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FEDERAL DEPOSIT INSURANCE CORPORATION

CHALLENGE AND RESPONSE

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I'm pleased to have what I presume will be my final opportunity to address the National Council before I leave the FDIC.

Incidentally, I won't be the only bank regulator leaving his job. Todd Conover, the Comptroller and a member of the FDIC Board, has already left and Irv Sprague, the third member of our Board, will soon leave. This will be the first time since the FDIC was established that our entire Board will have changed in so short a period of time.

Other significant changes are in process. Saul Klaman, the head of your organization, will be retiring next month. Saul will be sorely missed, having done an outstanding job in a difficult period. I'm sure he won't disappear altogether from the Washington and the thrift scene. Somehow I can't visualize Saul leading a quiet life, reading novels in his rocking chair. Willis Alexander recently retired from the comparable position at the American Bankers Association, and with his departure and Jerry Lowrie's, the A.B.A. will also face a period of transition. Finally, we have a whole new team at Treasury.

Because so many of the participants are changing and because Congress has had so much difficulty in dealing with major banking issues, this might be a good time to review some of the events of the past few years and to try to understand what has been happening and what changes are needed.

THE CHALLENGE

During the last four years the FDIC has handled over 210 bank failures. Last year the number was 79, the highest number since the FDIC began functioning in 1934, and this year the pace is faster. Insurance losses have averaged about $1 billion during each of the last four years, although our fund has enjoyed dramatic growth, up from $11 billion to $18 billion during my tenure as Chairman. Currently there are about 950 banks on our problem bank list, way above the previous peak. I won't try to recite the numbers and costs faced by the FSLIC in recent years. Many of you are quite familiar with those statistics and are beginning to feel their impact through increased assessments.

Why so many problems and failures? The economic environment of the past several years has been extremely difficult. Following more than a decade of accelerating inflation, we experienced high and volatile interest rates and two back-to-back recessions, the second one the most severe since the 1930s. While the recovery has been strong in the aggregate, interest rates have continued to fluctuate sharply, real rates have remained high and major areas of weakness in the economy have persisted.

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We've heard a lot of explanations concerning bank and thrift problems and ways to overcome them that are wrong -- popular myths. The problem with some of these myths is that legislators, bankers and others believe them and use them as bases for supporting policy and legislation. I would like to review a few of these myths.

Myth 1: Interest Rate Deregulation Brought on the Problems. Interest ceilings on deposits probably never made good sense. The process of getting rid of them goes back quite a few years, but it was the dramatic interest rate increases that began in the late '70s that brought on devices to circumvent the ceilings and set in motion their elimination.

Neither rate ceilings nor their elimination contributed significantly to high interest rates. Poor management of the economy and, particularly, federal deficits were the principal culprits. For most of the 50-year existence of deposit interest rate ceilings, they served no purpose because the ceilings were above market rates. When, in the late 1970s, market rates rose to levels persistently higher than the ceilings, there was no choice but to abolish the ceilings.

Deposit deregulation by itself has not been an important part of the bank and thrift problem, though combined with some other things deposit deregulation has exacerbated a few problems. Deposit rate deregulation coupled with high insurance coverage, the use of brokered deposits and the absence of market discipline has allowed weak or insolvent institutions to bid for funds. This has undoubtedly pushed up the cost of funds to some degree for all depository institutions, kept some institutions alive and, in some cases, allowed them to increase their losses and raise the ultimate cost of failures to the deposit insurance funds.

In the case of well capitalized banks, deposit rate deregulation has caused no problems. Bank managers who are concerned about returns to stockholders have no incentive to "overpay" for deposits. They are concerned about earning sufficient spreads to produce satisfactory returns to stockholders.

Myth 2: Expanded Powers Have Been the Cause of the Problems. There is no evidence that expanded powers have contributed to the current problems. First of all, there has been virtually no expansion of the powers or activities of banks at the federal level. What little expansion there has been has come from state initiatives and aggressive legal challenges by some banks. Expanded powers certainly were not a factor in the interest rate risk problem. Bank and thrift failures in recent years have been the result of a harsh economic environment coupled with poor management, insider abuse and fraud.

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Many bank and S&L failures have involved illegal activities and self-dealing. The bank literature is packed with confusion about potential conflicts of interest or abuses that will arise if banks or their affiliates engage in activities that don't fit the traditional bank label. The FDIC believes that so long as bank affiliation with other businesses occurs within the corporate structure and strict limits are placed on intercompany transactions, there is very little, if any, higher risk involved. There are innumerable informal affiliations today outside the corporate structure, where disclosure and the rules governing intercompany transactions are less rigorous. These situations are of greater concern to us than where the affiliation is in the open and subject to tight control.

Expanded activities can help expand the range of services, improve margins and diversify risk. As for the ownership of banks or thrifts by nonbank firms, it is hard to see how broadening the potential ownership and capital base can be anything but positive.

Myth 3: The Solution for Thrifts is to Grow Out of their Problems. This particular myth has largely been confined to thrifts, although we hear a lot of competitive complaints from commercial banks. The argument basically holds that if you have a substantial asset-liability maturity mismatch you can diminish or eliminate it by growing at a very rapid rate. The trouble is, it's hard to grow at a very rapid rate unless you pay above market for your money. It's harder yet to put out a lot of money without increasing interest rate risk and it's harder still to earn good spreads on expensive money without taking excessive risks. And, of course, if you're growing rapidly it's hard to exercise controls over the risky assets put on the books. Finally, even if one or two institutions are successful in this process, it's virtually impossible for a large number of competitors to be successful.

THE RESPONSE

This brings me to the final topic I would like to discuss: the changes that are needed to correct the problems that have plagued the financial system in recent years.

We believe the appropriate prescription for improving the financial system contains four basic components. These are:

(1) reduction of the federal deficit;
(2) elimination of most restrictions on products and services and on geographic expansion;
(3) reform of the deposit insurance system; and
(4) implementation of uniform supervisory rules for banks and thrifts.

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At the outset, let me stress that none of these major changes can be achieved overnight. We can, however, begin the process of phasing in these necessary reforms.

Federal Fiscal Policy

Many, if not most, of the problems plaguing financial institutions are the direct result of years of mismanagement of fiscal policy at the federal level. The federal budget deficit is easily the number one threat to financial stability in our country and even the world. It clearly is a major contributor to the high level of real interest rates and the serious balance-of-payments problem we face. There is virtually no problem in the financial system today that would not be greatly alleviated by a substantial reduction in the deficit.

Expanded Products and Services and Interstate Banking

Several points that I made earlier concerning the need to expand products and services bear repeating. Banks and thrifts have been forced to pay more for their deposits but have not been given the opportunity to make up the lost income. At the same time, competition also has intensified because of technological innovations and entry by nonbanks into previously sheltered product lines. The resulting pressures on profit margins are tempting some banks and thrifts to take higher credit risks. In view of these developments, banks and thrifts need more, not less, freedom to compete.

They should be permitted to engage, either directly or through subsidiaries or affiliates, in the full range of financial services. There is no prudential reason why ownership links between these firms and nonfinancial firms should be prohibited. Real estate developers, auto dealers, insurance agents and others from all walks of economic life own and operate banks throughout the nation. They are prohibited only from placing their banks and other business interests under a common corporate umbrella which, incidentally, would require expanded disclosure and significantly reduce the potential for self-dealing.

The time has also come to accept interstate banking as a rational development in our system that will serve the public interest. Some progress is being made at the regional level by the states and, for the most part, this is good. However, these arrangements frequently contain restrictive elements, and they may be used to forestall moves to eliminate regional barriers altogether. Congress should set a date for the elimination of these barriers, coupled with a strengthening of the antitrust laws to limit significant acquisitions by the largest banks.

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Eliminating restrictions on who can own depository institutions and where depository institutions can operate will broaden the market for troubled institutions. In a period of higher risk and change, it is important that we maximize the potential for private sector solutions to problem situations.

Deposit Insurance Reform

This brings me to the third necessary change -- deposit insurance reform. The deposit insurance system currently provides so much comfort to depositors that all-too-often they cease to be concerned about the condition of their bank or thrift, thereby sheltering the institution from private sector discipline. As a result, risk taking is overly encouraged. One corrective measure would be to base deposit insurance premiums on risk. This would impose increased costs on high-risk institutions and allocate the cost of deposit insurance more fairly.

The FDIC has strongly supported a move in this direction since 1983 and has submitted legislative proposals to Congress to implement such a system along with other deposit insurance reforms. Variable rate premiums have been endorsed by the Bush Task Group, a working group for the Cabinet Council on Economic Affairs and the American Bankers Association, among others.

Another, complementary approach to restrain bank risk and safeguard the insurance fund is through increased capital requirements. The FDIC recently issued for public comment a proposal which would raise the bank capital requirement from six to about nine percent over a period of several years, while allowing subordinated debt to satisfy the additional capital requirement. This would provide an enhanced cushion for the deposit insurance fund and result in fewer bank failures. Stronger institutions would be able to acquire the increased capital at little or no net cost. Institutions perceived by financial markets to be weak will have to pay more. In some instances the market will deny funds so that growth will be constrained. In this way the marketplace will price and control bank leverage.

Uniform Standards

The capital issue brings me to the final needed change which I would like to discuss -- the implementation of uniform supervisory rules for banks and thrifts. The FDIC's current capital requirement is considerably higher than the net worth percentages that are required for FSLIC-insured institutions. Accounting standards and asset valuation techniques widen

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the disparity. We feel strongly that both competitive equity and prudential considerations dictate common capital and accounting standards and that this parity should be achieved by raising the standards for FSLIC-insured institutions rather than lowering those for banks. We recognize that the thrift industry has faced problems for several years and that it would not be feasible to implement the requirements overnight. However, it is important that we start moving in the right direction.

The Bank Board's policy in tying net worth requirements to growth is an important step toward improving the capital position of S&Ls. However, we do not endorse the specific numbers; we believe that S&L capital requirements should be much higher than present levels. Policies geared to achieve rapid growth frequently put pressure on interest margins and asset quality so that the performance of depository institutions in the aggregate suffers.

CONCLUSION

The reforms I have outlined today admittedly constitute a tall order. Most of them require legislative action. Unfortunately, Congress appears to be immobilized by special interest politics, and the outlook for meaningful reform in the near term is cloudy at best. If Congress would enact comprehensive reforms along the lines suggested, we are convinced that the result would be a far stronger and more responsive financial system than America has ever known.

Let me conclude by thanking you once again for this opportunity to address your group and for your support during one of the most difficult and challenging periods in history.

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