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Financial Condition of the Federal Deposit Insurance Corporation's Bank Insurance Fund

Statement of
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Before the
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss the results of our audit of the Federal Deposit Insurance Corporation's (FDIC) December 31, 1988 financial statements. We are currently beginning our audit of the insurance fund's 1989 financial statements. The results of our 1989 audit will be available in March or April of 1990. We share your view that the financial condition of the Bank Insurance Fund should be closely monitored. With the ink on the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) barely dry, we certainly do not want to see a problem of the magnitude and cost of the one the savings and loan industry is experiencing repeated in other sectors of the financial services industry. In that respect, we would like to offer our thoughts on the characteristics of failed financial institutions and the need for institutions to have strong internal controls for operations and compliance with laws and regulations.

BANK INSURANCE FUND'S FINANCIAL CONDITION AND OPERATING RESULTS

During the 1980s, banks have been failing at record rates. From 1934, the year FDIC was created, through 1979, a period of 46 years, 558 FDIC-insured banks failed. In the 9 years from 1980 through 1988, 879 FDIC-insured banks, including 424 in the last 2 years alone, failed or received assistance from FDIC. These failures and assistance transactions have had an adverse affect on the insurance fund. Our 1988 audit (Financial Audit: Federal

Deposit Insurance Corporation's 1988 and 1987 Financial Statements, GAO/AFMD-89-63, dated April 28, 1989) reported that the insurance fund incurred its first net loss since its inception--$4.2 billion. This loss reduced the balance of the insurance fund from $18.3 billion at the end of 1987 to $14.1 billion at the end of 1988. The ratio of the fund balance to insured deposits was reduced to its lowest level ever--about 0.83 percent as of December 31, 1988.

The net loss was primarily due to the $7.3 billion cost associated with 1988 bank failures and estimated bank assistance for several troubled banks identified by the regulatory process. These costs included:

-- $3.0 billion for the failed First RepublicBank Corporation;

-- $1.8 billion for the MCorp banks which failed in 1989;

-- $0.6 billion for the Texas American Bancshares, Inc. (TAB) banks which failed in 1989; and

-- $0.2 billion for the National Bancshares Corporation banks for which FDIC has approved but not yet executed assistance.

As part of our 1988 audit, we analyzed various industry trends and statistics to evaluate the adequacy of the insurance fund. Overall, at September 30, 1988, less than 2 percent of all FDIC-insured banks, with about 1 percent of industry assets, were insolvent (capital of less than zero determined in accordance with generally accepted accounting principles (GAAP)) or barely solvent (GAAP capital of between 0 and 2 percent of total assets). Our analysis showed that at September 30, 1988, 80 FDIC-insured banks were insolvent with assets of $20.0 billion and GAAP capital of negative $584 million. There were also 140 barely solvent banks with assets of $19.4 billion and GAAP capital of $233 million. (See Attachment I for a summary of the financial condition of FDIC-insured banks.)

Between September 30, 1988, and December 31, 1988, FDIC acted on or set aside funds for 39 (of the 80) insolvent institutions with assets of $18.3 billion and negative capital of $482 million, and 17 (of the 140) barely solvent banks with $4.9 billion in assets and capital of $53 million. Because of the relatively small number of insolvent or barely solvent banks, their asset size, and FDIC's timeliness in acting on troubled banks, we believe the insurance fund did not have a significant exposure related to these banks. However, as discussed in our 1988 audit report, we do have other concerns which could potentially result in additional costs to the Bank Insurance Fund.

-- The growth of nonperforming assets (the sum of loans past due 90 days or more and loans in nonaccrual status), which has historically been an early indication of a deteriorating economy, has continued to persist through the first quarter of 1989 for banks in the Northeast and Southeast regions of the country.

-- If interest rates increase rapidly, the net interest margin of banks could decline, thus reducing the industry's profitability.

-- Although banks have taken action to minimize the effect of less developed country (LDC) debt, continued debt servicing problems of some less developed countries could result in further losses and write-downs of this debt and could place a strain on banks holding a significant amount of LDC debt.

Based on our analysis of the insurance fund's exposure to insolvent and barely solvent banks and the above concerns, we concluded that the insurance fund had sufficient resources to handle current and near-term identifiable needs. However, we expressed the importance of increasing the Bank Insurance Fund through higher insurance premiums. FIRREA includes provisions which increase bank insurance premiums beginning January 1, 1990, and give FDIC greater discretion than it has had to adjust premium levels to meet the insurance fund's needs. This action should strengthen the financial condition of the fund.

THE BANK INSURANCE FUND REMAINS STABLE IN 1989

We recently began our work to audit the Bank Insurance Fund's 1989 financial statements and thus cannot make any conclusions based on our work at this time. FDIC will complete the financial statements after the end of the calendar year and our audit results will be available in March or April 1990. However, FDIC has reported some interim activity that has occurred during 1989 that will be reviewed during our audit.

FDIC reported that 151 insured banks failed and one bank received assistance through August 24, 1989, compared to 200 bank failures and 22 assisted banks during 1988. However, the 151 bank failures included 44 MCorp and TAB banks for which FDIC had already charged estimated losses to the insurance fund as of December 31, 1988. (See Attachment II for information on the remaining 1989 bank failures that were not charged against the insurance fund in 1988.)

The Bank Insurance Fund's unaudited July 31, 1989, financial statements reported a fund balance of approximately $14.4 billion compared to $14.1 billion at December 31, 1988. The interim statement of financial position also showed that the Bank Insurance

Fund had $94.0 million in cash and investments of $15.7 billion in U.S. Treasury obligations, which together account for approximately 70 percent of total assets. Thus, the insurance fund's unaudited interim statement of financial position suggests that the fund continues to remain fairly liquid as of July 31, 1989.

Industry trends and statistics as of March 31, 1989, the most current information available to us, showed that there were 89 insolvent insured banks with assets of $7.3 billion and GAAP capital of negative $588 million. In addition, there were 108 barely solvent insured banks with assets of $24.7 billion and GAAP capital of $94 million. The $24.7 billion in assets for barely solvent banks includes $13.1 billion for a bank which temporarily had zero capital as a result of assistance from the insurance fund. Overall, less than 2 percent of insured banks with about 1 percent of industry assets were insolvent or barely solvent as of March 31, 1989. The exposure to the fund for these banks as of March 31, 1989, is similar to what it was at September 30, 1988.

The unaudited financial statements of the Bank Insurance Fund, in conjunction with the relatively small amount of assets in insolvent and barely solvent banks, suggests that the Bank Insurance Fund continues to be adequate to handle its current and near-term identifiable needs. Nonetheless, the fund's financial condition merits close attention as FDIC deals with emerging problems of nonperforming assets in the Northeast and Southeast, the effect increased interest rates could have on banks' earnings, and continuing LDC debt servicing problems. In addition, the strains placed upon FDIC as it fulfills its responsibilities for managing the resolution of troubled savings and loan associations must not be allowed to result in another crisis in the financial services industry.

STRENGTHENING INTERNAL CONTROLS IN FINANCIAL INSTITUTIONS

We recently conducted a study of the 184 banks that failed in 1987 to identify the causes of the failures. (See Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management, GAO/AFMD-89-25, dated May 31, 1989). In virtually all cases, we found that federal regulators cited the presence of serious internal control weaknesses as contributing significantly to the bank failures. Although the regulators cited no single weakness as the sole contributing factor to the banks' failures, the weaknesses noted related to some aspects of the banks' operations directly within the control of the board of directors and bank management. For example, regulators often found that:

-- the board of directors inadequately supervised bank management,

-- a dominant figure was present who had a detrimental effect on bank operations,

-- banks engaged in risk-oriented activities, such as excessive growth-oriented practices and overreliance on volatile funding sources,

-- excessive out-of-area lending occurred where banks did not fully understand the regional economics and banking practices, and

-- banks lacked appropriate policies for loan underwriting and approval, had poor loan documentation and inadequate credit analysis, or established inadequate allowances for losses on loan portfolios.

In our report, we expressed concern because these serious weaknesses in internal controls related to some aspects of bank operations directly within the control of the board of directors and management. Also, many of these weaknesses remained uncorrected despite regulators' efforts.

To establish and maintain effective internal controls and to enhance management accountability at banks, we recommended that the Congress enact legislation with the following requirements.

-- Bank management should be required to prepare and submit to federal regulators an annual report describing (1) management's responsibility for preparing financial statements and for establishing and maintaining an effective internal control structure, including controls to assure compliance with laws and regulations, and (2) management's assessment of the effectiveness of the internal control structure. These reports would heighten management's sensitivity to actions needed to ensure that effective internal controls are in place to operate the bank in a safe and sound manner and would promote management accountability for its actions.

-- Banks should be required to undergo annual, full-scope audits by independent public accountants that would include a review of management's report on internal controls and compliance with laws and regulations. Such audits would assist bank management in fulfilling its fiduciary duty to operate banks in a safe and sound manner and would assist federal regulators conducting supervisory examinations and off-site monitoring.

We noted similar internal control weaknesses in our companion study of certain failed savings and loan institutions (see <u>Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices</u>, GAO/AFMD-89-62, dated June 16, 1989.) Internal control weaknesses in conjunction with economic and environmental factors had a catastrophic affect on a large segment of the industry and the Federal Savings and Loan Insurance Corporation's insurance fund. Promoting and developing strong internal controls in both banks and savings and loans as we have recommended will most assuredly result in fewer drains on the insurance fund and, potentially, the need for taxpayer assistance.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or the members of this subcommittee might have.

ATTACHMENT I

CONDITION OF THE BANKING INDUSTRY
(dollars in billions)[a]

Description	Number	Percent of Total	Assets	Percent of Total	GAAP Capital
As of September 30, 1988:					
Insolvent banks[b]	80	0.6	$ 20.0	0.6	$ (0.6)
Barely solvent[c]	140	1.0	19.4	0.6	0.2
All other banks	13,445	98.4	3,287.5	98.8	211.9
Total Industry	13,665	100.0%	$3,326.9	100.0%	$211.5
As of December 31, 1988:					
Insolvent banks[b]	95	0.7	$ 6.1	.2	$ (0.6)
Barely solvent[c]	135	1.0	10.1	.3	0.1
All other banks	13,298	98.3	3,343.5	99.5	215.3
Total Industry	13,528	100.0	$3,359.7	100.0	$214.8
As of March 31, 1989:					
Insolvent banks[b]	89	0.7	$ 7.3	.2	$ (0.6)
Barely solvent[c]	108	0.8	24.7	.8	0.1
All other banks	13,276	98.5	3,355.9	99.0	221.0
Total Industry	13,473	100.0	$3,387.9	100.0	$220.5

[a]This analysis excludes savings banks which are insured by the Bank Insurance Fund but regulated by the Office of Thrift Supervision. As of March 31, 1989, there were 21 of these institutions with assets of about $46.7 billion and equity of about $2.9 billion, which represents a collective equity-to-assets ratio in excess of 6 percent.

[b]Insolvent institutions are defined as those with negative capital as defined by generally accepted accounting principles (GAAP).

[c]Barely solvent institutions are defined as those with GAAP capital between 0 and 2 percent of assets.

Source: Bank Source by Ferguson and Company.

BANK INSURANCE FUND
1989 BANK FAILURES AND ASSISTANCE
As of August 24, 1989
(dollars in thousands)[a]

Total Closed	State	Total Assets	Total Deposits
64	Texas	$2,295,039	$2,164,632
2	Alaska	915,314	892,842
1	Massachusetts	854,858	678,622
12	Louisiana	781,392	792,567
2	New York	450,117	416,138
8	Oklahoma	394,853	379,716
5	Colorado	62,844	55,278
3	Florida	41,753	39,686
4	Kansas	39,243	37,967
1	North Dakota	30,314	27,753
2	Arizona	24,237	23,009
1	Montana	14,604	12,878
1	Missouri	5,182	5,192
1	West Virginia	4,125	3,973
107		$5,913,875	$5,530,253

[a]Does not include 44 MCorp and Texas American Bancshares banks for which FDIC had already charged estimated losses to the insurance fund as of December 31, 1988.

Source: FDIC press releases on failed and assisted banks.