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BANK FAILURES: RECENT TRENDS AND POLICY OPTIONS

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SUMMARY

During the 1980s the U.S. banking industry has experienced a rapidly growing number of failures. Many factors have contributed to this trend including deregulation, technology, individual bank management, and economic conditions. The Federal Deposit Insurance Corporation (FDIC) handles insured bank failures. Congress has been monitoring the recent trend and is concerned with the FDIC's ability to continue to perform its supervisory and insurance operations. The present situation, information on key factors affecting the banking industry, and the FDIC's role when a bank fails are discussed in this issue brief. The reference section of this issue brief contains a list of CRS products providing background on the FDIC and legislative issues relevant to the agency.

ISSUE DEFINITION

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BACKGROUND AND ANALYSIS

The Record of Bank Failures

From 1980 to 1986, 447 FDIC-insured U.S. banks (commercial banks and mutual savings banks) failed. The banks that failed during this seven-year period account for over one-third of the total number of insured banks that have failed since 1934, the year in which the FDIC began operations. In 1986, the largest number of banks (138) failed in any calendar year since the Great Depression. FDIC spokesmen expect the trend to continue in 1987; by July 1, 1987, 100 banks had failed.

While the number of failed institutions is small when compared to the total number of insured U.S. banks -- 14,487 commercial banks and 292 mutual savings banks -- the escalating trend may be significant. Also increasing is the number of banks on the FDIC's problem institution list. The banks on the list carry a 4 or 5 rating according to the standards of the Uniform Financial Institutions Rating System. Under the System, an institution is given a numerical rating (from 1 to 5) which reflects the institution's financial condition, overall operating soundness, and compliance with laws and regulations. Institutions with a rating of 4 or 5 are generally characterized by unsafe, unsound or other seriously unsatisfactory conditions and are considered to have a relatively high probability of failure or insolvency.

Almost invariably, the failed institutions have been on the problem list. Exceptions usually involve massive fraud. Currently, the FDIC expects about 10 percent of the banks on the list to fail.

Table 1 lists the number of banks that failed from 1970 through 1986. For each year, the table displays the total deposits held by failed banks and the number of banks on the FDIC problem list. In addition, the table provides monthly data for 1987.

Reasons Behind Recent Failures

Many factors have contributed to the recent trend of increased failures. Few failures are a result of a single cause. The U.S. banking system has been adjusting to dramatic changes resulting from financial deregulation. A broad goal of deregulation was to enable depository financial institutions (commercial banks, savings and loan associations, mutual savings banks, and credit unions) to compete more effectively with each other and with non-depository financial institutions. The increased level of competition has placed new pressures on bank management. Some banking industry observers feel deregulation has fostered increased risk-taking by banks.

TABLE 1. Number and Deposits of Insured Failed Banks and Banks on FDIC Problem List

Year	No. of failed banks	Deposits (in thousands of dollars)	No. of banks on FDIC problem list (year end)**
1970	7	54,806	251
1971	6	132,058	239
1972	1	20,480	190
1973	6	971,296	155
1974	4	1,575,832	181
1975	13	339,574	347
1976	16	864,859	385
1977	6	205,208	368
1978	7	854,154	342
1979	10	110,696	287
1980	10	216,300	217
1981	10	3,826,022	223
1982	42	9,908,379	340
1983	48	5,441,608	642
1984	79	2,883,162	848
1985	120	8,136,786	1,140
1986	138	6,553,400	1,484
1987 Jan.	17	495,700	N/A
Feb.	16	484,700	N/A
Mar.	19	449,700	N/A
Apr.	17	394,200	N/A
May	14	278,400	N/A
June	13	358,600	N/A

** Monthly information on problem banks is not published

Source: Federal Deposit Insurance Corporation.

Technological change has provided many advances in state-of-the-art banking but they have also added pressures to the banking industry. Advances in the delivery of services have increased competition. Using new technology, individual banks have extended their areas of operation and increased the variety of financial products they offer. The start up and maintenance costs associated with new equipment can be substantial.

The management of an individual bank must decide what is feasible for their institution. This decision involves consideration of the bank's market. It can involve joint ventures with other institutions or correspondent relationships. The more sophisticated and complicated the decisions become, the easier may be for wrong choice to affect the safety and soundness of a bank.

Economic factors have contributed to bank failures. The fact that inflation and interest rates are relatively stable now is a change from the accelerating inflation of the 1970s, a period of high and volatile interest rates. Financial decisions based on the belief that the economic conditions of the 1970s would continue could have negatively affected a bank's operations.

The agriculture and energy industries have both encountered severe problems recently. Banks with loans concentrated in either of these areas have experienced difficulties. In 1986, farm bank failures accounted for 59 of the total 138 bank failures. A farm bank is defined as having more than 25% of its loans in agricultural credit. In addition, a number of banks with significant funds in loans to less-developed countries have experienced problems.

FDIC Procedures for Failed Banks

The Banking Act of 1933 created the Federal Deposit Insurance Corporation (FDIC) as an independent agency to insure deposits at commercial banks and mutual savings banks. Membership is mandatory for commercial banks belonging to the Federal Reserve System (FRS). All national (federally chartered) banks belong to the FRS. State-chartered banks which are not members of the FRS have the option of being insured by the FDIC. Membership for mutual savings banks is also optional. Eligible accounts are insured by the FDIC for up to $100,000.

The FDIC has established procedures to deal with problem and failing institutions. A law enacted on October 15, 1982, P.L. 97-320, broadened the circumstances under which the FDIC can provide financial assistance to troubled institutions. P.L. 97-320 expanded the FDIC's authority to arrange mergers. The law sets priorities for mergers and includes mergers between different types of depository financial institutions and mergers that involve crossing State lines. The provisions of P.L. 97-320 dealing with failed banks expired in October 1985. The provisions were extended several times on a temporary basis. The last extension expired on Oct. 13, 1986. The 100th Congress is expected to consider legislation which would expand the FDIC's authority to deal with failed and failing banks.

The FDIC has two alternative solutions to merging a failed institution, a purchase and assumption or a direct payoff. In a purchase and assumption transaction the institution is closed and its liabilities are assumed by another institution with or without FDIC assistance.

In the case of a direct payoff, the FDIC is named receiver and pays off the insured depositors. The FDIC liquidates the assets of the failed bank and from the proceeds pays the uninsured depositors on a pro rata basis. The FDIC introduced a variation of the payoff procedure in 1983 called the deposit transfer method. The FDIC makes insured deposits in a failed bank available to their owners by transferring their accounts to another insured bank. This approach minimizes disruption to both the account holders and the affected communities. This method also reduces the FDIC's cost.

In 1984, the FDIC tested a new feature of the deposit transfer approach, the modified payout plan. Under this plan, the uninsured depositors immediately receive pro rata shares of what the FDIC thinks it can recover from the liquidation of the failed bank's assets. Then if the actual collections on the assets of the failed bank exceed the advance payments and administrative expenses, the uninsured creditors receive additional payments. If the opposite happens, the FDIC insurance fund absorbs the shortfall. The test was used in eight failures and then suspended.

Table 2 shows the types of actions taken by the FDIC in handling failures during 1980-1986.

Policy Considerations

The recent trend in bank failures has raised policy questions for the financial services industry. The FDIC is reviewing its current supervisory and insurance procedures. The industry is developing measures to prevent bank failures as well as considering new options for failed banks. This section of the issue brief outlines some of the major policy issues raised as a result of the increase in bank failures.

In December, 1986, the FDIC issued a revised policy statement concerning assistance to insured banks in danger of failing. Under Section 13 (c)(1) of the Federal Deposit Insurance Act, the FDIC has the authority to grant aid to a bank in danger of failing, under certain conditions. The most important guideline for open-bank assistance is that the FDIC's cost in providing assistance is less than if it took alternative action. The FDIC revised its policy in response to increased requests for assistance and because of the number, size and complexity of recent bank failures. The statement provides information on the conditions and terms the FDIC believes appropriate if it is to provide open-bank assistance to FDIC insured banks or thrifts to prevent closing the institution. The FDIC granted open-bank aid to seven institutions in 1986.

One subject under consideration is the capital levels for insured institutions. In March 1985, the FDIC adopted a regulation concerning capital maintenance. The regulation establishes a minimum total capital to total assets of 6 percent. In addition, standards were established to determine when an insured bank is operating in an unsafe and unsound condition by reason of the amount of its capital. Additional proposals would base an individual bank's capital level in part on the riskiness of that bank's portfolio.

Currently each FDIC member bank pays an annual insurance premium of 1/12 of 1 percent of total deposits. This system is under review. Proposals to alter the pricing arrangements include raising the premium across the board, having a variable rate premium based on an institution's risk-taking activities, or some combination. The issue of non-government deposit insurance as an alternative or supplement to coverage by the FDIC has been raised. Private insurance could ease the FDIC's burden and offer additional coverage. Private sector involvement might result in tougher standards for insured banks. On the other hand, private insurance may not be practical and it could have a destabilizing effect on the banking industry.

Questions have been raised concerning the handling of small versus large institutions that are in trouble. The FDIC has been criticized for giving preferential treatment to the larger banks. Naturally, the larger the institution, the greater the potential costs to the FDIC if the institution is liquidated or merged with assistance. In addition, the spillover economic effects of closing a very large bank are greater. Any bank failure can cause fears about the solvency of other local banks. A large bank failure could result in panic withdrawals on a national level. Banks assist in allocating credit in their community and closing a large institution could significantly disrupt this flow of capital. Large banks have a greater proportion of their liabilities in uninsured deposits. The potential loss of uninsured funds could negatively impact the individual and business account holders.

Financially troubled banks that threaten the health of their parent holding company have raised new policy considerations. A holding company rescue increases the potential costs to the FDIC. In addition, the rescue may cut the losses of creditors or shareholders at Federal expense. Allowing the holding company to go under could have severe economic consequences.

TABLE 2. FDIC Treatment of Insured Bank Failures, 1980-1986

Year	1980	1981	1982	1983	1984	1985	1986
Purchase and assumption	7	5	27	37	62	87	98
Assisted mergers	0	3	8	2	1	4	0
Direct payoff	3	2	7	7	4	22	21
Deposit transfer	N/A	N/A	N/A	2	12*	7	19
Total number of failed banks	10	10	42	48	79	120	138

*In 8 of the 12, the modified payout plan was used.
Source: Federal Deposit Insurance Corporation.

CONGRESSIONAL HEARINGS, REPORTS, AND DOCUMENTS

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