THE CHANGING BUSINESS OF BANKING: A STUDY OF FAILED BANKS FROM 1987 TO 1992

The Congress of the United States
Congressional Budget Office

NOTES

Numbers in the text and tables may not add to totals because of rounding.

Cover photo shows a run on a bank in New York City in 1987 (The Bettmann Archive).

Preface

Since the Banking Act of 1933 established the Federal Deposit Insurance Corporation, the FDIC has resolved about 2,000 banks. More than 1,000 of these resolutions occurred in the six years between 1987 and 1992. The dramatic increase in the number and costs of resolutions in this period, coming on the heels of the savings and loan crisis, raises questions about the long-term condition of the banking industry and the Bank Insurance Fund.

This study, which was prepared in response to a request from the Senate Committee on Banking, Housing, and Urban Affairs, examines major factors contributing to bank failures during this six-year period and why these failures resulted in such extraordinary resolution costs. It examines bank-specific factors such as asset quality and portfolio composition, as well as more general structural and economic conditions affecting the industry. In keeping with the mandate of the Congressional Budget Office (CBO) to provide objective analysis, this study makes no recommendations.

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Sherwood D. Kohn edited the manuscript, and Christian Spoor provided editorial assistance. Gwen Coleman and Angela Z. McCollough produced the numerous drafts. With the assistance of Regina Washington and Martina Wojak-Piotrow, Kathryn Quattrone prepared the study for publication.

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Summary

The history of banking in the United States is like a volatile stock market, characterized by wide fluctuations in profitability and decline. In the 35 years between 1885 and 1920, the number of U.S. banks tripled from 10,000 to 30,000. It took only five years--from 1929 through 1933--for the number of banks in the industry to shrink by one-half. This period of rapid decline was associated with deteriorating industries, depressed regions, and to some extent with runs on banks. Concern about the soundness of the industry was a catalyst for the Banking Acts of 1933 and 1934. These acts restricted competition and established the deposit insurance system.

The 1980s was also a turbulent decade for the U.S. banking industry. It ushered in intense domestic and international competition in financial markets. A peculiar confluence of economic forces, technical innovation, and deregulation contributed to an unprecedented number of bank failures and subsequent resolutions during the late 1980s and early 1990s. During the six years from 1987 through 1992, more than 1,000 bank resolutions (commercial and savings banks) cost the Bank Insurance Fund (BIF) about $30 billion, exhausting an $18 billion reserve in the deposit insurance system. The sheer number of bank failures and the extensive losses to the deposit insurance fund during the 1987-1992 period dwarfed the experience of the previous five decades. In conjunction with a crisis in the thrift industry, the bank failures and losses caused by the banks' resolutions brought about the first real challenge to the deposit insurance system.

The banking crisis may indeed be over. But what were the underlying causes of the failures, and why were the costs of resolving these banks so much higher than those in previous periods? Some of the factors associated with bank failures occurring over this six-year period could reemerge and once again expose some banks to increased risk of loss. Evidence from this turbulent period may be valuable in assessing the condition of the industry as it undergoes continued structural change and consolidation.

Why Did Banks Fail?

Banks failed for many reasons. Local market and macroeconomic influences, the regulatory environment, and management performance all contributed to the tendency of banks to fail and to the size of associated losses. Surveys reveal that fraud and abuse also contributed to failure, but those factors were primary causes in only 25 percent of the cases. Most banks failed because a significant portion of their asset portfolios defaulted; in other words, these banks made what turned out to be bad loans.

Many of the problems with loans that became apparent after the mid-1980s probably originated in the late 1970s and early 1980s. Two dramatic surges in inflation during the 1970s changed the business of banking. Both inflationary periods led to sharp rises in commodity prices, mercurial stock and bond prices, and particularly volatile interest rates. Initially, market interest rates climbed while regulated interest rates on deposits remained capped at 5.25 percent. Although ceilings on deposit interest rates had been in place for decades, banks had still been able to attract depositors. But once market interest rates exceeded the caps, depositors began to look elsewhere. By the early 1980s, disintermediation--the diversion of savings from accounts having low interest rates to direct investment in high-yielding instruments--had become a problem.

The double-digit interest rates available on money market mutual funds, Treasury securities, and other nondepository financial instruments made them popular alternatives to banks and thrifts. Banks could not legally compete with the products or rates offered by other financial institutions. After an outcry from banks and thrifts, regulated interest rate ceilings were phased out over a six-year period, starting in 1980 with the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). Banks were also permitted to offer a broader array of financial products. After DIDMCA, banks were better able to compete with other financial intermediaries for depository funds, but much of the damage was already done. At the beginning of the 1980s banks were in a weakened state.

Advances in computers, telecommunications, and other forms of technology greatly improved the dissemination and flow of financial information. Competition by other banks, thrifts, money market funds, and other nonbank financial institutions intensified. Bank earnings and rates of return from traditional activities suffered throughout the 1980s. By the end of the 1980s, new financial instruments proliferated. Banks became more dependent on off-balance sheet activities such as interest rate swaps, loan commitments, and future markets for exchange rates for income. Shares of assets of nonbank financial institutions grew dramatically. Meanwhile, the share of financial assets held by banks decreased steadily throughout the 1980s.

Competition took many forms, but banks--especially big banks with assets greater than $10 billion --lost ground in major markets, including that for large industrial borrowers with excellent credit ratings. These "blue-chip borrowers," formerly the mainstays of bank lending, defected for more favorable lending rates in commercial paper markets. Banks had to adjust their asset portfolios. They could no longer look to less risky commercial and industrial loans to bolster their earnings; the development of the commercial paper market had made these loans more difficult to obtain. As a result, commercial and industrial loans declined as a percentage of bank portfolios.

Faced with fewer investment alternatives, some banks sought refuge in higher-risk assets, including loans to developing countries and energy investments in the 1970s and 1980s. When oil prices fell and defaults on loans to developing countries increased in the 1980s, banks that had not properly diversified lost large portions of their asset portfolios. In some cases, banks turned to highly leveraged transactions and junk bonds in an effort to bolster sagging earnings. The subsequent softening of these markets resulted in substantial losses in bank earnings and equity. Rates of return for many banks dropped far below past averages. Bad loans began to surface, and provisions for bad loans began to overwhelm the income on good loans. Returns on equity in some of the largest banks were less than returns on government bonds.

Analysis of industry data reveals a strong pattern of higher-than-average bank failure associated with regions experiencing temporary economic difficulties. Banks tied to regional markets suffered from economic declines in energy, real estate, and agriculture. For example, bank failures in the Southwestern states can be attributed in part to regional collapses in oil and real estate prices. Texas banks were hit particularly hard by sectoral declines in the local oil and gas market and subsequent slumps in local real estate markets. Real-estate-related difficulties spread to the Northeast, the Southeast, and finally the West Coast. Bank failures in the West and Midwest regions can be linked to a downturn in the agriculture sector during the mid-1980s.

Although many of the problems that beset banks were externally induced, the primary responsibility for bank failures rests squarely on the shoulders of bank managers and boards of directors. This responsibility does not negate ineffective regulation or unforeseen economic developments as causes of failure, but the bank manager is the agent who reacts to economic conditions and the regulatory environment. Some managers made mistakes because they reacted incorrectly to a barrage of unusual factors. In some cases, managers simply failed to diversify asset portfolios and boards of directors did not insist on reasonable loan practices. Managers of failed banks often pursued aggressive loan policies without reasonable precautions against default. As a result, many bank managers who failed to deal effectively with increased competition and adverse economic shocks presided over the demise of their institutions.

A comparison of the financial characteristics of banks that failed and banks that survived is revealing. It shows that some of the traits that distinguish resolved and surviving banks began appearing in the institutions' balance sheets years before they failed. Industry data show that surviving banks were more likely to have higher equity-to-asset ratios (measured by book value) and lower loan-to-assets ratios than resolved banks had even three years before their resolution. Even with the limited data available, it is possible to infer that those banks that survived this period did so by holding more liquid assets, managing modest growth in diversified assets, maintaining a suitable buffer of capital, and complying with regulatory requirements. Banks that failed and were resolved experienced dramatic losses in book-value equity-to-asset ratios within one year of resolution--a relatively short period of time. Whatever caused the book-value equity ratios to fall so rapidly, the event has implications for regulatory efficiency in recognizing losses on assets and carrying out timely closure.

All resolutions were marked by one important regulatory decision--banks that were resolved could not raise capital. Regulators did not resolve a bank if it proved that it was capable of raising capital. Capital is simply defined as the difference between assets and liabilities--the equity held at book value. The act of raising additional capital is an act of validation--a market affirmation of the continued existence of a bank. Weakly capitalized banks may raise capital either by increasing income for retained earnings or by otherwise raising capital in the equity market. Surviving banks generated positive income and raised capital when it was required; failed banks were unable to do so.

Why Did Resolutions Cost So Much?

During the 1980s, regulators faced not only an increase in the number of bank failures requiring resolution, but also an increase in the average cost of resolving a bank. The cost to the BIF of resolving a bank depends on the value of liabilities covered by deposit insurance and the value of assets that can be recovered during the resolution process. Covered liabilities mostly include insured deposits. A major factor determining the cost of resolution is the loss on assets--that is, the difference between the book value of assets at the time of resolution and the net value that can be recovered if the assets are sold. As the recoverable value of assets decreases, the cost of resolving an institution increases. If banks are resolved when they first become insolvent on the basis of market value--that is, when liabilities are just greater than the market value of assets--losses to the fund can be held roughly to the administrative costs required to process the resolution through the FDIC system.

The average loss on assets for resolved banks in the late 1980s was about 30 percent. In the 1980s, most banks were closed when they became book-value insolvent--that is, when the book value of their equity dropped to zero. When asset values are declining, banks will generally be insolvent on a market-value basis before they display book-value insolvency. Because there was such a drain on the insurance fund, recognition of bank insolvency and a timely exit policy for insolvent institutions became a critical part of regulatory effectiveness.

The fact that losses were, on average, higher in the 1980s than they were in the previous period may indicate diminished regulatory effectiveness. Two factors could have contributed to diminished effectiveness. First, examiners may not have been able to identify potential failures early enough to permit regulators to avoid additional losses. Although bank examiners can usually determine which banks are financially distressed, judging when a bank first becomes insolvent is very difficult.

Also, during this interval an extraordinary number of banks failed over a short period of time. Second, examiners may have identified severely undercapitalized banks, but either practiced a policy of forbearance or were unable to elicit compliance through supervision.

The process of classifying a bank as economically incapable of surviving before it reaches book value insolvency is fraught with uncertainty. Regulators can make two kinds of errors in classifying a bank as insolvent. First, they may classify a bank that is really functional as insolvent. In the second case, regulators may classify a bank that is really insolvent as functional.

In the history of the insurance fund, the two errors have not been equally important. Since 1934, regulators have rarely resolved a bank that was solvent by book-value measures. During the 1980s, regulators usually preferred to err on the side of leaving a financially distressed bank operating rather than close a functional bank. The costs associated with behaving as though a bank is functional when it is not can appear eventually as embedded costs that show up as relatively high resolution costs per dollar of assets. Regulators also faced legal and economic pressures to avoid closing a bank before it became book-value insolvent. To close such institutions meant that the regulators would have had to endure immediate vocal disapproval from those directly affected--owners of banks, boards of directors, local communities, and their representatives. Beneficiaries of timely closures were conspicuously silent and typically unaware of the costs of regulatory delay.

Along with the problem that regulators may have been uncertain about when an institution became insolvent, regulators may have been simply overwhelmed by the events of the 1980s. In the context of new financial instruments and the greater latitude afforded banks by deregulation in the early 1980s, regulators may have been unable to keep up with the technological changes caused by deregulation and increased competition in the industry. On-site examinations, conducted to assess the financial health of an institution, were less frequent (as a result in part of budget cutbacks) at a time when financial markets were changing faster than at virtually any other point in the nation's history. Without relatively current assessments from examiners, regulators had to rely solely on quarterly call reports based on book-value data. Book-value data based on past transactions can overstate the current market value of a financially weak institution. When events in the market affect the value of an institution, book-value accounting does not reflect a change in value. Without data based on examination and the true value of assets, regulators could not easily recognize asset losses and bank insolvency.

A policy of forbearance gives economically functional banks--those that may be undergoing short-term difficulties--a window of time in which to adjust to market conditions without enforcing otherwise applicable bank regulations. Although not every undercapitalized bank is a likely candidate for resolution, all are unquestionably candidates for increased regulatory oversight and supervision. Regulators have the authority to force banks to raise equity, suspend dividends, reduce assets, issue new stock, force divestiture of affiliates, remove directors or managers, demand increased allowances for loan losses, or charge off uncollectible loans. Enforcing such actions on these undercapitalized banks may have resulted in even more failures. In some cases, regulators decided to forgo enforcement of supervisory actions--in particular, enforcing capital requirements--presumably because they felt that these banks would be more likely to survive rather than fail.

Post-FDICIA: An Outlook of Guarded Optimism for the Banking Industry

The Congress intended the deposit insurance system to be self-sustaining. Revenues collected from premium assessments paid by insured banks are used to cover the costs of resolving insolvent banks. For almost 50 years, the fund's revenues exceeded its costs. But the expense of resolving banks in the late 1980s drained the Bank Insurance Fund. By 1991, there was increasing concern about the numbers and losses of bank resolutions.

The financial condition of the banking industry and the ability of the federal deposit insurance fund to cover losses from the alarming number of resolutions in the 1980s were major motivating factors for passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Along with recapitalizing the BIF (the FDIC is to recapitalize the insurance fund by 2005), a major theme of this legislation is to foster "safety and soundness" in the banking industry.

Because only little more than two years have elapsed since its passage, it is difficult to evaluate fully the effects of FDICIA. Nevertheless, the reforms put in place by this act appear to have addressed directly some of the major problems identified during the 1980s--a period that put considerable stress on the regulatory and deposit insurance systems. The FDICIA authorized the Federal Deposit Insurance Corporation to take prompt corrective action (or intervene earlier) to limit insurance losses. That is, bank regulators must employ regulatory constraints depending on whether a bank meets minimum prescribed capital levels. The act requires prompt closure of severely undercapitalized banks. In FDICIA, the Congress also charged the FDIC with the responsibility of putting into place a risk-based capital system and developing a risk-based premium system. Properly designed risk-based premiums will provide increased insurance funds to cover heightened risk in bank portfolios. A system of risk-based capital requirements, along with the mandated yearly on-site examinations, may provide a better buffer (to absorb losses on assets) between assets that default in a risky bank portfolio and bank insolvency that requires resolution.

After several years of poor performance, the banking industry earned record profits in 1992 and 1993. The average return on assets for commercial banks was 1.21 percent in 1993, a year in which the return on assets in each quarter surpassed averages previously reported by the industry. At the same time, the average annual return on equity for the industry exceeded 15 percent. Several factors contribute to the improved health of the banking industry even as the industry undergoes continued structural change and consolidation. In particular, favorable interest rate conditions and a growing economy have enabled banks to prosper. Banks have been able to take advantage of the fact that they can pay less for their liabilities and receive greater returns on assets. Moreover, the growing economy has helped to reduce the amount of troubled assets--noncurrent loans declined in all regions of the country and across all major loan categories--which means that banks do not have to set aside as much money to cover potential bad loans.

The outlook for the Bank Insurance Fund has improved as the banking industry continues to earn record profits. After incurring positive outlays from 1988 to 1992, the fund is now in the black. The fund's balance (net worth) rebounded to $6.8 billion in the second quarter of 1993, from a negative $100 million at the end of 1992 and a negative $7 billion at the end of 1991. In its January 1994 baseline, the Congressional Budget Office projected that the BIF will take in $8 billion more than it spends in fiscal year 1994 and continue in the black with a smaller excess in the next several years.

At the close of 1993, only 41 banks had been resolved through the BIF, the fewest resolutions in any year since 1982, when there were 42. The assets of banks resolved by the FDIC have been falling from a record $63.4 billion in 1991 to $44.2 billion in 1992 and only $3.6 billion in 1993. As a rule, larger banks are more costly to resolve. The average size of a resolved bank in 1993 was $87 million, down from $363 million in 1992.

The record profits in the two years following FDICIA tend to obscure the fact that the banking industry has been losing ground to other types of financial services. To some degree, however, banks are earning profits by taking advantage of low interest rates, which exposes them to increased interest-rate risk. Although favorable conditions for interest rates have allowed banks to increase profits and replenish their capital, their increased exposure to interest rate risk warrants a posture of guarded optimism. When economic conditions change so that the returns based on interest rate spreads narrow, it could expose some banks to increased risk of failure. Given the possibility that the industry may be susceptible to such periodic crises because of changing economic conditions, policymakers are examining the need for further structural reform in the banking industry. In particular, there is continuing interest in legislative reform that would enable banks to diversify, either geographically or through various product offerings. An interstate branching bill currently under consideration by the Congress would permit banks to diversify their loan portfolios across state lines.