Chapter 6
A Costly Evolution: 1971 – 1991

The economic environment affecting banks began to change during the 1970s and the pace of change accelerated during the 1980s. Also, the market for financial services became far more competitive as nonbanking companies began to encroach on traditional banking markets and banks sought to enter new product markets. As a result, banking became a riskier and more demanding business than ever before. The ramifications of unforeseen market developments or bad decisions were greatly magnified. This chapter documents some major changes in the banking environment that occurred from 1971 to 1991, a period that included record insured-bank failures and insurance losses and ended with the Bank Insurance Fund technically insolvent by $7 billion.

Key Economic Variables

Foreign exchange-rate volatility. The period of remarkable post-World War II stability came to an end in the 1970s. An important change resulted from the movement to a floating exchange-rate system from a fixed-rate system that occurred in 1973. As international trade expanded in the post-World War II era, the maintenance of fixed exchange rates required adjustments to trading relationships and domestic economic policies of trading nations that were not optimal. With the Smithsonian Agreement (Washington, DC, 1971), exchange rates among all of the major currencies of the world were realigned and permitted to float without upper and lower bounds. This development predictably gave rise to considerably greater exchange-rate volatility at a time when world trade was expanding rapidly.

Since 1970, there have been periods of relative calm in the exchange rates – for example, 1976 and 1977 – interspersed with periods of substantial volatility, some considerably extended, and periods with volatility varying among currencies. Markets for forwards and futures exchange-rate contracts were developed to permit firms to manage foreign exchange-rate risk more effectively. For example, the Chicago Mercantile Exchange formed the International Money Market in 1972 and began offering the first foreign exchange futures contracts on major currencies. Without well-developed markets for forwards and futures contracts for foreign exchange, this volatility would be less manageable and would significantly lessen foreign trade.

Interest-rate volatility. Interest-rate volatility also increased considerably in the 1970s. Oil embargo shocks in 1973 and 1978 resulted in accelerating inflation and contributed considerably to interest-rate volatility. The Federal Reserve dramatically changed monetary policy in October 1979 by switching from an interest-rate target to a monetary aggregates target, such as nonborrowed reserves, with the objective of reducing inflation. The result of this policy was a highly volatile interest-rate period from October 1979 until late 1982.

Interest-rate volatility can give rise to volatility in bank earnings to the extent that banks face gaps between interest-sensitive assets and interest-sensitive liabilities. The causes of this volatility in interest rates have been linked to expectations of changes in future short-term interest rates, fed by the volatility in the rate of inflation and inflation expectations. The yield curve – *i.e.*, the relation between interest rates and maturity – has been volatile and at times has become inverted, such as 1972 through late 1974 and early 1978 through 1982, when the one-year Treasury bond yield was higher than the 10-year yield. This required considerable caution in funding long positions in long-term assets or fixed-rate assets with short-term, variable-rate liabilities. This was a particularly difficult period for FDIC-insured savings banks, which held proportionately more fixed-rate, long-term assets (residential mortgages) than did the typical commercial bank

Economic conditions. Volatility in the 1970s and 1980s also arose from general economic activity. To a considerable extent, the volatility in general economic activity can be traced to real shocks, such as the oil embargoes of the 1970s, wars, dissolution of the Soviet Union, and the fiscal and monetary policies of the major industrialized nations. These shocks caused considerable volatility in commodity prices and real output. The record inflation of the late 1970s was followed by a period of slower inflation, but greater commodity-price volatility. The 1980s also witnessed a surge in the number of newly issued commercial bank charters, which began operations at a time when inexperience was a distinct liability.[26]

The volatility of prices and general economic activity can have a substantial effect on banking performance, as the experience of the 1980s made clear. The sectoral inflation and subsequent deflation of agricultural prices in the late 1970s and early to mid-1980s were major contributors to the failure of hundreds of agricultural banks. Similarly, the boom and subsequent collapse of oil prices caused significant problems for banks in states whose economies had important energy sectors. The declines in real-estate markets in the 1980s and early 1990s caused major problems for many banks. These problems can be traced in part to unanticipated changes in regional economic conditions, as the behavior of real-estate prices departed sharply from past patterns.

Developments in the Banking Industry

The business of banking changed considerably during this period. As noted above, risks increased as interest rates, exchange rates and commodity prices became more volatile and as economic shocks were transmitted more widely *via* the globalization of markets. Meanwhile, competition in the financial marketplace greatly intensified. The traditional intermediation function of banks assumed a smaller role in aggregate economic activity, largely because financial and technological innovations increased the funding options for firms that formerly were restricted to bank loans. Banks were forced to seek new sources of income and to implement untested business strategies, and such experimentation carried inherent risks.

[26] George Hanc, "The Banking Crisis of the 1980s and Early 1990s," *FDIC Banking Review* 11, no. 1 (1998), p. 19.

Dramatic evidence that banking became riskier is evident in the annual rates of bank failures. Although annual bank failures exceeded single digits only rarely between 1940 and 1980, failure rates rose rapidly thereafter, to a record high of 280 in 1988. A similar picture emerges from the data on FDIC insurance losses relative to insured deposits. Annual insurance losses were quite stable and extremely low, on average, before 1980, at less than half a basis point (0.005 percent) of insured deposits. Losses for the period from 1980 to 1991 averaged nearly 16 basis points (0.16 percent) and were highly variable.

Net loan charge-offs as a percent of average total loans trended upward beginning in the early 1970s and accelerated rapidly in the 1980s. This ratio was 0.34 percent in 1970 and 0.37 percent in 1980 before soaring to a peak of 1.59 percent in 1991. Over the same period, bank stocks substantially underperformed the Standard & Poor's 500 index.

The effects of increased competition and innovation are inextricably intertwined. Both played a role in the banking industry's declining share of financial-sector credit-market assets since 1971. U.S.-chartered commercial banks held a 37.6-percent share in 1971, but this share declined to 23.2 percent by the end of 1991. Many larger companies found that they could raise money more efficiently by issuing their own commercial paper. In 1971, outstanding commercial paper equaled just 4 percent of banks' commercial and industrial (C&I) loans, but by 1991 this ratio had risen fourfold, to nearly 17 percent. This development had added significance because many of these larger companies had been banks' most creditworthy, "prime" borrowers. During this period, banks also were losing business borrowers to finance companies. In 1971, finance companies' business loans were 15 percent of banks' C&I loans, but by 1991 this ratio had grown to more than 50 percent.

The growth of asset-backed securities represents another dimension of the competitive pressures faced by depository institutions. By increasing the liquidity and efficiency of the credit markets, securitization produces a narrowing of the spreads available to traditional lenders such as banks and thrifts. The outstanding example of this process occurred in the mortgage market, where the proportion of consumer mortgages that had been securitized grew from about 8 percent in 1971 to more than 40 percent as of year-end 1991.

On the liability side, banks faced increasing competition from many nonbank financial institutions. Foremost among these were the money-market mutual funds (MMMFs), which rose from obscurity in 1975 to prominence by 1981. Because of interest-rate regulations, banks were unable to match the high, market interest rates offered by these instruments. The ratio of MMMF balances to comparable commercial bank deposits (small time and savings deposits) was virtually zero in the mid-1970s, but reached 36 percent by 1981. Despite the elimination by 1983 of most interest-rate controls, MMMFs had established a durable presence. By 1991, the ratio of MMMFs to banks' small time and savings deposits had risen to 39.5 percent.

These developments forced changes in the strategies of commercial bankers. Faced with diminished opportunities for C&I lending, banks shifted into real-estate lending. This new portfolio composition exacerbated the adverse effects on banks of downturns in regional real-estate markets, including the Southwest in the mid-1980s and the Northeast a few years later. This typified other periodic, large-scale movements in and out of particular types of lending, and these portfolio shifts suggested that many banks embarked on a widening search for new profit opportunities in response to the competitive pressures undermining their traditional niche in the financial marketplace.

The behavior of banks in the regions and sectors that suffered recessions during the 1980s exhibited some common elements. Recessions occurred in the Midwest in the early 1980s, in the Southwest in the mid-1980s, in the Northeast in the late 1980s and in California in the early 1990s. In the economic expansions that preceded these recessions, banks generally responded aggressively to rising credit demands. Banks that failed generally had assumed greater risks, on average, than those that survived, as measured by the ratios of total loans and commercial real-estate loans to total assets. Banks that failed generally had not been in a weakened condition, as measured by equity-to-assets ratios, in the years preceding the regional recessions.[27]

Safety-and-Soundness Examination Policy

In 1936, the problems cited most frequently by bank examiners were inadequate capital, excessive insider lending, excessive volume of poor loans, inadequate credit documentation and incompetent management. In a survey 40 years later (1976), these same problems were cited by examiners, along with inadequate liquidity and violations of consumer credit law. Some people recognized, though, that it was becoming increasingly difficult in the 1970s to effect adequate supervision within the confines of policies and procedures designed for the less diversified, less dynamic industry of previous decades.

Edward Roddy, who served as the FDIC's Director of Bank Supervision from 1971 until his death in 1975, was credited by many as being particularly aware of the changes that were taking place and the growing inadequacy of existing supervisory policies. It was largely through his efforts that policies were overhauled in the early and mid-1970s, the first substantive changes in several decades. In an important shift in FDIC policy, it was decided that smaller, sound, well-managed banks did not require annual full-scope examinations and that it would be more effective to concentrate examination resources on those banks presenting greater risks to the insurance fund. This concept was furthered in the late 1970s and early 1980s with the expanded use of off-site monitoring systems to identify institutions posing unacceptable risks and to target supervisory resources.

[27] Ibid., pp. 15-18.

Insured-Bank Failures

Open-bank assistance. In 1971, the FDIC utilized for the first time powers granted under the 1950 Act to provide "open-bank assistance" to a failing insured bank. Section 13(c) of the Federal Deposit Insurance Act authorized the FDIC to provide financial assistance to an insured operating bank in danger of closing whenever, in the opinion of the Board of Directors, the continued operation of such a bank is essential to providing adequate banking services to the community. Unity Bank, with deposits of $9.3 million, was established in 1968 as a community venture to serve the black community of the Roxbury-Dorchester area of Boston, Massachusetts. The bank received a loan from the FDIC in the amount of $1.5 million, but Unity did not remain viable and in 1982 was merged into another bank with FDIC assistance.

Failures. Many of the economic and banking developments described above encouraged banks to take greater risks, but the new environment also provided harsh punishment for their mistakes. The *number* of bank failures during the 1970s and early 1980s remained within historical parameters, but the failed-bank assets and insurance losses soon began to escalate beyond historical levels. When Bank of the Commonwealth (Detroit, Michigan) failed in 1972[28] and United States National Bank (San Diego, California) failed in 1973, they each had total assets greater than $1 billion and were by far the largest FDIC-insured banks to fail. Insurance losses for 1973 totaled $67.5 million, nearly double the losses incurred by the FDIC in its previous 39-year history. However, much larger losses were soon to come.

From 1982 through 1991, more than 1,400 FDIC-insured banks failed, including 131 that remained open only through FDIC financial assistance. In Texas alone, more than 500 insured banks failed. Total insurance losses exceeded $1 billion in each of these 10 years, topping $6 billion in 1988, 1989 and 1991. The insurance fund had grown to $18.3 billion by year-end 1987, but these crushing losses quickly exhausted the fund. At the end of 1991, the balance of the Bank Insurance Fund, excluding loss reserves, was *negative* $7 billion. A succession and overlapping of regional and sectoral problems combined temporarily to overwhelm the system's ability to absorb losses.

There was a sharp increase in the number of new charters issued in the 1980s, and these institutions suffered a disproportionately high rate of failure. Of the 2,800 banks chartered from 1980 to 1990, 16.2 percent had failed by the end of 1994. By comparison, of the banks that already were in existence at the beginning of 1980, just 7.6 percent had failed by year-end 1994. In New England in the early 1990s, mutual savings banks that converted to the stock form of ownership suffered a similar high rate of failure. After conversion, these institutions had large amounts of new cash to invest, just at the time the

[28] Bank of the Commonwealth received open-bank assistance from the FDIC, in consultation with the Federal Reserve Board and the State of Michigan, because of its essentiality in providing banking services to minority neighborhoods in Detroit. In 1984, Bank of the Commonwealth was acquired by another bank, without FDIC assistance.

region was plunging into a recession. Twenty-one percent of stock savings banks failed in the early 1990s, compared to 8 percent of mutual savings banks.[29]

Financial Operations

Insurance coverage. In 1974, deposit insurance coverage was increased from $20,000 to $40,000, and to $100,000 for deposits held by states and political subdivisions. Coverage was increased to $100,000 for IRA and Keogh accounts in 1978. In 1980, despite the reservations of the FDIC, deposit insurance coverage for all accounts was increased to $100,000 by provisions of the Depository Institutions Deregulation and Monetary Control Act. This last increase represented a departure from previous changes in insurance coverage, which generally had been more modest and more or less reflected changes in the price level. The increase to $100,000 was not designed to keep pace with inflation but rather was in recognition that many banks and savings-and-loan associations, facing disintermediation in a high interest-rate climate, had sizable amounts of large certificates of deposit (CDs) outstanding. The new limit facilitated retention of some of these deposits and attraction of new deposits to offset some of the outflows. In 1980, only time accounts with balances in excess of $100,000 were exempt from interest-rate ceilings.

Assessments. In 1980, the assessment credit percentage was reduced from 66-2/3 percent to 60 percent, the level that had been in effect from 1950 to 1960. At this time, there also was established a range in which the reserve ratio of the fund was to be maintained. The assessment credit percentage was to be adjusted if the reserve ratio either exceeded 1.40 percent or fell below 1.10 percent. Because of mounting losses, reduced assessment credits were paid in 1981 through 1983, and no assessment credits were paid thereafter.

Effective assessment rates generally ranged under 4 basis points during the 1970s. Thereafter, rates grew rapidly as insurance losses mounted throughout the 1980s and early 1990s. When the full statutory rate of one-twelfth of 1 percent (8.3 basis points) proved too low, Congress mandated an increase to 12 basis points in 1990 and gave the FDIC board more flexibility to raise rates. With losses continuing at record levels, rates were increased twice in 1991, first to 19.5 basis points and then to 23 basis points.

FIRREA. Congress enacted the Financial Institution Reform, Recovery, and Enforcement Act (FIRREA) in 1989 in a largely successful effort to resolve the savings-and-loan crisis of the 1980s. Many provisions of FIRREA drastically affected FDIC operations. The former Federal Deposit Insurance Fund was renamed the Bank Insurance Fund (BIF), and the FDIC assumed responsibility for the new Savings Association Insurance Fund (SAIF), which replaced the defunct Federal Savings and Loan Insurance Fund. A third fund was placed under FDIC management – the FSLIC Resolution Fund – which consisted of the remaining FSLIC receivership assets. The FDIC also was charged with organizing and, initially, managing the new Resolution Trust Corporation (RTC),

[29] Hanc, pp. 18-19.

which was created to resolve failed and failing savings associations and to manage savings association receiverships.

Investment policy. By law, FDIC investments essentially are limited to Treasury securities. Before the mid-1970s, the FDIC assumed a passive role in managing its portfolio, allowing the Treasury to invest FDIC funds in whatever issues the Treasury felt appropriate. About this time, though, the FDIC started to shorten the average maturity of its portfolio and began to achieve a better maturity balance with respect to anticipated bank failures and liquidity needs.