THE VALUE OF EXPERIENCE

An Address by

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Good morning, it's a pleasure to be here with you today. It's good to meet with a group of bankers who have come from hard times to prosperity. In fact, your luck has really changed; the new tax law will require all citizens to have two home mortgages as a basic necessity of personal finance -- new business will abound.

FDIC-insured savings banks have been doing extremely well recently. I know of no financial institutions that have experienced anything approaching their improved performance over the past three or four years. The improvement is most apparent in New York, where savings banks have come from an average loss on assets of about two percent to an average profit of over one percent this year. To say you have done well would be an understatement. Others are not so fortunate. Thrift performance overall, like that of commercial banks, has been uneven -- maybe that's an all-time understatement. I am reminded of the opening sentence in Charles Dickens' A Tale of Two Cities: "It was the best of times, it was the worst of times."

Many thrift institutions are doing very well, but too many are performing disastrously. A recent conversation with a newly chosen board member of an S&L in the FSLIC consignment program provides an example of just how poorly some thrifts are doing. Puzzled by the above-market rates being paid by the Association, he questioned the heavy emphasis on growth. He was told, "We need to grow. So few of our loans are paying, we need the deposits just to pay salaries."

Today, I would like to briefly review the recent experience of thrifts as well as how the FDIC dealt with problems in the industry. I believe that experience has important implications and lessons for the FDIC, particularly in how to handle today's bank failures. I also believe that the past several years hold some important lessons for thrifts in how to approach today's economic and business environment.

When interest rates rose dramatically between 1980 and 1982, the cost of funds for savings banks skyrocketed. Interest margins soon turned negative. The situation was worst for New York City savings banks, many of whom had large portfolios of long-term, low-yielding corporate bonds and FHA and VA loans with yields below six percent. When the average cost of funds exceeded 10 percent in 1982, some New York City savings banks were losing as much as 350 basis points on assets. Book capital was wiped out for some and, if assets were valued at market, nearly all savings banks would have been insolvent. For the weakest, the extent of that insolvency reached 30 percent.

There was ample evidence of interest rate risk in the 1960s and 1970s. Some thrifts learned from these early experiences and moved to reduce their exposure to rate increases. And they fared better in the crisis. Most savings banks and their regulators, including the FDIC, largely ignored the potential problem. Virtually nobody anticipated the severity of the interest rate increase that occurred during the early eighties.

Between November 1981 and October 1982 the FDIC assisted mergers of

11 failing savings banks with total assets in excess of $15 billion. In all but two of the cases the institutions were acquired by other savings banks. In most of the transactions, the FDIC assumed considerable interest rate risk by guaranteeing margins on acquired assets. Through these arrangements, known as income maintenance agreements, the FDIC was able to reduce its cost considerably. Initial estimates of FDIC costs for these transactions totaled $1.8 billion -- about 12 percent of the assets involved. Had the FDIC effected clean purchase and assumption transactions with assets marked to market, we estimate the cost would have been twice as much. It is important to understand the FDIC was not betting on lower rates, the $1.8 billion estimate assumed constant rates. Of course, rates did decline, and dramatically so, in the last couple of years. As a result, FDIC costs were further reduced and the cost of the 11 assisted mergers will turn out to be only two-thirds of the $1.8 billion.

In October 1982, Congress enacted the Garn-St Germain Act which initiated a net worth certificate program for thrifts, a program that served to halt (or at least materially slow down) the forced merger of failing thrifts.

The FDIC did not favor net worth certificates, arguing that they imposed undue restriction on FDIC policy and kept afloat institutions that should fail. As good soldiers, the FDIC implemented the program quickly and generously. The FDIC disbursed $719 million in net worth certificates to 29 savings banks representing $38 billion in assets. Participation could begin, you will recall, when book net worth dropped below three percent.

A few of the participants would have survived without the program due to the interest rate decline which began in the summer of 1982. This may be proof of Greenspan's law which says that by the time the government acts, the need for action has passed. Nevertheless, it is clear that the net worth certificate program kept a considerable number of institutions alive and saved the FDIC a large amount of money -- about $2 billion. Without the net worth certificate program, the FDIC would have had considerable difficulty finding buyers for failing savings banks and that would have further increased costs. Aggregate net worth certificate balances started declining during 1986 and are now down to $542 million, a decrease of 25 percent. This year alone, eight savings banks, all of them in New York, have completely prepaid their certificates. Only 14 institutions are still in the program and all of them are now profitable.

Hindsight argues that it made good sense to slow down the failure process and exercise forebearance -- just so long as the institutions were not pursuing policies likely to increase the FDIC's ultimate exposure. The FDIC did impose constraints on what "assisted" institutions could do. Exotic activities were discouraged as was overly aggressive bidding for deposits. Performance was closely monitored through examinations and a review of planning submissions. The FDIC was undoubtedly helped by several forces: traditionally, savings bankers were conservative and community oriented; the east coast concentration tended to limit a strong growth orientation; and these same east coast markets proved to be solid and the source of few credit problems.

When the cost of funds declined, losses for most of the net worth recipients turned to profits. And the institutions, for the most part, were not encumbered by loan quality problems. Unfortunately, that has not been the universal scenario for all thrifts. Attitudes toward taking risk, the economic environment and supervisory policy served to convert an interest rate problem into a loan quality problem in other parts of the country. Some thrifts tried to grow out of the interest rate problem by making high-yield loans to minimize the relative importance of old, low-yielding loans.

Not all institutions had the experienced staff to grow rapidly and soundly. Loan quality deteriorated. The Bank Board, squeezed by pressure from the White House Office of Management and Budget, didn't have the staff to monitor lending practices. Their policies initially did not tie growth to the condition of institutions. Finally, weakness in energy prices and commercial real estate values has so devastated some economic sectors that even well-screened loans have turned sour. Thus, many thrifts, despite the dramatic decline in rates, are facing enormous difficulties. In large part, it reflects the failure to temper forebearance with appropriate supervisory restraint.

Forebearance must also be tempered with judgement. It makes no sense to allow institutions to continue to operate if doing so significantly increases the likely ultimate cost to the insurance fund and to competitive institutions. Unfortunately, the weakened financial condition of FSLIC prevents the optimal resolution of such problem institutions. That is one very important reason for recapitalizing FSLIC.

We can all learn from what has happened over the past several years. We have seen enormous changes in the economic environment. During an eight-year period we have seen Treasury bill rates go from six percent to 16 percent and back below six. The percentage swings in oil prices have been even greater. Not too long ago, big banks would have done most anything to get into Texas. Who would have thought that New Jersey would become more coveted? We must be ever vigilant for change. Never rely too heavily on things staying the way they are -- because they won't!

We have seen capital forebearance work -- through the way failing savings banks were handled by the FDIC. Forebearance also helped many S&Ls, but allowed major problems to develop for others. Clearly, a number of factors contributed to the uneven thrift performance. However, I am convinced one important ingredient was the relative level of regulatory oversight of troubled institutions. The only way to check the behavior of high rollers and incompetents is through good, effective safety surveillance.

In today's economy, we see some very weak sectors contributing to severe problems at commercial banks in the southwest and in some of the agricultural midwest. A good case can be made for some degree of capital forebearance, particularly where bank managements are competently doing what they can to lessen their problems. Closing banks precipitously and placing distressed assets in a liquidation mode serves no useful purpose. It is apt to increase FDIC costs, place additional burden on distressed markets and hurt other banks and bank customers.

We are doing some things and looking at others that are consistent with the general philosophy, "don't make a bad situation worse." We have a capital forebearance program that allows institutions in distressed environments to operate with less than normal capital requirements. Participation in that program has been limited, but growing. Also, examiners have become more tolerant of banks struggling in depressed economies. Enforcement actions are initiated less eagerly, unless insiders are misbehaving.

When banks are closed we encourage acquiring institutions to buy more assets. As you might expect, it is becoming increasingly hard to find acquiring banks -- especially banks who will take on a lot of a failed bank's loans. Understandably, potential buyers are very apprehensive about the potential credit risk as well as the drain on their managerial resources. In some respects this buyer resistance is similar to what we encountered in trying to arrange mergers for savings banks. As was done in those cases, the FDIC may need to assume much of the risk associated with failed bank assets. We have offered risk-sharing arrangements in some purchase and assumption transactions. Such an approach could reduce our costs.

Another option is to provide open bank assistance and avoid failure altogether. This also keeps distressed assets out of the liquidation mode and can reduce FDIC costs. However, we envision only limited use of this option. And only then, when there is clear financial benefit for the FDIC. In addition, the surviving institution must have good future prospects. We clearly do not want to enhance the position of shareholders and junior creditors of the failing institution, and we want new private sector capital involved. We recognize, though, that all objectives cannot always be achieved for all transactions. Today's environment calls for a pragmatic approach to assistance proposals -- one that looks closely at potential benefits and doesn't reject requests automatically.

Experience shows that forebearance does not always work. It can allow, even encourage, increased risk-taking. It can make things worse. Keeping failing institutions alive can add to FDIC costs. Assets can deteriorate further; remaining franchise value can disappear. Deterioration can occur more rapidly in distressed commercial banks than in distressed thrifts. Thus, I think we need to evaluate each case carefully. We need to be hard nosed in looking at options. Not all decisions will come easily. Our decisions may sometimes appear arbitrary. Life isn't always easy.

What are the lessons of this history for savings banks? Before the interest rate problems hit savings banks, there is little evidence that many managers anticipated that borrowing short and lending long might invite problems. Given the restrictive regulatory environment, there weren't perfect or easy ways of avoiding the problem. As I suggested, the FDIC's record on the mismatch problem was not so hot, either.

I don't know how interest rates will behave in the future, although I have a feeling that some thrifts may have already forgotten about interest rate risk. Even a very stable rate environment contains risk. Your markets will change in other ways. Regulators are not especially astute at anticipating future problems or opportunities so it's up to you to be prepared. I would urge you to invest some of your growing earnings in the kind of management depth that will help you plan ahead, and contribute to your long-run strength.