



NEWS RELEASE

FOR IMMEDIATE RELEASE

PR-57-79 (5-23-79)

Statement on

THE CONDITION OF THE FINANCIAL SYSTEM

Presented to

Senate Committee on Banking, Housing and Urban Affairs

United States Senate

by

Irvine H. Sprague, Chairman

Federal Deposit Insurance Corporation

May 23, 1979.
10:00 a.m.

Dirksen Senate Office Building
Room 5302

Mr. Chairman, I am here today in response to your call for a discussion of the condition of the banking system.

During the past several weeks, our staff has been providing your staff with voluminous statistical material that I trust has been useful and responsive to your requests. Attached is a detailed FDIC staff commentary which is keyed to the statistical material and the questions from your Committee.

I would like to give you today a summary and overview of our assessment of the situation. Briefly, our banking system has shown a remarkable resilience, particularly since the 1974-75 recession, and it is demonstrating the innovation and ingenuity that are necessary to adapt to the changing, dynamic world of today.

The change for the most part has been beneficial to banks and the banking public, but it has required careful monitoring by the regulatory agencies to assure safety and soundness in a period of transition. I believe that we have fulfilled our responsibility well. Times of growth and change inevitably bring problems with progress. I believe that we are meeting the challenge and that we can look forward to continued improvement and continued development of our banking system.

You are well aware of the legislative and regulatory proposals that would have an impact and could change the picture: consolidation of the regulatory agencies, phasing out of Regulation Q, new consumer deposit instruments, Federal Reserve membership, the McFadden Act, and Edge Act changes, among others. Additionally, your newly

enacted legislation such as the International Banking Act, the Financial Institutions Regulatory and Interest Rate Control Act, and the Community Reinvestment Act all are just now being implemented with no certainty as to the ultimate effect.

The other witnesses on this panel will be speaking to the statistical trends, i.e., capital, liquidity, assets, etc. I will touch on these issues but would prefer to highlight the situation from the FDIC perspective -- the strength of our insurance fund and the trends evidenced by our problem bank tabulations.

FDIC INSURANCE FUND

Speaking first as the insurer of the Nation's bank deposits, I can report that our insurance fund, now totaling \$8.8 billion, is strong and adequate. Our investment portfolio is managed so that interest income has now become the major source of net fund growth.

The ratio of the insurance fund to insured deposits was 1.17 percent at the end of 1978. The ratio reached a high of 1.96 percent in 1941. In the past decade, it has ranged from a high of 1.29 percent to a low of 1.15 percent.

Gross income for 1978 was \$952 million, including net assessments from banks of \$367 million, \$566 million from interest on U.S. Government obligations, and \$12 million in interest on notes receivable. The effective assessment charge to the banks this year will be one twenty-sixth of 1 percent of their deposits. This charge has ranged between one twenty-third and one-thirtieth of 1 percent over the past decade.

Ninety percent of FDIC's assets is held in U.S. Treasury obligations and currently yields income of 7.66 percent of book value, an increase from 7.15 percent at the end of 1977 and 7.55 percent at the end of 1978. FDIC also holds a net of \$760 million in claims acquired against assets in failed banks and \$135 million in capital notes purchased from sound banks in connection with their purchase and assumption of failed banks' assets and liabilities.

Experience has demonstrated that our fund is adequate to cover the likelihood of loss. In 1978, when seven banks with deposits totaling \$858 million failed, FDIC arranged for transfers of assets to other banks in six cases and paid out to depositors in the seventh. Altogether FDIC paid out \$471 million in 1978 to acquire assets and expects to recover enough through liquidation of these assets to reduce our estimated net loss to \$7.8 million. During 44 years, FDIC has paid out \$5 billion to acquire assets but has incurred an estimated net loss of only \$349.5 million.

We have never had to use the statutory right to call on the United States Treasury for an additional \$3 billion if it should be needed, but this does provide an additional, essential backup should we be faced with an unusual concentration of large bank failures. This we do not anticipate.

We are able to meet demands on the insurance fund immediately because our fund managers maintain high liquidity in our investment

portfolio. Maturities are held to ten years or less, and as we prepare for disbursements for operating or insurance expenditures, we move our funds into short-term instruments.

PROBLEM BANKS

Turning now from our insurance fund to our problem bank list, I can report that the number of insured banks on the FDIC problem list showed an encouraging decline in 1978 and the first one-third of 1979. The totals as of April 30, 1979 are 317 insured banks with \$66.4 billion in assets -- down from 342 banks and \$82.9 billion in assets at the end of 1978 and 368 banks and \$78.9 billion in assets at the end of 1977.

I should note that over the past decade the makeup of the problem list has changed drastically.

Ten years ago there were no institutions with over \$1 billion in deposits and only two over \$100 million in deposits on the list. On April 30, 1979, there were five over \$1 billion and 30 between \$100 million and \$1 billion. However, none of these large banks are on the potential payoff list, the most severe classification, and the number of larger banks on the list does reflect a slight decline from previous years.

As you know, we are in the process of dealing with differences among the three supervisory agencies in problem bank classifications and in 1978 we began a new, coordinated program called the Uniform Interagency Bank Rating System (UIBRS). Our problem list, which goes back to the late 1940s and covers all insured banks regardless of supervisory authority, traditionally has consisted of banks

which present an unusual risk to the insurance fund. However, the UIBRS constitutes a 1-to-5 numerical rating assigned to all banks on the basis of supervisory examination, with categories 3, 4 and 5 reserved for banks of varying degrees of special supervisory concern.

The General Accounting Office has recommended that we phase out the problem list and begin releasing public data on all insured banks based on the new rating system. This proposal has considerable merit; however, we are aware of definitional and other problems which we believe must first be carefully considered.

For example, if we were to use the new system to rate the State nonmember banks for which we have direct supervisory responsibility, as of the end of 1978 we would show 1,093 of them in the supervisory concern categories 3, 4 and 5, although only 262 of them were actually on the traditional problem list. Abandoning the historical system for the new one with such definitional discrepancies would only cause confusion to the detriment of banks and the banking public.

Additionally, we are concerned that at present under UIBRS the FDIC has no system to change a bank's category until after a formal examination. The problem list, on the other hand, has an established system for changing designations more rapidly in response to changed conditions. For example, our current list is 25 banks smaller than on January 1.

Further, there is the question of whether a rating assigned by the other banking agencies for supervisory purposes should also be consistent with a rating the FDIC would assign for insurance purposes.

Finally, the problem bank list has great statistical and analytical validity because of its long existence and because it covers all insured banks as measured consistently by one agency.

Our intention is to maintain both systems simultaneously for the time being.

LIQUIDATION

A good indication of the essential soundness of our banking system and of the regulatory and insurance mechanism that supports it is provided by historical statistics on bank failures and our record for depositor protection.

We have had two bank failures in the first five months of 1979 -- the Toney Brothers Bank, Doerun, Georgia, totaling \$5.9 million in assets and the Village Bank, Pueblo West, Colorado, totaling \$5.2 million in assets. There were seven insured bank failures in 1978 and six in 1977 and 16 and 13 failures, respectively, in the preceding two years. Assets of failed banks last year totaled \$994 million -- less than one-tenth of 1 percent of all assets held by our 14,729 insured banks -- and most of it was accounted for by the third and fifth largest bank failures in our history, the \$610-million Banco Credito y Ahorro Ponceño of Ponce, Puerto Rico, and the \$198-million Drovers' National Bank of Chicago.

Since January 1, 1934, when Federal deposit insurance was established, there have been 550 bank failures, an average of 12 a year, contrasted with the 9,755 failures in the five Depression years (1929-33), and an average 528 failures per year in the post-World War I decade.

However, the 48 bank failures since the 1974-75 recession have included larger banks with assets totaling about \$6.6 billion. We attribute these failures to poor economic conditions and to severe and prolonged real estate problems of recent years, in addition to the traditional causes: insider abuse which has accounted for 56 percent of all failures since 1960; criminal wrongdoing, 25 percent; and managerial weaknesses, 19 percent.

Depositors have fared well -- 99.9 percent of depositors in failed insured banks have recovered their deposits in full since the start of the FDIC in 1934. Insurance originally was \$2,500 and has been increased in stages, most recently in 1974 to \$40,000 for most deposits and \$100,000 for public unit deposits, and in 1978 to \$100,000 for IRA and Keogh Plan deposits. Last year our Liquidation Division set a record by collecting \$813 million on bank assets in their possession. At present, the Division is administering assets with a book value of about \$2.1 billion.

SUPERVISORY ACTIVITIES

Bank supervision, through which we strive to oversee the safety and soundness of State nonmember banks and compliance with law and regulations and to reduce the likelihood of demands upon the insurance fund, accounts for most of our FDIC resources and personnel.

In 1978, the Corporation's Division of Bank Supervision continued to modify and adjust its activities in response to the changing nature of the industry. The number of regular bank examinations decreased from 7,473 in 1977 to 6,961 in 1978, reflecting our shift to an 18-month examination cycle for most banks and 12 months for problem banks. This shift freed necessary personnel

to allow us to focus on areas of special concern. Additional emphasis has been given to concentrating on bank management policies and to modifying an examination to fit individual circumstances. The 6,684 consumer compliance examinations conducted in 1978 were a big absorber of extra examiner resources. Consumer compliance examinations continue to expand in the scope of the number of laws they cover as well as the depth to which we check for compliance. The advent of the Community Reinvestment Act requirements has added another heavy load.

In coping with these responsibilities, the FDIC has increased its degree of examiner specialization in the areas of trust and electronic data processing and just recently announced a major step of creating consumer compliance specialist positions. Staffing for all this specialization, however, has come from slots in our regular examination force and without any increase in the total examiner force.

As a partial offset for the multiple demands on our examiner staff, the Corporation has continued to perfect its Integrated Monitoring System, an automated surveillance program which allows us to monitor the performance of banks between examinations with an aim of detecting any developing adverse trends and of helping determine in which banks or which parts of a given bank we should concentrate our on-site efforts.

In 1978, the Corporation brought to three the number of states with which it has entered a divided examination program. Under this program, both FDIC and the state examine the problem banks at least once a year; the other banks are divided into

two groups with the state doing one and the FDIC the other; in the ensuing year, we switch groups.

With the cooperation of the Office of the Comptroller of the Currency and the Federal Reserve, we were able during 1978 to increase our program of review of national and Federal Reserve member bank examination reports. This is now done at the regional level which permits us better use of our people and gives us a more current picture of the condition of the banking system.

During 1978, the FDIC staff reviewed 162 applications for deposit insurance, 877 branch applications, 103 merger applications, and 614 other applications. Most of the branch applications, plus a large number of miscellaneous other matters, were approved at the regional level by delegated authority and steps have been taken to expand this delegated authority to as many areas as possible. One big area of new responsibility in 1979 will be that imposed by the change-of-control provisions of FIRIRCA. We expect to receive several hundred notices under this new law each year.

This delegated authority, the new CRA examinations, our increased availability to mediate bank customer disputes, combined with the increased size and complexity of activities in our State nonmember banks, the new requirements of FIRIRCA, and our dedication to a superior training program at all levels will continue to absorb personnel freed by reducing the frequency of our examinations of banks which do not indicate the need for special concern.

The industry continues to respond positively to our program by which examiners meet more frequently with bank

boards of directors. We communicate with the board about its bank and new developments in the industry.

A major part of our supervisory effort has gone into development of uniform interagency practices. You are aware of the Uniform Interagency Bank Rating System. We also have common policies for shared national credits, examination and rating of EDP services, rating of trust departments, valuations of securities, definition of concentrations of credit, illegal payments by banks, classification of installment loans, and evaluation of foreign country risk.

And, of course, the new Federal Financial Institutions Examination Council will be developing a variety of coordinated and hopefully consolidated efforts. One priority is rationalizing the supervision of bank holding companies.

ENFORCEMENT

A logical extension of our examination process is enforcement proceedings.

We regard Section 8 enforcement procedures as an integral part of our mandate under law to assure safety and soundness of banks and to enforce other laws. We have used it vigorously in recent years whenever we determined it was necessary, and we will not hesitate to use this authority, including the expanded powers granted by FIRIRCA, in the future. Our objective must be to stop unsafe or unsound practices before they threaten the bank.

FDIC first issued a final cease-and-desist order under section 8(b) in 1971, during my first term with the Board, to require a

Michigan bank to take specific steps to improve its management, curtail insider loans, and inject new capital. Thirty-seven such orders had been issued by 1975. Section 8(c), authorizing temporary cease-and-desist orders, was first used in 1976 to prevent a Texas bank from paying out uncollected funds to an insider. Since 1975, there have been 136 additional sections 8(b) and 8(c) orders, including in 1978 the first aimed at correcting trust operations and four others aimed at consumer violations.

All told, in 1978, the FDIC Board authorized 51 actions which produced 26 final cease-and-desist orders under section 8(b) and five temporary cease-and-desist orders under section 8(c). FDIC also brought an enforcement action in the U.S. District Court for violation of one section 8(b) order. FDIC issued six other final orders in cease-and-desist proceedings begun in 1977, and it terminated 32 orders when it determined that banks had complied and eliminated objectionable practices.

To date, in 1979, FDIC has begun 24 actions, including three involving consumer laws, and has issued 18 orders to cease and desist. FDIC terminated proceedings in 15 cases in which banks complied with previously issued orders.

Termination of insurance proceedings, instituted under section 8(a) when banks are determined to be in an unsafe or unsound condition, were begun in three cases in 1978 and two in 1979. Two 1978 proceedings are still pending; in the third, the bank was closed. Another 240 section 8(a) proceedings have been

instituted since 1934; in almost one-half of the cases, corrections were made; in most of the others, banks were absorbed or ceased operations. In 15 instances, insurance was terminated.

In 1978, three persons were suspended under section 8(g) authority applying to individuals indicted for a felony involving dishonesty or breach of trust. No such actions have been necessary this year.

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 empowered FDIC to issue cease-and-desist orders against bankers as well as banks and to levy fines up to \$1,000 a day against individuals and institutions for violations of cease-and-desist orders. Our section 8(e) authority to remove bankers also was expanded by FIRIRCA to include instances in which an individual has received financial gain or has demonstrated a willful and continuing disregard for the safety and soundness of the bank. No actions have been taken under these new authorities, but we will not hesitate to use them if necessary.

CAPITAL, EARNINGS, LIQUIDITY, AND PROBLEMS

Now, to a general discussion of the industry. Banking developments during 1978 and the early portion of this year have been substantially affected by an economic and financial environment characterized by a high level of economic activity, a substantial rate of inflation, and rapidly rising interest rates. These factors importantly affected bank growth, earnings, and capital. These same economic forces contributed to a decline in loan losses and in the level of classified loans.

Interest rates were driven up by borrower demand, monetary actions to dampen inflation, and actions to support the dollar in international exchange. Borrowers were willing to pay higher nominal rates of interest when inflation would translate them into smaller real rates. Savings declined and personal indebtedness grew. Business loans increased as greater use of manufacturing capacity led to larger expenditures for plant and equipment and to inventory accumulation.

Despite tightening monetary policy, bank deposits increased by 10 percent in 1978. Strong loan demand (bank loans which increased by 18 percent) induced banks to increase other liabilities, principally borrowing, by almost 30 percent. At the same time, bank holdings of government securities were maintained and other investments were increased slightly. Overall, these balance sheet changes amounted to a modest reduction in bank liquidity.

Among key interest rates, those on 3-month Treasury bills rose by one-half in 1978, to 9.122 percent from 6.063 percent, and the prime rate on bank loans, the rate on prime 4- to 6-month commercial paper, and the Federal Reserve discount rate rose proportionately. Rates on longer term instruments increased by smaller amounts; those on 3-year Treasury obligations rose by one-fourth and on 10-year obligations by one-sixth. Conventional new home mortgage rates were up one-tenth and still climbing in 1979.

The continuing interest rate increases of 1978 threatened disintermediation, and regulators responded by creating the

\$10,000-minimum, 6-month certificate of deposit tied to market interest rates. After 11 months ending April 30, 1979, \$146.6 billion worth was outstanding.

Net income improved substantially as a result of increased earning assets, an increased net interest margin (the difference between returns on assets and money costs), and a decline in loan losses. FDIC data indicate that net income of insured commercial banks increased by about 20 percent during 1978.

Banks had higher income in 1978 than in previous years, amounting to about a 13-percent return on equity, but banks were not able to improve their capital ratios. Although banks retained almost two-thirds of their net income, additions to equity did not keep pace with asset or loan growth. As a result, the ratio of equity to bank assets or to risk assets declined slightly during 1978. However, if we factor in the large increase in loan loss reserves that occurred in 1978 and consider these reserves to be part of the equity cushion of banks, then banks just about held their own in 1978, depending on the specific ratio used.

FDIC has undertaken a special study of the subject of adequacy of bank capital for the Federal Financial Institutions Examination Council, and we hope that the study will give us a better grasp of the problem and how to deal with it. We expect the staff to have a draft report in about 90 days.

In 1979, bank performance has largely continued last year's developments. Earnings have continued to improve significantly. Deposits have grown less rapidly than in 1978 and liquidity has been eroded somewhat. Bank performance during the balance of

1979 and beyond will, of course, be affected by developments in the economic environment. Any significant weakening in the economy probably will impact on interest margins and, eventually, in loan losses.

The mutual savings bank industry faces a profit squeeze from inflation and high interest cost that seems likely to curtail earnings sharply in 1979. Last year was generally favorable for mutuals' earnings, but with a substantial portion of their investment in long-term real estate mortgages, mutual savings banks remain particularly vulnerable to rapid increases in interest costs.

Classification of assets by the three regulatory agencies was covered in a Comptroller General's report of March 29, 1979. The report notes that the agencies use common categories of classification and engage in a number of common practices.

The report raises questions about the kinds and number of assets considered in loan sampling selections but points out that definitions used for classifications "are very broad and only intended to provide a general framework." We agree. Asset evaluation is not a matter of formula; it requires the professional judgment of a qualified bank examiner. We continue to be willing to consider possible use of various statistical sampling methods, but we have yet found no method that satisfies in all regards.

Real estate investment trusts made marked progress in 1978 and the first quarter of 1979, through either expanded operations or resolution of portfolio problems. However, the trusts in difficulty account for about 40 percent of the industry and continue to dominate

the overall industry balance sheet. Trusts have been shrinking in asset size in the past 3 years and this is expected to continue at least another year because the high proportion of nonearning assets has forced trusts to exchange assets for cancellation of their debts with creditor banks. The situation is not improving as rapidly as we might wish, but the bright spot is that new problems are not developing.

Standby letters of credit, on which banks must pay in the event the borrower cannot fulfill an obligation, are issued usually by giant banks. Of \$25.7 billion worth outstanding at the end of 1978, \$16.2 billion was in national banks of more than \$1 billion and \$6.6 billion in State member banks of that size. Use of this instrument continues to grow. A few years ago the three agencies adopted common regulations which made standby letters of credit subject to a bank's legal lending limit.

Finally, consumer debt has increased at a rapid clip in recent years and requires careful monitoring. Monthly payments as a proportion of consumers' disposable income were their highest in more than three decades at Christmas last year. Thus far, consumers seem to be keeping up with their installments. However, consumer loans account for about 20 percent of bank loan portfolios, and there could be ramifications for repayment if the growth in personal income should slacken substantially or if unemployment should jump. To date, as I

said, consumers are meeting their obligations, but the growth of consumer debt is an area we should watch.

On balance, the banking system continues to show a high level of lending and seems to be receiving the large time deposits necessary to help support that borrowing.

Briefly, we are encouraged by the condition of the banking system and current trends, but we are not complacent.



FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D. C. 20429

FIRST-CLASS MAIL
POSTAGE & FEES PAID
FDIC
PERMIT No. G36

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, \$300

TO THE CHIEF EXECUTIVE OFFICER