

# HOW SAFE IS YOUR BANK?

By  
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and the Editorial Staff



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**Uniform Bank Performance Report  
 Price List and Order Form  
 are included at the back of this booklet.**

## INTRODUCTION

**T**HE financial crisis in the banking system is far from over. The number of insolvent banks and savings and loans remains historically high and many profitable institutions are in precarious shape. An unprecedented amount of deposits is at risk. Treasury Secretary Nicholas F. Brady has described the situation as “one of the biggest financial problems in the history of the country.”

The Government’s “solution” to the crisis in many ways has *exacerbated* it. The Federal bailout of the thrift industry effectively authorized the Government to nationalize a large part of the industry while, at the same time, its myriad provisions have hampered regulators’ efforts to sell off the assets of insolvent thrifts. Regulators may be managing these assets for much longer than expected, and it is far from clear that they will do a better job than private managers did. To the extent they are able to sell the assets to private investors, the financing arrangements and other terms of sale may reflect a “sell now, ask questions later” approach that could come back to haunt the Government (*i.e.*, the taxpayers). In the banking industry, the record cost of closing insolvent institutions nearly bankrupted the Federal deposit insurance fund in 1991. Congress recapitalized the fund by authorizing it to borrow \$70 billion from the Treasury, but even this may be insufficient.

How extensive will the failures be among the Nation’s banks and thrifts? And how costly? Will the problem be limited to parts of the country or will it be nationwide? Why did it happen and what changes are needed in our money and banking system to avoid similar debacles in the future? Last, but certainly not least, how safe is *your* bank and how can you judge this for yourself?

To this point, few depositors have suffered large losses as a result of bank, thrift, or credit union failures. So far, the Government has continued to back the Federal deposit insurance system with the “full faith and credit of the United States.” Failures are not without consequences, however. When a bank fails, accounts may be frozen, “guaranteed interest” earnings lost, loans called, lines of credit canceled, and the value of bank bonds and equity shares reduced or lost completely. Thus it is in your interest as a depositor, borrower, shareholder, bondholder, or holder of certificate of deposit to avoid doing business with a financially troubled bank. Taxpayers, of course, face the largest financial risk of all (the savings and loan debacle already ranks as the most costly financial scandal in history, and taxpayers will pay most of the bill).

For concerned individuals, detailed information on the financial condi-

tion of a particular bank, thrift, or credit union is not easy to find. Officials have been reluctant to disclose detailed information on which institutions are in trouble, fearing that if depositors knew such details they would respond with massive withdrawals that could lead to a collapse of the banking system. Newspaper and media reports typically appear "after the fact," too late to help the individual concerned with protecting his savings or investment. Rarely does one hear of the shaky financial condition of a local bank until the day after it has failed or been merged with another.

Pertinent information *is* available, however. Indeed, our assessment of the recent performance of the banking and thrift industries (and the financial status of the Federal deposit insurance agencies) in the opening chapters of this booklet is based largely on such information. You can use similar information to evaluate the soundness of your own savings institution. The pages that follow provide a guide to sources of such information and the procedures that bank analysts and examiners use, which you can apply to your own situation.

Chapters I-IV give our analysis of the overall banking/thrift "crisis." In our view, a general "banking collapse" remains unlikely (see Chapter I). Despite the large number of insolvent and near-insolvent thrifts, there are many more solvent ones, and in fact the weakness is concentrated in certain regions of the country (see Chapter IV).

Despite the financial problems of the Federal agencies that insure bank and thrift deposits, the Government is unlikely to renege on its promise to keep insured deposits whole. The stakes are simply too high — breaking the promise would risk the loss of public confidence in the banking system. Making good on the Government's guarantees will come at great expense to taxpayers, however. A large part of the cost of Government assistance is being, and will continue to be, disguised through the use of "creative accounting" on Government balance sheets (see Chapter II).

In addition to the risks to customers and taxpayers, there are more general hazards associated with large-scale "bailouts" of banks and thrifts. Regardless of what method Government officials devise to finance their rescue plans, over the long run all of us will have to pay the price of the banking crisis through price inflation (induced by the creation of excessive bank credit) and the higher costs of financial services (among other things, as a result of higher insurance assessments and regulatory restrictions that promote inefficiencies). In all likelihood, these costs will be greater the longer that regulatory authorities and politicians continue to promote schemes that, in effect, punish sound banks and reward mismanaged ones (see Chapters II and III).

Be that as it may, there are steps that you can take to determine if your

own bank, thrift, or credit union is financially sound. In Chapters V and VI, we describe the “yardsticks” that are used by bank analysts to measure the financial condition of banks, the procedures that Federal bank examiners use in rating them according to a variety of criteria, and where you can get information that will enable you to be your own “bank examiner.”

As we mention elsewhere in this booklet, there *are* specialized bank reporting services that, for a wide range of fees, will provide analyses of the financial status of a particular financial institution. Some of these are very costly. This booklet focuses on low-cost alternative ways of assessing the strength of a bank or other Federally insured institution. The fact is that the overwhelming majority of deposits are held in financially sound institutions. In the vast majority of instances, ascertaining whether your bank or thrift is in sound condition is a fairly simple matter that can be accomplished without resort to any bank reporting service — once you know what to look for and where to look for it.

The concluding chapter and the two appendixes suggest that, in its broadest sense, the answer to the question “How Safe Is Your Bank?” depends on the soundness of our money and credit system. In our view, no bank — however well-managed — can provide security on funds deposited (*i.e.*, that a dollar deposited now will have equivalent value when withdrawn sometime in the future) so long as “money” can be created “out of thin air” and credit manipulated according to the whims of monetary authorities and bank officials. Until sound money and credit conditions are restored (via a return to convertible currency and adherence to the principles of sound commercial banking described in Appendix B), funds deposited in banking institutions will continue to be funds at risk.

## I.

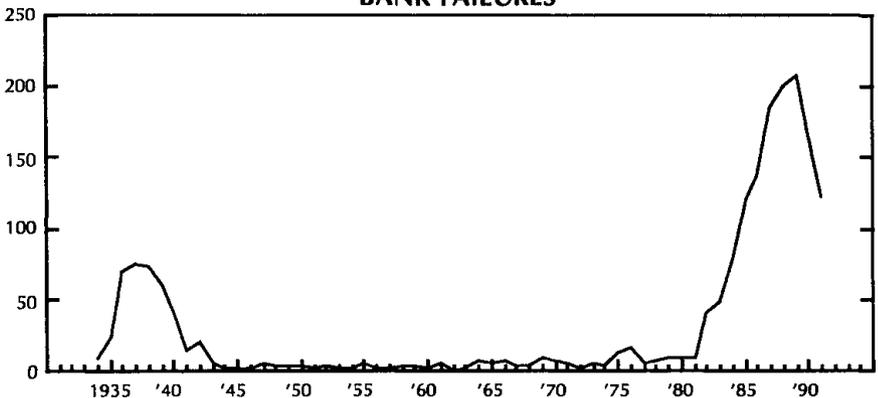
### AN IMPENDING BANKING COLLAPSE?

**N**EWs of bank and thrift failures has become routine. Nowadays it is the dollar size of the failure, not the failure itself, that attracts attention. This is in sharp contrast to just a few years ago, when a failure of any size was considered by many to be a newsworthy event. Until the 1980's banks and thrifts failed so seldom that, when they did, the circumstances that led to the closing were of great interest.

Between 1941 and 1981, on average only about seven banks failed per year. Now that many fail every *month*, and many more are in danger of failing. In 1991 alone, 123 banks insured by the Federal Deposit Insurance Corporation (FDIC) were closed due to financial difficulties. One hundred and sixty-eight banks failed in 1990, 206 in 1989, 200 in 1988, and 184 in 1987. In all, 1,300 Federally insured banks have failed in the past 10 years. By comparison, only 348 banks failed in the 47 years from 1934 to 1981. In addition, there are hundreds of FDIC "problem banks" — banks judged by Government examiners to be in questionable financial shape. In 1991, there were 1,066 "problem banks," a fourfold increase compared to 1980. (See Charts 1 and 2.)

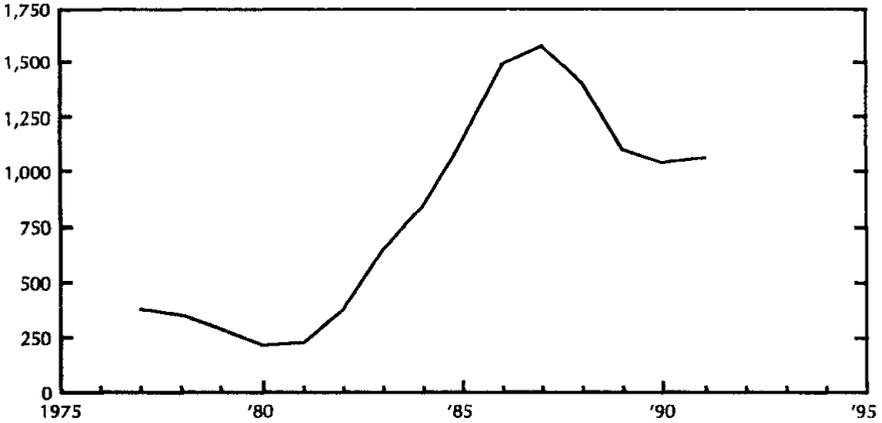
The Nation's thrifts are in even worse shape, as everyone familiar with the \$500,000,000,000 taxpayer bailout of the industry is aware. Since August 1989, when the bailout bill was enacted, over 500 thrifts have been placed in "conservatorship" (*i.e.*, taken over) by the Federal Government. More are scheduled to be taken over in 1992, and still more could fail if their financial condition deteriorates more than Government analysts ex-

Chart 1  
BANK FAILURES



Source: U.S. Federal Deposit Insurance Corporation.

Chart 2  
FDIC "PROBLEM" BANKS



Source: U.S. Federal Deposit Insurance Corporation.

pect. (They have consistently underestimated the magnitude and depth of the industry's problems.) As many as 1,000 savings and loans — one-third of the industry — might eventually be declared insolvent and seized by Government regulators.

The credit union industry has not been immune to financial problems either, as indicated by the sudden shutdown of three dozen Rhode Island credit unions in 1991 when their private insurer failed. The credit union industry is much smaller than the bank and thrift industries, and a rash of credit union failures on the scale seen in those industries seems unlikely. Nonetheless, the rapid growth of many individual credit unions in the 1980's raises doubts about how well the most aggressive institutions would fare in a prolonged economic downturn. Since 1980 nearly 900 credit unions have been "involuntarily liquidated," and there are over 1,000 on the "problem" list maintained by Federal regulators.

### *A Long History of Weakness*

The jump in the number of failures of all types of savings institutions in the United States in the 1980's tells only one part of the story of their weakening financial condition. The low failure of banks and thrifts in earlier decades of the postwar period masked a persistent, cumulative deterioration in the financial standing of many institutions. In fact, throughout the 79-year history of central banking in this country (1913-present), banking performance has measurably worsened. During this period, the ratio of banks' capital to assets fell almost continuously from 17 percent to 5 percent. Liquidity ratios fell from almost 23 percent to 10 percent. Asset quality deteriorated as loan portfolios became increasingly stocked

with nonperforming loans extended to ever-poorer credit risks. From a historical perspective, the recent failures and insolvencies are only more visible symptoms of institutional problems that began not in the 1980's but many years ago.

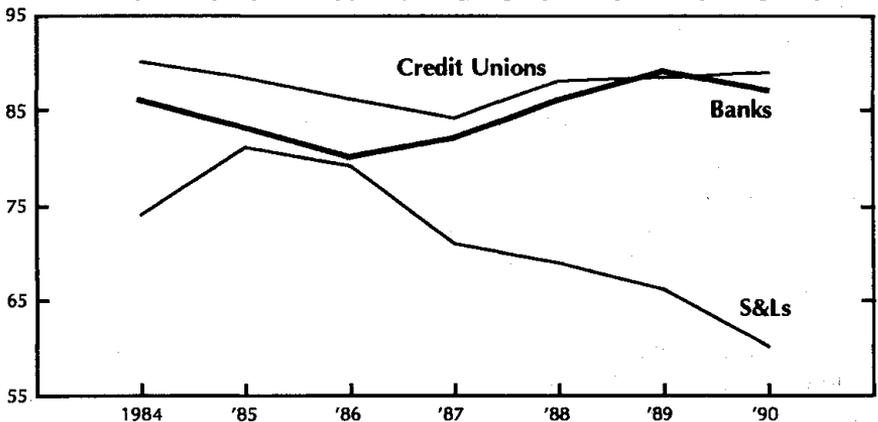
### ***Regional Weaknesses***

No doubt these numbers may alarm many readers. However, it is important to note that while many institutions are in financial straits, many more are not. In 1990, 87 percent of the Nation's 12,000 banks, 60 percent of its 2,900 thrifts, and 89 percent of its 8,800 Federally chartered credit unions operated with a profit (see Chart 3). Most institutions are in little danger of failing.

Most of the financial industries' problems are concentrated in limited geographic regions. As Figure 1 shows, the majority of bank failures in the period 1987-90 occurred in the Southwest region. Texas experienced the largest number of failures by far, 399. Yet even though failures were heavily concentrated in a few states, 38 states registered at least one failure. Precise state-by-state data on savings and loan failures are not available, but their distribution is similar to that for failed banks, with the largest number occurring in the Southwest.

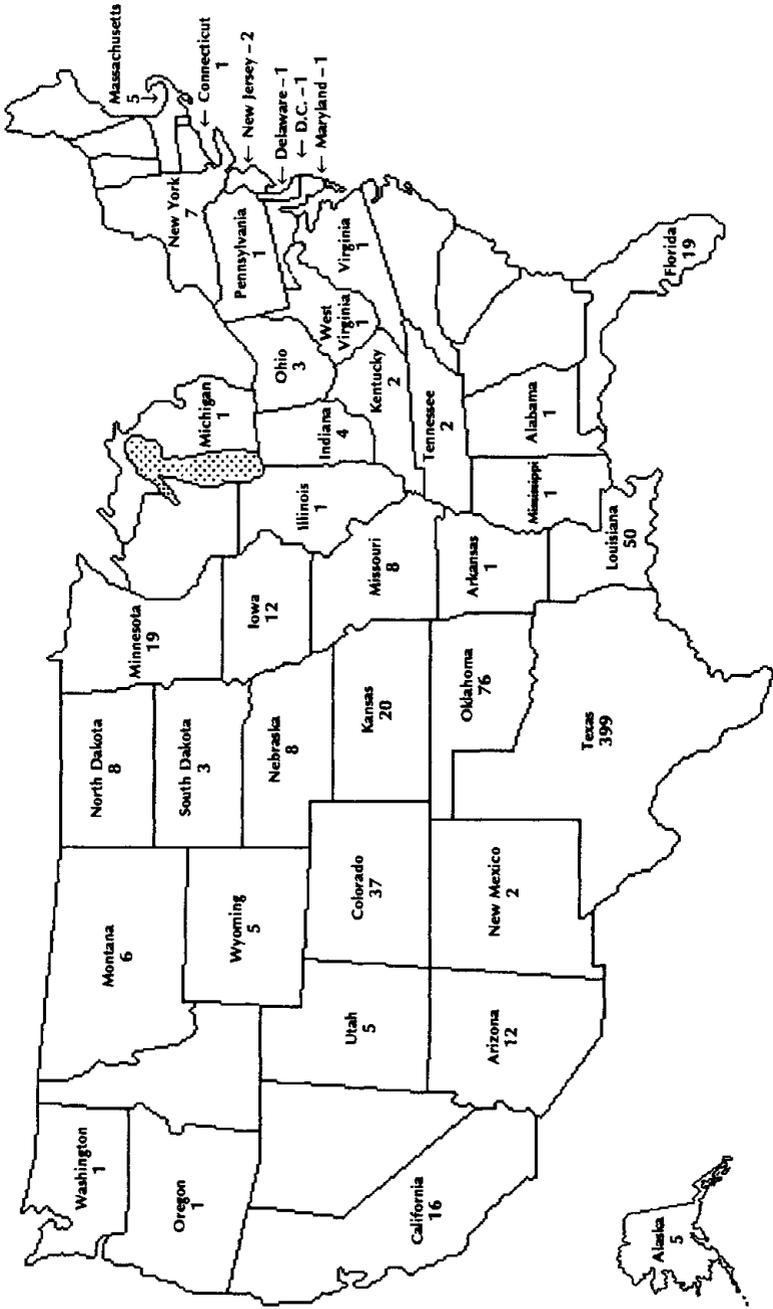
Overall, the numbers on failure rates and financial performance indicate that an imminent collapse of the entire banking or thrift industries is improbable. However, they also suggest that, in breadth and depth, the situation has deteriorated greatly in the past few years and continues to do so. Moreover, industry analysts and the Government have consistently

Chart 3  
**PERCENT OF SAVINGS INSTITUTIONS REPORTING PROFITS**



Source: *Sheshunoff Bank Quarterly*.

Figure 1: NUMBER OF FAILED BANKS BY STATE, 1987-90



Source: U.S. Federal Deposit Insurance Corporation.

underestimated the magnitude of the problem. Few predicted the thrift debacle would be as serious and costly as it has become; fewer expected banks in the Northeast to be as weak as they now are.

The lesson for depositors and other customers is clear: you should be concerned about the financial condition of your savings institution, regardless of geographic location. That an institution is in the "right place" is no guarantee of its solvency and safety — as customers of the Bank of New England discovered in 1991. Although Massachusetts has registered only a handful of failures of insured banks during the past decade, compared to hundreds in Texas, the Bank of New England was one of them, and it ranks as the third largest bank failure in U.S. history.

### *One Failure Begets Many Others*

The recent history of financial institutions' failures shows that banks and thrifts of widely differing characteristics have suffered crippling reverses. Both small "backwater" banks and thrifts and major money center institutions have failed. When it comes to banking, the public perception is an all-important factor. While (as yet) there has been no nationwide banking panic, public concern evidently is growing that the "risk pools" of large financial institutions that regularly swap assets and liabilities and make casual contingency commitments involving hundreds of millions or even billions of dollars have become unmanageable. Today, when one institution fails, it very likely is apt to lead to problems for one or more corresponding institutions.

For example, hours after taking office at the beginning of 1991, Rhode Island Governor Bruce Sundlun declared a bank holiday and closed 45 state-chartered credit unions and small banks. His action was triggered by the failure of a private deposit insurer. Five days later most of the institutions, which collectively accounted for \$1.9 billion (10 percent) of all assets held by savings institutions in the state, reopened with Federal deposit insurance protection. Eleven credit unions were denied coverage, however, and some of their depositors will be paid in noninterest-bearing "scrip" issued by the state, to be redeemed for cash over a period of 5 years.

As another example, in 1982 the Penn Square Bank in Oklahoma City failed and it was reported that Continental Illinois National Bank had purchased hundreds of millions of dollars of energy loans from it. Continental reported further problem loans in 1983 and early in 1984. The bank's first quarter 1984 financial statements revealed that a profit was earned only because the bank sold its credit card business. In May 1984, a massive run by depositors began and they quickly withdrew several billion dollars, thereby triggering the famous (or infamous) Continental rescue engineered by the FDIC. As a result of this rescue, the FDIC

expects to lose over \$1.3 billion due to uncollectible loan purchases. However, all depositors were paid in full.

In another celebrated instance, on March 4, 1985, ESM Government Securities was closed by the SEC with \$300 million in losses. One of the major unsecured creditors, Home State Savings of Ohio, lost \$150 million. Although the depositors of Home State were insured by a private insurance fund, the Ohio Deposit Guarantee Fund, Home State's losses exceeded the \$130 million in the insurance pool. Because the state and Federal governments did not back the insurance, a run on deposits occurred. From March 6 through March 8, estimated deposit outflows from Home State Savings were \$150 million. On March 8, Home State announced that it would not be open the following day, freezing deposits of over \$600 million.

The Home State episode quickly precipitated additional runs on many other savings institutions insured by the Ohio Deposit Guarantee Fund. On March 15, the governor of Ohio declared a bank holiday for the Ohio savings and loans with private insurance, freezing \$3.6 billion in deposits. Over the following 3 months, institutions were gradually reopened, either through mergers or with full or conditional approval for Federal deposit insurance. During that period, depositors suffered — and allowing savings institutions to operate without Federal insurance provided a costly experience for Ohio taxpayers: the state of Ohio committed more than \$150 million to reopen the institutions insured by the Ohio Deposit Guarantee Fund.

In a different series of episodes in Maryland during the same year, this pattern was repeated. Trouble at Old Court Savings and Loan Association resulted in runs on several savings and loans that were insured by Maryland's private insurance program. When a second institution, Merritt Commercial Savings and Loan Association, was criticized by state regulators, the runs accelerated — necessitating the imposition of a withdrawal limit by Governor Harry Hughes of \$1,000 per month per depositor. This, on top of the Ohio crisis, sped the demise of many private insurance programs. In addition to the Ohio and Maryland programs, North Carolina and Massachusetts quickly moved to switch insurance coverage to the Federal insurance agencies. Rhode Island had to learn the hard way.

### ***What Your Risks Are***

It is in your interest as a depositor, borrower, shareholder, holder of a certificate of deposit, and taxpayer to determine for yourself whether your own bank, thrift, or credit union is financially sound. The potential costs to you can be substantial if the Federal Government takes action to close

(through either liquidation or, more likely, merger) your savings institution.

Generally speaking, depositors bear small risks if their accounts are held in banks, thrifts, or credit unions insured by one of the two Federal deposit insurance agencies (FDIC and NCUA). Assuming that the total value of your holdings at any single institution is less than the \$100,000 insurance limit, your largest risk is of delays in accessing your funds. (Note that this limit applies to *the total of all accounts* held by a single investor in a failed bank. For example, if a customer held \$15,000 in a checking account, \$30,000 in a savings account, and an \$80,000 CD at the same bank, only \$100,000 of the \$125,000 total would be covered by the insurance.) Your account could be “frozen” (*i.e.*, you may not be able to withdraw needed funds) for some weeks or months; withdrawals may be limited; and you may lose interest — or business opportunities may have to be passed by that could have been undertaken if your funds were not encumbered. Perhaps far more important, if you operate a small business and are unable to make payroll or pay bills when due because of a bank closing (or if a bank’s drafts are not honored), you can lose the support of your employees and your credit standing through no fault of your own. So far, we have heard of few such delays. However, there is no guarantee that the current record of making good on insured deposits will prevail in the future. Given the high failure rate of banks and thrifts, the probability that it may take longer to settle accounts in the future cannot be dismissed.

Depositors may have more reason for concern if their accounts are held in institutions insured only by state or private insurance funds. These funds can be quickly depleted by a few failures, and there is no assurance that the Federal deposit insurers will step in to assume their liabilities. And if they do so with delay, the disruptions and costs to consumers described above can still be incurred, as some depositors of failed Rhode Island credit unions learned.

Borrowers, shareholders, bondholders, and holders of certificates of deposit face potential losses at all financial institutions, even Federally insured ones. Borrowers’ unused lines of credit may be canceled if a bank fails, short-term loans may be denied refinancing, loans may be called, and their deposits used to pay down outstanding debts. Shareholders and bondholders stand to lose a substantial part, if not all, of their investment, which is *not* covered by Government insurance. Individuals with high-yielding certificates of deposit may lose some of their “guaranteed” interest: since deposit insurance covers only the principal, high yields can be reduced when an insolvent institution is taken over or merged with another.

The general public bears the largest financial risk of all: to the extent

that Government insurance funds are insufficient to cover the debts of insolvent institutions, the Government must refinance these agencies, and any “rescues” and “bailouts” will be paid for either through explicit taxes or the hidden tax of inflating.

## II.

### HOW RELIABLE IS FEDERAL DEPOSIT INSURANCE?

**M**ORE than 15 years ago, we observed that Federal deposit insurance agencies had successfully “managed” bank failures to then by means of inflationary credit practices so as to prevent a 1930’s-type banking collapse (see box on page 13). We also cautioned: “There is no way of knowing whether or not the existing reserves and borrowing power of the FDIC [the Government agency that insures bank deposits] are sufficient coverage for commercial bank deposit liabilities. The FDIC has not operated during a period of severe depression and has not been seriously tested. There is no sound actuarial basis for determining what demands might be made on the FDIC, and what losses it might sustain, during such a period. Public confidence in the FDIC will be the key to its continued success or failure in the future.”

In hindsight, our concern about the actuarial adequacy of Federal deposit insurance reserves was well-founded. The agency that used to insure savings and loan deposits went bankrupt in 1989, and the agency that insures bank deposits nearly went bankrupt in 1991. However, we underestimated the propensity of policymakers to “solve” problems by throwing more money at them. The politicians did not respond to the financial troubles of the deposit insurance agencies by letting them fail or restricting the insurance they provide. Instead, they simply “recapitalized” the funds by authorizing the agencies to borrow hundreds of billions from the Treasury and the general public.

There appears to be no limit to the financial aid that Congress will approve as long as it can be paid for by issuing debt rather than raising taxes. And since there is no practical limit to the insurance these agencies offer (the more money deposited in banks and thrifts, the greater the insurance) there is no limit to the taxpayers’ potential liability (eventually, all the debt will have to be repaid with taxpayers’ money). As described below, the taxpayers’ share of the cost of Federal deposit insurance is larger now than ever before.

**Savings and Loan Deposit Insurance.** Until 1989 deposits in savings and loans were insured by the Federal Savings and Loan Insurance Corporation (FSLIC). The financial problems of this Government agency began years before they began to receive media attention. FSLIC reserves peaked in 1980 and then decreased sharply, even as the amount of insured deposits grew rapidly.

In 1986 the FSLIC’s “reserves” fell below zero for the first time. In other words, the Government insurance fund intended to cover the deposit

## THE FEDERAL DEPOSIT INSURANCE FUNDS

**The Bank Insurance Fund (BIF).** The BIF insures deposits in the Nation's 12,000 commercial and savings banks, up to a limit of \$100,000 per depositor per bank. (In theory, this limit is meaningless since a wealthy individual could deposit his funds in as many banks as necessary to have insurance coverage on all his liquid assets. Pending legislation may change this.) The fund is managed by the Federal Deposit Insurance Corporation (FDIC), an independent agency of the U.S. Federal Government. Until 1991 the BIF was funded entirely through insurance premiums paid by banks and through interest income earned on the fund's reserves. However, increased bank failures in the 1980's drained the fund and by the end of 1991 it was nearly depleted. Congress then authorized the FDIC to replenish the BIF by borrowing up to \$70 billion from the Treasury. If this amount proves inadequate to maintain the ratio of reserves to insured deposits that is required by law (as many analysts predict), Congress will probably allow the FDIC to borrow more, in order to maintain public confidence in the banking system. To the extent that this borrowing is financed by issuing Treasury debt rather than raising taxes or cutting spending elsewhere, it will add to the national debt.

**The Savings Association Insurance Fund (SAIF).** In 1989, as part of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), the insolvent Federal Savings and Loan Insurance Corporation (FSLIC) was dissolved and replaced by a new fund, the SAIF. The SAIF insures deposits in the Nation's 2,400 savings and loans (thrifts) up to a maximum of \$100,000 per depositor per institution. Unlike the FSLIC, which was part of the Federal Home Loan Bank System, the SAIF is supervised by the FDIC (which also oversees the BIF).

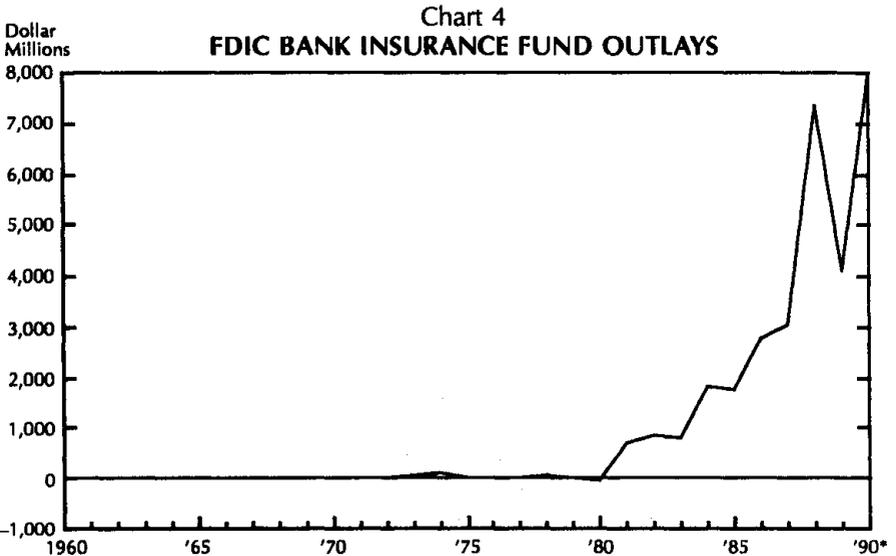
At present the SAIF has no reserves and is not scheduled to receive any until August 1992. Until then, premiums collected from insured thrifts and taxpayer money allocated by Congress will go into a separate fund (the FSLIC Resolution Fund) that finances Government assistance to insolvent thrifts. FIRREA authorized various "bailout" agencies to borrow up to \$90 billion to pay for the costs of closing, merging, or selling hundreds of insolvent thrifts. Congress has since authorized more borrowing. The cost of paying the interest and principal, most of which will be paid by taxpayers, is unknown but unofficial estimates put it as high as \$500,000,000,000 over 10 years.

**The National Credit Union Share Insurance Fund (NCUSIF).** This Federal insurance fund is managed by the National Credit Union Administration, a Government agency. It insures over 8,000 Federal credit unions and over 4,000 state-chartered credit unions. Shares (deposits) are insured up to \$100,000 for each member (depositor) similar to the BIF and SAIF coverages. The fund was recapitalized in 1984 through assessment to its members and its target ratio of equity-to-insured shares was increased to 1.3 percent. In 1989, the latest year for which data are available, fund equity equaled 1.25 percent of total insured shares of \$163 billion.

liabilities of insolvent thrifts was itself insolvent. By 1989, the FSLIC's annual expenses, incurred as it closed down growing numbers of insolvent thrifts, exceeded its income by tens of billions of dollars. These losses would have been even larger had the FSLIC moved more quickly to close down hundreds of insolvent but still operating thrifts. The delay saved the agency money in the short run but added billions more to the eventual cost of shutting down these institutions later on.

In 1989 the Government responded to the insolvency of the FSLIC and the thrift industry by enacting a massive "bailout" plan. Among other things, the plan abolished the FSLIC and transferred its existing liabilities (in the hundreds of billions) to a new FSLIC Resolution Fund and a new agency, the Resolution Trust Corporation (RTC). The RTC was initially capitalized with \$50 billion in taxpayers' dollars and another \$60 billion in borrowed funds, but by the end of 1990 it had run out of money. In early 1991 Congress appropriated another \$30 billion, but 6 months later this money was gone, too. In late 1991 Congress appropriated another \$25 billion. This was far less than the \$80 billion the RTC requested and will almost certainly be inadequate to cover the cost of closing down all insolvent thrifts. Thus the taxpayers' bill for the thrift bailout, already \$165 billion plus interest costs, will probably increase further.

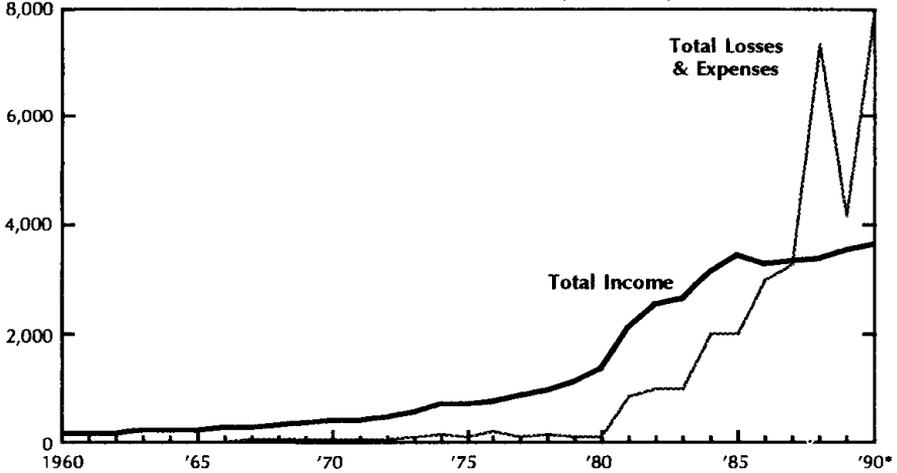
The Government bailout created another new fund, the Savings Association Insurance Fund (euphemistically known as SAIF) to provide the savings and loan deposit insurance previously provided by the FSLIC.



Source: U.S. Federal Deposit Insurance Corporation, *Annual Report, 1989*. \* AIER estimate.

Chart 5

Dollar Millions **FDIC BANK INSURANCE FUND INCOME, LOSSES, AND EXPENSES**



Source: U.S. Federal Deposit Insurance Corporation, *Annual Report, 1989*. \* AIER estimate.

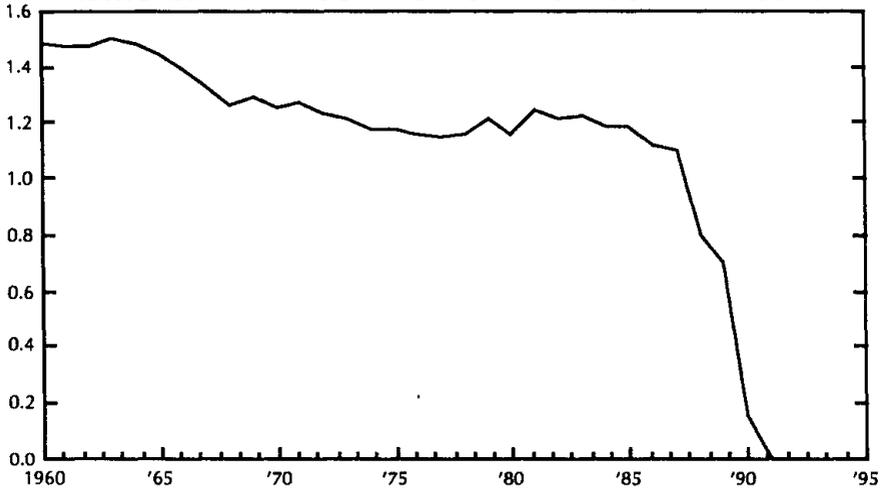
Although SAIF, which also is managed by the FDIC, insures some \$800 billion in deposits, it currently has *no* reserves. It is not scheduled to receive any funding before August 1992. Until then, the insurance premiums paid by thrifts and the taxpayer dollars appropriated by Congress will go toward financing the industry bailout now underway. If the pace at which the RTC completes this job continues to run behind schedule, funding for SAIF may be delayed until 1993. Regardless of when SAIF begins operating, it will probably have to be funded initially with taxpayers' dollars, since the insurance premiums paid by thrifts will be insufficient to cover its operation.

**Bank Deposit Insurance.** The Bank Insurance Fund (BIF), which insures deposits in banks and is managed by the FDIC, has fared better than the FSLIC did. Over the past few years, however, its reserve fund dropped dramatically. By the end of 1991 the fund was nearly bankrupt.

As shown in Charts 4 and 5, FDIC outlays for assisting insolvent banks skyrocketed in the 1980's. At the same time reserve income, primarily from insurance premiums paid by banks to the FDIC, increased only slightly. As a result, the net income added to the insurance fund each year began to decrease. By 1988 BIF net income was actually negative for the first time in the fund's history, and total reserves began to shrink. Large losses in 1989, 1990, and 1991 further depleted the fund, and by late 1991 it was nearly exhausted.

The BIF's shrinking ability to cover insured deposits is starkly evident

Chart 6  
RATIO OF BANK INSURANCE FUND TO INSURED DEPOSITS



Source: U.S. Federal Deposit Insurance Corporation.

in data showing the ratio of the fund to insured deposits. Chart 6 shows this ratio decreased from 1.48 in 1960 to less than 0.2 in 1990. In other words, for every \$100 of insured deposits there were fewer than 20 cents of reserves. In 1991 the ratio dropped to almost zero.

Throughout 1991 FDIC officials warned that the Bank Insurance Fund was rapidly running out of money. They attempted to shore up the fund by raising the insurance premiums paid by banks, but the extra money was far from enough. The FDIC then requested permission to borrow funds from the Treasury, and in late 1991 Congress granted it. The new legislation authorizes the FDIC to borrow up to \$70 billion over the next 5 years. FDIC officials have acknowledged that even this enormous infusion may not be enough and additional borrowing may be necessary.

**Credit Union Share Insurance.** The National Credit Union Share Insurance Fund (NCUSIF) has fared better than either the bank or thrift deposit insurance funds since it was established in 1970. After the ratio of reserves to insured shares (which are the equivalent of bank deposits) weakened in the early 1980's, the NCUSIF was recapitalized under legislation approved by Congress in 1984. The law requires credit unions to deposit 1 percent of their insured shares in the fund and requires the fund to maintain a reserve ratio of 1.30 (*i.e.*, \$1.30 for every \$100 of insured shares). For the past 6 years the reserve ratio has ranged between 1.25 and 1.30 percent of insured shares, and in 1989 it was 1.25 percent. During that period the fund's annual investment income has been high enough to

allow the National Credit Union Administration, the Government agency that oversees it, to waive insurance premium fees for member credit unions.

Although the NCUSIF is currently the financially soundest of the three Federal deposit insurance funds, the new, recapitalized fund could be strained by a few large failures. During the recession years of 1980-82, 650 of the Nation's 17,000 Federally insured credit unions failed, and the cost of resolving those failures brought the fund to its lowest level ever. Fewer than 50 credit unions failed annually between 1983 and 1988, but over 1,000 credit unions were rated "problems" by Federal regulators in 1988. Some of these institutions are quite large. During the past decade the credit union industry's assets tripled to \$196 billion, and the average assets of individual institutions increased from \$3.2 billion to \$12.5 billion. Thus a few large failures could strain the \$2 billion insurance fund. By law, credit unions draw their business from a narrow base of depositors and borrowers sharing a common bond, such as employment at a given business or membership in an organization. Thus they are vulnerable if an economic downturn hits their particular region or industry especially hard. The simple fact is that no one knows how well positioned the larger credit unions, and the Federal fund that insures them, are to withstand a prolonged or sharp downturn.

The potential inadequacy of bank, thrift, and even credit union insurance reserves does not necessarily imply that depositors in failed institutions will lose their savings. As the 1989 "rescue" of the FSLIC suggests, so long as Government officials have the power to create money "out of thin air," and so long as taxpayers' funds are available, we expect that various "bailouts" will be engineered and eventually depositors' claims will be honored, although perhaps in dollars of vastly reduced purchasing power. Insurance agency officials, as well as President Bush, have declared their intent to promote "public confidence" in the deposit insurance system, and they will likely continue to press Congress for new sources of relief for these hard-pressed agencies, if needed.

### *The Inflationary Way Out*

If the past is any guide, policymakers will attempt to finance additional appropriations by issuing yet more debt. Even if no new funds are needed, the debt already issued eventually will have to be repaid. From where will the funds come?

Government entities that find themselves in a debt squeeze have several options that are unavailable to private debtors. The easiest way for governments to cancel debt is simply to refuse to pay some or all of it, as frequently has happened in relation to loans to Third World governments.

The current "international debt crisis," for example, is at least in part a consequence of the unenforceability of creditors' claims against sovereign governments. But as is well-known to debtors and creditors alike, such behavior destroys a country's international credit.

A far more politically attractive option for governments than outright repudiation is "inflating away debt," because it surreptitiously reduces the real value of dollar claims over a period of years. Over the past 30 years, the *real* value of the dollar (*i.e.*, its purchasing power) has decreased to less than one-quarter of its original value — which implies that the *real* value of debt contracted in dollars 30 years ago now is worth less than a quarter of its worth then. For the Government, the practice of inflating debt away has proved irresistible for the past 50 years or more, and, given the nominal magnitudes of the debt it is now assuming, in our view, it will continue to be so. Indeed, as the dollar volume of Government debt obligations accelerates, so do political pressures to inflate.

In short, the final cost of recapitalizing the Federal deposit insurance reserves would seem almost surely to involve further erosion of the currency. That Congress so far continues to support such appropriations should not lead taxpayers to assume that adequate provisions have been made for financing them. On the contrary, the financing methods chosen by politicians are based primarily on the political desire to minimize the near-term impact on the Federal budget, and pay little heed to the long-term cost. However, if the experience of the past half century provides any indication, the eventual real costs to the general public, whether through explicit taxes or the hidden tax of inflating, will be *much* greater than the politicians now are willing to admit.

### III.

#### WHY BANKS AND THRIFTS ARE IN TROUBLE

**P**ROPOSERS of reregulation of the banking and thrift industries (and of multibillion dollar “bailout” legislation for the Federal deposit insurance agencies) usually cite a raft of circumstances that they say coalesced during the 1980’s to produce the persistent “debt crisis” in the banking industry: bad real estate loans, bad oil loans, bad foreign loans, outright fraud, speculative greed, and a litany of other management excesses — all of which they say deregulation of the financial industry unleashed.

There can be little question that bank and thrift managements often have shown staggeringly poor judgment where loan portfolios are concerned. For the past 20 years they have lurched from one disastrous experience to another. During the 1970’s banks made billions of dollars of “petrodollar loans” to plainly uncreditworthy Third World nations. Many of these loans still have not been written off, and the eventual resolution of the Third World debt issue — that is, how much and what the banks finally will receive — remains unresolved. During the “OPEC years” they lent billions more to speculative (and sometimes felonious) enterprises in the Southwest whose fortunes were tied to the price of a single commodity, oil. When oil prices collapsed, so did the loans. For decades bank and (to a greater extent) thrift managers committed the classic banking blunder of “borrowing short and lending long.” This posed no problem so long as interest rates remained fairly stable. But when rates began to increase dramatically, as they did in the 1970’s and early 1980’s, the lending institutions found themselves caught in a textbook illustration of the “interest-rate squeeze.”

Given the troubled history of American agriculture over the past 50 years (much of it brought on by Government interference with agricultural markets), it also is not surprising that a high proportion of farm loans based on the expectation of rising land values and ever-larger farm subsidies (rather than on operating results) went bad in the 1980’s. What seems most striking about the “debt crisis” in America’s farm belt is that lenders who were well-acquainted with the vicissitudes of farm enterprise (and presumably had seen the results of previous episodes of speculative mania) were so easily seduced in the 1970’s by new prophecies of endless prosperity in the agricultural economy. Despite the historical record, farm bankers abandoned good sense when it came to making extravagant loans to visionaries who had been taken in by the doomsayers’ predictions of worldwide starvation and unlimited markets for American agricultural produce.

Most recently, the collapse in 1990 of the speculative bubble that buoyed real estate prices in the Northeast, California, and the Southeast in the 1980's has left banks and thrifts holding commercial and real estate loans worth far less than their book value (and in some cases, worth nothing). Lenders made billions worth of these loans on the basis of rosy economic projections for local regions and the expectation that land values would continue to soar. These forecasts turned out to be wrong (again). Instead of the business cycle being "obsolete," as some analysts had asserted, the national economy entered a recession in 1990. The recession was accompanied by a widespread deflation in real estate values that hit some regions, such as New England, especially hard. The combination of recession and real estate deflation reduced the assets of many financial institutions to the point that their very survival is now in question. Bank management, it seems, has done it again.

### *Deregulation Is NOT the Problem*

There is, however, virtually no evidence that these problems are related to deregulation. Rather, the evidence suggests that the financial statuses of commercial banks and thrifts deteriorated for many years before deregulation — and that therefore the current troubled condition of many institutions was "brewing" long before the recent reverses became manifest in bank and thrift closings.

In many ways, Government banking policies themselves have contributed to the long-term weakening of American lending institutions. First and foremost, it was chronic inflating (the creation of excessive bank reserves "out of thin air") that not only caused the deposit liabilities of the banking system to grow more rapidly than bank capital, but also led bankers to abandon sound lending practices in their search for borrowers to soak up their bloated deposits. It is clear that many of today's bad loans would not have been made at all if the bankers had relied on the borrowers' ability to pay out of income rather than on fantasies such as "governments don't default" or "the prices of oil and real estate have nowhere to go but up."

The Federal deposit insurance programs have aggravated the problems of troubled banks and thrifts. In the absence of such insurance, banks bear the responsibility for the safety of deposits, and this liability influences the riskiness of the loans they make. However, *deposit insurance severs the link between the lending risks taken by banks and the safety of depositors' funds*. Without this link, banks and thrifts have little incentive to limit their lending risks, because they are assured that if the borrowers default, the Government will make good on depositors' funds.

The distorted incentives created by Federal deposit insurance have existed since the FSLIC and FDIC programs were introduced during the

Great Depression. However, relatively few related problems surfaced until the 1970's, when accelerating price inflation and interest-rate volatility squeezed bank and thrift profits, and pressured managements to make riskier loans. Under these conditions, the perverted incentives created by Federal deposit insurance proved disastrous.

### ***Government Policies Have Made Things Worse***

The Government's response to the industry's financial problems made matters worse. Piecemeal "deregulation" during the 1980's freed banks and thrifts to make riskier loans but did not restore their liability for depositors' funds. On the contrary, instead of reducing Government guarantees that encourage unsound lending, Congress actually *expanded* deposit insurance coverage from \$10,000 to \$100,000 per depositor. This level of coverage, an amount far beyond what was originally contemplated, has lulled depositors further into believing that their funds are protected no matter what happens, freeing lenders to take risks greater than they would if people demanded sound banking to secure their deposits. It also has helped attract funds from institutional depositors, thereby giving thrifts and banks more money to invest at scant risk to themselves but at considerable risk to Government agencies and their backers — *i.e.*, the taxpayers.

In short, the Government's policy of providing (and expanding) deposit insurance for banks and thrifts while partially deregulating their lending and investment practices is an invitation to malfeasance. It ought to come as no surprise that a government that guarantees the liabilities of an entire industry invites incompetence and fraud. Although deregulation of banking practices often has been blamed for the current troubles, it would seem that the underlying problem is that deregulation did not proceed far enough. The patchwork deregulatory reforms of the late 1970's and 1980's were fashioned with little regard for the need to overhaul — or abandon — the entire regulatory apparatus.

That Congress failed to anticipate the consequences of its actions is not surprising. It is commonplace for Government authorities to consider separately the successes or failures of the various types of financial intermediaries that serve the public. The performance — and regulatory oversight — of commercial banks is measured apart from that of thrifts; that of the thrifts and commercial banks is differentiated from that of the investment banks; securities brokers are segregated from commodities brokers; and so on. Usually, only the narrow data that describe the balance sheets of the institutions targeted by a particular agency (the FSLIC, FDIC, etc.) enter into any evaluation of their "social impact."

Underlying this practice seems to be the implicit, and bizarre, assump-

tion that transactions involving one financial industry occur totally independently of transactions in all the others. But they emphatically do not. No matter how the regulators might try to create separate entities that exist in a world of their own and “manage” them accordingly, as long as consumers are free to seek the most favorable terms (as depositors/lenders/investors/speculators or borrowers) what happens in one industry will affect what happens in all of the others to some degree. The “success” of one narrowly applied set of regulations must be measured against its possible effects elsewhere.

There are numerous examples of policymakers’ failure to understand this. For example, bank analysts have long observed the negative effects that restrictions against interstate banking and investment banking for commercial banks have had on banks’ ability to distribute risk. In many cases, the recent bank failures are directly attributable to the fact that the lending institutions are prohibited from operating outside of their immediate locality — and thus, are prone to disaster if the local economy falters. Despite this, in 1987 Congress enacted the “Competitive Equality Banking Act,” which further restricted interstate banking and prohibited the Federal Reserve from authorizing banks to underwrite securities, sell insurance, or broker real estate — thus sharply constraining their investment activities.

### *Government Bailouts*

Government “solutions” to the problems of the Federal deposit insurance agencies also have done little to address the underlying causes of the thrift and banking industries’ financial difficulties. In some respects they have exacerbated them. At the same time they have vastly increased taxpayer liability for the industries’ losses.

In 1987 Congress responded to mounting insolvencies in the thrift industry and the insolvency of the FSLIC by empowering that agency to issue \$10 billion in debt to cover its activities. This amount proved not nearly enough to assist the hundreds of thrifts that were insolvent and accruing more losses every day. Because the agency had insufficient funds (and for political reasons as well) it delayed closing many thrifts, adding to the cost of eventually taking action.

In 1988 Congress dealt with the mushrooming thrift debacle by sweeping it under the rug until after the Presidential election. In the meantime the FSLIC came up with a politically expedient strategy that enabled it to provide large amounts of financial assistance to thrifts with a minimal cash outlay. It concentrated on selling insolvent thrifts, and to make them attractive to buyers it permitted them to acquire the sick thrifts at “bargain prices” and with little capital outlay, guaranteed the value of the thrifts’ bad loans, and issued promissory notes to supplement the buyers’ invest-

ment. These guarantees and notes cost the FSLIC little initially, but they introduced a huge contingency liability for the agency and for the American taxpayer. It is now widely believed that many of the guaranteed loans will never be repaid, and the FSLIC's "penny-wise and pound foolish" actions are expected eventually to cost taxpayers \$40 billion.

After many months of delay Congress enacted a second legislative "solution" to the thrift problem in August 1989. In its scope and potential cost to taxpayers the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) surpassed any previous legislation. It provided for a taxpayer-funded bailout of the thrift industry costing billions of dollars, and initiated sweeping changes in the regulation of savings and loans.

FIRREA abolished the old system of thrift regulators and created a new alphabet soup of Federal agencies — the RTC, the OTC, REFCORP, SAIF, and more — to supervise solvent and insolvent thrifts. The FSLIC was abolished and many of its functions were transferred to the FDIC, which oversees banks. The bankrupt FSLIC insurance fund was replaced with the Savings Association Insurance Fund (SAIF) and a separate thrift resolution fund was created to finance assistance to thrifts that were already insolvent or expected to become so. The law abolished the Federal Home Loan Bank Board, which managed the FSLIC and received much criticism for its performance, and put the new funds under the management of the FDIC, which continues to manage the Bank Insurance Fund (BIF).

The new law requires that both the bank and thrift insurance funds maintain reserves equal to at least 1.25 percent of insured deposits by 1995. To achieve this the FDIC is authorized to increase the premiums paid by institutions to each fund. The agency already has done so and is considering additional increases, but reserve ratios remain far below their target level. Even reserves of 1.25 percent would be vastly insufficient to meet the thrift industry's needs, however, so the FIRREA bill also provided for billions of dollars of Government bonds to be issued to finance the cleanup.

The total cost of the Federal bailout was initially projected to be \$300 billion over 30 years. Taxpayers were expected to pay \$225 billion and the thrift industry the rest. Interest costs, which apparently were not included in these estimates, will add tens of billions more to the final cost.

As described in the previous chapter, the RTC (the thrift bailout agency) has consistently run through its periodic appropriations faster than expected, and ultimately all this assistance may cost far more than initially indicated. In other words, the official estimates were only a "floor," and

there is no “ceiling” or limit to taxpayer liability. The latest unofficial estimate of the eventual cost to taxpayers of Government assistance to the thrift industry is \$500 billion over 10 years — making the thrift debacle the largest financial scandal in human history.

The mounting estimates of the cost of the bailout prompted media analysts belatedly to question the FIRREA plan. This stands in sharp contrast to August 1989, when many of these same critics hailed the FIRREA bill for “solving” the thrift crisis. The assumption then seemed to be that once the bailout machinery was put in place, it would function smoothly and cost no more than projected. Little attention was paid at that time to two aspects of the situation that we addressed in earlier editions of this booklet: 1) underlying the bailout legislation and similar proposals is the notion that the Government regulators’ judgment is better than that of the market; and 2) thus far, even vastly increased surveillance and intercession by banking regulatory officials in the affairs of troubled institutions has *not* prevented a rash of bank and S&L insolvencies.

Some of the “deals” worked out by the FDIC for failed banks have turned out no better than comparable ones made by the FSLIC for thrifts. And in some instances heavy losses have continued in the wake of assistance from either agency. Indeed, some of the institutions bailed out a few years ago have failed *again* and are in need of *second* bailouts. It seems unlikely that regulators will find it any easier to manage up to 1,000 failed thrifts and their billions of assets than they did a few hundred.

For all the debate that went into the FIRREA bailout bill, and all the billions that will be spent enforcing it, Congress and the Administration failed utterly to address the problem that lies at the heart of the thrift debacle — deposit insurance. The only attempt legislators made to address this fundamental concern was to commission a study of deposit insurance. The results of that study, released in 1991, called for only minor restrictions of existing coverage. The idea of reducing or eliminating deposit insurance is anathema to politicians, and at this time reform appears unlikely.

### ***What Should You Expect?***

Despite the Bush bailout and the recapitalization of the Bank Insurance Fund, the difficulties of the thrift and banking industries are far from over. All indications are that there are still hundreds of financially shaky institutions and that both industries will continue to shrink, by a combination of closings and mergers, for years to come. Whatever healthy portion of them survives will be ill-equipped to shoulder its share of the bailout and maintain adequate reserves at Government deposit insurance agencies.

Additional legislative bailouts will probably be required in the future, and there can be little doubt that Congress stands ready to provide them.

In late 1991 Congress passed yet another banking-related bill, a watered-down version of a banking reform proposal submitted earlier in the year by the Bush Administration. The bill did not include the Administration's proposal to allow interstate branch banking and permit banks to underwrite securities. Its chief accomplishment was to provide the nearly insolvent FDIC with a \$70 billion line of credit at the Treasury. It also increases regulation and oversight of the banking industry. Some of the new regulations, such as a provision that would regulate bank officials' pay beginning in 1993, reflect the sort of mindless micromanaging that plagues most Government attempts to "fix" private markets. Other provisions may have unintended consequences. For example, the bill requires regulators to act quickly to close down banks with low capital. The effect probably will be to encourage banks to keep a larger-than-required ratio of capital to assets, either by slowing asset growth (*i.e.*, making fewer new loans) or merging with each other to increase their capital cushion. Neither of these results is necessarily bad, but it is doubtful that Congress seriously considered them before voting.

The 1991 bill *does* restrict deposit insurance in a small way: beginning in 1995, it generally prohibits reimbursement by the FDIC of uninsured deposits in excess of \$100,000. To this point, the FDIC has followed an informal policy of treating such large deposits as fully insured if they were in banks regarded as "too big to fail."

A larger effect of the legislation passed in recent years, particularly the FIRREA bill, has been to increase greatly the Government's presence in the financial and real estate markets. When regulators seize insolvent thrifts, the Government effectively nationalizes their assets. An estimated \$350 billion of financial and real assets already have been seized and eventually another \$200 billion may be. The bailout plan requires regulators to sell these assets and use the revenue to defray the cost of the bailout. So far, about half the assets seized have been sold. The liquidation of such an enormous amount of property, however, requires a Government operation of unprecedented scale.

How long it will take the Government to dispose of all these assets, no one can say. Aside from the usual bureaucratic hurdles there are dozens of rules and regulations covering the sale of seized assets. Most were included to prevent corruption and political favoritism from tainting the operation. Be that as it may, they hamper legitimate efforts to sell assets quickly. Indeed, regulators belatedly recognized this and have modified or abandoned many of the rules since the bailout operation began in 1989.

Regulators also have attempted to speed up the liquidation in recent months by packaging together "good" and "bad" assets and selling them in large bundles. By doing this, the Government may well receive less for the assets than if it held each one until it got a better price. In our view, however, any such loss will be offset by the benefit of getting the Government out of the financial and real estate markets sooner rather than later.

On the other hand, if the deals now being made involve Government financing or Government guarantees of asset values, they could require Government assistance or oversight for years to come. Reportedly such guarantees have been given, but at this point few people other than the regulators and buyers seem to be aware of what the terms of most sales are.

More generally, it seems clear that the entire bailout operation will take longer than the 7 years initially called for in the FIRREA bill. The Government may be in the thrift business, and responsible for maintaining thrift assets, for far longer than policymakers anticipated. And so long as the Government is running a large part of the thrift industry, the industry will be unable to compete effectively against less-regulated financial industries in ever-changing markets. Almost the same can be said of the banking industry: unless the current system of Government regulation is reformed, banks will be hard-pressed to compete successfully in the international financial markets.

### *Are Credit Unions Next?*

Credit unions operate under the same system of distorted incentives as banks and thrifts that participate in the current system of Federal deposit insurance. In this sense, the potential exists for the same bad lending policies, and generally unsound banking practices, followed by many thrift managers. However, there are a number of important differences between credit unions and other savings institutions that make a credit union crisis less likely. By law, credit unions are nonprofit tax-exempt businesses overseen by volunteer boards of directors and officers. Federal and state laws substantially limit the scope of their borrowing and lending operations. For example, they can accept deposits only from members, and membership is limited to individuals sharing a clearly defined "common bond" such as employment or association. Thus credit unions cannot compete for the large "brokered deposits" that fueled the expansion of many thrifts in the 1980's and enabled financially troubled savings and loans to raise enough funds to postpone insolvency (and make more bad loans). Credit unions are restricted to making loans to members and other credit unions, and are limited in the types of loans they can make (although their loan options have been steadily broadened in recent years,

they still cannot make loans for second homes or investment purposes, for example). Their non-loan investments are restricted to low-risk instruments like government-insured securities. Thus credit unions are less likely than thrifts or banks to be directly involved in relatively riskier investments such as commercial real estate development and “junk bonds.”

Partly as a result of the legal limits on its activities the credit union industry is much smaller than the bank or thrift industries. At the end of 1988 the Nation’s 15,700 credit unions held total assets worth \$196 billion, compared to \$1.4 trillion held by thrifts and over \$3 trillion by banks. Nonetheless the industry experienced rapid growth during the 1980’s (when lending restrictions were eased). Much of this growth came through mergers and expansions of existing credit unions; there were few new charters and there were actually 7,000 fewer credit unions in 1990 than there were in 1980. From 1980 to 1988 the average credit union’s assets increased from \$3.2 billion to \$12.5 billion.

The rapid growth of credit unions has raised concern among some analysts about whether the Federal fund that insures credit union shares, NCUSIF, is financially strong enough to withstand a few large credit union failures or a rash of smaller failures like that experienced in the early 1980’s. However, the NCUSIF was recapitalized after 1984 and is currently in better financial shape than the thrift or bank deposit insurance funds. Given the relatively stronger position of the insurance fund, and the comparatively small size of the industry, it appears that the NCUSIF will be able to take care of troubled institutions without taxpayer assistance.

This is not to say that credit union customers have no reason to be concerned. The same operating restrictions that make it unlikely the credit union industry will experience a debacle on the scale seen in the thrift industry make *individual* credit unions vulnerable to financial instability. Because credit unions depend on a narrow base of customers (typically drawn from a limited geographic region or a single industry or both) they run a high risk of experiencing serious financial difficulties, and even failing, if the local economy is hard hit by a downturn. For this reason, generalizations respecting the overall condition of the credit union industry are of limited use to individual customers. If your credit union does fail, you face the same risks and inconveniences as customers of a failed bank or thrift (as described in Chapter I). To minimize these risks, you should monitor the performance of your credit union closely.

## IV.

### COMPARATIVE BANK AND THRIFT PERFORMANCE

**R**EGULATORY agency officials understandably are reluctant to disclose the names of individual institutions that are in shaky financial condition. Nevertheless, data on the aggregate experiences of insured banks and thrifts are available to the public, and these are useful for distinguishing groups of lenders that currently are experiencing difficulties. In this chapter we review a number of financial aggregates that are derived from the reports that individual banks and thrifts are required to provide to the Federal regulatory and deposit insurance agencies. This information alone may alert you to the possibility that your bank or thrift is in a high-risk group.\*

#### *Which Banks Are In Trouble?*

In evaluating bank performance, examiners consider five broad factors, commonly known as the "CAMEL" factors. These are *Capital, Assets, Management, Earnings, and Liquidity*. Of these, management probably is the most important but also the most difficult to measure objectively. Asset quality is crucial, because it provides insight into a bank's lending policies and its ability to collect on credits. Information on earnings indicates sources of a bank's income, how much of it is paid out in expenses, and how large net income is relative to assets (a primary source of income). Data on capital indicate whether a bank's capital cushion against losses is adequate, and whether its capital base is large enough to support continued growth. Finally, liquidity provides a measure of a bank's ability to raise cash quickly, which is particularly important if earnings are low or large liabilities (such as depositors' funds) must be repaid on short notice. Each of these factors is described in greater detail in the next chapter. We use them here to provide an overview of conditions in the banking and thrift industry.

During the first half of 1991, the most recent period for which data are available, the commercial banking industry's performance was not much changed from the previous year. Reflecting continued weakness in the overall economy, net profits through June at the Nation's 12,000 banks were \$9.8 billion, down from \$11 billion in the same period a year earlier but a better annual rate than the \$15.9 billion earned in all of 1990. Profits were far below the record \$24 billion reported 3 years ago, but well above the \$3.4 billion earned in 1987.

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\* The sources for much of the data cited in this chapter are the *Sheshunoff Bank Quarterly* and *Savings and Loan Quarterly*. For more information on these publications see Chapter VI.

The percentage of banks reporting profits increased slightly to 89 percent from 87 percent in 1990. Profits at these 10,700 banks totaled \$13 billion, compared to \$13.4 billion during the same period in 1990. The percentage of unprofitable banks decreased from 13 percent to 11 percent, and their losses were \$3.2 billion, compared to \$2.3 billion a year earlier. The actual number of unprofitable banks decreased by about 180 to just over 1,300. This decrease did not reflect a return to profitability — the number of profitable banks increased by only 2 — but rather the closing of insolvent banks and the merging of weak banks with stronger ones. Since 1986, in fact, the number of unprofitable banks has decreased by about 1,500 but the number of profitable banks has not increased at all. Roughly 800 of the unprofitable banks were closed and the rest were either merged or sold.

Profits are only one indicator of performance. Other financial measures commonly used to gauge the banking industry's financial condition (some of which are shown in Table 1) paint a more mixed picture. Total industry assets of \$3.36 trillion did not increase at all during the first half of 1991, compared to a 3 percent increase in 1990. The quality of these assets deteriorated, reflecting the contracting economy and the deflation in real estate prices. Nonperforming assets and repossessed real estate (3.25 percent of assets) and net charge-offs (0.72 percent of loans) increased from their levels a year earlier. However, banks' core capital, their cushion against losses and the foundation for future growth, increased nationwide to 6.47 percent of assets from 6.19 percent in 1990.

One of the broadest measures of bank performance, the industry's rate of return on assets, increased in the first half of 1991 to 0.58 from 0.48 in 1990. A breakdown of earnings shows that both net interest income and noninterest income increased. Gross interest income decreased (in relation to assets) on account of falling interest rates, but interest expense decreased even more. Banks' provisions for loan losses, which cut into earnings, were roughly the same as in 1990. However, at 0.91 percent of assets these provisions were about twice their level in 1988.

Banks' liquidity remained fairly stable amid flat asset growth and weakening asset quality. Liquid assets were 21.1 percent of total liabilities in June 1991, compared to 21 percent in 1990. As a percent of assets, the share of liabilities held in the form of large time deposits of \$100,000 decreased to 10 percent from 11 percent. This suggests that the overall liquidity of the commercial banking system changed little during the period.

Obviously, wide variations in individual or regional bank performance are not captured in such aggregate data. As Tables 1, 2, and 3 show,

disaggregated data on the performance of U.S. banks during 1991 indicate that *some banks are far more likely to be in trouble than others*. We review below a number of the danger signals suggested by the data.

### *Regional Variations Are Great*

Tables 1 and 2 show the selected performance characteristics of banks according to regional and state "peer groups."\* They indicate great variation and mark a significant change in regional conditions from only a year ago. We warned in a recent edition of "How Safe Is Your Bank?" that the Northeast was clearly the new "trouble spot" of the banking industry and that developments there warranted close attention. Since then, the performance of Northeast banks has deteriorated rapidly.

In the first half of 1991 Northeast banks had a far higher share of nonperforming loans than any other region. The share of nonperforming assets and repossessed real estate in their asset portfolios (4.95 percent) and the value of charge-offs as a percent of average loans (1.03) were the highest in the Nation. One consequence of this abundance of troubled loans was a very weak earnings performance. The return on assets in the Northeast was, at 0.18 percent, barely positive, down from a year ago and the worst in the Nation. In contrast, banks in the North Central states earned a substantially higher return of 1.13 percent.

\* Banking and thrift regions referred to in this booklet are described as follows: **Northeast** includes Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont; **Southeast** includes Alabama, Delaware, District of Columbia, Florida, Georgia, Kentucky, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, and Virginia; **Midwest** includes Illinois, Indiana, Michigan, Ohio, West Virginia, and Wisconsin; **North Central** includes Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota; **Southwest** includes Arkansas, Louisiana, New Mexico, Oklahoma, and Texas; **West** includes Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, and Wyoming. Regional and national aggregates are asset-weighted averages of state data.

Table 1: NATIONAL AND REGIONAL AVERAGES

	———— Asset Quality ————		———— Liquidity ————	
	Nonperforming Assets and Repossessed Real Estate as a % of Total Assets	Net Charge-Offs as a % of Average Loans	Liquid Assets as a % of Total Liabilities	\$100,000 and Over Time Deposits as a % of Total Assets
<b>National</b>	3.25	0.72	21.1	10
Northeast	4.95	1.03	23.1	7
Southeast	2.62	0.72	17.2	13
Midwest	1.78	0.38	21.6	10
North Central	1.55	0.45	21.5	7
Southwest	2.59	0.65	27.7	13
West	3.01	0.55	17.9	10

Source: *Sheshunoff Bank Quarterly*, Sheshunoff Information Services, Austin, Texas, June 1991.

A factor in the Northeast banks' low rates of return was the large percent of assets that had to be set aside as a provision against loan losses. Assets reserved in this way cannot be loaned out, and thus do not contribute to earnings. Northeast banks reserved 1.05 percent of assets for loan losses, well above the national average; in contrast, Midwest banks set aside less than half that much. Core capital, which does not include loan loss reserves, was only 5.49 percent of assets compared to 6.47 percent nationally. Earnings at Northeast banks also were hurt by low net interest income (the spread between gross interest income and interest expenses). At 2.97 percent of assets, interest income was well below the national average of 3.69 percent. The liquidity position of Northeast banks was somewhat better. Liquid assets equaled 23.1 percent of total liabilities, slightly higher than the national average of 21.1 percent and substantially better than in the Southeast and the West. Holdings of deposits of \$100,000 or more remained relatively low at 7 percent of assets. In addition to being a potentially volatile source of increased deposit withdrawals, these large accounts are costly for banks to maintain, since they carry higher-than-average interest rates.

In contrast to the Northeast, the experience of Southwest banks was relatively better than the nationwide average. In part this is because the worst banks in this region have been closed by regulators, and their horrendous performance is no longer dragging down the regional averages. The average rate of return on assets was 0.63, higher than the national average and up from a year ago. Nonperforming assets and repossessed real estate, as well as net charge-offs, were below the national average. Liquidity and capital adequacy were also relatively strong, suggesting that the banks that managed to escape the massive failures in the Southwest during recent years are in fairly good shape compared to the rest of the country.

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**FOR FDIC-INSURED COMMERCIAL BANKS**

<i>— Capital Adequacy —</i>		<i>— Earnings —</i>		
<i>Core Capital as a % of Assets</i>	<i>Nonperforming Assets as a % of Core Capital and Loan Loss Reserves</i>	<i>Net Interest Income as a % of Average Assets</i>	<i>Provision for Loan Losses as a % of Average Assets</i>	<i>Return on Average Assets</i>
6.47	32	3.69	0.91	0.58
5.49	54	2.97	1.05	0.18
7.08	23	4.17	1.23	0.65
7.20	17	3.84	0.55	0.93
7.88	12	4.06	0.58	1.13
6.66	18	3.47	0.50	0.63
6.37	31	4.38	0.95	0.71

Banks in the Southeast deteriorated significantly from 1990 to mid-1991. Both nonperforming assets and net charge-offs increased. Net interest income was well above average (second only to the West) but so was the provision for loan losses. The return on assets, 0.65 percent, was better than the national average but down from 0.81 a year earlier. Liquidity and capital adequacy were better than the national average. Overall it appears that while Southeast banks did not do as well in 1991 as in 1990, they did not weaken as much as banks in other regions, such as the Northeast. The quality of Southeast banks' assets clearly bears watching, but even if nonperforming loans and repossessed real estate do increase further, these banks have one of the largest cushions of core capital (7.08 percent of assets) to draw upon.

As in 1989 and 1990, banks in the Midwest and North Central regions performed best in 1991 with respect to earnings, asset quality, capital adequacy, and liquidity. Banks in the Western region weakened, however, and by mid-1991 their financial standing was worse than any region except the Northeast. Nonperforming loans increased from a year earlier and were substantially higher than in most other regions. Net charge-offs also increased. The ratio of core capital to assets was below the national average, and earnings were hurt by an increase in the provision for loan losses from 0.66 percent of assets in June 1990 to 0.95 percent in June 1991. The return on assets, 0.71 percent, was above the nationwide average but well below the 1.06 percent reported a year earlier.

Overall, in 1991 there were some signs that bank performance was slowly improving, but many institutions remain vulnerable to regional economic weakness. Moreover, in the fast-changing financial industries cracks can appear quickly in the seemingly strongest institutions or "safest" region. It would seem prudent, then, to check your bank's financial performance regardless of its location.

### *Bank Performance By State*

Within each region there was even greater variation, as indicated in the aggregate state "peer group" financial results shown in Table 2. Banks in some states performed far worse than others. In Connecticut, for example, nonperforming assets and repossessed real estate were an astonishing 10.07 percent of assets, the highest of any state. Core capital was the lowest of any state in relation to assets (4.39), and nonperforming assets equaled an incredible 97 percent of core capital and loan loss reserves. The return on assets in Connecticut banks (-1.62) was among the lowest in the Nation. In most other New England states — Massachusetts, New Hampshire, Vermont, and Maine — banks' rates of return were negative and nonperforming assets were high. In short, the aggregate banking results for

the New England states, which may well have worsened since mid-1991, ought to be alarming to any depositor or bank shareholder there. Of course, not all banks in the area are financially fragile, but many are.

Two other states — New Jersey and Maryland — as well as the District of Columbia reported a negative return on bank assets. States with non-performing loans above the national average of 3.25 percent of assets, in addition to those mentioned above, were Arizona, California, Florida, Louisiana, Maryland, New Jersey, New York, Rhode Island, Virginia, and the District of Columbia. In many of these states, net charge-offs also exceeded the national average. Most of these states' banks also set aside above-average provisions for loan losses. (Interestingly, New York banks set aside a relatively small percent of assets, given their large losses.) Again, it is apparent that the Northeast states have the weakest loan portfolios and are experiencing the deepest financial problems, but the weakness is not confined to that region.

Not all states in weaker regions performed poorly. In the Northeast, Pennsylvania posted results near or better than the national average in many categories. Likewise, some states in relatively strong regions turned in relatively poor showings. For example, in the generally strong North Central states, South Dakota had the highest level of net charge-offs of any state (largely because Citibank's huge credit card business is headquartered there and charge-offs on their consumer loans increased sharply during the recession). On the other hand, South Dakota also reported the highest return on assets of any state (again, largely on account of Citibank's credit card operation). These "mixed" results underscore the importance of weighing *all* the "CAMEL" data when evaluating a bank's overall performance.

Again, the data for an individual bank can vary widely from the state or regional peer group averages. Table 3 lists, in terms of total assets, the 20 largest banks in the United States. These banks, with assets ranging from \$160 billion to \$17 billion, show even greater variation in performance than the state averages. For example, two banks within New York, Bank of New York and Republic National Bank of New York, had widely different experiences in 1991. Bank of New York had an extremely high 5.26 percent of its assets in nonperforming loans and repossessed real estate, compared to 0.37 percent at Republic. Republic posted a positive return on assets (0.76), but Bank of New York reported a negative return (-0.2).

Among all banks of all sizes, the variations in financial performance are even greater. The substantial differences in the data for each of these large banks underscore the need to look beyond peer group averages to answer the question, "How safe is your bank?"

Table 2: COMMERCIAL BANK PEER GROUP

	Asset Quality		Liquidity	
	Nonperforming Assets and Repossessed Real Estate as a % of Total Assets	Net Charge-Offs as a % of Average Loans	Liquid Assets as a % of Total Liabilities	\$100,000 and Over Time Deposits as a % of Total Assets
Alabama	1.80	0.23	14.2	12
Alaska	1.51	0.08	19.9	13
Arizona	3.55	0.84	21.0	7
Arkansas	1.40	0.18	23.1	12
California	3.50	0.57	16.7	11
Colorado	2.81	0.59	27.2	8
Connecticut	10.07	1.23	11.9	9
Delaware	1.66	1.88	12.0	27
District of Columbia	9.30	1.87	23.8	20
Florida	3.31	0.68	17.7	12
Georgia	1.93	0.45	18.7	11
Hawaii	0.51	0.05	20.5	23
Idaho	0.73	0.23	19.2	8
Illinois	2.08	0.36	28.2	13
Indiana	1.62	0.34	19.3	9
Iowa	0.82	0.17	21.2	5
Kansas	1.67	0.29	23.7	10
Kentucky	1.63	0.38	18.4	10
Louisiana	4.04	0.67	25.8	14
Maine	4.28	0.57	11.6	8
Maryland	3.82	0.96	16.4	13
Massachusetts	7.14	0.81	26.1	10
Michigan	1.27	0.25	17.2	9
Minnesota	1.71	0.46	20.9	7
Mississippi	1.43	0.35	20.0	13
Missouri	1.83	0.33	25.2	7
Montana	1.51	0.13	28.3	6
Nebraska	0.87	0.33	19.5	6
Nevada	3.10	1.69	15.2	9
New Hampshire	5.80	1.53	18.4	10
New Jersey	5.85	0.90	20.7	8
New Mexico	3.04	0.64	33.4	11
New York	4.80	1.19	26.0	6
North Carolina	1.81	0.31	17.6	13
North Dakota	1.21	0.15	23.5	7
Ohio	2.02	0.61	16.9	8
Oklahoma	2.67	0.29	27.8	10
Oregon	2.06	0.52	20.5	6
Pennsylvania	2.63	0.52	14.6	9
Rhode Island	6.59	0.97	17.7	24
South Carolina	1.64	0.33	14.5	8
South Dakota	2.25	1.90	8.3	11
Tennessee	2.06	0.52	19.3	8
Texas	2.38	0.76	28.3	14
Utah	1.83	0.62	24.2	7
Vermont	4.33	1.05	11.8	9
Virginia	3.52	0.76	18.0	11
Washington	1.76	0.24	12.8	7
West Virginia	1.40	0.32	20.0	6
Wisconsin	1.27	0.22	18.1	6
Wyoming	1.20	0.31	23.9	14

Source: Sheshunoff Bank Quarterly, Sheshunoff Information Services, Austin, Texas, June 1991.

## AVERAGES BY STATE

<i>Capital Adequacy</i>	<i>Earnings</i>			
<i>Core Capital as a % of Assets</i>	<i>Nonperforming Assets as a % of Core Capital and Loan Loss Reserves</i>	<i>Net Interest Income as a % of Average Assets</i>	<i>Provision for Loan Losses as a % of Average Assets</i>	<i>Return on Average Assets</i>
7.74	16	4.10	0.40	1.07
11.74	7	5.00	0.14	1.53
6.06	30	3.41	0.81	0.12
8.49	10	4.04	0.26	1.13
5.90	39	4.34	1.00	0.64
7.44	16	4.35	0.72	0.60
4.39	97	2.59	1.98	-1.62
9.23	13	6.84	3.71	2.05
5.66	72	2.71	2.59	-2.03
5.83	30	3.90	1.21	0.07
8.44	14	4.36	0.65	0.94
6.69	7	3.87	0.20	1.12
6.53	8	4.25	0.33	1.10
6.92	19	3.20	0.42	0.79
7.74	14	4.01	0.55	0.90
8.81	6	3.87	0.24	1.11
7.93	10	3.94	0.37	0.91
8.09	14	3.83	0.60	0.87
6.42	30	3.90	1.16	0.06
5.91	45	3.77	1.29	-0.06
6.40	33	3.78	1.28	-0.02
5.36	76	2.95	1.08	-0.12
6.83	14	4.03	0.42	1.00
7.09	16	3.93	0.50	0.94
7.61	10	3.99	0.46	0.88
7.59	13	3.63	0.42	0.89
8.18	13	4.18	0.22	0.95
8.27	8	4.36	0.41	1.23
8.19	25	7.97	2.97	1.54
5.14	43	4.82	2.58	-1.03
5.39	56	3.64	1.70	-0.62
7.13	20	3.99	0.70	0.43
5.33	55	2.70	0.93	0.33
6.14	21	3.36	0.65	0.78
8.27	11	3.85	0.23	0.93
7.05	20	4.43	0.95	1.06
7.96	14	3.79	0.26	0.91
7.13	21	4.50	1.66	0.66
6.38	26	3.61	0.78	0.69
5.85	55	3.21	1.31	0.16
6.76	16	4.10	0.85	0.96
8.86	21	6.28	2.77	2.97
7.44	14	4.02	0.66	0.78
6.23	17	3.22	0.41	0.66
7.97	15	4.60	0.89	0.92
6.91	35	4.11	2.58	-1.04
6.72	34	3.87	1.22	0.46
7.06	16	4.51	0.46	1.16
8.89	11	4.25	0.31	1.05
8.14	11	4.26	0.41	1.01
8.73	8	4.08	0.20	1.06

### *Comparative Performance of Thrift Institutions*

The performance of the savings and loan industry improved sharply in the first half of 1991. Seventy-six percent of thrifts reported a profit, compared to only 60 percent in December 1990. Earnings at profitable institutions were \$2.6 billion through June, which compares favorably with the \$3.9 billion reported during all of 1990. These profits were more than offset by \$4.7 billion in losses at unprofitable thrifts, but this too was an improvement over 1990, when such losses exceeded \$17 billion. Net losses for all savings and loans in the first half of 1991 were \$2.1 billion, down from \$13 billion in 1990 and \$19 billion in 1989.

These numbers are somewhat misleading, however, in that they mask

Table 3: **FINANCIAL PERFORMANCE**

	————— <i>Asset Quality</i> —————		————— <i>Liquidity</i> —————	
	<i>Nonperforming Assets and Repossessed</i>	<i>Net Charge-Offs as a % of Average Loans</i>	<i>Liquid Assets as a % of Total Liabilities</i>	<i>\$100,000 and Over Time Deposits as a % of Total Assets</i>
	<i>Real Estate as a % of Total Assets</i>			
Citibank, NY .....	7.37	1.44	20.5	3
Bank of America, CA <sup>1</sup> .....	3.20	0.83	16.9	7
Chase Manhattan Bank, NY ...	6.96	1.31	20.7	10
Morgan Guaranty Trust, NY ...	0.93	1.36	25.3	2
Manufacturers Hanover Trust, NY <sup>2</sup> .....	5.72	1.31	18.3	7
Security Pacific, CA <sup>1</sup> .....	5.15	0.61	16.8	10
Bankers Trust, NY .....	3.23	1.60	56.1	4
Wells Fargo Bank, CA .....	3.69	0.50	6.8	8
Chemical Bank, NY <sup>2</sup> .....	4.95	1.20	20.8	7
Bank of New York, NY .....	5.26	0.67	18.9	13
NCNB Texas, TX <sup>3</sup> .....	0.23	0.27	27.1	13
First National Bank of Chicago, IL .....	3.83	0.61	38.8	11
First National Bank of Boston, MA .....	4.50	0.77	20.0	15
Mellon Bank, PA .....	3.17	0.53	11.8	8
Continental Bank, IL .....	3.15	0.42	37.3	28
Republic National Bank of New York, NY .....	0.37	0.46	51.4	6
NCNB of North Carolina, NC <sup>2</sup> .....	2.50	0.46	21.3	7
NBD Bank, MI .....	0.85	0.16	17.9	9
First Interstate Bank, CA .....	2.43	0.69	31.3	3
First Union National Bank, NC .....	2.93	0.38	9.0	23

<sup>1</sup> Bank of America and Security Pacific have agreed to merge.

<sup>2</sup> Manufacturers Hanover Trust merged into Chemical Bank on December 31, 1991.

<sup>3</sup> NCNB and C&S/Sovran have agreed to merge. The new bank will be called NationsBank.

the main reason the thrift industry is doing better, which is that the Government has shut down so many insolvent institutions. As the worst thrifts are removed from "active duty" the average performance of those that remain open is bound to look better. Since 1986 the number of thrifts has decreased from about 3,300 to less than 2,500. From mid-1990 to mid-1991 alone, over 400 thrifts ceased operation. They were either closed by regulators or merged (with Government financial assistance) with other institutions.

The total value of assets at SAIF-insured thrifts decreased through June 1991, continuing a trend that began in 1989. From a historic peak of \$1.39 trillion in 1988, assets decreased \$360 billion, or 25 percent, through mid-

**OF 20 LARGEST BANKS**

— *Capital Adequacy* —

— *Earnings* —

<i>Core Capital as a % of Assets</i>	<i>Nonperforming Assets as a % of Core Capital and Loan Loss Reserves</i>	<i>Net Interest Income as a % of Average Assets</i>	<i>Provision for Loan Losses as a % of Average Assets</i>	<i>Return on Average Assets</i>
5.30	85	3.13	1.39	0.06
5.05	43	4.03	0.58	1.07
4.33	88	2.47	0.60	0.14
4.57	14	1.76	0.03	1.13
5.20	57	2.81	1.06	0.53
5.21	55	3.23	1.22	0.48
4.67	38	1.18	0.27	1.14
4.89	44	4.69	1.56	0.71
4.81	64	3.00	0.67	0.50
5.14	54	2.47	1.94	-0.20
5.24	4	1.87	0.10	1.56
4.70	31	1.54	0.22	0.35
4.45	45	2.77	1.00	-0.66
4.71	32	2.99	0.59	0.78
7.07	35	1.93	0.79	0.41
6.55	5	1.64	0.07	0.76
4.49	35	2.73	1.10	0.49
6.02	11	3.54	0.24	1.04
5.83	24	4.87	1.18	0.38
5.04	41	3.18	0.92	0.58

Source: *Sheshunoff Bank Quarterly*, Sheshunoff Information Services, Austin, Texas, June 1991.

1991. Assets are expected to shrink further as insolvent thrifts are shut down by regulators and the solvent portion of the industry acts to comply with new regulations limiting the types of loans and investments thrifts can make and requiring higher capital ratios. The vast majority of thrift assets continue to be mortgages (65 percent of total loans), although insolvent thrifts hold a disproportionately high share of loans for construction, land, and real estate development (27 percent) compared to solvent thrifts (14 percent). The percent of industry assets that qualifies as tangible capital (similar to banks' core capital) increased in 1990 and 1991, after decreasing steadily in earlier years. Tangible capital equaled 2.5 percent of assets in June 1991, well above the 1.5 percent level required under the provisions of the thrift bailout law. By comparison, however, bank holdings of core capital were a much higher 6.5 percent of assets.

The return on assets for the thrift industry as a whole improved over the 12-month period ending in June 1991 from -1.02 percent to -0.36 percent. As insolvent thrifts are shut down and near-insolvent ones divest themselves of riskier investments (as required by law), the numbers should continue to improve. (This "improvement" will reflect the infusion of billions of taxpayer dollars and the transformation of the industry back to one restricted largely to mortgage lending.) The most recent national thrift data are shown in the first row of Table 4.

Financial distress among savings and loans is evident in every region but the Midwest and the North Central, as the data in Table 4 indicate. Conditions in the Southwest were especially bad, as they have been for several years. There, thrifts reported losses of \$1.9 billion and a negative return on assets of -2.44 percent, a disastrous performance by any measure. This region was the only one with negative net income from interest, equal to -0.39 percent of assets. Nonperforming assets and repossessed assets (a remarkable 15.34 percent of assets) and net charge-offs (0.86

Table 4: NATIONAL AND REGIONAL AVERAGES

	Asset Quality		Liquidity	
	Nonperforming Assets and Repossessed Assets as a % of Total Assets	Net Charge-Offs as a % of Average Loans	Liquid Assets as a % of Total Liabilities	Deposits over \$100,000 as a % of Total Assets
National	4.89	0.31	8.7	8
Northeast	5.83	0.44	9.1	5
Southeast	5.03	0.34	9.7	7
Midwest	1.53	0.14	10.3	6
North Central	2.68	0.12	9.8	4
Southwest	15.34	0.86	15.2	4
West	3.85	0.22	5.7	12

Source: Sheshunoff S & L Quarterly, Sheshunoff Information Services, Austin, Texas, June 1991.

percent of loans) were higher in the Southwest than anywhere else. Tangible capital held by Southwestern thrifts was actually *negative* (-6.86 percent of assets).

As in the banking industry, the newest "trouble spot" for the thrift industry is the Northeast. Thrifts here reported the second worst return on assets (-1.12) and the second highest percentage of nonperforming and repossessed assets (5.83). Northeastern thrifts also set aside the highest percentage of assets for loan losses (0.98), an indication that thrift managers expect even more loans to turn sour. The Southeastern peer group of thrifts also turned in a weaker-than-average performance by most measures. The poor financial condition of thrifts in this and most other regions becomes clearer when one reviews the numbers for the Midwest, the strongest region. Here, tangible capital equaled 5.03 percent of assets in June 1991. Nonperforming loans and charge-offs were low, and the return on assets was the highest of any region (0.45). The liquidity position also appeared to be strong in the Midwest, where volatile and costly deposits of more than \$100,000 equaled only 6 percent of assets, compared to 12 percent in the West.

Statewide patterns of financial distress among thrifts echo those for various regions. As shown in Table 5, the return on assets was negative in three of the five Southwest states but *18 additional states posted negative returns*. Of the 21 states posting losses in the first half of 1991, 17 lost money in 1990 as well: Arkansas, California (which accounts for nearly a third of the thrift industry's assets and nearly a third of its nonperforming loans), Colorado, Connecticut, Florida, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, South Dakota, Texas, and Virginia. State industries in the Southwest, the West, the Northeast, and the Southeast (and that covers most of the country) posted losses.

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**FOR SAIF-INSURED THRIFTS**

Capital Adequacy		Earnings		
Tangible Capital as a % of Assets	Nonperforming Assets as a % of Tangible Capital and Loan Loss Reserves	Net Interest Income as a % of Average Assets	Provision for Loan Losses as a % of Average Assets	Return on Average Assets
2.50	57.2	1.89	0.55	-0.36
2.09	125.6	1.96	0.98	-1.12
2.71	59.8	2.05	0.60	-0.34
5.03	18.6	2.41	0.22	0.45
3.26	30.0	1.85	0.29	0.34
-6.86	23.8	-0.39	0.50	-2.44
3.48	46.9	2.09	0.53	-0.01

Table 5: THRIFT PEER GROUP

	Asset Quality		Liquidity	
	Nonperforming Assets and Repossessed Assets as a % of Total Assets	Net Charge-Offs as a % of Average Loans	Liquid Assets as a % of Total Liabilities	Deposits over \$100,000 as a % of Total Assets
Alabama	5.15	0.16	9.5	8
Alaska	4.10	1.33	27.7	10
Arizona	22.20	0.86	4.3	3
Arkansas	15.49	0.29	10.5	7
California	3.87	0.20	5.2	12
Colorado	6.68	1.09	15.1	16
Connecticut	5.82	1.10	5.0	4
Delaware	4.11	0.28	6.2	4
District of Columbia	1.88	0.12	4.1	11
Florida	5.61	0.28	10.4	7
Georgia	3.45	0.21	7.4	7
Hawaii	1.09	0.14	7.4	13
Idaho	1.60	0.02	12.4	8
Illinois	1.49	0.06	12.1	6
Indiana	1.19	0.10	11.3	7
Iowa	2.20	0.12	9.2	4
Kansas	1.85	0.03	7.8	3
Kentucky	1.47	0.09	13.2	5
Louisiana	6.50	0.52	13.9	3
Maine	3.34	0.23	9.9	8
Maryland	5.58	0.58	7.7	6
Massachusetts	10.19	0.62	9.7	8
Michigan	1.02	0.14	5.9	6
Minnesota	1.67	0.17	9.7	4
Mississippi	3.80	0.69	11.9	7
Missouri	4.37	0.08	10.0	4
Montana	1.64	0.09	8.7	4
Nebraska	1.79	0.21	10.2	3
Nevada	1.47	0.01	5.7	8
New Hampshire	5.81	0.70	13.7	5
New Jersey	5.71	0.19	9.6	5
New Mexico	3.29	0.05	13.3	11
New York	6.03	0.58	8.0	5
North Carolina	3.06	0.14	12.0	8
North Dakota	2.57	0.20	12.6	10
Ohio	2.10	0.24	11.1	6
Oklahoma	9.74	1.66	11.6	3
Oregon	2.73	0.39	10.8	4
Pennsylvania	4.21	0.19	11.8	5
Rhode Island	12.71	0.74	5.8	13
South Carolina	2.84	0.18	8.2	8
South Dakota	2.96	0.61	21.0	8
Tennessee	4.05	0.64	13.9	7
Texas	17.54	0.87	16.1	4
Utah	6.17	0.12	6.1	7
Vermont	3.82	0.33	5.0	5
Virginia	8.61	0.57	7.5	8
Washington	2.43	0.14	5.5	7
West Virginia	2.40	0.22	18.1	6
Wisconsin	1.29	0.13	9.4	4
Wyoming	3.99	0.28	24.7	8

Source: Sheshunoff S &amp; L Quarterly, Sheshunoff Information Services, Austin, Texas, June 1991.

## AVERAGES BY STATE

Capital Adequacy		Earnings		
Tangible Capital as a % of Assets	Nonperforming Assets as a % of Tangible Capital and Loan Loss Reserves	Net Interest Income as a % of Average Assets	Provision for Loan Losses as a % of Average Assets	Return on Average Assets
2.65	68.1	2.06	0.26	0.20
3.31	24.6	2.66	4.90	-4.80
-65.48	nm	-2.06	1.90	nm
-35.51	nm	-1.46	0.41	-2.98
3.53	50.3	2.08	0.52	-0.02
0.91	40.4	1.11	1.41	-1.65
2.55	126.6	1.88	0.47	-0.31
1.45	103.3	2.37	0.07	0.96
3.20	44.2	2.35	0.23	0.19
-0.19	nm	1.76	0.40	-0.42
3.85	37.8	2.12	0.38	0.00
5.18	9.0	2.79	0.06	0.97
5.20	20.9	2.81	0.16	0.65
4.05	22.9	2.41	0.19	0.42
6.93	11.1	2.81	0.19	0.85
4.15	27.5	2.11	0.32	0.06
3.01	13.7	1.52	0.16	0.59
6.76	12.0	2.40	0.22	0.59
-9.02	nm	1.01	0.78	-3.56
7.03	23.7	2.91	0.75	-0.25
4.24	44.7	2.38	1.09	-0.21
1.24	203.8	1.72	1.08	-3.59
3.87	14.2	1.77	0.22	0.43
3.45	20.7	2.57	0.11	0.12
2.70	55.9	2.09	0.63	-1.91
3.79	52.6	1.84	0.49	0.01
8.87	9.8	3.03	0.13	0.91
1.88	26.7	1.44	0.19	0.70
3.12	22.8	2.05	0.37	-1.29
4.36	56.7	2.17	1.34	-1.67
2.63	107.2	1.89	1.40	-1.67
6.86	23.8	1.88	0.15	0.21
1.74	150.6	1.85	0.93	-0.98
6.05	22.3	2.55	0.37	0.10
3.51	14.5	1.97	0.16	0.90
5.28	23.6	2.52	0.23	0.35
-0.42	nm	1.32	0.03	0.32
-5.51	nm	1.32	0.18	-0.50
1.66	88.5	2.33	0.75	-0.42
5.38	110.5	1.61	0.44	-1.48
5.08	24.7	2.61	0.35	0.46
2.33	57.1	2.79	1.05	-0.47
5.23	34.4	2.29	0.41	0.18
-6.02	nm	-0.78	0.53	-2.62
16.37	20.6	2.56	0.59	0.70
5.67	37.0	2.85	0.52	0.22
1.05	151.4	1.48	1.36	-1.73
6.70	16.7	2.76	0.40	0.87
8.08	14.0	3.06	0.29	0.89
7.42	7.9	2.87	0.29	0.46
5.02	16.1	2.51	0.04	0.26

nm Not meaningful.

As with the banking industry, much of the recent deterioration occurred in the Northeastern states. None of these nine states had a negative rate of return 2 years ago, whereas all but Vermont posted losses in 1991. This rapid change in performance underscores the need to check on the financial condition of your bank or thrift regularly.

Of course, these regional and statewide averages suggest only where the proportion of ailing thrifts is most likely to be greatest. Every region has "problem thrifts" and even though your thrift may be located in a "safe" region (such as the Midwest) this does not necessarily mean that it is sound. Oppositely, there are many sound thrifts (and banks) located even

Table 6: FINANCIAL PERFORMANCE

	Asset Quality		Liquidity	
	Nonperforming Assets and Repossessed Assets as a % of Total Assets	Net Charge-Offs as a % of Average Loans	Liquid Assets as a % of Total Liabilities	Deposits over \$100,000 as a % of Total Assets
Home Savings of America, CA .....	2.74	0.12	1.4	14
Great Western Bank, CA ..	3.50	0.17	2.0	20
World S&L, CA .....	0.93	0.00	4.4	4
Glendale Federal Bank, CA .....	2.52	0.45	6.2	14
California Federal Bank, CA .....	4.28	0.27	8.0	18
First Nationwide Bank, CA .....	6.04	0.33	3.9	10
American Savings Bank, CA .....	0.82	0.04	2.0	9
Homefed Bank, CA .....	9.66	0.69	7.3	12
Citibank, CA .....	1.51	0.27	7.8	9
Dime Savings Bank of New York, NY .....	10.12	1.10	3.7	7
First Federal of Michigan, MI .....	0.27	0.05	6.6	3
Great American Bank, CA .....	15.84	0.45	7.9	5
Standard Federal Bank, MI .....	0.45	0.07	2.4	11
Coast Federal Bank, CA ....	3.07	0.19	7.6	13
Household Bank, CA .....	1.29	0.29	8.8	6
Anchor Savings Bank, NY .....	0.83	0.29	10.2	3
Crossland Savings, NY .....	10.02	0.71	5.0	5
First Gibraltar Bank, TX ....	9.47	0.07	45.3	9
Pacific First Bank, WA .....	3.71	0.20	3.5	7
New West Federal S&L, CA .....	6.91	0.17	4.0	1

Source: *Sheshunoff S & L Quarterly*, Sheshunoff Information Services, Austin, Texas, June 1991.

in the most-troubled regions. These data simply show where financial weakness is most widespread and therefore where insolvencies are apt to be most frequent.

As with banks, the data for an individual thrift can vary widely from the state or regional peer group averages. Such variation is evident in Table 6, which lists, in terms of total assets, the 20 largest thrifts in the United States as of June 1991 (ranging in asset size from \$41 billion to \$7 billion). For example, two thrifts within New York, the Dime Savings Bank and the Crossland Savings Bank, had very different experiences in 1991. Tangible capital at the Dime was 3.93 percent of assets, compared to -5.18 percent

#### OF 20 LARGEST THRIFTS

<i>Capital Adequacy</i>		<i>Earnings</i>		
<i>Tangible Capital as a % of Assets</i>	<i>Nonperforming Assets as a % of Tangible Capital and Loan Loss Reserves</i>	<i>Net Interest Income as a % of Average Assets</i>	<i>Provision for Loan Losses as a % of Average Assets</i>	<i>Return on Average Assets</i>
3.72	43.9	2.52	0.38	0.59
4.97	24.4	2.60	0.24	0.82
5.13	15.4	2.68	0.13	1.08
2.04	63.9	2.07	0.56	-1.24
2.92	64.0	2.02	0.34	0.01
4.26	73.3	1.81	1.23	-0.74
4.15	16.3	3.02	0.28	1.14
1.78	102.1	1.55	2.39	-3.26
13.55	10.0	3.82	0.64	1.00
3.93	136.8	2.11	1.33	-0.69
3.55	4.6	0.67	0.08	0.26
-0.89	nm	0.39	0.83	-2.33
4.06	6.6	2.07	0.15	0.62
2.58	34.5	1.95	0.99	0.52
3.12	21.8	3.07	0.31	0.77
1.17	46.4	1.95	0.30	1.20
-5.18	nm	-0.32	1.93	-3.76
4.30	18.1	0.46	0.06	1.06
5.33	27.9	2.48	0.74	0.49
0.00	0.0	-5.09	0.12	0.00

nm Not meaningful.

at Crossland. The total rate of return at the Dime was  $-0.69$  percent of assets, compared to  $-3.76$  percent at Crossland.

Again, peer group averages are helpful in "flagging" potential areas of weakness, but they are insufficient for evaluating an individual thrift. To make an informed judgment, you must take into consideration specific financial data for the institution, as well as state and regional conditions.

### *Credit Unions*

Information on the financial performance of the credit union industry is harder to come by. As far as we are aware, there is no comprehensive source of data on national, regional, or state performance similar to those available for banks and thrifts (which are described in Chapter VI). Without this information it is difficult to get a sense of which areas of the country have relatively stronger or weaker credit union industries.

As noted in Chapter III, however, credit unions are more vulnerable than either banks or thrifts to economic conditions at the local level, since they typically serve customers working in a single industry or community. In this respect, state and regional peer group averages would be of even more limited use as indicators of a particular credit union's condition than comparable bank and thrift data are. That is, a credit union operating in a strong regional economy could still be hard hit by a slowdown in a particular industry or, say, the closing of a single factory. For this reason it is especially important to examine financial data for the particular credit union you do business with, since performance varies widely from the "average."

Table 7  
**CREDIT UNION INDUSTRY FINANCIAL PERFORMANCE, 1985-89**  
 (Federal Credit Unions)

<b>Earnings:</b>	<b>1985</b>	<b>1986</b>	<b>1987</b>	<b>1988</b>	<b>1989</b>
Yield on average assets	12.00%	10.80%	10.10%	10.20%	10.60%
Ratio of operating expenses to gross income	31.40	33.10	35.30	35.20	35.10
Provision for loan losses as a percent of loans	0.52	0.64	0.65	0.66	0.73
<b>Capital Adequacy:</b>					
Ratio of reserves to assets	3.70%	3.50%	3.50%	3.70%	3.90%
<b>Asset Quality:</b>					
Delinquent loans as a percent of loans	2.09%	2.12%	1.90%	1.80%	1.77%
Net charge-offs as a percent of loans	0.43	0.59	0.60	0.60	0.66

Source: National Credit Union Administration.

When evaluating the condition of a credit union, you should consider the same factors used when examining a bank: capital adequacy, asset quality, management, earnings, and liquidity. The historical data in Table 7 show national averages of various financial measures for Federally chartered credit unions. These figures, the latest available, offer a guideline to average performance that you can compare with similar data that your own credit union should be able to provide. Information on individual credit unions also is available from Veribanc and IDC Financial Publishing, two ratings services, as described in Chapter VI.

## V.

### HOW TO BE YOUR OWN BANK EXAMINER

**S**INCE regulatory agencies and local bank or thrift managements are not about to reveal weaknesses that might erode public confidence and precipitate runs on shaky institutions, it is up to you to become your own "bank examiner." It would be impossible in a publication of this size to list all of the pertinent performance data on roughly 30,000 commercial banks, thrifts, and credit unions that are insured by Federal or state deposit insurance agencies. Such reference publications are available to financial specialists and research libraries, and there are several rating services that will evaluate the soundness of individual institutions on request. But these publications and services (discussed in Chapter VI) are available only at substantial cost.

It is our aim in this booklet to provide you with a "do-it-yourself" guide to inexpensive sources and uses of information about your bank or savings institution, and to describe procedures of inquiry that you can apply much as bank examiners do when they assess a financial institution's soundness. The first section of this chapter, "What You Should Look For," describes the various performance categories listed in the peer group tables in Chapter IV and relates how they reflect on a bank or thrift's financial position. The second and third subsections, "Procedures of the Federal Financial Institutions Examination Council" and "The FFIEC Bank Rating System" outline the methods used by the principal agency charged with assessing the strength or weakness of commercial banks in the United States.

#### *What You Should Look For*

Although financial data supplied by Government agencies and depository institutions cannot by themselves measure accurately the soundness of a given institution, there are a number of data that financial analysts often use as yardsticks by which to judge a bank's financial position. They include:

**Assets.** In banking parlance, assets comprise the total of tangible and intangible assets and all claims a bank or thrift has against others (that is, what others owe to the bank). Categories of assets listed in the *Uniform Bank Performance Report* (UBPR, discussed below) include: real estate loans, agricultural loans, commercial and industrial loans, loans to individuals, municipal loans, acceptances of other banks, other loans in domestic offices, foreign office loans and leases, lease financing receivables, securities over 1 year duration, interest-bearing bank balances, Federal funds sold and resales, trading account assets, debt securities under 1 year

duration, temporary investments, noninterest cash and cash due from banks, acceptances, premises, fixed assets, cap leases, other real estate owned, investment in unconsolidated subsidiaries, intangible assets, and all other claims against others. The UBPR further distinguishes among securities according to the following categories: commercial paper in loans; officer and shareholder loans; U.S. Treasury and agency securities; municipal securities; foreign securities; all securities. In the above listing, fixed assets refer to those used for carrying on business, *e.g.*, land, buildings, office machinery and equipment, furniture, fixtures, etc. They are of a permanent character and cannot be converted into cash during the ordinary course of business. They are also known as permanent property and capital assets.

Not all assets are of equally reliable value. For the purpose of assessing the quality of a financial institution's strength, assets are further distinguished as being either risk or nonrisk. *Risk assets* (assets that could be "wiped out" through defaults) comprise all of the above excepting cash and due from depository institutions ("due from depository institutions" describes asset accounts with balances outstanding with, and due from, other banks), obligations of the U.S. Government (including agencies and corporations), trading-account assets, Federal funds sold and securities purchased under agreement to resell.

**Liabilities.** Liabilities are the opposite of assets, *i.e.*, the debts and other obligations that are due to others from the bank. The chief liabilities of a bank are deposits, borrowings from the Federal Reserve bank or other banks (or in the case of thrift institutions, borrowings from a Federal Home Loan Bank), liabilities on account of letters of credit and acceptances, and capital accounts. A bank's liabilities may be either fixed or current. Fixed liabilities are those liabilities that do not mature within a short time, *e.g.*, bonds, mortgages, and long-term notes. Current liabilities are those that become due within a year or less — *e.g.*, demand deposits, short-term Certificates of Deposit, etc. A bank may also have *contingent liabilities*, which are potential liabilities that it may or may not ever be compelled to meet (these include obligations arising from endorsements of notes or commercial paper, issuing and guaranteeing letters of credit, commitments to buy and sell foreign currency, liabilities incurred as a result of agreements on contracts, and responsibilities incurred in various ways other than through contractual agreement, including pending lawsuits or the possibility of litigation). The UBPR distinguishes among the following categories of liabilities: demand deposits; NOW and ATS accounts; regular savings deposits; regulated time deposits over \$100 million; money market deposit accounts; super NOW accounts; unregulated time deposits under \$100 million; time deposits over \$100 million; depos-

its held in foreign offices; Federal funds purchased and resales; volatile liabilities; brokered deposits; officer and shareholder loans; real estate acquired for investment purposes; total current restructured debt; other borrowings; acceptances; other liabilities.

As with assets, not all liabilities carry the same potential risks: depending on current interest-rate levels, fixed liabilities can be either favorable or hazardous to a bank's position (when current rates are high, long-term liabilities at relatively lower rates are highly favorable; on the other hand, when current rates are relatively low, long-term liabilities involving higher rates are unfavorable). Likewise, current liabilities may pose interest-related problems. The classic banking blunder of "borrowing short and lending long" that thrift institutions confronted in the late 1970's and early 1980's simply described a situation where assets of long duration produced inadequate income to service short-term liabilities that compelled payment of high rates of interest.

**Charge-Offs.** Charge-offs (also called "write-offs") involve reducing the book value of an asset in order to bring it into line with its market value. They are, in short, bank losses. Charge-offs create a valuation of reserve against the asset, in full or partially, so that the carrying value of the asset, after deduction of the valuation reserve, is either zero or a reduced amount.

**Return on Assets.** This is the institution's net income, including security transactions and nonrecurring items, as a percentage of total assets, and is a basic yardstick of an institution's profitability. As a rule of thumb, bankers generally regard a 1 percent return on assets as a benchmark that separates highly profitable institutions from weaker ones.

**Nonperforming Loans (Sub-Quality Loans and Leases).** In simplest language, these are bad loans. This category includes loans that are past due (usually 90 days or more), and those that are nonaccruing. The level of nonperforming loans can be a sign of weakness, although there are no regulatory guidelines that describe acceptable or unacceptable limits for bad loans.

**Repossessed Assets.** Assets that have been seized by creditors in settlement of a bad debt. As with nonperforming loans, a high level of repossessed assets can indicate weakness in a bank's or thrift's loan portfolio, although there are no regulatory guidelines that describe acceptable or unacceptable limits. An increase in repossessed assets often is preceded by an increase in nonperforming loans.

**Core Capital.** This comprises the total of a bank's equity capital plus some "goodwill" and other intangible assets. Unlike other assets, such as loans and leases whose value depends on the ability of borrowers and

lessees to fulfill their contractual obligations, core capital is risk free. Very simply, it is what is “left over” to service a bank’s liabilities (obligations to depositors and other creditors) when at-risk assets go bad. Core capital usually is expressed as a percentage of assets. Banks are required to maintain a capital level of at least 6 percent, depending on the types of stock and debt that are issued. The national average of the ratio of bank capital to assets is 7.9 percent.

**Tangible Capital.** Basically, a thrift’s equity capital, excluding intangible assets such as goodwill. The ratio of tangible capital to assets is an indication of a thrift’s solvency. A low ratio calls into question the soundness and safety of a savings and loan.

**Provisions for Loan Losses.** These are reserves set aside by banks to cover possible losses. A large percent of assets set aside for losses indicates that a relatively large portion of its loans is considered by the bank to be at high risk of default. Actual loan losses may be more or less than the provision for loan losses. Because banks cannot know in advance how much of the provision will be used, the entire loan loss provision is treated as an expense and deducted from operating income.

**Large Time Deposits.** Accounts in banks, thrifts, and credit unions are insured up to \$100,000 per depositor. Because deposits in excess of \$100,000 are uninsured, they typically earn a higher interest return than insured deposits. Most large deposits are commercial deposits of corporations, financial businesses, and individuals. “Brokered deposits” are \$100,000 accounts held by brokers which, because of their size, are able to command very high yields. Competition for large deposits is keen, and their depositors shift funds quickly in response to changing interest rates. This makes them a volatile source of funds for banks and thrifts. (Credit unions are restricted by law to accepting deposits from members only.)

**Net Interest Income.** The difference between total interest earned by a bank or thrift from interest-bearing assets, and total interest paid by the institution on deposits, borrowings from the Federal Reserve bank or other banks (or, in the case of thrifts, borrowings from a Federal Home Loan Bank Board), and other borrowed money.

**Overhead Expenses.** Personnel, occupancy, and noninterest expenses of operating a bank or thrift. The level of overhead is a measure of an institution’s ability to control expenses.

**Liquidity.** Liquidity exists if an asset can be sold quickly at a known price. The price may vary over a period of time; however, it can be determined quickly and accurately by making a query in the marketplace. Negotiating or bargaining is not necessary. Even though the price of an asset may rise or fall within a relatively small range on a daily or hourly

basis, its liquidity will remain constant. Liquid assets thus can be converted into cash, specie, or another asset of equal market value at a known price in a short period of time. As discussed below, a proper asset liquidity balance is necessary for a bank or thrift to be prepared to meet its obligations and at the same time provide adequate asset earnings.

**Short-Term Assets less Large Liabilities.** This figure provides a measure of a bank's liquidity. If it is a very small (negative) number, it suggests that a bank might have difficulty meeting quickly a sudden increase in withdrawals of deposits (liabilities). Liquidity is a greater concern in banks with a high level of poor-quality assets. Bad assets can lead to earnings problems and eventually endanger cash flow.

### *Procedures of the Federal Financial Institutions Examination Council*

With few exceptions, U.S. commercial banks, thrifts, and credit unions are subject to examination by the following Federal agencies: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and the Office of the Comptroller of the Currency. These agencies make up the Federal Financial Institutions Examination Council (FFIEC) for the purpose of prescribing uniform principles, standards, and reports forms for the examination process and to make recommendations to promote uniformity in the supervision of financial institutions, their holding companies, and the nonfinancial subsidiaries of both of them. The annual report of the Council for 1989 (the latest available) shows that 30,500 banks, thrifts, and credit unions reported to members of the council. Their assets amounted to \$5.4 trillion and their net worth was \$275 billion, or 5 percent of total assets. Net income after taxes was \$18 billion for a 6.5 percent return on net worth.

Federal bank examiners use the following guidelines in determining the ratings of individual financial institutions.

**Capital Adequacy.** Capital is rated (1 through 5) in relation to: (a) the volume of risk assets; (b) the volume of marginal and inferior quality assets; (c) bank growth experience, plans and prospects; and (d) the strength of management in relation to (a), (b), and (c). In addition, consideration may be given to a bank's capital ratios relative to its peer group, its earnings retention and its access to capital markets or other appropriate sources of financial assistance.

Banks rated 1 or 2 are considered to have adequate capital, although the former's capital ratios will generally exceed those of the latter. A 3 rating is ascribed to a bank's capital position when the relationship of the capital

structure to points (a), (b), or (c) is adverse even giving weight to management as a mitigating factor. In most instances, such banks would have capital ratios below peer group averages. Banks rated 4 and 5 are clearly inadequately capitalized, the latter representing a situation of such gravity as to threaten viability and solvency. A 5 rating also denotes a bank that requires urgent assistance from shareholders or other external sources of financial support.

**Asset Quality.** Asset quality is rated (1 through 5) in relation to (a) the level, distribution, and severity of classified (sub-quality) assets; (b) the level and composition of nonaccrual and reduced rate assets; (c) the adequacy of valuation reserves; and (d) demonstrated ability to administer and collect problem credits. Obviously, adequate valuation reserves and a proven capacity to police and collect problem credits mitigate to some degree the weaknesses inherent in a given level of classified assets. In evaluating asset quality, consideration should also be given to any undue degree of concentration of credits or investments, the nature and volume of subquality assets, lending policies, and the adequacy of credit administration procedures.

Asset quality ratings of 1 and 2 represent situations involving a minimal level of concern. Both ratings represent sound portfolios although the level and severity of classifications of the latter generally exceed those of the former. A 3 asset rating indicates a situation involving an appreciable degree of concern, especially to the extent that current adverse trends suggest potential future problems. Ratings 4 and 5 represent increasingly more severe asset problems; rating 5, in particular, represents an imminent threat to bank viability through the corrosive effect of asset problems on the level of capital support.

**Management/Administration.** Management's performance must be evaluated against virtually all factors considered necessary to operate the bank within accepted banking practices and in a safe and sound manner. Thus, management is rated (1 through 5) with respect to (a) technical competence, leadership and administrative ability; (b) compliance with banking regulations and statutes; (c) ability to plan and respond to changing circumstances; (d) adequacy of and compliance with internal policies; (e) depth and succession; (f) tendencies toward self-dealing; and (g) demonstrated willingness to serve the legitimate banking needs of the community.

A 1 rating indicates management that is fully effective with respect to almost all factors and exhibits a responsiveness and ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the bank's affairs. A 2 rating reflects some deficiencies but generally indicates a satisfactory record of performance in light of the

bank's particular circumstances. A rating of 3 reflects performance that is lacking in some measure of competence desirable to meet responsibilities of the situation in which management is found. Either it is characterized by modest talent when above-average abilities are called for, or it is distinctly below average for the type and size of bank in which it operates. Thus, its responsiveness or ability to correct less than satisfactory conditions may be lacking. The 4 rating indicates management that is generally inferior in ability compared with its responsibilities. A rating of 5 applies to those instances where incompetence has been demonstrated. In these cases, problems resulting from management weakness are of such severity that management must be strengthened or replaced before sound conditions can be brought about.

**Earnings.** Earnings are rated (1 through 5) with respect to (a) the ability to cover losses and provide for adequate capital; (b) earnings trends; (c) peer group comparisons; and (d) quality and composition of net income. Consideration also is given to the interrelationships that exist among the dividend payout ratio, the rate of growth of retained earnings, and the adequacy of bank capital. A dividend payout rate that is sufficiently high as to cause an adverse relationship to the rate of growth suggests conditions warranting a lower rating despite a level of earnings that might otherwise warrant a more favorable appraisal.

Quality is also an important factor in evaluating this dimension of a bank's performance. Consideration should be given to the adequacy of transfers to the valuation reserve and the extent to which extraordinary items, securities transactions, and tax effects contribute to net income. Earnings rated 1 are sufficient to make full provision for the absorption of losses and the accretion of capital when due consideration is given to asset quality and bank growth. Generally, banks so rated will have earnings well above peer group averages. A bank whose earnings are relatively static or even trending downward may receive a 2 rating provided its level of earnings is adequate in view of the considerations discussed above. Normally, banks so rated will have earnings that are in line with or slightly above peer group norms.

A 3 rating is accorded earnings that are not sufficient to make full provision for the absorption of losses and the accretion of capital in relation to bank growth. The earnings pictures of such banks may be further clouded by static or inconsistent earning trends, chronically insufficient earnings, a high dividend payout rate or less than satisfactory asset quality. Earnings of such banks are generally below peer group averages. Earnings rated 4, while generally positive, may be characterized by erratic fluctuations in net income, the development of a downward trend, intermittent losses or a substantial drop from the previous year.

Earnings of such banks are ordinarily substantially below peer group averages.

Banks with earnings accorded a 5 rating are experiencing losses or reflecting a level of earnings that is worse than described for 4 above. Such losses may represent a distinct threat to the bank's solvency through the erosion of capital.

**Liquidity.** Liquidity is rated (1 through 5) with respect to (a) the volatility of deposits; (b) reliance on interest-sensitive funds and frequency and level of borrowings; (c) technical competence relative to structure of liabilities; (d) availability of assets readily convertible to cash; and (e) access to money markets or other ready sources of cash. Ultimately, the bank's liquidity must be evaluated on the basis of its capacity to meet promptly the demand for payment of its obligations and to fill readily the reasonable credit needs emanating from the communities that it serves. In appraising liquidity, attention should be directed to the bank's average liquidity over a specific time period as well as its liquidity position on any particular date. Consideration should be given, where appropriate, to the overall effectiveness of asset-liability management strategies and compliance with and adequacy of established liquidity policies. The character, volume and anticipated usage of a bank's credit commitments also are factors to be weighed in arriving at an overall rating for liquidity.

A liquidity rating of 1 indicates a more than sufficient volume of liquid assets and/or ready and easy access on favorable terms to external sources of liquidity within the context of the bank's overall asset-liability management strategy. A bank developing a trend toward decreasing liquidity and increasing reliance on borrowed funds, yet still within acceptable proportions, may be accorded a 2 rating. A 3 liquidity rating reflects an insufficient volume of liquid assets and/or reliance on interest-sensitive funds that is approaching or exceeds reasonable proportions for a given bank. Ratings of 4 and 5 represent increasingly serious liquidity positions. Banks with liquidity positions so critical as to constitute an imminent threat to continued viability are accorded a 5 rating. Such banks require immediate remedial action or external financial assistance to allow them to meet their maturing obligations.

### *The FFIEC Bank Rating System*

The FFIEC has developed a rating system to be applied to the banks under the jurisdiction of Federal examiners. The Federal examiners assess adequacy of capital, quality of assets, ability of management and administration, quantity and quality of earnings, and the level of liquidity. They then grade each institution according to these categories on a one to five basis as follows:

**Rating No. 1** indicates strong performance. It is the highest rating and is indicative of performance that is significantly higher than average.

**Rating No. 2** reflects satisfactory performance. It reflects performance that is average or above; it includes performance that adequately provides for the safe and sound operation of the bank.

**Rating No. 3** represents performance that is flawed to some degree; as such it is considered only fair. It is neither satisfactory nor marginal but is characterized by performance of below average quality.

**Rating No. 4** represents marginal performance that is significantly below average; if left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

**Rating No. 5** is considered unsatisfactory. It is the lowest rating and indicates performance that is critically deficient and in need of immediate remedial attention. Such performance by itself, or in combination with other weaknesses, could threaten the viability of the institution.

Each bank is accorded a summary or composite rating that is predicated upon the evaluations of the specific performance criteria. The composite rating is also based upon a scale of one through five in ascending order of supervisory concern. In arriving at a composite rating, each financial dimension must be weighed and due consideration given to the interrelationships among the various aspects of a bank's operations. In addition to the categories that receive official performance "grades," the Federal examiners also take into account other factors that, in the judgment of the examiner or reviewer, are relevant to the overall condition and soundness of a particular bank. However, the assessment of the specific graded performance categories represents the essential foundation upon which the composite rating is based.

**Composite Rating.** The five composite ratings are defined and distinguished as follows:

**Composite 1.** Banks in this group are sound institutions in almost every respect; any critical findings are basically minor and can be handled in a routine manner. Such banks are resistant to external economic and financial disturbances and capable of withstanding the vagaries of business conditions more ably than banks with lower composite ratings.

**Composite 2.** Banks in this group are also fundamentally sound institutions but may reflect modest weaknesses correctable in the normal course of business. Such banks are stable and also able to withstand business fluctuations quite well; however, areas of weakness could develop into conditions of greater concern. Minor adjustments can be made in the

usual course of business without threatening the bank's financial soundness.

**Composite 3.** Banks in this group exhibit a combination of weaknesses ranging from moderately severe to unsatisfactory. Such banks are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if substantial adjustments are not effective in correcting the areas of weakness. Consequently, such banks are vulnerable. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

**Composite 4.** Banks in this group have an immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory. Unless prompt action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability. A potential for failure is present but is not pronounced. Banks in this category require close attention and financial surveillance.

**Composite 5.** This category is reserved for banks whose conditions are worse than defined under No. 4 above. The volume and character of weaknesses are such as to require urgent aid from the shareholders or other sources. Such banks require immediate corrective action and constant supervisory attention. The probability of failure is high for these banks.

## VI.

### SOURCES OF INFORMATION

**T**HE problem of selecting a sound bank or other savings institution with which to do business would be made easier if the above-described ratings developed by the bank examiners were available to the public. However, such is not the case. If they were, the weak banks would be readily exposed and most likely would suffer runs. Thus, the ratings are reserved for the use of regulatory agencies and the individual bank that is rated.

Federal law prohibits a bank officer or bank director from divulging the contents of FFIEC rating reports. Thus, even if a bank's ratings are good, the detailed ratings described in Chapter V will not be made available to you. Although it is intended to protect the banking system in general, the secrecy of bank ratings obviously disadvantages depositors in troubled institutions. Be that as it is, you can apply the criteria described above to an analysis of what data are available for your bank or thrift.

While the ratings themselves are not made public, a great deal of information *is* available to individuals from a variety of sources.

The chances are good that you will have to go no further than your bank itself to obtain sufficient information about its financial condition. It is possible that your banker will have his bank's most recent Uniform Bank Performance Report (UBPR), which is described below. At the very least, you should be able to obtain an annual "Statement of Condition" or "Annual Report" from the bank. These reports often are brief, "glossy" pamphlets that try to present the institution's performance in the best possible light. Often they emphasize the bank's "personality" and its involvement in community affairs. Nevertheless, such reports contain at least some statement of the institution's asset strength, liabilities, capitalization, earnings, and growth, and should provide a brief overview of its performance (you can use the peer group tables in Chapter IV to compare your bank's performance with others).

Other published sources of information are available in the finance section in the reference room of your public library or at a local college or university (many brokerage houses also have financial libraries and you should check these as well). The most useful of these sources are:

- 1) *Sheshunoff Bank Quarterly Ratings and Analysis*, published quarterly by Sheshunoff Information Services, Austin, Texas. This very useful (and very large) reference book offers extensive financial data on each of the Nation's 12,000 FDIC insured banks, as well as national, regional, and state peer group averages. Based on information from the most recent

quarterly “call reports” submitted by banks to the Federal Reserve, it includes data on asset size and growth; loan exposure (in construction, commercial real estate, agricultural, and foreign loans); capital adequacy; asset quality (nonperforming loans and charge-offs); earnings (interest and noninterest earnings, provisions for loan losses, return on assets, return on equity); and liquidity (short-term assets less large liabilities, large deposits). Easily understood graphics illustrate the latest state and regional averages, as well as their recent historical trends. The text contains a clear and concise description of the data and their significance. The percentile rankings of individual banks within peer groups of similar asset size are included for key performance measures; this gives you a quick idea of your bank’s performance in comparison with other banks of similar size. A single overall rating (based on a scale of A+ to “not rated”) is given for each bank and state; the text describes in detail how the ratings are obtained. If your bank or public library has not acquired this reference book (and the companion book described below), it is available from Sheshunoff Information Services, Inc., P.O. Box 13203, Capitol Station, Austin, Texas 78711. The cost of an annual subscription (4 issues) is \$315.

2) *Sheshunoff S and L Quarterly*. This book provides data comparable to those in the *Bank Quarterly*, but for FDIC insured savings and loans. Individual thrifts are listed by state, and average performance data for states, regions, and the Nation also are presented. Summary financial data for each thrift cover asset growth and quality, earnings, liquidity, capital adequacy, and loan portfolio. In addition to many of the same financial measures used in the *Bank Quarterly*, the *S and L Quarterly* includes data on repossessed assets, tangible capital, loan exposure (variable rate mortgages; residential, commercial real estate, and consumer loans), and brokered deposits. State and regional performances are also shown graphically. As with the *Bank Quarterly*, percentile rankings of each thrift are given for various data, and these rankings are the basis for a single overall performance rating assigned to each institution. Your local thrift may carry this volume; if not, an annual subscription (4 issues) costs \$275; an annual subscription to both the *Bank Quarterly* and the *S and L Quarterly* costs \$465.

3) *Moody’s Bank & Finance Manual*, Volume 1, published by Moody’s Investors Service (a subsidiary of Dun & Bradstreet). Volume 1 of *Moody’s Manual* covers banks, trust companies, savings and loan associations, and Federal credit agencies. This substantial (larger than a telephone directory) book provides an indispensable overview of the banking and thrift industries in the United States and gives extensive financial information on the Nation’s largest banking corporations and thrift institutions. Some information is provided on virtually all financial institutions in the coun-

try, and for some institutions, the financial record is exhaustive. Special features include sections on the largest banks and thrifts, the statement of operations and the balance sheet of FDIC insured institutions; earnings and statements of condition of mutual savings banks; income of insured commercial banks, grouped by class; and earnings and statements of condition of insured commercial banks. Moody's *Manual* is published annually, and by referring to earlier editions, you can plot the performance of your bank or thrift over a number of years.

4) ***Uniform Bank Performance Report (UBPR)***. Available from the Federal Financial Institutions Examination Council, UBPRs contain the most comprehensive published information on individual institutions. Based on the quarterly "call reports" submitted by the banks, the UBPR is an analytical tool created for bank supervisory, examination, and management purposes. In a concise format, it shows the impact of management decisions and economic conditions on a bank's performance and balance-sheet composition. The performance and composition data contained in the report can be used as an aid in making decisions concerning the adequacy of earnings, liquidity, capital, asset and liability management, and growth management. Bankers and examiners use this report to further their understanding of a bank's financial condition and through such understanding perform their duties more effectively. There is no reason why you cannot use your bank's UBPR as the basis for your own evaluation of its soundness.

A UBPR is produced for each commercial bank in the United States that is supervised by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, or the Office of the Comptroller of the Currency. The report is computer-generated from a data base derived from public and private sources, and contains several years of data, which are updated quarterly. Those data are presented in the form of ratios, percentages, and dollar amounts computed mainly from Reports of Condition and Income submitted by the bank. Each UBPR also contains corresponding average data for the bank's peer group and percentile rankings for most ratios. The UBPR therefore permits comprehensive evaluation of a bank's current condition, trends in its financial performance, and comparisons with the performance of its peer group. An order form that you may remove and use to obtain the UBPR of one or more banks is printed in the back of this booklet.

The various reports available from the Federal Financial Institutions Examination Council are described as follows:

**UBPR Bank Report** — The Bank Report is prepared each quarter for each Federally insured commercial bank in the United States and contains

approximately 20 pages of bank financial data, peer group averages, and state averages (for 5 periods). Again, the senior officers at your bank may be the best source for obtaining the UBPR. If they do not want to show you their copy, this report is available to the general public for \$40 per copy. This may seem like a large amount; but compared with the inconvenience and possible losses you might suffer if your bank failed, it is a modest sum.

**UBPR State Average Report** — The State Average Report is prepared each quarter and includes state averages for approximately 35 ratios per state (for 5 periods). This report is available to the general public for \$40 per copy.

**UBPR Peer Group Report** — The Peer Group Report is prepared each quarter and includes ten pages of peer group averages (for 5 periods), for each of the 25 UBPR Peer Groups. In addition, this report presents ten pages of averages (for 5 periods), for all banks in the Nation. This report is available to the general public for \$60 per copy.

**UBPR User's Guide** — The UBPR User's Guide provides the bank report user with definitions of methodology and content of the report including description of all pages and items, and tax equivalency formulation. This guide is available to the general public for \$25 per copy.

5) **Call Reports** — A substantial amount of information contained in the UBPR Reports is derived from the quarterly *call reports* submitted by the banks. Those *call reports* are available from the Sales Office, National Technical Information Service, Springfield, Virginia 22161. The cost is \$25 (\$20 each for two or more copies) plus \$3 for handling. However, the UBPR Bank Report is a better value since it contains peer group averages and state averages for comparison.

Annual and quarterly reports available from the bank and Form 10K reports to the Securities and Exchange Commission also are available from the bank upon your specific request, and may contain sufficient information to make a sound judgment regarding its soundness. Small banks usually do not offer as much information as large banks and may be harder to analyze. However, if you are living in a small town and using a small bank, the bank's condition may be well known by the general population. A bank serving primarily one industry will prosper when the industry prospers and falter when that industry falters.

### ***Rating Services***

As we mentioned earlier, there are bank rating services available to those who do not want to take the trouble to do their own research and can afford the (sometimes substantial) fees involved. One such service that we

are aware of is Moody's Bank Credit Report Service. It provides a monthly "Bank Ratings List" covering some 400 banks and their affiliates (this represents only a very small percent of banks in the United States). It also publishes "Credit Alerts" when bank ratings are reviewed or changed, as well as weekly "Watchlists" on pending rating reviews. A monthly update on quarterly financials is included to subscribers, an 8-page annual "Bank Reports" is provided on request (for banks included in the survey) on individual institutions. Moody's service includes telephone access to bank analysts for BCR clients. This service is designed primarily for use by institutional investors and client fees are quite substantial. Further information can be obtained from Moody's Investors Service, 99 Church Street, New York, New York 10007, telephone (212) 553-1653.

We are aware of three organizations that *will* provide information about a particular bank or thrift to individuals for a modest fee:

1) **Sheshunoff Information Services, Inc.**, mentioned earlier, offers a variety of reports on Federally insured banks and thrifts.

**The Sheshunoff Bank Rating Report:** A concise 5-page report providing a clear and graphic overview of the particular bank, supported by detailed financial data. The bank's percentile ranking within its peer group is provided for more than 50 financial categories, as well as the 5-year trend for each. Sheshunoff provides three composite ratings for each bank, based on its performance compared to 1) others in its state, 2) all banks in the country, and 3) banks of similar asset size. Data are updated quarterly. Cost: \$25 per bank plus postage and handling.

**The Sheshunoff Bank Report:** A more extensive report, using 5 years of historical data including balance sheets and income statements. Over 20 separate sections, with detailed historical analyses of a wide range of financial data. Includes percentile rankings and bank's composite rating for the past 5 years. Updated quarterly. Cost: \$105 plus postage and handling.

**The Sheshunoff S & L Rating Report:** Similar to the *Bank Report*, with 20 sections of extensive historical analyses and performance summary. Updated quarterly. Cost: \$25 plus postage and handling.

For more information, contact Sheshunoff Information Services, P.O. Box 13203, Capitol Station, Austin, Texas 78711. Telephone: 1-800-456-2340 or (512) 472-2244.

2) **Veribanc, Inc.**, will supply a variety of reports on any Federally insured commercial bank, thrift institution, or credit union on request. The most pertinent and affordable of these reports are:

**The Veribanc Short Form Report:** This report provides a brief sum-

mation of the financial status of a bank, thrift, or credit union. Capital ratios and earnings ratios are presented in color-coded graphic form and peer group averages are appended to each report. Data are updated quarterly. Cost: \$25 per financial institution.

The **Veribanc Bank Research Report**: This report provides more complete data on a bank's performance and includes Veribanc's analysis of its financial condition. Cost: \$45 per financial institution.

Veribanc's report of "Banks Which Could Reach Zero Equity in One Year" lists the highest-risk financial institutions that, on the basis of current performance, are projected to become insolvent unless performance changes. Cost: \$55.

The **Veribanc Blue Ribbon Bank Report**: This lists the 40 or 50 financial institutions, by region, that are judged by Veribanc to be in the soundest financial condition. Cost: \$35.

In all, Veribanc will prepare some 35 different reports on request. For more information, contact Veribanc, Inc., P.O. Box 461, Wakefield, Massachusetts 01880, telephone: 1-800-442-2657.

In addition, Veribanc offers an **Instant Rating** telephone service, by which callers can obtain instantly the Veribanc rating of any insured bank, thrift, or credit union. The phone information is verified with a follow-up written report. Cost: \$10 for the first rating, \$3 for each additional rating. (Caller must have a Visa or Mastercard account.) Telephone number same as above.

3) **IDC Financial Publishing, Inc.** offers the following written reports on banks, savings and loans, and credit unions:

The **IDC Research Report** is a 5-page evaluation that reviews separately the capital, asset, management, earnings, and liquidity position of an institution. The analysis does not contain specific financial or graphic data but summarizes IDC's assessment of an institution's standing based on such data. Each institution is given a "quality rating" by IDC on a scale ranging from superior to below average to "rank of one" (most likely to fail). The informative text is written in layman's terms. Cost: \$25 per institution.

The **IDC Quality Report** includes a 5-page written analysis, historical financial data, and a 5-year graph of the rating given by IDC to the individual bank, thrift, or credit union. The "numerical rating" shown is based on a scale of one to 300; this more precise scale provides the basis for the broader "quality rating" categories in the less-detailed *Research Report*. Cost: \$69 per institution.

The **IDC *Management Analysis*** is the most detailed of the IDC reports for individual institutions. It includes a 5-page written evaluation, historical financial data, graphic analysis of loan and investment performance (for banks only), and 5-year numerical ratings. Cost: \$89 per thrift or credit union, \$120 per bank or bank holding company.

For more information, contact IDC Financial Publishing, Inc., 300 Cottonwood Ave., Hartland, WI 53029. Phone: 1-800-544-5457.

For those who do not want to take the trouble to “dig out” the pertinent data on their own (or do not have access to any of the other sources of information described above, which contain essentially the same data that are provided by the Sheshunoff, Veribanc, and IDC reports), their services may be useful.

We have no connection with any of the above organizations and cannot vouch for the accuracy of the information contained in their reports.

As you obtain pertinent information from one or more of the above sources, you may want to enter it in the worksheets on pages 68 and 69. The worksheets list the summary financial ratios provided in the Uniform Bank Performance Reports.

## CONCLUSION

**T**HROUGHOUT this booklet we have maintained the view that the current financial weakness of banking, thrift, and other depository institutions does not necessarily pose the threat of an imminent “banking collapse.” Rather, in our view, the “shakeout” that is taking place is an expected consequence of the myriad restrictions that Government regulations have imposed on the financial services industry and of long-standing policies that have created incentives to unsound banking practices. If deregulation of banking were allowed to proceed and financial institutions were allowed to respond to market directives unencumbered by such policy restraints (and without the blanket guarantees of their liabilities provided by the current system of Federal deposit insurance), then the outlook for a return to sound banking practice via freer banking would be more favorable than it now is.

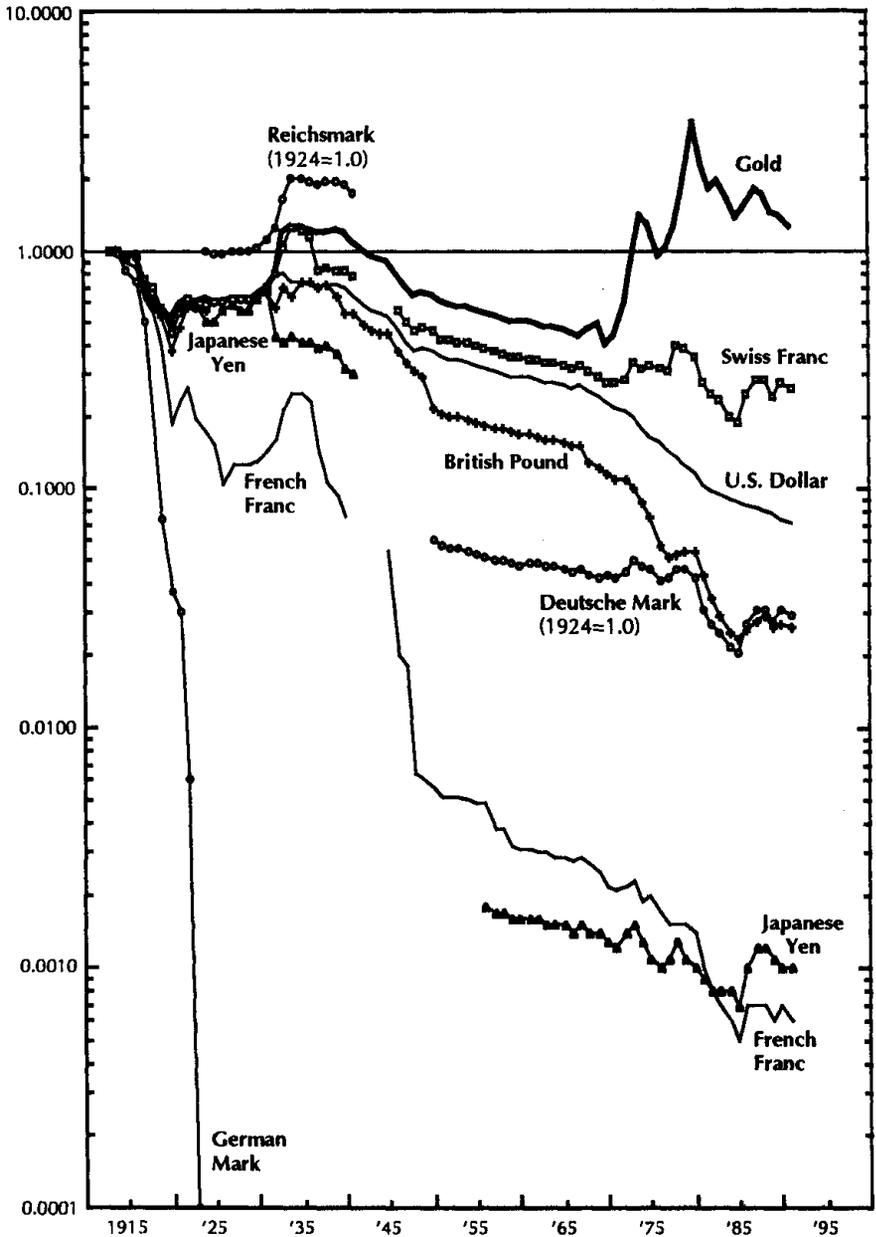
Unfortunately, the pace of deregulation has slowed. The focus has shifted toward greater, rather than less, Government oversight. Misdirected policies have left the Federal Government with huge liabilities for thrift and bank deposits, and its “stake” in these industries’ performance is larger than ever. Under these circumstances, the likelihood that lawmakers will renew the deregulatory initiative seems increasingly remote. Of course, the opposite also *could* occur: taxpayer outrage at having to pay billions to “rescue” the thrift industry *could* lead lawmakers to take steps to avoid similar “crises” in the future.

Whatever happens, under the present monetary regime no funds that are denominated in dollars are genuinely “safe” — no matter what institution holds them on deposit. A genuine measure of safety requires that funds deposited today will be worth the equivalent amount in terms of purchasing power when they are withdrawn. But the simple fact is that no bank, thrift, or credit union, Federally insured or not, can provide such a guarantee so long as dollars can be created “out of thin air” and are not redeemable in any monetary commodity. As we have said many times in other publications, a dollar is an “IOU nothing,” and the precipitous decline in its purchasing power over the past half century would seem virtually to guarantee that funds deposited in a bank today will *not* be worth as much when they are withdrawn.

Apparently many people today believe that “inflation” is now behind us, and that any loss of savings on its account is something that they will be able to live with.

Anyone inclined to believe this view could benefit from a short course in human history: it is an inescapable fact that throughout known history,

Chart 7  
**PURCHASING POWER IN THE UNITED STATES  
 OF GOLD AND SELECTED CURRENCIES (1913 = 1.0)**



Note: Purchasing power was calculated from the implicit price deflator for U.S. GNP and the exchange rates of foreign currencies for U.S. dollars.

there has *never* been a fiat currency that over an extended period of time has retained its purchasing power. All irredeemable currencies have in time become worthless, and (except for collectors' items or rarities) *all* paper currencies are today worth less than when they were first issued.

Chart 7 shows the dismal record during this century of some major nations' experiences with paper currencies. (The experiences of most less-developed nations with paper currencies have been dramatically *worse* than those shown in the chart.) Plainly, the historical record is that the world's major paper currencies, in terms of what they will purchase, today are worth only from about  $\frac{1}{1000}$ th to  $\frac{1}{4}$ th of what they were worth in 1913. By contrast, the purchasing power of gold today is *above* what it was in 1913.

Chart 8 shows the purchasing power of the U.S. dollar since 1792. The solid portions of the curve show periods when the dollar was redeemable into monetary commodities and the dotted portions are periods when redeemability into monetary commodities at fixed rates was impaired or suspended.

The precipitous decrease in the fiat dollar's purchasing power since 1933 (when the domestic gold standard was abandoned) has been interrupted briefly at several "disinflationary" or deflationary junctures. But anyone who believed during those episodes that "inflation" was permanently ended obviously was seriously mistaken. The current "disinflation" so far has been neither as great in magnitude nor as long-lived as any of those earlier episodes that failed to end the larger trend.

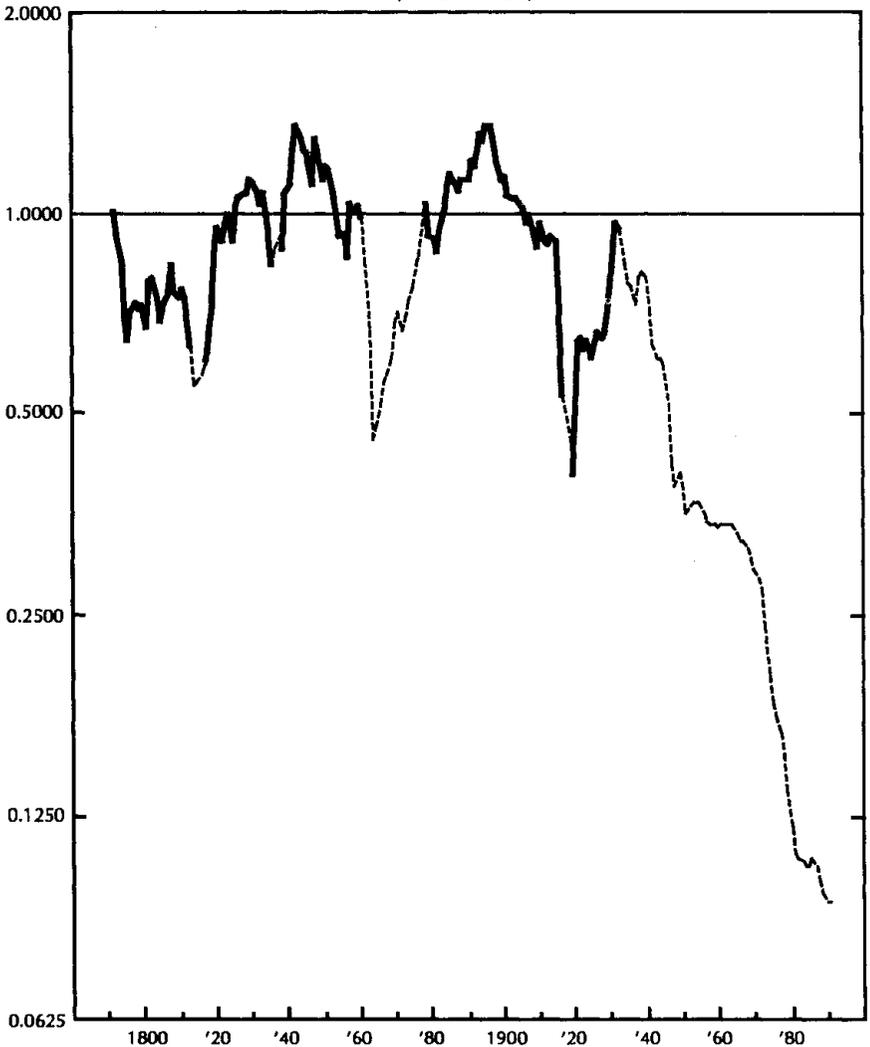
The question that should be asked is: what have the authorities discovered that will enable them to soundly manage fiat currency? As long as money managers are able to exercise "discretion," can they really be expected to withstand the pressures to inflate?

Such pressures come from many sources, most obviously from debtors of all kinds who have misjudged the market. The many interests and groups that explicitly or secretly want more inflating include not only debtors and their bankers, who want to see the real value of their obligations reduced, but also producers who wish to increase or maintain the nominal value of their output. What they all have in common is a desire to evade market discipline — and by far the largest offender in this regard is the Federal Government. The Government's response so far to the current banking crisis is a case in point. Time after time, wherever large amounts of bank credit have been needed to forestall a major failure, that credit has been extended regardless of its inflationary consequences.

As we describe in the appendixes that follow, both the bankers and their

Government overseers have been chiefly responsible for the process of inflating. Until such time as sound money and credit conditions are restored — and we doubt that they soon will be — there can be no such thing as a genuinely “safe” bank.

Chart 8  
**PURCHASING POWER OF THE DOLLAR**  
(1792 = 1.00)



Note: Purchasing power was calculated from the Wholesale Price Index (source: U.S. Department of Labor). The broken portions of the curve are periods when redeemability of the dollar into the monetary commodity at fixed rates was suspended.

## KEEPING A FINANCIAL RATIO RECORD

A worksheet for recording a financial institution's primary financial ratios that are reported in the UBPRs and other information sources is provided on the following two pages. The four main categories included in the worksheet — capital adequacy, asset quality, earnings and profitability, and liquidity and interest-rate sensitivity — reflect the same groupings of data used by the FFIEC in ranking the performance of an institution (the fifth FFIEC category, management competency, is omitted, since objective criteria rather than "hard data" are used in that ranking).

Unless you obtain a UBPR for your bank, you probably will not be able to enter all of the ratios listed on the worksheet. However, you probably will be able to derive at least one or two ratios in each category from other sources — and in most cases these will be sufficient to provide a summary of an institution's overall financial condition. To derive the ratios from base data such as that reported in a bank's "Statement of Condition" or *Annual Report*, simply divide the first category mentioned in the ratio by the second: e.g., the core capital to average assets ratio is obtained by dividing core capital by average assets. Growth rate percentage ratios are determined by subtracting the account balance as of the corresponding reporting period in the previous year from the current period account balance and dividing the result by the previous year balance.

As we mentioned previously, you should look for sharp divergences from previous experience, and for trends indicating deterioration in one or more of the broad categories (e.g., declining capital ratios and growth rates, increasing loss ratios, decreased earnings ratios or increased overhead ratios, or restricted liquidity as shown by a decrease in the repriceable assets ratio or an increase in volatile liability dependence). Performance in one category may not indicate significant problems. But if a general pattern of below-average performance in many or most categories appears, then the institution is in trouble.

## SUMMARY FINANCIAL RATIO RECORD

Name of Institution \_\_\_\_\_

	Reporting Period							
	12/31/91		12/31/90		1989		1988	
	Bank	Peer*	Bank	Peer*	Bank	Peer*	Bank	Peer*
<b>Capital Adequacy Ratios</b>								
Core capital to average assets (a)								
Cash dividends to net income (a)								
Retained earnings to average total equity (a)								
Growth Rates:								
Assets (a)								
Core capital (a)								
Net loans and leases (na)								
Volatile liabilities (b)								
<b>Asset Quality Ratios</b>								
Net loss (charge-offs less recoveries) to average total loans and leases (b)								
Percent of nonperforming (sub-quality) loans and leases (b)								
Loss reserves to total loans and leases (b)								
Loss reserves to net losses (na)†								
Net operating income to net loan and lease losses (a)								



## Appendix A

### SOUND COMMERCIAL BANKING

**I**N Colonial America, early experiments by the several colonies with paper currency (as well as those with other substitutes for specie) founded because limits on their creation were ineffectual. Too much money was issued, and the "money" tended to worthlessness when it no longer was generally accepted in transactions. The framers of the Constitution specified gold and silver coinage as the money of the United States in a deliberate attempt to prevent the further issue of paper currencies that had so disrupted the several colonies at various times and had threatened the existence of the fledgling republic during the Revolution and in the years following it.

During the early decades of this country's history, there was no money-credit system capable of fostering the greatly-to-be-multiplied number of transactions associated with the extraordinary growth of the United States. No theory of money and credit developed to that date offered a solution to the problem; no economists had proposed how the task could be accomplished; no government planners were prepared to provide the increase in purchasing media that would be needed in the decades to follow; and bankers generally were as ignorant of the broader consequences of their actions as they are today.

Nevertheless, the problem was solved. Unplanned evolutionary development in free markets accomplished a task that might well have seemed impossible to anyone who could have foreseen the need. By the later 1800's, increasing output no longer threatened to outrun the capacity of the money-credit system to efficiently effect the transactions that were an integral part of industrialization and mass marketing.

During the decades following the Civil War, production of the things desired increased at an unprecedented rate. In only a man's lifetime, about 70 years, the volume and exchange value of things passing through markets in the United States multiplied more than 50 times, although population increased only 4 times. Gold in circulation (including coins and, later, gold certificates) multiplied only 8 times from 1865 to 1930 (the peak year), but total purchasing media in use (checking accounts plus currency) multiplied about 20 times from 1867 to 1934.

Aiding this growth was the evolution of sound commercial banking. It tended to foster a dynamic balance between the purchasing media available to prospective buyers for use in the markets and the gold-exchange value of newly produced things available for purchase. The expansion of purchasing media in excess of the available monetary commodities was

based on the discovery by bankers that some of the claims they issued were not presented for redemption in the monetary commodity but were exchanged for other things in the markets. The sellers of those other things then returned claims to the bankers in payment of loans that originally involved the creation of claims.

The dynamic balance fostered by sound commercial banking was not, to repeat, the result of the deliberations of official committees, economists, or planners. Indeed, the bankers, borrowers, and lenders who participated in the process probably gave little thought to the monetary implications of their actions that were determined by market conditions. Because the claims issued by bankers to represent the gold-exchange value of things offered in the market could be redeemed in gold, misjudgments and changes in market conditions were quickly reflected in shipments of gold.

This principle applied among industries as well as among geographical areas, whether they were nearby towns, states, regions, or even countries. The outflows of gold ensured that bankers who could not or would not adapt to market conditions soon found themselves bankrupt and out of the market. Bank runs, adverse clearing balances, gold losses, etc., also kept banks "honest," or they simply ceased being banks (that is, they went broke).

This is not to say that the dynamic balance fostered by the evolution of sound commercial banking eliminated fluctuations. Economic growth involved change, and change involved risk. New products, processes, and markets did not arise as self-fulfilling prophecies of planning boards; rather, they arose as ventures into the unknown and unfamiliar. Mistakes probably were the rule rather than the exception, but errors and distortions could not cumulate to catastrophic levels except when Government intervention prevented early correction of the errors. In the absence of Government intervention, those early corrections would affect chiefly those persons local to the misguided ventures, not the entire country or perhaps several countries.

Today's nationwide and worldwide financial crisis can be traced in part to the focus of economic thought and policy on aggregate *quantity* levels of activity to the virtual neglect of *quality* considerations.

A total quantity of credit in and of itself does not reveal whether it is or is not a sustainable (equilibrium) amount. A sustainable credit structure is one in which every borrower is willing and able to pay in real value his debt as contracted at maturity. Banks as "borrowers" of depositors' balances must pay their demand liabilities "on demand." If debts between individuals, between banks, and between banking systems are continuously limited *in fact* to those that can be offset by monetary claims against

other individuals, against other banks, and against other foreign institutions, *there is no limit to the volume of credit that can be sustained by a given asset-reserve base.* The corollary in the banking sphere is that a given ratio of a bank's asset-reserves to its liabilities does not determine if the amount of asset-reserves is or is not sufficient to support the liabilities.

### ***Sound Credit Rests on the Exchangeability of Goods***

A sound credit structure rests on the exchangeability of the specific goods debtors expect to sell to others in order to gain credits needed to offset their debts.\* This applies to banks (and their credit instruments used as purchasing media) as well as to nonbanks. For banks, the exchangeability is one step removed; it is accomplished through the bank's loan customers. An appropriate increase in total credit (and transactions money), therefore, is determined by the increase in the volume, the exchange values (prices), or both of the specific goods (explicit or implicit) against which the credit is granted. If in every instance, credit extension is limited to the in-fact-realizable real prices of the *goods debtors expect to exchange for credits* in order to clear their debts, both the distribution of credit and the total amount of credit will be sustainable.

Every individual debtor would have credits against other members of the community sufficient to cancel his debt; every bank would have credits against other banks sufficient to pay its depositors and to offset any debits with still other banks. The national banking system as a whole would have sufficient credits against foreign banking systems to offset debits with others. *All debts would be canceled by credits — that is, by offset.* No transfer of reserve assets would be necessary — by individuals, by banks, or by banking systems.

When, however, more credit is extended on the basis of the expected value of specific goods available for exchange than the debtor can exchange them for, the debtor does not gain sufficient credits from other members of the community to offset his debt. If the debtor has other assets he can exchange (sell) for credits sufficient in amount to offset his debt, the lender's (say, bank's) credits would remain sufficient to offset his debts.

But if the borrower does not transfer to his bank sufficient credit to cover his debt, the bank would not have sufficient credits to offset its liabilities to depositors, its debts with other banks, or both. The bank then might have to sell assets (constituting part of the bank's net worth, or capital) in order to gain enough credits to offset its debts with other banks.

Alternatively, the net debt position of the one bank (or many banks)

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\* "And services" is not added to "specific goods" because the provision of services ultimately is settled by the exchange of goods, although many exchanges of services for other services may occur before a good is taken in final exchange and consumed.

might be maintained for a time. The banking system *as a whole* would continue to have a balance in debts and credits among the banks, inasmuch as the net debt position of some banks would be counterbalanced by the net credit position of others. No assets of the debtor banks would have to be sold. Therefore, if the debtor banks were many and if the book value of the assets they held as net worth were far more than the banks could realize on a forced sale of them, the banking system as a whole could conceal the asset deficiencies, block adjustments in relative prices of assets, and prevent the contraction of total credit, including the purchasing media component.

It is imaginable that a national banking system could indefinitely maintain a large imbalance in debts and assets among its separate component banks, and the separate banks in turn could do likewise for their individual debtors — were it not that there are international goods and credit flows. When credit is extended on a transaction involving a foreign entity, the potential arises for an imbalance between debts and credits among national banking systems. When those imbalances occur, the net-debtor system must transfer to the creditor system some internationally acceptable settlement asset to clear its debt. Or, alternatively, the creditor national systems might allow the debtor systems to remain indebted. As with the component-member banks of a national system, the credits and debits of the international banking system as a whole would remain in balance although some component national systems might be chronic net debtors. International adjustments in relative prices, wages, and flows of goods and long-term investment funds thereby would be blocked, however.\*

These relationships are evident in the way today's debt crisis is being handled:

- The Federal Farm Credit System is created to direct more credit to agriculture than private market participants are willing to commit there. The credits turn out to be uncollectible, so it is proposed that the Farm Credit System's assets and liabilities be consolidated (indirectly) with the U.S. Treasury to cover the deficiency of its credits and of the market value of its capital-reserve assets.

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\* There is the possibility that such immediate adjustments should be "blocked," if nonpayment is attributable to a temporary condition, say, drought or cyclical recession. The difficulty is to differentiate at the moment between temporary and more lasting imbalances. Private creditors assessing the condition as temporary would be inclined to renegotiate the credits, albeit at perhaps penalty terms, in which event there would not be a reported imbalance. When governments act to offset private-sector imbalances and thereby block adjustment, the assessment of politicians as to the degree of permanence of the condition overrides that of market participants. There is no basis for expecting the politicians' decision to be more accurate. On the contrary, inasmuch as the time horizon of incumbent officials is the next election and inasmuch as they do not risk their own funds when they grant government credit, they are biased toward interpreting as temporary every imbalance that would require difficult domestic economic adjustment during their incumbency.

- The FSLIC is formed to protect S&L depositors from unsound credits extended by individual S&Ls. But so many S & Ls have extended unsound credits that the FSLIC no longer can cover the deficiencies with its own credits and net-worth assets. Massive recapitalization is authorized in order to add hundreds of billions of credit power and asset reserves from a new agency, the RTC, to the deficient ones of the FSLIC.

- Private banks in many countries made unsound loans to borrowers (private and public) in other foreign countries. The borrowers cannot earn enough credits to offset their debits with out-of-country lenders, and the debtor national banking systems do not have sufficient international settlement assets to transfer to the creditor systems to settle the deficiency. Creditor national systems transfer some of their international settlement assets and national credits to the IMF and World Bank and empower them to create or borrow more. This consolidates, in part, debtors and creditors among different national systems and thereby enables credits to be more nearly offset by debits. To the extent international settlement assets (reserves) are centralized in these institutions or are increased by them (the IMF's SDRs), these institutions can settle (pay) some of the remaining net deficiency of credits.

### *Sound Purchasing Media and Commercial Loans*

Today's massive debt problems thus are traceable to the extension of credit based on inaccurate estimates of realizable values from expected sales of goods. When a businessman extends credit to another businessman he receives the debtor's IOU. The creditor-businessman ordinarily does not use the debtor's IOU to make payments to other members of the community. If the IOU turns out to be uncollectible, the loss is absorbed by the creditor alone. (Although, if large enough, it could affect many employees, vendors and their employees.)

A bank's credit extension differs from that of a nonbank. When a bank originates credit, it takes as an asset an IOU that does not circulate as purchasing media ("money") and extends its own IOU, a checkable deposit balance, that does serve as purchasing media. By substituting its own liabilities for those of individual nonbank debtors, a bank transforms specific debt into debt generally acceptable as a means of payment throughout the community. In doing so, a bank also has the potential for taking specific unsound, distortionary credits and generalizing them more widely in the community.

For all banks operating within a national banking system, the "community" is the national economy. Unsound specific credits of individual banks that are absorbed within a consolidated national banking system, therefore, have generalized distortionary effects throughout the national economy.

And likewise for an international money-credit system and the international real-goods economy.

Since bank credit, especially that constituting purchasing media, has a widespread effect on the community at large, it is of great importance to the fostering of a sustainable economic condition that banks accurately estimate the values in anticipation of sales of goods ultimately to be used to settle debts. In the words of one student of bank credit, “a banking system which extends credit only on goods which are in the process of marketing or as near final sale as possible, thus limiting the degree of anticipation, will not make as many errors in judgment as one which extends credit for the purpose of providing the capital equipment to be used in the production of other goods. Thus clearance will be improved and the necessity of resorting to reserves in order to pay for goods which have not been exchanged against other goods will be reduced. When a banking system ceases to base the medium of exchange on exchangeable goods and becomes more deeply involved in production, it is treading on dangerous ground. For by making the bonds of industry or loans on stocks the basis of its deposits [Ed.–purchasing media], the bank incurs a larger measure of liability for the risks of industry. Even though its debtors fail to repay their loans, it must meet its obligations on demand. Therefore, not only will industrial mistakes affect the bank’s net worth, but losses will have to be made up by payments out of its reserves.”\*

The notion that banks should limit the creation of their monetary liabilities to the realizable exchange value (real prices) of *newly produced goods being marketed* is known as the “commercial-loan theory” or “real-bills doctrine” of banking.† If purchasing media creation were so limited, the nominal supply of purchasing media would be continuously balanced by an equivalent real demand for it for effecting exchanges of newly produced goods. Chronic inflating would not occur.

Early in this century monetary experts widely accepted the commercial-

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\* William E. Dunkman, *Qualitative Credit Control*, Columbia University Press, New York, 1933, p. 33.

† In a narrow sense a “real bill” is a specific type of credit instrument, being an order to pay (a “draft”) a specified amount at a specified time (usually in 90 days or less), drawn by one business firm (or merchant) or another business firm (or merchant) to whom the first has shipped goods. (See *Instruments of the Money Market*, Federal Reserve Bank of Richmond, 1981, p. 114.) In a broader sense, a “real bill” is any type of credit instrument evidencing a short-term obligation arising in connection with goods being marketed. A broad-sense “real bill” involving a bank as creditor is a narrow-sense “commercial loan.” The “real” modifier to “bill” is attributable to Adam Smith. He used it to differentiate bills of exchange that genuinely are “drawn by a real creditor upon a real debtor, and which as soon as it becomes due, is really paid by that debtor” from fictitious bills of exchange (Smith called them “circulating bills”) that two or more traders conspire to draw and re-draw against each other when the earlier one becomes due, in effect never paying. (See *The Wealth of Nations*, Book II, Chapter II.)

loan theory of banking, although it also had many critics. It had enough support that when the Federal Reserve Act was passed in 1913 the Act specified that member-bank borrowings from a Federal Reserve bank be backed by "eligible paper," specifically credit instruments evidencing such commercial loans. And Federal Reserve banks were required to back their "notes" outstanding (paper currency) by a combination of gold and commercial-loan credit instruments.

### *Fallacious Fallacies*

But over the years the commercial-loan principle of sound banking lost credibility among monetary "experts" and in monetary theory, as did gold. That these two key aspects of sound money-credit arrangements fell into intellectual disrepute together is more than coincidental. The commercial-loan principle, or real-bills doctrine, of money and banking was said to be fallacious in two ways.

The alleged *nominalist fallacy* is that the real-bills doctrine provides for the determination of one nominal quantity (the supply of purchasing media) by another nominal quantity (the sum of the prices of the goods supporting the commercial bills of exchange) and, therefore, the doctrine would not prevent the creation of an excess nominal supply of purchasing media. According to the supporting reasoning, if goods prices rise for some nonmonetary reason (possibly because of some "shock" such as a poor harvest, an OPEC-like cartel, or war in another country), the initial price rises of those specific goods would warrant the creation of a larger nominal amount of commercial bills and this in turn would induce an increase in the supply of purchasing media that would support the initial price increases and generalize the price rise throughout the economy. Accordingly, a vicious inflationary circle could arise: higher prices would "justify" monetary expansion, which would induce further price rises, and on and on. By this reasoning, the noninflationary supply of purchasing media would be an indeterminate quantity under the real-bills doctrine.

The nominalist fallacy now is widely admitted even by real-bills critics to apply only in a fiat-money regime. If the monetary unit is gold and all monetary liabilities are convertible into gold, "the domestic money stock is determined by the conjunction of the exogenously determined purchasing power of gold (world price level in terms of gold), the definition of the domestic monetary unit in terms of gold, and the desired real money balances of the domestic public."\*

An essential aspect of the commercial-loan theory is that bankers accu-

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\* Lawrence H. White, *Free Banking in Britain*, Cambridge University Press, 1984, p. 121. "Exogenously" refers to "external" conditions; specifically in this instance, all the factors that determine the world exchange ratios between gold and other things.

rately judge the realizable exchange value of the goods backing the short-term, self-liquidating loan. With gold as the monetary unit, bankers would have a standard against which exchange values (prices) of specific goods could be judged. If, nevertheless, a banking system as a whole created more convertible monetary liabilities than were justified by the gold-exchange value of goods marketed, and if as a consequence the general price level began to rise, gold at banks would become a “bargain” in relation to newly produced gold and the people would present the bank liabilities for redemption in gold. This would leave the banks with smaller gold reserves and force them to cut back their liabilities in order to maintain a prudent gold-reserve ratio. The crucial aspect is that “the price level” would be determined by the exchange value of gold for all things in general, so an initial monetary excess could not feed back on itself indefinitely.

The alleged *inelastic-supply-of-bills fallacy* relates to the volume of bills offered to banks for discounting (that is, as collateral for bank loans) and thus used as the basis for originating additional purchasing media under the commercial-loan principle. Critics assert that, contrary to the doctrine’s implicit assumption that the volume of real bills is determined by exogenous factors, the volume of bills offered to banks is determined by the rate of interest banks charge on their loans in relation to the rate of return borrowers can earn on the borrowed funds.\* Therefore, say the critics, banks can generate an increase in the volume of real bills presented to them for discounting by lowering their interest-rate charges, thus fostering the cumulative expansion of bills, loans, money and prices.

Lawrence H. White describes the fallacy as it applied to the Bank of England’s operations even after gold convertibility was restored in 1821 (a period of repeated overexpansions and subsequent contractions of paper money and credit): “In theory, however, there was no obstacle to the bank’s overissuing through aggressive discounting or open-market purchases of real bills. The qualification ... that the bank should discount *at the market rate* was pointless, since the bank had the short-run power, by overissuing, to drive down the market.”†

Inasmuch as the Bank of England had been granted a monopoly of note issue in and around London and also was empowered to operate much as a central bank (its notes could be used as reserves by other banks), it could indeed adopt and pursue for some time a low-interest policy that would “set in motion a process of cumulative expansion of bills, loans, money and prices.” Initial unsound credit extensions arising from the Bank’s

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\* “Exogenous” in this context refers to conditions outside the banking system — specifically, all the factors that determine the volume of newly produced goods offered in the markets.

† White, p. 122.

“aggressive discounting” would not generate reserve losses to other domestic banks (an internal gold drain) and force a change in policy because Bank of England liabilities (notes) served as reserves for other banks and those banks therefore had less reason to demand gold itself. Not until “easy credit” in England resulted in a loss of gold to foreigners (an external gold drain) was the Bank of England forced to contract domestic money and to accept the consequences of higher interest rates and economic contraction. Even the Bank of England could “set” a below-market interest rate (an aggressive discount policy) only for a time.

A single bank operating in a competitive free-banking system is an interest-rate taker. The interest rate on *quality* real bills (those that actually, *ex post*, generate sufficient credits to clear the related debt) is a market-given figure. It would be determined by the decisions of income earners to spend and consume now or to save (and invest) and consume later, and the real rate of return on productive capital. A single bank charging below-market rates would discover it would not earn an adequate return on its commercial loans, and one charging a too-high rate would not attract borrowers.

For the competitive free-banking system as a whole (with no central bank), an “aggressive policy” to generate a higher total amount of bills would imply acceptance of lower-quality real bills. Lower quality in this context could imply only that virtually all bankers would (1) nearly simultaneously overestimate the realizable exchange value of the goods supporting the loans, or (2) intentionally disregard accurate estimates, with the consequence that more credit (including the purchasing media component) is granted than an accurate assessment would justify. Such lemming-like action by bankers could initiate a distortionary cumulative expansion process of more loans, more money, more spending, higher output, and more bills to start the process again. But if any banker(s) were cautious, the aggressive bankers would lose reserves to the duly cautious one(s), and aggressive ones would be forced to become more cautious. Thus, only in the most improbable event that virtually all bankers simultaneously would become overoptimistic would the supply of real bills be overstimulated within a competitive, free-banking system operating on the commercial-loan principle. Under reasonable circumstances, the supply of real bills would indeed seem to be inelastic, contrary to the alleged inelastic-supply-of-bills fallacy.

### *Contrasting Directions for Reform*

The overriding importance of limiting debts between individual borrowers, between banks, and between banking systems to those that in fact can be cleared against credits suggests the essential aspects of a sound

money-credit structure: (1) gold as the monetary unit; (2) application of the commercial-loan principle of banking; (3) free banking (with no central bank) so that individual banks and the entire banking structure would be subjected to the continual test of reserve losses and continual discipline of market competition. During the past decade or so, as monetary conditions domestically and internationally under fiat-money systems have been widely recognized as troublingly volatile, there has developed an increasing interest in and academic respect for a role for gold in a reformed monetary system. The possible roles mentioned cover a broad range.

Not just any role for gold would be useful in restoring a sound system. As we have described, a monetary unit of gold is essential for establishing price-level determinacy; without which all prices and other monetary variables are totally relative. Gold as the monetary unit thus improves the accuracy of estimated values in anticipation of sales of goods expected to clear debts. For this standard-of-value function of gold to be effective, demand liabilities (checkable deposits) stated in the monetary unit must in fact be redeemable in gold at the option of the claim holder. In other words, monetary demand claims must be fully convertible into gold.

Full convertibility is essential for two reasons. One is to provide the continuous market test and determination of exchange rates between things in general and gold. This is the process by which price-level determinacy is made effective. If the general price level begins to rise and if some purchasing media holders perceive the rise as an incipient chronic trend, those individuals should have a mechanism for directly affecting the levels of purchasing media and credit. Convertibility would provide it, since holders of purchasing media could choose to withdraw gold, and the banks would lose reserves and be forced by prudence to reduce their demand liabilities.

Gold also is essential for use as the ultimate settlement (reserve) asset between banks (and between national banking systems). Inasmuch as gold is a monetary asset that is nobody's liability, its value in exchange, and therefore its usefulness for settling debts, does not depend on the salability of other goods to provide an offsetting credit. Moreover, gold reserves cannot be created at the whim of bankers or monetary officials. Therefore, when excess credit advances lead to calls on bank reserves to settle unmatched debts and the reserve base thus seems inadequate, purchasing media and credit flows would change (and foster adjustment in prices and output). Under fiat systems, reserves are increased in order to make them "sufficient" for the settlement of greater unmatched debts. The repeated creation of additional fiat reserves by authorities in order to forestall incipient money and credit contractions (and the related economic recessions or depressions) was the source of the modern inflationary era. Being

outside the control of authorities, a gold-based monetary system would induce earlier correction of (1) unsound purchasing media and credit creation and (2) the related real-sector maladjustments.

The commercial-loan principle of banking, we submit, would re-evolve voluntarily in a free-banking, gold-based monetary regime for the reasons described above — in short, because it best assures the settlement of bank liabilities by offsetting credits rather than by the depletion of bank reserves. This principle of sound banking need not, and should not, be established by regulation or law, because banking practices should be determined by market forces and not imposed “by authority.” However, as mentioned above, experience with sound commercial banking during the 19th century was favorable enough that it was incorporated in the original Federal Reserve Act. Admittedly, its application leaves room for error and abuse, which impose a subsequent real-sector adjustment cost. But so does the market process for other goods and services. Yet, the market process provides substantial net benefits.

As with those other goods and services, the alternatives to market-determined money seem much more costly in terms of both economic efficiency and freedom. The slow dismantling of external constraints on reserve and purchasing media creation and the ever-broader cover-ups of unsound credit and unmatched debts has left a world financial mess that has yet to be solved. The full price for fiat monetary abuses is far from having been paid in terms of real-sector adjustment.

The current financial turmoil that is the legacy of unsound money also jeopardizes the people’s freedom generally. Proposals for major reform of the monetary system also run in the direction of *more* central (political) control of fiat-money and credit activities — including control by international bureaucrats. And, as mentioned earlier, although apparently not animated by a blueprint for reform, case-by-case “solutions” to major debt problems are providing more control to politicians and bureaucrats — domestic and international — over credit creation and flows.

A critical juncture in money-credit thought and policy is approaching. For those who think experience has amply demonstrated that economic freedom is a *sine qua non* of economic advancement and political freedom, present money-credit trends must be deeply disconcerting. The trend toward increased political manipulation of money and credit must be reversed to enhance the prospect of sustained economic progress. A competitive, free-banking, gold-based monetary regime operating on the commercial-loan principle would be the sound, lasting solution to today’s financial and monetary troubles.

## Appendix B

### THE LOST ART OF COMMERCIAL BANKING

by E. C. Harwood

**T**HE evolutionary development of human culture extended over millions of years. The written record of what has occurred is relatively short, but we know not only from the written record but also from the artifacts of earlier human societies that men acquired various arts or special skills only to lose them in subsequent centuries.

Perhaps in most instances loss of acquired arts was not a determining influence in the retrogressions, the decline and fall of an unknown number of civilizations. However, in the present century an art has been lost or nearly lost, and the consequences may have a significant influence on the breakdown of Western civilization. This now nearly lost art is the art of commercial banking.

As has been true for many developments in human culture, commercial banking evolved as men attempted to cope with their problems, in particular the exchange problems encountered in a world of rapidly increasing production. From one point of view, the development of modern science and its technological application to production forced the more or less parallel development of commercial banking. Although more and more men learned the procedures of scientific inquiry that enabled them to create the amazingly productive modern industrial society, they never did apply similarly scientific methods of inquiry to the problem of effecting the tremendously augmented number of exchanges that characterized mass production for mass markets. Commercial banking evolved as an art by a succession of trials and errors just as many other human arts have developed rather than as an outcome of scientific inquiry.

Eventually the developing art of commercial banking was crudely described and in some degree understood by its practitioners. For about a hundred years it was sustained at an advanced level of development before retrogression began. Today, almost no bankers and few money-credit economists are familiar with significant aspects of this lost art. No doubt, other lost arts that once flourished seemed durable and assured of perpetuity, but the fact is that arts once lost have not readily been recovered.

#### *The Problem Solved by Commercial Banking*

Medieval markets were like those existing today in the more primitive societies. Things were produced on a small scale, were brought to the public markets by the producers or their families or friends, and exchanges were effected by barter in large part. Even in those early markets where

money was used, the money frequently was gold or silver coin, and the transactions more nearly resembled primitive barter than the modern banking and exchange procedures now widely used.

However, as the Industrial Revolution developed through the 18th and 19th centuries, mass production for mass markets became commonplace. The flow of things to organized and continuous markets became thousands of times the physical volume of things exchanged earlier. Today, as anyone who has observed modern shopping centers, supermarkets, major discount houses, and department stores can see for himself, the problem of facilitating exchanges has become enormous compared with the exchange problems of a village market centuries ago.

The modern-day problem may be summarized as follows:

a. Coming to the markets of any country such as the United States is a vast flow of merchandise, transported in ships, freight cars, trucks, and airplanes, a flow continuously in movement day and night (with intermissions for parts of the flow at times).

b. Millions of individuals and businesses obtain varying portions of this flow, for consumption or perhaps for facilitating the production of other things.

c. If the flow is to continue uninterrupted and without either accumulations of surpluses or serious scarcities in the markets, potential claimants (buyers) must be provided the claim checks (purchasing media) that will enable them to continuously to buy what is offered. Neither an excess nor a deficiency of claim checks must be provided.

If you were suddenly confronted with such a problem, and had no experience with modern financial and exchange procedures, had never handled what you think of as money, the problem might well seem extraordinarily difficult. Remember that innumerable items flow into the markets: gold ingots from South Africa, manufactured watches, silver in many shapes and forms, diamonds and other precious gems, food in infinite variety from raw material to precooked TV dinners, fabrics and clothing also of seemingly unlimited variety, millions of automobiles, all kinds of chemicals, medicines, household appliances, etc.

Also, remember that practically all of the buyers in the markets have, in some manner or another, participated in the processing efforts that have resulted in this vast flow of things. Each is entitled to his share: this man has fitted the wheels on each of thousands of cars; that woman has sewn the seams of hundreds of suits; this manager has coordinated the efforts of a few hundred thousand people engaged in processing a flow of tires to market; another man has loaned his savings to a company that provides

electricity for all to use; still another, a barber, has just performed a service for Tom Jones and has received from him some of the claim checks earned by Tom during the past week, so that, although a barber sends no things to market, he also obtains the means to buy.

Let us suppose that your problem is to provide for all the potential sharers in the flow of things some means of claiming their shares in the markets. We shall not suggest that you stumble down all the blind alleys where men were frustrated in trying to solve this problem during the long evolutionary development of useful commercial banking. Instead we provide a summary description of the most advanced, most efficient stage of development that was reached in the decades before World War I.

We chose that stage of development because retrogression began with World War I as will be described in more detail later.

### *How a Useful Money-Credit System Functioned*

One of the obvious requirements for solving the problem as described is an accounting unit in terms of which the exchange values of all things in the markets can be determined. Clearly, claim checks valid in the markets for purchasing things being offered for sale must be denominated in some unit of measure for exchange values. Thus, the claim checks can be anonymous and available for general use in claiming (buying) anything. Unlike the situation in a baggage checkroom, those who wish to claim things offered in the markets want their claim checks to be valid for any item available, rather than valid for claiming only one thing. The buyer in a market wishes to claim the number of units of exchange value to which he is entitled rather than the specific items that he may have participated in producing or in bringing to the market.

Nevertheless, the market situation is in some respects like that in a baggage checkroom. If claim checks for baggage were counterfeited, or in some way were issued when baggage had not actually been left in the checkroom, people could be trying to claim more baggage than there was baggage to claim. Conversely, if baggage checks that had been issued properly as baggage was received were either lost or destroyed, some baggage eventually would remain unclaimed in the checkroom.

Similarly in a nation's markets, if the claim checks (or purchasing media, or "money") were counterfeited or in some other way amounts were issued to potential buyers in excess of the amount required to represent values of things in the markets, buyers would have far more to spend than the usual market prices of things for sale. In trying to use their excessive purchasing media, buyers would bid for relatively scarce goods, and prices would rise.

In the reverse situation, that is, if claim checks (purchasing media) were not issued in sufficient amount to represent the values of things being offered in the markets at the usual prices, prospective buyers would not be able to claim all the things offered. Then merchants would be forced to reduce prices in order to sell their stocks of things before the continuing flow of goods to market exceeded the capacity of their storerooms.

The accounting unit finally chosen by all leading industrial nations was a specified amount of gold by weight and degree of purity. In some instances, different weights of gold were designated as the accounting unit, and various names were applied by the different nations to the weights of gold they selected, such as dollars, francs, pounds, etc. Nevertheless, because all the accounting units were gold all were freely exchangeable with one another in the simple proportions of their relative weights of gold.

While these conditions prevailed, any specific number of the accounting units designated so much gold by weight. One had no need to talk about a "price" of gold in terms of various currencies, any more than one would discuss the "price" of a bushel of potatoes in terms of potatoes. One might talk about the weight of a bushel of potatoes as being 60 pounds of potatoes; and in similar fashion one might talk about 100 dollars as being a specified amount of gold by weight, because a dollar by statutory definition was approximately one-twentieth of an ounce of pure gold.

The fact that gold was the accounting unit chosen explains neither how that choice came to be made nor how it facilitated the issue of claims for things in the markets. As for how the choice happened to be made, we shall comment here only briefly.

As human culture evolved, men discovered the usefulness of gold as an exchange medium. This was not a scientific discovery in the usual sense involving laboratory experiments and analyses; it simply was the result of unplanned experience. Men discovered the durability of gold, which neither rots nor rusts; its comparative scarcity; the fact that its exchange value for other things (or rather for the average of other things over wide areas and prolonged times) was relatively stable, as compared with the relative exchange value of anything else; even its pleasing appearance to men and women; its easy divisibility; and possibly other attributes may have been taken into consideration.

At this point we are focusing attention on some of the facts and are not attempting to describe how those facts came to exist. These are aspects of the entire problem that need not concern us here, however interesting they may be to students of economic history. The fact is that gold was the unit of account for modern industrial civilization.

We turn now to a description of the commercial banking procedure that issued claim checks representing things in the markets, retired those claim checks from circulation as things in the markets were sold, and issued new claim checks to represent the new things coming into the markets. These procedures had to occur in order to facilitate the huge volume of exchanges essential to the orderly functioning of a modern industrial society.

At this point, one must first realize that gold held in the banking system was one of the things continually offered in a nation's markets. As gold was brought to the banks, paper currency was issued to represent it, or additions to individual checking accounts were made to represent the gold; *i.e.*, to the account of the man who deposited gold was added, by a bookkeeping entry, the appropriate number of gold accounting units (in the United States, dollars). These purchasing media, *i.e.*, currency or checking accounts, could be used by the holders at any time to claim gold from the banks, that is to buy the gold in that segment of the nation's markets.

The commercial banks also created claim checks (purchasing media consisting of currency and checking accounts or demand deposits) representing things being shipped to and offered in the nation's markets. The procedure formerly more widely used is somewhat easier to understand.

As a manufacturer shipped completed things to market, he would prepare a document describing the shipment, take it to his bank, and borrow purchasing media that, in practical effect, represented the things en route to market. The bank made the loan by crediting an appropriate amount to the checking account of the manufacturer, but this amount was *not* deducted from other checking account liabilities of the bank. Thus, new purchasing media were created and were placed in circulation when the manufacturer used the addition to his checking account to pay wages, salaries, suppliers, and other costs of processing the things sent to market. (As the things were sold, the receipts from sales were used to repay the bank loan by having the amount deducted from the manufacturer's account. Thus the purchasing media created for temporary use were withdrawn when their purpose had been served.)

Those who received the newly issued purchasing media from the manufacturer then could choose whatever they wanted that the markets offered. Also demanding things in the markets were those individuals who had purchasing media representing gold in the banks. Everyone who had purchasing media at his disposal could buy anything he chose in the markets including the gold continually being offered by the banks, which was one segment of the entire market.

A brief digression is necessary at this point, because the procedure de-

scribed above has been modified in recent decades as mass production has developed on a broader scale and now occurs almost continuously throughout the year. For example, automobile manufacturers ship cars to market practically every business day except for the few weeks each summer when plants are closed for the changeover to new models. Preparing new sets of documents nearly every day for all shipments for use as a basis for bank credits would be unnecessarily time-consuming. Consequently, a different procedure has been developed.

The automobile manufacturer arranges with commercial banks for a "line of credit" and gives a promissory note that may be paid off only once each year during the model changeover period when no cars are en route to markets. Thus a series of borrowings continually being repaid as cars are sold is replaced by a single borrowing resulting in the creation of purchasing media that remain in circulation as long as the flow of cars to markets continues. Instead of using the receipts from today's sales of cars to pay off the note secured by the bill of lading for the shipment, the receipts from today's sales are used by the manufacturer to finance his next shipment. (Whether the time intervals involved are daily, weekly, or monthly depends in part on customary timing for the payment of wages, salaries, dividends, bills for materials, etc.)

Clearly, the art of commercial banking requires knowledge about many aspects of production and exchange. The banker must be an expert judge of financial statements and must know the customary production and shipping procedures of those for whom he creates new purchasing media by discounting their notes. He also needs to have some knowledge of market prices, although much of this information is available in the records of billings by the processors of things being sent to or in the markets.

### ***Potential Errors in Judgment***

The commercial banker also must have a sound basis for judging prices. Inasmuch as gold by weight was the accounting unit when the gold standard was in general use, as it was before World War I, prices of all things except gold were quoted in terms of gold. For example, at that time, "dollar" was simply another and shorter name for about one-twentieth of an ounce of pure gold. Today, "dollar" is a fictional unit, and judging prices quoted in it is a nightmare.

Errors by commercial bankers in judging the prices of things that are represented by new credits (by newly created purchasing media) could have disturbing repercussions. If, because of overoptimism about prices generally, the bankers created so much new purchasing media that prices in the United States increased in relation to prices for similar things elsewhere in the world, some potential buyers would buy in foreign markets.

In that event, the banks would have had to send gold abroad, because a foreign holder of U.S. purchasing media (or claims on it) would buy the relatively cheapest thing available in U.S. markets, which at that time would be gold.

The outflow of gold would reduce the purchasing media in the United States representing gold and thus would reduce somewhat demand for other things. Prices of most things would fall, and the commercial bankers' error attributable to overoptimism perforce would be corrected. A cumulative distortion attributable to errors of overoptimism would seem to be highly improbable, provided the basic principle of sound commercial banking were followed. However, major errors of a different type have created increasingly greater distortions that have led to periodic breakdowns of the money-credit system.

### *Savings and Investment*

As commercial banking developed, especially in the United States, two quite different functions have been performed by the same institutions. In addition to the commercial banking function already described, most banks performed an investment function, accepting saved purchasing media and investing it.

Savings are purchasing media that the original holder decides not to spend himself; instead he requests the bank to invest it for him and pay him interest on his savings account, sometimes called a time deposit. The bank invests such purchasing media by lending it to a borrower who perhaps is buying equipment for his factory or to a borrower who may desire to buy a new car or for some other purchase. Thus, the purchasing media (currency or checking accounts) are used by someone to buy things in the markets although the original recipient of those purchasing media chose not to buy but to save. He acquires a credit to his savings account or time deposit, which shows that he is the owner, indirectly, of whatever investments the bank has selected, such as bonds, mortgages, installment loans, etc.

The borrower from the bank in the savings-investment transaction is *not* at that time sending to or otherwise offering things of equal value in the markets to be sold. He does *not* desire purchasing media so that he may distribute it to employees and suppliers who participated in preparing things *for* the markets. His desire is to claim things *from* the markets, either equipment for his factory, or a new car for personal use, or any of the multitudes of other things available, such as new bricks for construction of a factory, etc. Consequently, the bank should not create new purchasing media for such a borrower but should lend him purchasing media already in existence that some present owner or owners save and deposit in the bank.

Probably because the same banks have been performing two functions, each of which involves lender-borrower transactions, similar forms (such as promissory notes), and related procedures, many bankers have confused the two functions. In the United States the "wildcat banks," usually small institutions in more or less remote areas, so inextricably confused these two functions that they not only created new deposits (by discounting notes and crediting the proceeds to checking accounts) for typical commercial purposes but also they followed the same procedure and created new checking accounts when discounting mortgage notes. In the first type of procedure, the new purchasing media created represented the exchange value of things en route to or being offered for sale in the local markets; however, in the second the new purchasing media represented things (such as land, factories, or consumer goods) not being offered by the borrowers for sale but on the contrary being removed by them from the markets.

Perhaps the clearest example of the confusion between commercial and noncommercial banking is provided by the financing of automobiles in or en route to markets in contrast with consumer installment borrowing to purchase a new car. The important distinction that makes all the difference between sound and unsound commercial banking is:

a. When an automobile manufacturer borrows newly created purchasing media and distributes them among employees, suppliers, and others, he is arranging for those potential buyers to obtain their shares (in dollar value) of things in or en route to markets.

b. When an installment buyer arranges to purchase a car, he is *not* claiming a share corresponding to his participation in producing things for markets, he is claiming someone else's share. James Brown can properly do that provided John Doe is willing to lend to James Brown the share that Doe's purchasing media (currency or checking account) proves he is entitled to claim. Such an arrangement usually is effected via the savings-investment procedures with a bank as intermediary. If the bank creates new purchasing media for James Brown to use instead of arranging a loan from John Doe or others, the result will be more purchasing media available to potential buyers than the corresponding value of things in or en route to markets.

Thus, one can see that a bank's lending transaction may reflect additional things offered in the markets *or it may not*. If it does, creation of new purchasing media (for use until retired by repayment of the loan by the seller) is sound commercial banking. If the lending transaction does *not* reflect *additional* offerings in the markets, it should be financed by the savings-investment procedures.

When the borrowers from "wildcat banks" attempted to buy, they

discovered that merchandise was scarce; they bid prices higher and higher for the available things. Soon, those having purchasing media tried to buy more cheaply in more distinct markets. The sellers in those markets did not wish to buy most things in the local markets but used their claims to demand gold from the “wildcat banks,” which then were unable to meet their obligations and collapsed.

This disastrous practice has been repeated again and again in human experience. Another notorious instance was that of the Scottish banks, of which a multitude collapsed after similarly neglecting to apply what might be called the basic principle of sound commercial banking.\*

Finally, the lesson was learned. During nearly a century prior to World War I, the leading English banks applied the basic principle of sound commercial banking most of the time with outstanding success. The basic principle became more widely understood and applied among industrial nations. Even U.S. bankers, who were “slow learners,” embodied this basic principle in the original legislation for the Federal Reserve System in 1913. The Federal Reserve banks originally were permitted to rediscount for the member banks only commercial paper directly tied to the volume and value of things flowing to markets. Such widespread application of the basic principle of sound commercial banking marked the farthest advance achieved by the human race in the evolutionary development of a money-credit system that could serve a modern industrial society.

### *Retgression*

During World War I the prolonged evolutionary development ended, and retrogression began that has continued to date. Perhaps the decisive influence was the political decision by each leading combatant to finance the war by inflating. This procedure was not justifiable on economic grounds (as Napoleon had demonstrated a century earlier), but apparently it was politically expedient. The basic principle of sound commercial banking was simply disregarded when the governments used the various banking systems to monetize government debt. Not only the central banks but also the commercial banks generally were stuffed with government promissory notes of short and long duration, the latter called bonds, in exchange for credits to the checking accounts of governments. As the new purchasing media or claim checks were used to buy things in the markets, things already represented by other purchasing media in use, demand exceeded supply at the original gold-exchange values. This was inflating, and of course prices rose.

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\* Ed.—Lawrence H. White in *Free Banking in Britain* (Cambridge University Press, 1984) presents substantial evidence that Scottish banking in the 1700’s and 1800’s was not nearly so defective as portrayed in most history of banking accounts.

During the 1920's, similar inflating occurred by means of the over-expansion of private debt. The gold-exchange-standard experiment then underway facilitated nearly simultaneous inflating in most industrial nations by the double-counting of gold reserves. When the credit bubble finally burst, the aftermath was the worldwide deflation and depression of the early 1930's.

Before World War II, the Keynesian notion that perpetual prosperity could be sustained by perpetual inflating was applied. It was continued through World War II, and thereafter it was applied on an increasing scale. The basic principle of sound commercial banking was forgotten. Perpetual inflating became the new way of life.

As the currencies of several leading nations deteriorated, that is, as prices generally rose at increasing rates, gold was demanded from the banking systems. After the gold held by U.S. banks had decreased to only 40 percent of the amount held shortly after World War II, the pretense that the dollar was still a unit of gold was abandoned in 1971.

No longer was gold by weight the accounting unit of all leading industrial nations. The "governor" of modern banking that had made possible dynamic equilibrium was abandoned. The depreciating paper currencies provided no standard of value.

From then on, lacking both a warning signal in the form of an outflow of gold and any definite restraint on the expansion of purchasing media, bankers based commercial loans on current inflated prices and made other loans and investments at similarly inflated prices. All increases in wages and other prices were validated by more and more increases of purchasing media by the central banks and the other commercial banks. Thus all the leading industrial nations became trapped in an inflation spiral of ever-increasing wages and other prices, in other words, a spiral of depreciating currencies. For this situation there is no certain end short of complete depreciation of the currencies, depreciation to the point that currencies no longer are used to effect exchanges.

From time to time during a prolonged inflationary spiral temporary setbacks occur. Overspeculation in various aspects of the economy, such as building construction in major cities or excess tanker construction, may be followed by recessions or even more severe depressions. Nevertheless, in the absence of the gold governor or any other sound basis for judging comparative exchange values, the inflationary spiral continues as long as the banks create more inflationary purchasing media to finance government deficits and/or excessive private borrowings.

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