persons participating in the conduct of a bank's affairs because of violations of certain laws, regulations, or cease and desist orders.

Part 325 Capital Directive - Final order issued by the FDIC to a bank that fails to maintain capital at or above the minimum capital requirement as set forth by Part 325 of the FDIC Rules and Regulations.

Memorandums of Understanding and Board Resolutions - Informal agreements between the FDIC and the bank's board of directors which are used in banks of supervisory concern but which have not deteriorated to the point where formal administrative action is warranted.

Capital Forbearance - Formal agreements to give undercapitalized institutions time to recapitalize. These are supported by a written plan discussing the bank's plans for operating in a safe manner and their intentions and timetable for increasing capital.

PROBLEM BANK PERFORMANCE
January, 1984 to March, 1989

	# Banks	%
3, 4, or 5-rated during period	3,977	100%
"Problem Bank" during period	2,072	52%
Subject to enforcement action (1)	2,953	74%
Failed or required assistance	448	11%
3, 4, or 5-rated as of March 31, 1989	1,767	44%
Improved or merged	1,762	44%

(1) - Includes formal and informal actions.

Attachment C

Response to the Joint Congressional Testimony of R. Dan Brumbaugh and Robert E. Litan

Introduction:

In their article entitled "Cleaning Up the Depository Institutions Mess" published in the Brookings Papers on Economic Activity, 1:1989, and in testimony before the Senate Banking Committee and the House Subcommittee on Financial Institutions, R. Dan Brumbaugh and Robert E. Litan suggest that the banking industry is much weaker than official reports indicate. They contend that, while the banking industry is generally sound, the existence of a sizeable number of insolvent and thinly capitalized institutions indicates that "actual" bank insurance fund reserves are far less than officially reported. From their analysis as of September 1988, Mr. Litan and Mr. Brumbaugh assert that one-third of the industry's assets were being managed by banks with sub-standard capital ratios. From these findings they concluded that actual FDIC year-end 1988 reserves were closer to $4 billion, rather than the reported $14.3 billion.

An updated version of their analysis using March 1989 data was presented to the Senate Banking Committee on October 5, 1989. In their testimony, Mr. Litan and Mr. Brumbaugh stated that they found 31 large banks with $22 billion in assets that were open but insolvent as of March 1989. In addition, they assert that 30 banks with assets of $9.3 billion had risk-adjusted capital ratios of 3 percent or less, and another 130 institutions with $929 billion in assets had risk-adjusted capital ratios of less than 6 percent. In other words, Mr. Litan and Mr. Brumbaugh claim that roughly $1 trillion of assets, or almost one-third of industry assets were held by banks with capital ratios of less than 6 percent. In their calculation of risk-adjusted capital ratios, the authors state that they followed the Basle guidelines with one exception: capital was defined as shareholder's equity (common, preferred and retained earnings) and subordinated debt. Loan loss reserves were not included in their definition of capital.

In an attempt to determine the extent of the exposure to the bank insurance fund, Mr. Litan and Mr. Brumbaugh applied a 26 percent loss ratio to assets in institutions they determined were insolvent, stating that 26 percent is the average loss ratio for the FDIC throughout the 1980s. A 10 percent loss ratio was applied to assets held in thinly capitalized institutions (those with capital ratios between zero and three percent), by reasoning that there is some likelihood that a portion of this group will become eventually insolvent. In doing so, they suggest that the bank insurance fund is about $7 billion weaker than official year-end 1988 reports. (The authors attribute about $6 billion of this loss to insolvent institutions and about $1 billion to probable failure of the thinly capitalized banks in the industry).

Attachment D

In their testimony before the House Subcommittee on September 19, 1989, Mr. Litan and Mr. Brumbaugh stated that the insurance fund was overstated by $10 billion at year-end 1988 (about $6 billion attributable to insolvencies, and about $4 billion attributable to undercapitalized banks). In that testimony, the authors referred to their analysis based on September 1988 data. At that time, Mr. Litan and Mr. Brumbaugh asserted that fifty banks with $45 billion in assets had risk-adjusted capital ratios between zero and three percent. When the analysis was updated using March 1989 data, Mr. Litan and Mr. Brumbaugh found that total assets in undercapitalized institutions (zero to three percent risk-adjusted capital) fell by some $36 billion. As of March 1989, the authors found only about $9 billion in assets in thirty undercapitalized institutions. Thus, their loss estimate regarding undercapitalized banks fell from $4 billion to about $1 billion, simply because more current data was used.

Evaluation of the Litan/Brumbaugh Analysis:

Table 1 illustrates the differences in the FDIC's analysis and the Litan/Brumbaugh assessment of the capital position of large banks in the industry as of March 1989. The results of this analysis show that, for large banks in the industry as of March 1989, 11 institutions with $2.7 billion in assets, less than one-tenth of one percent of industry assets were in insolvent institutions operating without resolution from the FDIC. One-quarter of one percent of industry assets, were in institutions that had less than a 3 percent capital ratio, while about 10 percent of industry assets were in institutions with capital ratios of between 3 percent and 6 percent.

The major difference between the Litan/Brumbaugh analysis and the FDIC assessment appears to be in the treatment of off-balance sheet items in the largest banks in the industry. The FDIC's assumptions regarding the extent of off-balance sheet activity by these large banks is in substantial agreement with a similar analysis conducted by the Federal Reserve.

In an attempt to relate the capital position of the industry to the level of reserves in the bank insurance fund, Mr. Litan and Mr. Brumbaugh make two crucial errors in arriving at the conclusion that fund balance is overstated by roughly $7 billion (a balance of $7.3 billion rather than $14.3 billion).

Their first error comes in determining the average cost-to-failed-bank-asset ratio for the FDIC during the 1980s. The authors arrived at a 26 percent average loss ratio through 1987, indicating in their article in the <u>Brookings Papers</u> that the average fluctuated widely, from a low of 10 percent in 1981 and 1985, to a high of 75 percent in 1982 and 1984. This is simply not the case. In fact, between 1980 and 1988, the FDIC's weighted average loss-to-asset ratio was 12 percent, registering a low of 10.4 percent in 1985, and peaking at 31.3 percent in 1987.

In addition, Mr. Litan and Mr. Brumbaugh fail to take into account that the majority of the insolvencies present in the industry were in the process of being resolved, and that reserves had already been established to account for the cost associated with these resolutions. Therefore, because the year-end 1988 bank insurance fund balance reflects the cost of resolving most of the March 1989 insolvencies, the $6 billion figure Mr. Litan and Mr. Brumbaugh associate with resolving these institutions is a significant overstatement. If the actual average loss figure of 12 percent were applied to the $2.7 billion of assets we find in insolvent institutions, the resolution costs would be about $320 million, rather than the figure of $6 billion advanced by the authors. Applying their 10 percent loss ratio to the assets in institutions falling in the zero to three percent capital range results roughly $1 billion in additional potential losses to the FDIC.

However, as the authors themselves point out, it is reasonably likely that these thinly capitalized banks will eventually become insolvent and require FDIC resolution. Given that assumption, it would seem reasonable to expect that the failure of these institutions would occur probably within the next one-to-two years. The cost of resolving these failures will be offset by the fund's additional premium and investment income earned in those years. FIRREA provides for significant increases in assessment income so that the bank insurance fund will be sufficiently capitalized to handle future problems in the industry. Assuming a modest 4 percent annual growth rate in insured deposits, projections for 1990 and 1991 alone show that income from assessments will be almost $3 billion and $3.9 billion respectively. Premium income will continue to increase until the fund reaches the target level of 1.25 percent of insured deposits. Even if the aforementioned losses were incurred by the FDIC next year, the bank insurance fund would still show a net gain in reserves. Thus, any analysis of future FDIC loss exposure should be balanced with a discussion of increasing premium income.

Mr. Litan and Mr. Brumbaugh suggest that their analysis underestimates the problems of insolvency and undercapitalization in the industry, because they have examined only those institutions with at least $50 million in assets. We do not find that to be the case. Banks with assets of less than $50 million account for less than 8 percent of total industry assets. Therefore, as Table 2 illustrates, including small banks does not substantially change the analysis, nor does it substantially add to the potential costs to the FDIC. Table 2 presents the capital position of the entire industry, using the risk-adjusted standards (excluding allowances), and updates the analysis by providing data as of mid-year 1989.

Based on risk-adjusted capital standards using data as of June 30, 1989, less than one-half of one percent of total industry assets are held in institutions with less than 3 percent capital; only 10.3 percent of total industry assets are held in institutions with capital ratios of 6 percent or less. With respect to insolvent institutions, the addition of the small banks in the industry boost assets by about $1.5 billion by adding another 41 institutions.

TABLE 1

RISK-ADJUSTED CAPITAL POSITION OF BANKS WITH AT LEAST $50 MILLION IN ASSETS AS OF MARCH 1989
(assets in billions of dollars)

FDIC ANALYSIS

CAPITAL RATIO	NUMBER OF BANKS	ASSETS ($ billions)		CUMULATIVE ASSETS ($ billions)	
< 0%	11*	$2.7**	(0.1%)	$2.7	(0.1%)
0 - 3%	35	9.1	(0.3%)	11.8	(0.4%)
3 - 6%	113	325.2	(9.9%)	335.0	(10.3%)
> 6%	5380	2,612.9	(89.7%)	2,947.9	(100.0%)

* Excludes 22 banks with $18.7 billion in assets that have been resolved by the FDIC.
** Includes 3 banks with $416 million in assets that are solvent on a GAAP basis.

LITAN/BRUMBAUGH ANALYSIS

CAPITAL RATIO	NUMBER OF BANKS	ASSETS ($ billions)		CUMULATIVE ASSETS ($ billions)	
< 0%	31	$22.1	(0.7%)	$22.1	(0.7%)
0 - 3%	30	9.1	(0.3%)	31.4	(1.0%)
3 - 6%	130	928.7	(30.8%)	960.1	(31.8%)
> 6%	5,380	2,055.5	(68.1%)	3,015.6	(100.0%)

TABLE 2

CAPITAL POSITION OF THE BANKING INDUSTRY
AS OF JUNE 30, 1989

CAPITAL RATIO	NUMBER OF BANKS	ASSETS ($ billions)		CUMULATIVE ASSETS ($ billions)	
< 0%	52*	$4.2**	(0.1%)	$4.2	(0.1%)
0 - 3%	106	8.6	(0.3%)	12.8	(0.4%)
3 - 6%	245	314.3	(9.9%)	327.4	(10.3%)
> 6%	12,489	2,860.8	(89.7%)	3,188.2	(100.0%)

* Excludes 52 banks with $19.4 billion in assets that have been resolved by the FDIC.
** Includes 12 banks with $2.6 billion in assets that are solvent on a GAAP basis.