Chapter 7
A Remarkable Turnaround: 1992 - 1998

In 1991, the commercial banking industry was struggling. A recession in 1990 and early 1991 had trimmed loan demand, losses related primarily to commercial real estate lingered, and the Bank Insurance Fund was insolvent by $7 billion. More than 1,000 commercial banks, with aggregate assets exceeding $500 billion, were on the FDIC's "problem bank" list, many of which were expected to fail. The industry earned a return on assets of just 0.53 percent, well below the profitability benchmark of 1 percent. These hardly were measures of an industry on the verge of an unprecedented run of prosperity, but events already were underway that would reverse banks' fortunes.

Short-term interest rates began to plummet in the latter part of 1990. The three-month Treasury bill had an average yield of 7.75 percent in the second quarter of 1990. The yield fell to 4.54 percent by the end of 1991, and it would continue to fall, remaining near 3 percent throughout 1993. Following the 1990-1991 recession, the U.S. economy began an expansion that continued well into 1998.

Developments in the Banking Industry

Performance. Commercial banks earned an industry record $32 billion in 1992, compared to $18 billion in 1991. Their earnings would improve in each of the following five years, reaching $59 billion in 1997. In 1991, one of every nine banks was unprofitable, but by 1997 that figure had fallen to less than one in 20. Part of this earnings improvement was attributable to the overall growth of the industry: total assets were up from $3.4 trillion at the end of 1991 to $5 trillion at year-end 1997. However, banks' average return on assets also improved markedly, surpassing 1 percent in each year from 1993 through 1997, including a record 1.23 percent in 1997. Despite this rapid growth in total assets, the growth of bank capital more than kept pace. The ratio of total equity to assets rose from 6.75 percent in 1991 to 8.33 percent at the end of 1997.

Important changes also were underway in the composition of bank earnings. Banks became less reliant on spread-based revenues (*i.e.*, net interest income) and more reliant on noninterest income. Banks and their holding companies diversified into new activities that were less affected by interest-rate swings than were traditional banking products. In 1997, noninterest income was 60 percent of net interest income, up from 49 percent in 1991.

Banks also used this period to improve the quality of their assets. The proportion of noncurrent loans fell from a crippling 3.70 percent in 1991 to under 1 percent in 1997. The level of foreclosed assets also fell dramatically, from $28 billion in 1991 to $4.5 billion by the end of 1997. Banks also maintained a high level of loan-loss reserves. Coupled with the decline in noncurrent loans, banks had nearly $2 in reserves for each dollar of noncurrent loans at year-end 1997, up from 73 cents in 1991. At the end of

1997, the number of institutions on the FDIC's "problem bank" list had fallen to just 71 banks, with total assets of $5 billion.

Consolidation. The number of FDIC-insured commercial banks remained remarkably constant from 1934 to 1988, ranging from 13,000 to 14,500. In 1989, the number of banks fell below 13,000 for the first time and continued to fall, to 9,143 at the end of 1997. Part of this consolidation was attributable to bank holding companies combining their bank subsidiaries, which was facilitated by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. This Act, which became fully phased in by June 1997, also enabled interstate combinations between unaffiliated banks. The most dramatic effects have been mergers between some of the nation's largest banking companies. Some concerns were raised about the ability of smaller banks to compete with these enormous financial conglomerates, but there are many reasons to believe that well-managed community banks will continue to prosper independently. Additional concerns were raised about the ability of the FDIC to handle the failure of one of the "megabanks." This is addressed in Chapter 8.

FDICIA

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) was enacted in December 1991 as Congress addressed the insolvent Bank Insurance Fund. The Act was comprehensive in nature, covering both insurance funds and their finances as well as supervisory and resolution practices. Its most important provisions are summarized here.

Risk-based premiums. By statute, the FDIC had always charged a flat rate for deposit insurance. FDICIA required the FDIC to have in place by 1994 an assessment system wherein each bank's assessment would be reflective of the risks it posed to its insurance fund. The FDIC had backed such a change and implemented a risk-based premium system on January 1, 1993, a year ahead of schedule.

Assessment rate schedules were adopted separately for the BIF and the SAIF. Each schedule was composed of a nine-cell matrix, with rates ranging from 23 cents per $100 of assessable deposits to 31 cents. Institutions were categorized according to a capital subgroup (1, 2 or 3) and a supervisory subgroup (A, B or C). Thus, the best-rated institutions were in cell 1A, and the weakest institutions were in cell 3C.

FDICIA set the minimum assessment at 23 basis points until each fund was fully capitalized at 1.25 percent of insured deposits. It required the FDIC to adopt a recapitalization schedule for the BIF to achieve full capitalization with 15 years. Such a schedule was adopted in 1992. Because nearly half of SAIF assessments were diverted by law to other purposes, that fund was expected to take even longer to become fully capitalized. A capitalization schedule for the SAIF was not required until 1998.

Prompt corrective action. The law required federal regulators to establish five capital zones ranging from well-capitalized to critically undercapitalized that serve as the

basis for mandatory prompt corrective active by regulators. Increasingly harsh restrictions apply to institutions that are less than well-capitalized. Institutions whose tangible capital ratio falls below 2 percent are critically undercapitalized and face closure if the situation is not corrected within 90 days. It was expected that by closing institutions before their capital was totally depleted, losses to the deposit insurance funds would be mitigated. Until FDICIA, the FDIC did not have the authority to close a failing insured bank; that power rested with the chartering authority, which was the Comptroller of the Currency or the state.

Least-cost resolution. FDICIA required the FDIC to select the resolution alternative for failing institutions that results in the lowest cost to the insurance fund. Previously, the FDIC could select any resolution alternative if it was less costly than a payout of insured deposits and liquidation of assets. Thus, if two resolution alternatives were less costly than a payout, previously the FDIC could have chosen either method; under FDICIA, the FIDC must choose the least costly of the two. Beginning in the mid-1960s, the FDIC had routinely protected all depositors, when possible, by transferring all deposits of a failed bank to an acquiring institution, thus protecting even uninsured depositors. That policy was no longer an option.

Too big to fail. Before FDICIA, the FDIC had the authority under the open-bank assistance provisions of the 1950 Act to determine that a failing institution was so large that its failure could result in a systemic risk to the banking system by undermining public confidence. This authority was used only two times, in 1980 with First Pennsylvania Bank (total assets $8 billion) and in 1984 with Continental Illinois National Bank (total assets $45 billion). Both instances required a finding of essentiality.

FDICIA requires that, in situations threatening systemic risk, the FDIC Board, the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, in consultation with the President, must agree that the closure of the insured institution would have a serious effect on economic conditions or financial stability. Any loss to an insurance fund under this exception must be recovered through a special assessment paid by members of that fund. This authority has not yet been used.

Borrowing authority. FDICIA also increased from $5 billion to $30 billion the amount the FDIC is authorized to borrow from the Treasury to cover insurance losses. Any borrowings were to be repaid through deposit insurance assessments. In 1990, the FDIC was authorized to borrow money for working capital from the Federal Financing Bank. Any borrowings were to be repaid by the sale of receivership assets. These provisions were necessary because when an institution fails, the FDIC has large initial expenses – the payment of insured deposits – and relatively slow recovery through the sale of receivership assets. Working capital borrowings, which amounted to about $10 billion at year-ends 1991 and 1992, were repaid in full in 1993.

Depositor Preference

The Omnibus Budget Reconciliation Act of 1993 included provisions that established a uniform order for distributing the assets of failed insured depository institutions. Previously, federal and state laws often set different priorities in terms of the hierarchical order for payment of receivership claims. Under the national depositor preference law, a failed institution's assets are to be distributed in the following order:

1. The administrative expenses of the receiver;
2. The claims of all depositors, including the FDIC in the place of insured depositors;
3. General creditor claims;
4. Subordinated creditor claims; and
5. The claims of shareholders.

The law was expected to reduce the cost of resolutions and thus conserve the deposit insurance funds.

Insured-Bank Failures

The profitability of the overall banking industry recovered quickly in 1992, but some banks did not survive the travails of the preceding years. One hundred twenty-seven banks failed in 1992, resulting in estimated insurance losses of $3.6 billion.[30] The industry's financial health was evident in the lower numbers of failures and losses in subsequent years. From 41 failures in 1993, the numbers fell to 13, six, five and one in the years 1994 through 1997, respectively, and insurance losses declined proportionately. The low failure experience has continued in 1998. Through the first eight months of the year, just three commercial banks failed, resulting in estimated losses of $33 million.

Financial Operations

The Bank Insurance Fund recovered far more quickly than was anticipated from its insolvency at year-end 1991. With declining insurance losses and substantially higher assessment revenue mandated by FDICIA, the fund balance became positive in 1993 and reached full capitalization in May 1995. At midyear 1995, the fund's balance was $24.7 billion, which represented 1.29 percent of insured deposits.

It is important to note that the recovery of the BIF was aided significantly by a reduction in the reserves previously set aside for anticipated failures. Failures projected by the FDIC and the General Accounting Office in the early 1990s did not materialize as the banking industry went on to seven years of record profits. In 1992, 1993 and 1994, the FDIC recorded *negative* loss provisions totaling $12.8 billion, which increased net

[30] Insurance losses for any given year include estimated losses for institutions that failed during that year as well as adjustments to estimated losses for institutions that failed in previous years.

income and the fund balance. Much smaller – though still negative – loss provisions were recorded in 1995 through 1997.

BIF assessment rates. With the BIF recapitalized in 1995, the FDIC was able to reduce deposit insurance assessments for BIF members. In recognizing the legislative safeguards recently implemented, the FDIC Board concluded that the insurance losses of the 1980s and early 1990s were atypical of what could be expected in the foreseeable future. The staff determined that an assessment rate of 4 to 5 basis points would have been sufficient to balance revenues and expenses – and capitalize deposit growth – in the period from 1950 to 1980.[31] However, the Board also wanted to maintain risk-based pricing, so rates were reduced from a range of 23 to 31 basis points to a range of 4 to 31 basis points, effective June 1, 1995. Because of incentives in the risk-based premium system and improvements in the health of the industry, the vast majority of banks – nearly 92 percent – were in the 1A rate cell and qualified for the lowest rate. The average assessment rate was 4.4 basis points, down from 23.2 basis points before recapitalization of the BIF. Also, by increasing the spread from 8 basis points (23 to 31) to 27 basis points (4 to 31), the Board hoped to provide additional financial incentive to weaker banks to improve their condition.

Later in 1995, the Board lowered BIF rates again, to a range of 0 to 27 basis points, effective at the start of 1996. Because of the low level of projected insurance losses and receivership activity, the Board determined that investment earnings would be sufficient to cover the BIF's expenses. To maintain the incentives provided by risk-based pricing, though, it was decided to retain higher rates for banks presenting greater risks to the fund. In 1997, BIF assessment revenues totaled just $25 million, compared to $5.6 billion in 1994.

SAIF assessment rates. At the time the BIF became recapitalized in 1995, the SAIF still was substantially short of the designated reserve ratio of 1.25 percent. On June 30, 1995, the fund balance was $2.6 billion, and its reserve ratio was just 0.36 percent. Therefore, SAIF assessment rates could not be set lower than 23 basis points,[32] and there existed a sizable differential between SAIF assessment rates and the new BIF rates. It soon became apparent that this provided sufficient incentive to SAIF members to shift deposits to BIF insurance. Despite legislative and regulatory prohibitions, some SAIF members succeeded to some extent. Concern arose that if SAIF-assessable deposits continued to shrink, it eventually would not be able to meet its insurance and other financial obligations. Moreover, it was likely to be the stronger institutions that would be successful in shifting deposits, leaving the SAIF with a higher risk profile.

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[31] Interestingly, this was the same exercise undertaken by FDIC staff 60 years earlier, based on the period 1865 to 1934, in recommending an assessment rate when Congress was drafting the Banking Act of 1935. The results were not widely dissimilar.

[32] Under FIRREA, the FDIC Board had the option of reducing SAIF assessment rates to 18 basis points during the period from January 1, 1994 to December 31, 1997. However, the Board opted to maintain the minimum rate at 23 basis points until the SAIF was fully capitalized.

Congress responded with the Deposit Insurance Funds Act of 1996 (Funds Act). It called for a special assessment – later set by the FDIC at 65.7 basis points – on all SAIF-assessable deposits in order to bring the fund to full capitalization. The special assessment brought in $4.5 billion and raised the fund balance to $8.7 billion. The SAIF faced another significant problem, however. SAIF assessments of up to $793 million annually were diverted to cover interest payments by the Financing Corporation (FICO) on 30-year bonds issued in the 1980s in an effort to end the savings-and-loan crisis. This amounted to nearly half of all SAIF assessments and was the primary reason why the fund's growth lagged behind that of the BIF. Even when fully capitalized, SAIF assessment rates of 12 basis points or more would have been needed to cover expenses and fund FICO interest payments. The Funds Act allocated the FICO expense to all FDIC-insured institutions. Beginning in 1997, BIF members became subject to FICO assessment, though at a lower initial rate than SAIF members. SAIF members' costs were reduced significantly, and beginning in 2000, all insured institutions will pay a *pro rata* share of the FICO expense, expected to be about 2 basis points annually.

With the SAIF fully capitalized, the FDIC was able to lower SAIF assessment rates to a range of 0 to 27 basis points, the same as paid by BIF members, effective October 1, 1996.