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Testimony by

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of the

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I am pleased to be here today on behalf of the Board to discuss the state of the bank insurance fund and the adequacy of the supervisory framework for banking institutions. It may seem surprising to some that we find ourselves addressing the adequacy of that fund, after having just enacted major and costly thrift legislation which included provisions to strengthen both the bank and the thrift insurance funds. However, it is precisely because of the nature and severity of the problems experienced by thrifts, and the fact that the commercial banking system has, itself, gone through an exceptionally difficult period, that it is entirely appropriate that we do so.

The thrift legislation (FIRREA) includes numerous provisions and substantial financial resources that should strengthen both the nation's depository institutions and their federal deposit insurance programs. Only time will tell whether the funding provided is ample or will require future adjustments, but the resources already provided will permit the agencies to take decisive actions toward resolving problems that have already lingered too long. Stronger capital standards for thrifts, enhanced enforcement powers, and other actions should also improve the safety and soundness of the depository system, in general. Measures to increase insurance assessments on both thrifts and commercial banks should provide much needed resources to rebuild the insurance funds and to reduce the likelihood that further taxpayer monies will be required to support either the bank or thrift fund. Additional proposals for improvements may emerge from the broad study of the deposit insurance system required by the thrift legislation.

I shall begin my comments with a brief overview of the condition of the commercial banking system and then draw from that assessment to evaluate the relative strength of the bank insurance fund. I will also discuss several elements that the Federal Reserve believes are essential to a sound deposit insurance and supervisory program. While I recognize that the Subcommittee is also interested in issues affecting the credit union insurance fund, I will focus my prepared remarks principally on the banking industry, given the long-standing and important responsibilities of the Federal Reserve as a bank supervisor.

Developments Affecting Banking Risks

This decade has been a difficult and challenging one for the U.S. banking system. It began with the collapse of oil prices and back-to-back recessions that inflicted heavy damage on many business sectors and was associated with historically high and volatile interest rates. Increased levels of competition from both foreign banks and domestic nonbank firms, deregulation of interest rates, technological innovations, and a general blurring of distinctions between banking and securities markets have also forced virtually all U.S. banking organizations to respond to new competitive pressures and demands from the market. These and other events, together with excesses in both domestic and foreign markets, led, in some cases, to extensive losses in such areas as real estate and foreign lending. The high interest rates, combined with depressed commodity prices, also adversely affected many farming communities and led to record numbers of Midwestern bank failures.

Some of these problems remain. Lower oil prices and overbuilt real estate markets, resulting in part from excessive lending and investment practices, have created substantial problems in the Southwest for both banks and thrifts and have been a common factor in the failure of many of the institutions in that region. This sector could still strain the economic recovery of financial institutions in that area for years to come. Resolving the huge volume of assets of foreclosed thrifts could put pressure on certain segments of that real estate market for some time.

Elsewhere, real estate markets in the Northeast and in pockets of the Southeast have also shown growing signs of weakness during the past year. This factor, combined with the rapid growth of real estate development lending by banks in those areas, suggests that some new problems will appear there.

Problem loans to heavily indebted foreign countries remain a major area of concern for many of the nation's largest banking organizations, even though their exposures have declined in relative terms. As of March 31, 1989, claims on rescheduling countries of the nine most internationally active U.S. banks represented 101 percent of their primary capital (principally their equity and reserves). This relative exposure is down sharply from the 233 percent at the end of 1982, but is substantial, nonetheless. The improvement reflects, in part, efforts by banking organizations to strengthen their capital and reserve positions. However, some difficulties clearly remain, and we believe it is appropriate for these institutions to continue to take steps to assure that their reserve levels are consistent with the risk exposure in their loan portfolios. In contrast, most regional and super-regional banks have virtually eliminated foreign exposure as a material factor affecting their financial health.

Growing exposure to highly leveraged borrowers, including involvement in leveraged buyouts and other highly leveraged financings, also has important implications for the risk profiles of banking institutions. Such transactions can be important vehicles for the necessary restructuring of some companies, and, in this way, may contribute to the operating efficiency and financial performance of U.S. businesses. Nevertheless, the higher debt levels and relatively lower equity cushions that characterize such transactions can also weaken the borrower's ability to withstand financial adversity and, other things being equal, can raise the level of risk in bank loan portfolios. This is an area that warrants particularly close attention by bank managers and supervisors alike.

Ultimately, though, it is the size and number of banks that fail or that require federal assistance that affects the deposit insurance fund, and those figures remain stubbornly high. More than 150 banks have already failed during the first eight months of this year, a pace that is similar to the record number set last year. Although the assets of this year's failed banks are significantly less than those at this time a year-ago, at more than $25 billion they are still very large by historical standards.

Despite the picture I have painted, not all of the recent developments have been negative. Most of the largest and most severe problem institutions that loomed over us for months have now been addressed and, barring some further setbacks or shocks, should be resolved. They include what had been the six largest Texas bank holding companies--each of which had numerous subsidiary banks. With conditions in the Midwest stabilizing and the worst problems in Texas apparently resolved, there is reason to believe that we may have "turned the corner" and might finally begin to see fewer and smaller bank failures in the future.

During the past year, banking industry earnings also rebounded sharply from the net losses of 1987, which were caused when the larger banks created their special foreign debt reserves. As a percent of assets, last year's earnings of the 50 largest banking organizations were near their post-World War II highs, and have remained strong through the middle of this year. Recent earnings of smaller companies are also generally strong. Capital at major banks has continued to improve, not only in preparation for new risk-based capital standards, but also in recognition by many banks and bank holding companies that their capital ratios had fallen too low. Much of the improvement has come through stronger earnings and lower dividend payout rates, while other gains have come from new equity issues. Higher capital cushions, as recognized by the Congress in passing FIRREA, are critical in enhancing the condition of individual institutions, promoting the stability of the banking system as a whole, and protecting the strength of the deposit insurance funds.

In short, the banking system is basically sound, but there remain some unresolved problems that could continue to put pressure on the deposit insurance system and the supervisory apparatus. These pressures will come from growing competition in capital markets and from continued financial innovations, as well as from persistent asset quality problems.

Strength of the Bank Insurance Fund

I should acknowledge at the outset that the easiest way to evaluate the adequacy of an insurance fund is in hindsight. We can examine the general condition of the banking system, assess trends and risks that have appeared, and compare existing resources and coverage ratios of the fund to those of the past. Except in extreme cases, however, there is no obvious procedure or magic figure that will indicate whether existing resources are adequate to deal with future unpredictable events.

That said, I can offer some observations about the relative strength of the bank insurance fund.

The exceptional problems that the FDIC has faced this decade have reduced the fund, relative to the size of insured deposits, to an historically low level. At the end of 1988, the fund equalled only 0.80 percent of insured deposits, which was sharply lower than the level the year before and extended the generally steady decline in the coverage ratio that began in the late 1950s. Currently at its lowest point in history, the coverage ratio is also well below the statutory target of 1.25 percent recently set by FIRREA. Even in absolute terms, the fund declined $4.2 billion during 1988 to $14.1 billion, and by year-end was at its lowest level since 1982, when insured deposits were roughly one-third lower. Continued large outlays this year have further reduced the fund's resources. It should be rebuilt as soon as possible, and fortunately, steps are already being taken to do that.

Under FIRREA, deposit insurance premiums for banks are scheduled to rise from the current 8.3 basis points of deposits to 12 BPs in 1990 and then to 15 BPs beginning in 1991. Applying the 1991 rate to mid-year 1989 domestic deposits would yield an additional $1.4 billion annually of revenues for the fund, an amount equal to 10 percent of its balance at year-end 1988. Such future increases, matched with what should become declining payout rates, should do much to restore the fund to its traditional levels. It may still, however, be several years before that target is reached.

Meanwhile, we should recognize that recent events have demonstrated the strength of the bank insurance fund. The large number of failures we have witnessed, combined with the unprecedented size of the banks that failed, has tested the ability of both the fund and the bank supervisory system to deal with major problems. Throughout this trying period, the fund balance has remained substantial and capable of handling the difficult problems it has faced.

Deposit Insurance Reforms

While FIRREA takes several major steps toward improving the safety and soundness of the depository system, even its most ardent supporters recognize that it does not address a number of other significant reforms that might also be helpful. The Act, therefore, mandated a major study of the deposit insurance system by the Treasury, in consultation with the depository institution regulatory agencies, the OMB, and private experts. This study, along with recommendations for any necessary administrative and legislative actions, is to be submitted to the Congress in early 1991. Concurrently, the GAO is required to conduct a study of the deposit insurance system.

The Board attaches considerable importance to these studies, and it intends to participate actively in the Treasury's effort. A review, at both a conceptual and practical level, is needed of the consistency of an insurance system that evolved out of the Great Depression, on the one hand, with today's deposit-gathering industry of both small institutions and giant modern financial services organizations that operate across markets and national boundaries, on the other. It will be a difficult task that will require considerable care.

It is obviously premature to judge the conclusions of the study, and I have no wish to do so. Nevertheless, this is a subject to which much thought has already been given, and I would like to discuss some key ideas that should receive attention.

The existence of a federal safety net for depository institutions--consisting of federal deposit insurance, the discount window, and guarantees of the payments mechanism--will inevitably lead some owners and managers of firms that benefit from the safety net to increase their willingness to expose their depositories to excessive risk. The problems raised by such actions are endemic to all insurance programs, public and private, and have been given a descriptive name: moral hazard risk. There are many ways for the insurer to reduce the seriousness of moral hazard risk, and since, as a practical matter, none of the means for controlling this risk is sufficient by itself, several strategies are typically employed.

In the Board's view, two components must be included in a program for controlling moral hazard risk in the deposit insurance system. First, the risk position of the insured institutions must be monitored and measured by the regulator on a timely and accurate basis. For depository institutions, this means that there are no substitutes for good accounting data and frequent on-site examinations of the financial condition of the insured depository. Only with timely and accurate data and the unique insights that can be gained on-site can informed decisions be made as to whether the depository is exposed to excessive risk and what corrective actions are needed. This strategy does not require that the depository be subject to detailed and onerous regulations in virtually every facet of its business. It does require, however, that the supervisor be well informed regarding the financial condition of the insured institution.

Second, owners and managers must be given as much incentive as is possible to control the risk exposure of their businesses. If private individuals have such incentives, then there is far less need and tendency for public supervisors to become regulators and exert hands-on control of a depository institution. This in turn provides for maximum flexibility for depositories to respond to a dynamic financial environment while still not imposing unacceptable risks on the safety net.

Strong incentives for owners and managers to control risk are best achieved, we believe, by requiring that those owners who would profit from a depository institution's success have appropriate amounts of their own capital at risk. Capital acts as a buffer against unexpected shocks to a firm and thereby helps to insulate both individual firms and the depository system from risk. But more importantly for today's discussion, there is no better way to ensure that owners exert discipline on the behavior of their firm than to require that they have a large stake in that enterprise. Indeed, the need for larger cushions to absorb unexpected losses and for increased private incentives to monitor and control risk are the fundamental reasons why increasing the amount of capital in the insured depository institution system has been a major goal of Federal Reserve policy in the 1980s.

Appropriate public policies for controlling moral hazard would not eliminate bank failures nor would they put an end to supervisory mergers and acquisitions. Competitive pressures will continue and likely increase. Various sectors of our economy and of the world economy will no doubt experience unexpected changes in supply and demand. There will always be some owners and managers whose fraudulent behavior or outright incompetence puts their institutions at peril.

The continuing need to deal with insolvent or nearly insolvent depositories suggests that other policies to control moral hazard and minimize the adverse effects of capital-impairing events may be desirable. One such set of policies, and a set which is to be examined in the Treasury study, are actions to be taken with respect to the recapitalization or closure of insured depositories whose capital is depleted to, or near the point of, insolvency. Surely the thrift debacle has taught us that allowing insolvent institutions to remain open by living off the safety net can easily lead to massive taxpayer costs, not to mention serious misallocations of credit and distorted competitive incentives. It may be that we need to establish a clearer and more automatic set of regulatory actions that will be taken as a depository institution's capital falls below established minimums. These actions should probably be increasingly severe as capital ratios decline, culminating in closure or recapitalization and new ownership and management. The point would be that as private owners take risks and cause their equity in the business to decline, they give up management discretion to the caretakers of the public interest who insure the institution. Such a policy would help to internalize to management the cost of exposing the safety net.

Other policies designed to harness private incentives to control risk also deserve serious consideration. These include various proposals for use of subordinated debt to impose greater market-like discipline, and risk-based deposit insurance premiums. With regard to risk-based premiums, without prejudging the issue, I would emphasize that it would be vital to make any such system consistent with the risk-based capital policies adopted by virtually all of the major industrialized countries in 1988.

Supervisory measures

The implementation of any changes to the deposit insurance program, as well as the day-to-day maintenance of an effective supervisory framework, requires the timely detection of insolvent or near-insolvent institutions. For this reason, the Federal Reserve has long-employed a number of techniques to maintain the quality and effectiveness of its supervisory activities, and recently has taken some additional steps to strengthen its supervisory program. Although I have alluded to some of these actions already, I believe it is useful to highlight a few in greater detail.

Capital adequacy. The Federal Reserve and the other U.S. banking agencies, as well, have long stressed the importance of strong capital positions for banking organizations. In establishing capital requirements and assessing capital adequacy, the Federal Reserve has endeavored to utilize asset valuations based upon realistic and reasonably current on-site examiner assessments of the credit quality of bank assets. Equally as important, it has been Federal Reserve policy to exclude or severely limit goodwill and other intangible assets when assessing commercial bank compliance with minimum capital standards.

Since the early 1980s, the banking agencies have employed supervisory guidelines for minimum levels of capital to total assets, and have generally encouraged banking organizations to operate above the minimum levels. Our efforts in this regard have extended beyond the examination process and into the administration of the Bank Holding Company Act and other banking laws. Specifically, we have expected banking organizations undertaking significant expansion to maintain strong capital positions, well above supervisory minimums, without significant reliance on intangibles.

One of the most recent and important steps we and the other U.S. banking agencies have taken to strengthen bank capital is to adopt the new international risk-based capital standard, which will apply to banks of most major countries.

That standard was designed to recognize the different levels of credit risk inherent in various types of bank assets and off-balance sheet activities and also to lead to a more equitable basis for international competition. The new standard will be fully phased-in by the end of 1992, and specifies an interim target for the end of 1990. It stresses the need for an adequate level of "core" shareholder funds, defined as common equity and perpetual preferred stock (net of goodwill), and limits the amount of loan loss reserves that may be included in the total capital base. Still other risks that can affect a bank's financial health, such as interest rate exposure, are under review and may result in additional measures or refinements to the newly adopted risk-based standard.

Bank capital plays a critical role in protecting the deposit insurance system, both by absorbing losses and by giving bank investors the incentive to operate their institution in a safe and prudent way. These new risk-based standards should assist us in our effort to ensure that the banking system remains adequately capitalized.

On-site examinations. The Federal Reserve believes firmly that on-site examinations provide the best way to evaluate the true financial condition, including the asset quality and capital adequacy, of commercial banking organizations. As I have already suggested, only by making timely and realistic assessments of the credit quality of bank assets can a truly accurate measure of bank solvency and capital adequacy be derived. In addition, on-site examinations afford supervisors an ideal opportunity to assess directly the effectiveness of bank management, as well as the quality of the bank's internal operating practices and systems for monitoring and controlling risks.

Although reviewing periodic financial reports is also an important function, on-site examinations remain the cornerstone of our supervisory program. In this regard, it is the Federal Reserve's policy to examine all state member banks and bank holding companies with significant operations annually, either directly or in conjunction with state supervisory agencies. Problem institutions are examined more frequently, and subject to other more rigorous supervisory reviews.

Conditions of the past several years, in both the banking and thrift industries, have imposed significant pressures on our field examination resources. This year, in particular, our involvement in thrift institution examinations and closings has forced us to postpone the regular periodic examinations of some institutions that appear to be healthy and to limit the examination scope of others. While we can make such adjustments temporarily, we cannot do so for extended periods. Such actions would increase the possibility that problems could develop and grow without early detection. In light of these and other developments I have discussed in this statement, it is crucial that we continue to devote adequate resources to on-site examinations and other critical supervisory functions. It is also essential that we take any steps necessary to attract and retain qualified field examiners and supervisory personnel.

Other supervisory and regulatory measures. Earlier this year, the Board reiterated its policy regarding loans to highly leveraged firms. Among other things, that statement stressed the importance of a thorough and independent assessment by the lender and re-emphasized the need to consider the strength of such borrowers under various economic conditions, including the possibility of an economic downturn. The policy also emphasized the need for senior bank management to put in place procedures to monitor the performance of such credits, as well as effective internal controls to limit bank exposures to individual or related borrowers and industries. Our view is that any loan whose repayment is not based upon identifiable sources of cash flow that are realistic in terms of current, as opposed to future or expected, economic conditions is speculative and could involve undue risks.

Leveraged buyouts and other highly leveraged financings may offer substantial benefits to the economy, and, when properly structured, should also be sound extensions of credit. However, as I have already mentioned, such credits can involve significant risks and until we have more experience with these financings, the Federal Reserve plans to monitor these bank exposures carefully. We must obviously remain particularly sensitive to the potential effect of any possible economic slowdown on the ability of highly leveraged borrowers to repay their debts.

A number of other long-standing laws, regulations and supervisory policies exist to limit bank risk-taking. In particular, the banking agencies enforce numerous statutes and regulations that establish limits, collateral requirements, and appropriate review and approval terms regarding loans to affiliated companies and bank insiders. These areas, where credit judgments might be more readily compromised, are also closely evaluated during on-site examinations. The Federal Reserve has a broad array of enforcement powers, including cease and desist authority and civil money penalties, which it has used to address violations of banking laws and regulations and to prevent unsafe and unsound banking practices. Recently enacted provisions of FIRREA should provide additional tools to limit bank risk-taking. Among other things, this legislation contains provisions which call for the implementation of minimum collateral requirements for real estate loans, the establishment of appropriate appraisal standards for real estate loans, prohibiting the use of brokered deposits by troubled institutions, and expansion and strengthening of the banking agencies' enforcement authority.

Organizational structures. The final issue I will mention relates to the structure through which banking organizations should properly conduct any activities that carry risks not traditionally associated with banks, or activities that, as a matter of public policy, should not be supported by the federal safety net. The focus here is not on any specific banking powers, but rather on how best to limit risks to the federal safety net when distinctions between banks and other financial companies are becoming blurred. There are several organizational possibilities: (1) permit the bank to perform the activity directly; (2) permit the bank to perform the activity only indirectly through a subsidiary of the bank; or (3) require the activity to be conducted outside of the bank in a separate subsidiary of the bank holding company.

As a rule, the Federal Reserve believes that the third approach provides the greatest protection to any affiliated bank(s) and, in turn, offers the most protection to the deposit insurance fund and federal safety net more generally. Isolating such activities in subsidiaries of banks, the second option, seems to offer only limited protection to the bank, since any problems of the subsidiary would be transmitted immediately to the consolidated financial statements of the parent bank. That bank subsidiary structure also seems more vulnerable to legal challenges by creditors of the subsidiary to "pierce the corporate veil" and attach assets of the parent bank.

Conclusion

In summary, it is our view that the bank insurance fund has weathered a very difficult period and, while it remains sound, will benefit from the much-needed additional resources provided by FIRREA. Further changes and proposals for strengthening the deposit insurance system may come from the study required by that legislation. In our view, for the system to remain sound it must be governed by an adequate supervisory framework that strikes the proper balance between reasonable prudential rules, such as minimum capital standards, and an adequate on-site supervision and examination program. It is, of course, in the interests of both Congress and the regulatory agencies to work in a cooperative fashion to establish all of the components necessary to protect the stability of our nation's financial system and the health of our deposit insurance funds. Much progress has been made with the enactment of FIRREA, and we look forward to working with the Congress on further necessary steps in the future.