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Statement on

THE CONDITION OF THE FINANCIAL SYSTEM

Presented to *the*

Senate
Committee on Banking, Housing and Urban Affairs

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~~United States Senate~~

by

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Irvine H. Sprague, Chairman

Federal Deposit Insurance Corporation

Wednesday, *✓* May 21, 1980.
10:00 a.m.

Dirksen Senate Office Building
Room 5302

Mr. Chairman, I am here today to report that our nation's banking system is fundamentally sound but that we need to remain vigilant. We must improve our capacity to respond to any eventuality.

In preparing for this hearing, we have provided your staff with statistical material that I trust has been useful and responsive to your requests.

The banking system has spent the past year coping with change. After a steep climb in interest rates, we have now come to a period of sharp decline. The key six-month Treasury bill rate went down from a record 15.70 percent on March 24 to 8.78 percent on May 12 -- a drop of 700 basis points in just seven weeks. The prime rate, which hit a record 20 percent on April 2, fell to the 16.5-17.5 percent range by May 14.

The economists tell us that the economy is now in a recession. Ahead I see more change and uncertainty in the banking system.

Against this background, I want to give you a summary of our assessment of the condition of the banking system with particular focus on the nonmember banks we regulate. I will have specific comments in such areas as liquidity, asset quality, capital adequacy and others.

TABLES AND BACKGROUND MATERIAL

We have provided your staff with a series of tables that chart statistics of the banking industry. Separate tables covering respectively all 14,357 insured commercial banks and

all 325 FDIC-insured mutual savings banks in 1979 give us, for each sector of the industry, uniform measures of key banking activities. The tables contain seven measures of bank capital, five measures of loan activity and loan reserves, two measures of Federal funds purchases, one special tabulation each on other real estate activity and standby letters of credit, and dollar amounts of aggregate net income with two comparative measures of that figure.

Aggregate net income after taxes and securities transactions for commercial banks showed a 19-percent increase in 1979 from 1978, and for mutual savings banks a decrease of almost 20 percent in the same period.

As in previous years, we have broken down our commercial bank statistics into separate tables for insured State non-member banks, State member banks and national banks. This is the first time in this annual series of hearings that we have given you separate tables on the mutual savings bank industry.

Another series of tables, which focuses on quality of assets in insured nonmember banks, shows that the amounts of classified and special-mention assets -- that is, the problem assets -- declined in 1979 from 1978. This means that these banks in 1979 were holding loan portfolios with a perceptibly better assurance of repayment than they did in 1978. The decline in classified and special-mention assets was more than 25 percent for mutual savings banks, compared with six percent for nonmember commercial banks. The current downturn in the

economy could well mean an increase in the level of problem assets for the year 1980.

Other tables reviewing certain assets of insured non-member banks by problem list status show improvement in 1979 from 1978. The economic downturn is expected to have adverse effects on the list for 1980. I will discuss the problem list for the entire industry later in the statement.

Finally, we have given you the annual updates of two other historical tables. One shows that the ratio of the insurance fund to insured deposits was approximately 1.22 percent under the \$40,000 insurance coverage of 1979, up by .06 percentage points from 1978. With the \$100,000 insurance figure established this March, the ratio dropped to about 1.11 percent. The fund now is an adequate \$10 billion, and the new assessment credit rules should gradually build up the fund ratio. The other table shows that domestic assets of insured banks rose by \$126 billion or 9.9 percent in 1979 and that domestic assets of banks in bank holding companies went up by \$98 billion or 10.8 percent in 1979.

The remainder of our preliminary submission to your Committee consists of the following background material:

1. A description of the categories of problem banks used by FDIC and the characteristics used in classifying them,
2. A collection of FDIC regulations, policy statements, and guidelines used in the valuation of "other real estate owned,"

3. A summary of formal actions taken by the FDIC in 1979 to terminate insurance and to issue cease-and-desist orders,
4. A list of insured State nonmember banks closed in 1979 and the reasons for the closings,
5. State nonmember bank mergers in 1979 under Section 18(c) expedited procedures,
6. A report based on a semi-annual survey by the Comptroller of the Currency, the FDIC, and the Federal Reserve Board covering foreign offices of 128 U.S. banking organizations with significant foreign banking operations as of June 30, 1979, and
7. A report on the number of full and modified examinations conducted from 1975 through 1979.

OVERVIEW

Commercial banks had a favorable year in 1979.

Banks spent much of 1979 contending with unsettled economic forces, especially the pause in economic growth during the second quarter, the escalation in the rate of inflation, and the rapid rise in interest rates during the fourth quarter. Banks experienced some difficulties in adjusting to these changing market conditions because of the existence of usury ceilings, regulations on deposit interest rates and earlier portfolio decisions of some banks.

Total assets for all insured commercial banks grew 12.1 percent; however, total bank deposits grew only 10.4 percent,

largely as the result of competition from other kinds of institutions and financial outlets. Thus, the banking industry had to depend substantially on nondeposit sources of funds in 1979. Net Federal funds purchases increased by almost 20 percent over year-end 1978. For commercial banks in general, operating revenue was up but the percentage increase in interest expense was larger. Nevertheless, commercial banks showed a very favorable increase in net earnings, and the banking system as a whole continued the gains of the preceding two or three years.

The year 1979 was very different for mutual savings banks. Some of these institutions, with their fixed-yield mortgage portfolios and limited asset and liability powers in some States, suffered severely from curtailed deposit growth and increased interest expense. Aggregate net income of insured mutual savings banks dropped sharply in 1979. Many individual institutions have had a difficult year, and we can expect further challenges ahead.

EARNINGS

Net income of insured commercial banks after taxes but before security transactions totaled more than \$13 billion in 1979, an increase of 20 percent from 1978. That figure represented a return on equity capital of 14.3 percent. Commercial banks of all sizes showed substantial increases in earnings and return on equity capital.

Gross income for commercial banks was up 32 percent in 1979. More than two thirds of gross income came from interest and fees on loans.

Earnings of mutual savings banks were down to \$648 million in 1979, a drop of 19.8 percent from 1978 earnings. All size categories of mutual savings banks showed an earnings decline. The ratio of income to the capital (surplus) account for mutual savings banks dropped about 2.3 percentage points to about 6.8 percent with decreases in every bank size category except the smallest.

LIQUIDITY

Liquidity did not improve in 1979. One measure of liquidity -- the ratio of loans to deposits -- reflects a modest increase in liquidity pressure on banks as a whole. Smaller commercial banks generally showed less liquidity pressure under this measure; larger banks showed more. For mutual savings banks, the situation was reversed: smaller savings banks were under significantly more pressure.

Additional liquidity pressure arose because rising interest rates induced depositors to move their funds into shorter-term instruments. At the end of 1979, six-month money market certificates, passbook accounts and large certificates of deposit, most of which had maturities of six months or shorter, constituted 44 percent of all deposits in commercial banks. This means that, when demand deposits are included, more than 80 percent of all bank

deposits might be subject to withdrawal in six months or less. This is up five percentage points from the end of 1978.

ASSET QUALITY

Generally, asset quality improved in 1979. Classified and special-mention assets declined for nonmember commercial and mutual savings banks for the second consecutive year. The total of classified assets and special-mention assets as a percentage of total assets was down to 2.4 percent for nonmember commercial banks in 1979 from 2.5 percent in 1978 and 3.4 percent in 1977. For mutual savings banks the ratio declined to 2.7 percent in 1979 from 3.5 percent in 1978 and 3.8 percent in 1977.

Another indication of improved asset quality is that the rate of net loan losses as a percent of total loans continued to edge down both for commercial and mutual savings banks.

CAPITAL ADEQUACY

Equity and debt capital in all insured commercial banks rose to \$103.3 billion in 1979, an increase of \$10.1 billion from 1978. All categories of banks showed substantial dollar gains from 1978. The ratio of equity capital to total assets for all banks declined to 5.7 percent, down 0.1 percentage point from 1978. Within the average, the disparity between the ratios for large and small banks widened during 1979.

For commercial banks in the \$0-99 million and \$100-499 million deposits categories, the ratios climbed. For banks in the \$1-billion-to-\$4.99 billion category, the ratio roughly held about steady. It was for banks in the \$500-million-to-\$999 million category and, to a markedly greater degree, for the very largest banks in the nation -- those in the \$5 billion and over category -- that the ratios fell for the third straight year. Each year these ratios get smaller, especially for the biggest banks. For 1979 the \$5-billion-and-over ratio was down to 4.0 percent compared with a ratio more than twice as great for our smallest banks.

What the table says is that any decline in capital ratios is not widespread; it is confined to roughly the 300 largest banks.

The regulators are very mindful of this situation and have assigned a task force of the Federal Financial Institutions Examination Council to work on recommendations to address the situation. Meanwhile, through our regular examination process, our reviews of applications for deposit facilities and other dealings with banks we supervise, we are emphasizing capital adequacy considerations.

Almost 90 percent of the new 1979 equity capital in commercial banks came from retained earnings. The market for bank stocks and subordinated notes and debentures was depressed in 1979, and the relative amount of these debt instruments declined.

For insured mutual savings banks, the comparable ratio of capital to total assets was 6.7 percent. Every bank size category showed an increased percentage except that for largest banks which held steady. This reflected slow deposit growth.

MUTUAL SAVINGS BANKS

We have all recognized that mutual savings banks have been especially hard hit by the effects of the economic conditions of recent years. We at the FDIC have been monitoring the situation closely and meeting regularly with mutual savings bankers on these problems. The new Depository Institutions Deregulation and Monetary Control Act of 1980 contains a number of provisions designed to help thrifts hold their own in the economic environment of the eighties. These include new powers, certain usury pre-emptions and access to the discount window.

The law also created a Presidential task force that is required to report by June 30 on recommendations for the thrift industry.

At the State level, major legislative packages concerning powers of mutual savings banks are being readied in Pennsylvania and New York. Legislation is also pending in Rhode Island and New Jersey.

Thirteen mutual savings banks were in the red for the year 1979. Thirty-two were in the red in the last half of 1979. In the first quarter of 1980, savings banks earnings continued to decline, even though institutions had the benefit of an

abnormal spurt in penalty income -- ten times the level of a year before -- as savers accepted early withdrawal penalties to invest in higher yielding instruments. Were it not for this extraordinary penalty income, savings banks, in the aggregate, would have incurred net operating losses in the first quarter of 1980. With penalty income returning to a normal level as interest rates decline, we expect severe losses for the mutual savings bank industry in the second quarter that will wipe out the artificial gains of the first quarter.

However, we hope that over the entire year, the decline in interest rates will help materially in returning mutual savings banks to profitability.

It is true that mutual savings banks are using their reserves, but mutual savings banks are in a cyclical industry, and one basic purpose of reserves is to provide for losses and swings in interest rates and other unexpected circumstances. Overall, we believe the mutual savings bank industry is basically sound.

PROBLEM BANKS

The number of banks of all types on our problem list entered its fourth consecutive year of decline in 1980. As of April 30, 265 banks of all types with deposits of \$24 billion were on the list, down from 287 banks with \$20 billion in deposits at the end of 1979 and 342 banks with \$64 billion in deposits at the end of 1978.

These totals included 204 State nonmember banks with deposits of \$14 billion on the list as of April 30, compared with 222 State

nonmember banks with \$8 billion in deposits at the end of 1979 and 262 such banks and \$10 billion in deposits at the end of 1978.

Most of the figures show improvement, but I would include a cautionary note. The problem list contains a built-in lag, since it is usually 18 months or more before poor conditions in the economy magnify weaknesses that cause banks to go on the problem list. Any effects of the unfavorable developments in the last half of 1979 might not be reflected in the problem bank list until late 1980 or in 1981.

At the end of 1979, four banks of all types -- none exceeding \$100 million in deposits -- were in our most severe category of problem status, that considered likely to require an FDIC outlay in the immediate future. This so called "potential payoff" category had increased to eight banks of all types by the end of April, 1980.

It is important to point out that the problem bank list continues to be very fluid and that most banks remain on the list for a relatively short period. During 1979, there were 198 banks removed from problem status, while 143 were added. These figures included 152 nonmember banks coming off the list during the year and 112 going on. Of those on the list at the end of 1979, 55 percent had been there for 18 months or less, and 77 percent had been on the list for three years or less.

Implementation of the interagency uniform problem bank designation system, using a common rating system, is now in

progress. The Uniform Interagency Bank Rating System was inaugurated by the banking agencies in 1978. It was expanded into a common problem definition and its applicability broadened to include savings and loans and credit unions in 1979. Under the renamed Uniform Financial Institutions Rating System, 853 State nonmember banks were rated 3, 4 or 5 (categories indicating at least some degree of concern) at the end of April, 1980; of these, 115 banks were in the more serious categories 4 and 5.

For year end 1979, the comparable figures were 1,060 State nonmember banks of all types in categories 3, 4 and 5, with 154 of these in categories 4 and 5.

The FDIC is now sufficiently comfortable with the new uniform rating system and expects to phase out its old problem bank list designations within the next several months. An important feature in making the changeover possible is the expressed willingness of the Office of the Comptroller and the Federal Reserve to discuss with FDIC any differences on the proper rating to be assigned to any given bank and a commitment to reach an identical, common rating for the same institution by each of the evaluating offices.

MID-1970'S RECESSION

As I have indicated, the nation's banking system is fundamentally sound, but we are entering a recession, and we cannot accurately project its impact on the banking system.

It is important to review what happened in the mid-1970's recession and its impact on the banking system in the subsequent years. This will help us anticipate and prepare to meet the needs of the future when the impact of the current economic downturn will begin to make itself felt in our banking system.

In the early 1970's, a combination of factors triggered severe inflation and high interest rates coinciding with the worst recession since the Great Depression. For the banking industry, the economic upheaval generated high costs and big loan losses, particularly on certain real estate investment trust loans. It also meant weakened earnings and capital positions and presented other problems. At the same time the market for municipal debt issues was jarred by the New York City financial crisis; housing was in a steep decline and unemployment was up sharply. In this period and its aftermath, we had the four largest bank failures in our history: the \$931-million deposit United States National Bank in San Diego in 1973, the \$1.4-billion deposit Franklin National Bank in New York in 1974, the \$336-million deposit Hamilton National Bank of Chattanooga, Tennessee, in 1976, and the \$607-million deposit Banco Credito y Ahorro Ponceno in Puerto Rico in 1978.

The number of FDIC insured problem banks of all types climbed steadily from 183 at the end of 1974 to its all-time high of 385 in November, 1976. Large banks showed up on the problem list. The number of bank failures went from 10 in the two years 1973-74, to 13 in 1975, and 16 in 1976.

To keep matters in perspective, I want to point out that even during this extraordinary period the number of banks on our problem list stayed small -- less than 2.5 percent of the number of insured banks. Most banks never have been on the list. In the case of failures, thus far the FDIC has been able to use the powers available to it to make 98 percent of all deposits immediately available to depositors either through FDIC payment to insured deposits or successful purchase and assumption transactions; more than 99 percent of insured deposits were available in all cases within a few days.

EXTRAORDINARY ASSISTANCE

Three weeks ago, using existing authority, we were able to participate with a group of major banks in a joint interim assistance package to ensure the viability of First Pennsylvania Bank.

This is a unique cooperative effort designed to serve the public interest by enabling the nation's twenty-third largest bank to maintain its service to the community and to facilitate the bank's early return to full financial health. The loans are designed to give First Pennsylvania Bank the opportunity to put its house in order, hold the confidence of its depositors and other clientele and restore itself ultimately to profitability.

Although we were able to work this out within the constraints of current law, we want to be sure that we can take care of any eventuality that may arise in the uncertain future. The number of commercial banks with total assets exceeding

\$1.5 billion has increased by almost 70 percent since 1974 -- from 72 banks to 122 at the end of 1979. The number of mutual savings banks with assets exceeding \$1 billion has increased by 60 percent in the same period -- from 25 banks to 40.

The enactment of S. 2575, the extraordinary assistance bill introduced by yourself, Mr. Chairman, and co-sponsored in the House by Chairman Reuss, Congressmen St Germain, Stanton and Wylie, would give regulators the flexibility we need.

Currently, the FDIC can provide assistance to a bank only when it is in danger of failing and its continued operation is essential to provide adequate banking services in the community. The bill would expand FDIC powers so it would be able to act when it finds a bank is in danger of failing, that severe economic conditions exist which threaten the stability of insured banks in a large geographic area and it is probable that assistance to the failing bank will substantially reduce the risk or avert a threatened loss to the FDIC.

Another provision of the legislation would broaden the field of institutions which may purchase the assets and assume the liabilities of a failed bank. In addition to FDIC-insured banks, under the proposal associations or banks insured by the Federal Savings and Loan Insurance Corporation would become eligible bidders.

A third provision would create a new option for handling a mutual savings and loan association or savings bank in receiver-ship by authorizing the Federal Home Loan Bank Board to approve

the conversion, acquisition or merger of such a failed institution into a federal stock savings and loan association or savings bank. Federally chartered stock savings banks, which would be insured by the FSLIC, could be acquired by either savings and loan or bank holding companies and would have the advantage of access to a new source of capital in the form of stockholder equity.

The legislation also contains extraordinary acquisition procedures which would apply only in the event of failure of the leading banks or thrift institutions in a State and only then under certain extraordinary procedures. Specifically, the bill would permit the Federal Reserve Board to allow an out-of-State bank holding company to acquire a bank in receivership or its controlling holding company if the failed bank has total assets in excess of \$1.5 billion or if it is one of the three largest banks in a State. Such authority would be available to the Federal Reserve Board only if the Federal Financial Institutions Examination Council, with at least four members concurring first notifies the Board that an emergency exists and that an intra-state purchase is not in the public interest because of financial or competitive effects or is otherwise not feasible. The Federal Reserve Board would be given explicit authority to deny any such transaction on grounds of possible adverse effects on competition or the concentration of financial resources in any State, region or the nation.

The same procedure would be available for the interstate purchase of the successor of a failed insured savings bank if

the failed bank had assets in excess of \$1 billion or was one of the three largest thrift institutions in the State.

The legislation would grant similar authority to the FHLBB to approve an extraordinary acquisition by a savings and loan holding company of a failed institution insured by the FSLIC or to the successor of a failed FDIC-insured savings bank. The relief would be available only for a failed institution with at least \$1 billion in assets or which is among the three largest insured thrift institutions in a State. Again, a four-member vote of the Federal Financial Institutions Examination Council would be a prerequisite.

This is narrowly drawn, very specialized legislation. It is authority we hope we never have to use, but it is a necessary contingency. It provides a safety net, and it will enable us to make fuller use of the resources of our nation's financial system.

CONCLUSION

Generally, I am optimistic about the overall condition of the banking system and its ability to meet the challenges ahead. I believe that there are specific areas of concern which require legislative action, as I have outlined. I expect the current period of change and transition to continue into the foreseeable future. Our goal as regulators is to monitor the industry during a major period of evolution and to continue to work with the industry toward an improved banking system providing better service to the public.



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