A PRESENTATION ON

THE FINANCIAL CONDITION OF FDIC-INSURED INSTITUTIONS

TO THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

BY

ROBERT V. SHUMWAY
DIRECTOR
DIVISION OF BANK SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

10 a.m.
September 11, 1985
Room 2128, Rayburn House Office Building
Washington, D.C.

Good morning, Mr. Chairman. On behalf of the FDIC, I am pleased to have the opportunity to testify at this series of hearings evaluating the present system of Federal deposit insurance. Over the past several weeks my staff compiled and provided to your Subcommittee a series of statistical tables which I trust is responsive to your request and will be helpful to you throughout these hearings.

My purpose here today is to give a brief overview of the financial condition of depository institutions under the purview of the FDIC. It is well-known that we are faced with problems in the financial industry today. More than 1,000 banks are currently on our problem bank list. Since the beginning of 1981, the FDIC has handled over 250 bank failures totaling over $30 billion in assets, excluding Continental Illinois. To put those numbers into perspective, during the FDIC's previous 47 years, failures totaled only $9 billion in assets. The problems in the thrift industry are still serious, while weakness in agriculture, energy, real estate and the international debt arena continue to plague the banking industry.

But there is good news in all this. The good news is that for the most part the problems have been handled well. The vast majority of our banks are in remarkably good shape. While numbers of problem institutions are at historically high levels, they still constitute a small percentage of the total and the failure rate of about 1/2 of one percent per year is still far below that of any other industry. Earnings have held up reasonably well despite large loan losses and banks, particularly the larger ones, have added substantial sums to their capital base. In short, the banking system has shown a remarkable resilience by demonstrating that innovation and ingenuity are the keys to success in today's dynamic environment.

A CHANGING ENVIRONMENT

Any discussion involving the condition of the banking system must naturally begin with a description of the banking environment. After decades of relative stability, depository institutions are learning that recognition and adaption to marketplace changes are essential elements for survival, growth and profitability. Over the last five years alone the banking system has had to endure two back-to-back recessions, double digit inflation, unprecedented interest rate volatility, removal of most interest rate caps, erosion of geographic and product market barriers, a major technological revolution and demographic shifts. What's more, the economy, while rebounding strongly from a severe recession, has recovered much more unevenly than in any previous recovery. As a result, major sectors of the economy are still suffering from a recession hangover, and indications are that those sectors will continue to lag other sectors over the short run.

The forces behind these changes are many and quite diverse. One major force that often gets overlooked is the consumer. Consumers today have different financial needs than ever before. They have become more sophisticated and increasingly aware of the many financial products available to them. When inflation rates soared to double digit levels, consumers recognized that they could no longer afford to deposit funds in nonearning or low yielding bank accounts. Instead, they demanded new financial products that gave them reasonable yields, more convenient access to cash assets and safety. Consumers today are now less concerned about the type of institution providing the service than they are about the quality of the service provided and the returns they receive.

In response to these demands, banks and nonbanks alike took up the challenge. Supported by major technological innovations, new products were developed that reshaped the financial service marketplace. In some instances, consumer needs were satisfied by skirting geographic and product barriers and by exploiting loopholes in laws that were never designed to address electronic banking. Computers provided the means to transform product design to such an extent that banks and other financial service providers are able to offer new products and services more quickly and cheaply than anyone could have imagined over 50 years ago.

Deregulation has also been a major force in reshaping the financial system. Banks now pay market rates for deposits thus benefiting countless bank and thrift customers. But with those benefits comes an enormous cost to the paying institution. Geographic and market restrictions are increasingly evaded, and while some product deregulation has taken place, it has been permitted primarily for the thrifts and nonbanks.

Commercial banks are facing increased competition from a variety of sources. Not long ago we considered banks special because of the unique services they provided. This is no longer true. The marketplace has developed such a variety of product substitutes that there is not one product that is unique to banking anymore. For this reason commercial banks can no longer be viewed in a vacuum.

In response to increased competition, the banking industry has continued to seek expanded powers to deregulate the asset side of the balance sheet. While they wait, we have seen thrifts, credit unions and even investment banking firms offer a host of services including federally insured deposits accessible by check or other transfer mechanisms, once considered the unique province of commercial banks. Moreover, thrifts have more liberal authorities regarding investment and geographic expansion than do commercial banks or their holding companies, yet they have less strict capitalization, accounting and disclosure requirements. We see department stores expanding their financial centers and investment bankers targeting businesses for cash management accounts and loans. Realtors are selling mortgages while gas stations and grocery stores are installing ATMs and charging banks when their customers use them.

I could go on, Mr. Chairman, but the point is that if banks are to compete effectively in this new dynamic environment, they must be given the proper tools to do so. For this reason, the FDIC has long supported expanded bank powers. It is our belief that the expansion of bank powers would enhance the ability of banks to respond to the changing needs of the marketplace. If banks could offer a wide range of financial services, the American consumer would have a broader range of convenient financial services available at more competitive prices. Expansion of product and geographic powers would have the additional benefit of strengthening our financial system by allowing banks to diversify their activities so that they are less vulnerable to economic ups and downs. Like it or not, economic volatility, deregulation, technological advancements and changing consumer demands are the forces that will shape tomorrow's financial system. Our job is to fully understand these forces so that we can respond in a way that will foster a stonger financial system.

RECESSION AND RECOVERY -- ITS IMPACT

This brings me to the more specific questions detailed in your letter to the FDIC. Since I have been discussing the environmental changes facing banks today, let me begin by addressing the sensitivity of asset quality to economic conditions and the effect successive periods of recession and recovery have had on the banking system.

Any attempt to identify the causes or reasons for the increase in the number of problem and failed banks must logically begin with an understanding of the overall economic environment. Banks, by their very nature as suppliers of funds to American business, have historically mirrored the economy (either local, national or international). I do not need to tell you of the severe strains, and, in some cases, realignments, which have recently occurred in some sectors of our economy. Banks which serve those industries are also experiencing some difficulty.

Over the years, the FDIC has undertaken several studies designed to look at the correlation between economic conditions and condition of the banking system. Because of the numerous variables involved in a large, diverse economy such as ours, there are few simple answers. For example, it comes as little surprise that there is a correlation between general economic conditions and the asset quality of banks. It is also not surprising that as a recession becomes more protracted, increasing numbers of borrowers are forced to default, lowering bank profits and ultimately leading to higher failure rates.

But there are considerable time lags between the onset of a recession, deterioration of asset quality and increased bank failure rates. Internal studies have concluded that loan losses appear to lag changes in the economy by about three-quarters. Not surprisingly, the number of bank failures also increased significantly after the two most severe post war recessions. For example, after the 1974-75 recession 14 banks in 1975 and 16 banks in 1976 failed. Since the 1981-82 recession, we have seen 42 banks fail in 1982, 48 in 1983, 79 in 1984 and an additional 77 so far this year. Moreover, we are projecting that the failure rate will exceed 100 this year and next.

Obviously, the difference in failures between the two recessions is quite startling. But, that difference cannot be fully explained by merely comparing the severity or duration of the two recessions. While we have been able to establish a statistical relationship between failures and such macroeconomic variables as real GNP growth, unemployment rates, real interest rates and corporate debt burden, the relationship does not fully explain the huge disparity in failures. Other factors are undoubtedly involved.

One of those "other factors" may be the unevenness of this economic recovery. Although we are well into our third year of recovery, some industries and regions still lag far behind. Several factors may be responsible for this. The high value of the dollar relative to other currencies has significantly hurt export trade, and those industries which rely heavily on trade. Another factor has been the increased foreign competition against our more labor intensive industries, where lower labor costs give foreign firms a distinct advantage. Still other industrial problems are related to a secular decline in the demand of certain products. Steel and energy are examples of this, where a softening of world demand has resulted in chronic problems for segments of these industries. The segments of the economy that have given us, as bank regulators, the most concern recently include agriculture, energy and real estate industries, together with problems in the international arena. Because of the serious nature of these problems and their impact on the banking system, I would like to address each area individually so that you will better understand the nature of our concerns.

Agriculture

First is agriculture. Problems in the agricultural sector have been well-publicized over the past several months and are still cause for great concern. Many of the problems that we see today originated in the 1970s when farmers anticipated continued export growth, increasing commodity prices and rising land values. In response, many farmers borrowed heavily to finance major expansion programs. Farm debt doubled from 1976 to 1981 while interest rates spiralled upward bringing on significantly higher debt servicing requirements. Unfortunately for those farmers, the expectations of the 1970s never materialized in the 1980s. First the double digit inflation of the 1970s was brought under control and dramatically reduced. Then exports, instead of rising, plunged drastically. Commodity prices stagnated while interest and production costs remained at very high levels. On the supply side, domestic price supports, tax incentives, and other subsidies to U.S. farmers have encouraged continual overproduction and contributed to price declines for agricultural products on world markets.

Demand growth has also been severely curtailed since 1980. First, it was curtailed by global recession in 1981 through 1983 and the dollar's appreciation, and then by the slow recovery of many European economies, the imposition of import restrictions among LDC debtors and the increased self-sufficiency of many developed trading partners of the United States.

As a result, land values began to decline and farmers, who had relied on rising values to support their operations, were forced to rely on cash flows that were insufficient to meet high debt service requirements. Presently neither land values nor cash flows will support the credit needs of many of our farmers.

The toll taken on U.S. banks by these developments has been significant, and it promises to mount. We have defined agricultural banks as those banks with 25 percent or more of their loan portfolios concentrated in agricultural loans.

Although it is estimated that such banks provide less than 25 percent of total farm credit, there are approximately 3,900 agricultural banks in this country, of which 3,300 are concentrated in a 16-state area. In addition, a number of large institutions have sizable agricultural loan portfolios which may not reach the 25 percent benchmark used to designate agricultural banks but are still directly impacted by problems in the farm economy.

The problems in the farm belt are real and indeed worrisome, but I must caution against an overreaction with regard to their overall impact on the banking system. Looking at the problem from another perspective, the total assets of all agricultural banks represent only about five percent of all domestic bank assets. Nevertheless, total farm credit advanced by all insured commercial banks approximates $50 billion. It is also likely that there is a substantial number of loans not specifically designated as farm credits which are probably either directly or indirectly tied to the health of the agriculture industry.

Agricultural banks have historically reflected higher capital ratios than non-agricultural banks. From 1980 through 1984 capital ratios for these banks increased from 9.3 to 9.8 percent. As of March 31, 1985, that ratio increased to 10.2 percent. The problems in those banks do not begin to appear, however, until the earnings and nonperforming loan ratios are analyzed.

Looking at averages, the earnings performance between agricultural and nonagricultural banks appears virtually identical. But, as so often is the case when averages are used, the numbers can be deceiving. Statistics now show that there is a sizable and growing percentage of farm banks experiencing breakeven earnings or worse. As a group, agricultural banks experienced sizable loan losses during 1984. But perhaps the most disturbing trend is the high and increasing level of nonperforming loans. In the first quarter of 1985, the percentage of banks showing nonperforming loan totals at five percent or more of total loans increased from 23 to 32 percent. This trend is most troubling because historically the first quarter has not been one where farm banks normally recognize or encounter loan problems.

Only seven agricultural banks failed in 1982, but 25 such banks failed during 1984 and 28 failed in the first half of 1985. Furthermore, the number of agricultural banks on the problem list more than tripled during the 24 months ended June 1985. These numbers are likely to grow further in the coming months as the structural change in U.S. farming and world agriculture markets continues. The bumper crop expected for U.S. farmers in 1985 may greatly intensify debt repayment problems in the near term as commodity prices and agricultural profits could be severely depressed if crop forecasts prove correct. Moreover, with already depressed food prices worldwide and the growth of food production outside the U.S. still far surpassing the growth of world demand, it is difficult to see how U.S. agriculture can escape a future of further consolidation.

Real Estate

In the real estate sector, declines in interest and inflation rates have kept the housing market at moderately strong levels since 1983. While demographic and other social trends broadly determine housing demands over the long run, effective short-term demands are predominately affected by housing affordability. Several factors influence affordability including housing prices, family income and, most importantly, mortgage interest rates. Since the end of 1982, housing affordability has increased primarily because of declining interest rates. As long as the interest rates remain within reasonable levels it is expected that the outlook for housing will remain relatively bright.

Despite the generally positive outlook for most real estate sectors there are some major areas of concern that will continue to have an adverse impact on the banking industry. To a large extent, the problems that exist in the real estate industry can be traced to those sectors of the economy that are not participating in the recovery.

I have already mentioned agriculture as an area where major problems exist. Following a decade of rapidly inflating land values, farm real estate prices have declined 20 to 30 percent in several farm belt states since 1981. While some analysts believe land prices have stabilized to a point where cash flows, based on current commodity prices, will support the values, there is concern that the large amounts of land on the market may result in a significant undershooting of land prices.

Further examples of weakness in the real estate industry can be seen in several other areas around the country. In many Southwestern States, where problems in the energy industry are prevalent, we see signs of serious overbuilding as a result of speculation on growth in the energy industry. Houston and parts of Dallas show very high commercial office and multifamily vacancy rates. Similar high vacancy rates are beginning to surface in other cities around the country which may indicate a major oversupply problem. Further indications of weakness in this industry and the potential impact on the banking industry will be watched closely by the FDIC.

Energy

Looking toward the energy sector, the slide in world energy prices that began in the recession year of 1981 has not yet been completed. On the supply side of the market, price competition has steadily intensified outside of OPEC. Even members of the cartel (especially debtors) have responded by shaving official OPEC prices and cheating on production quotas in order to preserve oil revenues. This in turn has added to the downward pressure on world prices.

Domestically, the deregulation of energy prices has also generated increased competition and the predictable result has been a strong growth of supply, declining prices and sharp increases in the number of failed energy firms.

On the demand side, energy conserving innovations in response to years of high and rising prices have vastly reduced energy usage per dollar of production throughout the world. As a result of this, the economic recovery of recent years has had a far less buoyant influence on oil and gas prices than previously. The growth of world demand in 1985 is two percent (per annum) behind

1984's slow pace, and the effects of conservation can be expected to persist for the foreseeable future.

The developments on both the demand and supply sides of energy markets suggest that a transition to lower real energy prices is still taking place. In world markets, Mexico has cut its price by $1.25 per barrel with OPEC poised either to follow or dissolve, and non-OPEC production has surged throughout the summer. Reacting to these events, the futures market now prices June 1986 crude oil deliveries (United States) at $26.34 per barrel -- a forecast of an additional $3 per barrel decline in oil prices. A significant domestic price recovery could emerge temporarily if the dollar's foreign exchange value greatly depreciates but the fundamentals suggest that a protracted period of lower energy prices is still to come.

As retrenchment and consolidation continue in the oil and gas sector, increasing numbers of energy lenders suffer losses. Several major Southwestern banks reported severe losses due to energy loans for the first quarter of 1985 and, with oil prices currently falling, concern has heightened over the prospect of a new round of deteriorating credit quality at these banks. Many loans originated since 1981 may become nonperforming if domestic prices reach the $22 to $23 per barrel range. The likelihood of further erosion in energy prices makes it probable that significant loan losses will reappear in the future.

International Debt

In the international arena we have seen deterioration in the overall credit quality of foreign loans which has had a negative effect on the asset quality of U.S. banks. The impact has been greatest for the largest banks. The 25 largest U.S. bank lenders account for almost 80 percent of all foreign loans held by U.S. banks, and a comparable share of problem foreign loans At the end of 1984, nonperforming foreign loans, which are defined as nonaccrual loans plus renegotiated debt, totaled $11.1 billion or 4.5 percent of all foreign loans outstanding. Loans 30 days or more past due but still accruing stood at $2.9 billion. In comparison, total nonperforming loans, both foreign and domestic, were $42.6 billion at year-end or 2.9 percent of consolidated total loans, and total past due loans were $39.1 billion. This represents a departure from past experience, when foreign loan credit quality was consistently better than that of domestic loans. The higher levels of subquality foreign loans have not as yet produced high levels of loan chargeoffs, but the trend of foreign loan credit quality is not encouraging.

Countries that have had external debt reschedulings owed a total of $94 billion to U.S. banks at the end of 1984. Sixty billion dollars of that amount was owed to the nine largest U.S. lenders. The problems of Latin American borrowers have been widely publicized. United States banks' aggregate exposure to those troubled borrowers is over $82 billion, which is roughly equal to the combined net worth of all U.S. banks lending overseas.

The deterioration in foreign asset quality has not been evenly distributed geographically, and its impact on bank balance sheets has not been evenly felt among different sized banks. The main area of concern remains Latin America, and the main victims of foreign loan problems are the large money center banks. Their overseas problems are mitigated somewhat by improved domestic asset quality and a strong U.S. economy. Also, the largest banks have had stronger growth in their net worth positions, owing to regulatory requirements for increased capital levels. Nevertheless, foreign loan problems, because of their effect on public confidence, represent a major threat to large U.S. banks today.

CONDITION OF THE BANKING SYSTEM

Now, I would like to discuss some basic industry ratios and statistics that will help describe our assessment of the banking system as it is today. The FDIC, in its role of insurer and supervisor of almost 15,000 banks, has consistently had a critical interest in the capitalization of the industry and the capital levels of individually insured institutions. Capital adequacy is an important consideration in providing depositor protection and in maintaining public confidence in the stability of the financial system. Importantly, it can absorb short-term losses and temporary fluctuations in income thereby providing continuity during economic downturns. When prudent capital standards are enforced, it can also play a major role in restraining imprudent risk-taking or excessive expansion efforts.

In 1981, the FDIC and other Federal bank regulatory agencies took an important step to increase capital in the system and adopted policy guidelines specifying minimum capital ratios for insured banks. We were pleased that this had an immediate impact -- the declining trend in equity capital (relative to bank assets) was halted, and an increase in the systemic level of capitalization was achieved in 1983.

In March of this year the FDIC, the Office of the Comptroller of the Currency and the Federal Reserve jointly moved to define bank capital and to set a higher minimum acceptable capital level for banks. This was aimed at increasing the system's total capitalization by about $6.3 billion. Banks which do not maintain the minimums will be subject to supervisory measures such as enforcement actions and restriction of expansion proposals. Those banks judged to present more than a normal degree of risk or with a greater than normal volume of criticized assets will be required to maintain capital ratios at an appropriate level higher than the established basic minimum.

Off-balance Sheet Activities

While these capital requirements do not take into account off-balance sheet liabilities and exposures arising from banks engaging in nontraditional activities, we are looking closely at risks in these areas as they grow in size and potential impact. Such liabilities and exposures now total billions of dollars in many of the Nation's relatively large banking organizations, and often represent a sizable percentage of total assets. Bank supervision must provide for a closer scrutiny of these risks, including means by which these risks can be factored into capital standards.

Earnings

Despite the adverse trends reflected in loan loss reserves -- classified assets and nonperforming loans, increased competition from nonbank financial institutions, historically high and volatile interest rates -- commercial banks have been able to maintain reasonably satisfactory earnings ratios throughout this difficult period. This is not to say that there has not been a decreasing trend -- there has. In fact, 1984 marked the fourth consecutive year where the basic earnings ratios of insured commercial banks declined. But overall, considering today's environment, commercial bank earnings have been encouraging.

The dropoff in 1984's performance was most pronounced in small banks. These institutions have been under pressure from both narrowing net interest margins and widening credit losses. On a brighter note, medium sized institutions registered year-to-year gains in profitability as their greater diversification enabled them to weather the aftermath of the recession better than their smaller counterparts. The largest institutions also would have shown improved profitability if it had not been for the adverse effect of the extraordinary Continental Illinois earnings loss.

The prospect for improved future earnings depends to a large extent on future loan losses. While net chargeoffs continued to increase in 1984, the rate of increase slowed. Past due loans declined in relative terms, while nonperforming assets increased for small and large banks. Thus, the credit quality picture remains mixed.

Unlike the commercial banks, mutual savings banks have been unable to maintain even reasonable profitability. The most critical factors contributing to their problems have been interest rate deregulation and the unprecedented high and volatile interest rate levels over the past several years. These interest rates have created large asset/liability mismatches and exposed an unprepared thrift industry to extensive interest rate risk.

It should be noted, however, that based on performance, the mutuals can be divided into two distinct groups. One group made up of the largest institutions, which are primarily confined to the New York City area, has suffered the greatest problems. Even with the substantial declines in interest rates over the past several years, through year-end 1984 these institutions continued to generate losses. It was not until this past July that virtually all the New York City savings banks began to turn a profit. Our projections show that interest rates will have to remain low and stable for an extended period before most of these institutions have any chance of regaining reasonable profitability.

On the plus side, the balance of the mutual savings banks outside the New York area returned to profitable status in 1983 although their current levels of earnings remain well-below historical levels. Most of these institutions profited from less stringent usury laws and more liberal investment powers than their New York City counterparts. This group of mutuals was, therefore, not as vulnerable to the dramatic interest rate fluctuations. But even these institutions are depending on moderate interest rate levels to maintain profitability.

Liquidity

Now I will turn to a most interesting industry measure -- liquidity. There is no doubt that liquidity is one of the most important elements in determining the overall condition of individual banks and the banking system as a whole. The problem is, however, that there is no single benchmark currently used that can capture the many facets of liquidity. Indeed, market confidence, which may be correlated to asset quality, capital and earnings may be the most important factor.

As I have mentioned previously, we find ourselves in an era of financial innovation. In response to rapidly changing external events, banks are devising new products and operating procedures to deal with those challenges. We are seeing brokered deposits, asset "securitization," broadened secondary markets, forwards, futures, interest rate swaps and a variety of other financial commitments. To manage these new products, banks have developed such tools as liability management, gap management, duration analysis, modeling, simulation and a variety of hedging techniques. The result is that it is increasingly difficult to understand and evaluate liquidity, especially for larger institutions that are actively involved in the purchased funds market.

Using traditional measures -- that is measuring liquidity by the percentage of volatile liabilities to assets -- we have noticed that the volume of volatile funds tracks the economic and interest rate cycle fairly closely. The volume of purchased money rose through the late 1970s and peaked during the credit crunches of 1980 and 1981. Thereafter, the volumes decreased in 1982 and 1983; 1984 was up very slightly from 1983 but preliminary indications are that they have fallen back a bit in 1985. Also observable is the tendency for the amount of purchased funds to increase as bank size increases. For example, at the end of 1984 volatile liabilities for nonmember banks were 13.7 percent of assets in small banks, 22.3 percent in medium size banks and 33.9 percent in large banks.

Brokered Deposits

At this point, Mr. Chairman, I would be remiss if I did not mention the subject of brokered deposits. The use of deposit brokers to place fully insured investment monies has rapidly become one of the most serious problems facing the Federal deposit insurance system today. There are essentially two distinct problems associated with this issue -- one systemic and one supervisory.

First, current brokered funding practices have a very real potential to erode the deposit insurance system and call into question our ability to adhere to the purposes and original goals Congress established for the FDIC -- that is, promote stability in the banking system and provide protection to the Nation's small depositors. We do not think it proper to "leverage" upon the Federal guarantee of deposits for what are essentially high-yield seeking investment funds.

The second problem is that of risk control in troubled banks -- the primary area of concern for the Division of Bank Supervision. Insured institutions, by using brokered funding, can significantly expand or alter their very nature in as short a period of time as a few business days. Normal bank supervisory and risk control techniques can thus be rendered ineffective. All too often, we have found that the weakest banks are the worst abusers of this market and their failures have cost us hundreds of millions of dollars. Our potential liability runs into the billions. From our perspective, there is no problem more threatening to the deposit insurance fund.

Problem Banks

With regard to problem banks, I have already mentioned that more than 1,000 FDIC-insured commercial banks and thrift institutions have been accorded a "problem" designation. Without a doubt, this represents a dramatic increase in number from only a few years ago when, as recently as 1981, only 233 banks were so categorized. But, keep in mind that this means that more than 90 percent of the Nation's banks are not facing serious problems.

I also think it's important to emphasize that most problem banks do not fail and their managements are usually successful in overcoming the bank's particular difficulties long before there is any real danger of failure. As Chairman Isaac has stated on numerous occasions, there is a great deal of turnover on our problem bank list. We have provided you with statistics which demonstrate the number of banks going off the problem list as a result of improvements following regulatory orders.

There is a correlation between unfavorable economic environment and an increase in the number of problem banks. It would be simplistic, however, to dwell on this as the only direct cause-and-effect relationship. Deregulation of the banking industry and major advances in technological innovations have brought on dramatic change and served to increase risks. Many bankers are still learning and experimenting with ways of coping with the new challenges and competitive pressures.

A volatile economic environment and increased competitive pressures do not cause bank failure, per se. They are merely the catalysts, increasing the risks for banks and exacerbating existing weaknesses. Those banks which are poorly managed or marginally operated are the first to be adversely impacted when external circumstances turn unfavorable. That is why we are so concerned with the management factor. Good management can, and usually does, make the difference between a bank's success or failure.

SUPERVISORY AND REGULATORY RESPONSE

Mr. Chairman, you also inquired as to the supervisory response of the FDIC to the growing number of problem institutions. First, we have redirected our bank examination efforts, focusing less on the thousands of generally well-run banks while intensifying our effort on those institutions which present the greatest possibility for loss or failure. In doing so, we have developed a formal cooperative examination program with both the OCC and the FHLBB, and we are examining problem state member banks when necessary. Our improved offsite monitoring program is used to screen banks and to identify adverse trends or developing problems. Targeted "visitations" are also being used with increased frequency to monitor these institutions.

When problems have been identified and when these problems are not being successfully addressed by the bank's management we are vigorously pursuing enforcement actions tailored to the risks posed by the individual institution. These range from negotiating a simple agreement with bank management regarding a specific area of concern to the formal removal of bank officials and the imposition of fines or monetary penalties. Over the last five years there has been a substantial increase in our use of both formal and informal administrative enforcement actions. These actions include cease-and-desist orders, fines against officers and directors, removal actions and proceedings to terminate FDIC insurance. In each of the last two years, for example, there were about 250 enforcement actions, up from 50 in 1980. Total fines in 1980 came to only $2,000, while so far this year they total $8.8 million. This year there have been 25 bank officials removed by the FDIC, up from 23 in 1984, nine in 1983, six in 1982 and only one in 1981. At mid-1985 there were more than 400 formal actions outstanding under the FDIC's Section 8 authority and it is estimated that there are more than 1,000 negotiated Memoranda of Understanding with bank managements currently in force.

As regulators, however, we are constantly seeking new ways to improve our methods of supervision so that the system can remain strong. The complexity of today's environment has forced each agency to mount major efforts to improve examiner training and performance. In addition, millions of dollars are being spent on improved offsite monitoring techniques. We are targeting our supervisory efforts in those areas where our exposure is the greatest: mainly larger institutions and troubled banks. And, as I have already mentioned, we have taken steps to raise capital ratios and have increased the use of formal enforcement actions against banks, their officers and directors.

But there is much more that needs to be done. In today's deregulated environment, the inherent limitations of supervision and regulation must be recognized. That is why we are seeking the support of the marketplace in our efforts to create a stronger, more disciplined system. Public disclosure of the financial condition and practices of banks has been enhanced in recent years and these efforts will continue. The objective is to encourage depositors' funds to flow to the vast majority of banks that are well-managed rather than to the high-risk institutions that pay the highest rates. We are also researching various proposals that would enable suppliers of capital, possibly through the use of subordinated debt, to provide a measure of market discipline. This measure would address the off-balance sheet issue because banks which subject themselves to increasing off-balance sheet risk would be penalized in the marketplace by having to pay higher rates for funds.

Finally, we have put forth proposals for improving our deposit insurance system. Among the important reforms included in those proposals are risk-related insurance premiums and the authority to charge problem banks for costs of increased supervision. We are also seeking strengthened enforcement authority over all insured banks. While none of these reforms is a panacea, they are steps that need to be taken.

Thank you. I will be pleased to respond to any questions.