"The savings and loan crisis":

Remarks by

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Ladies and gentlemen, it is my pleasure to join you this afternoon.

It seems like only yesterday I was speaking before you on another occasion. Actually it was in December 1975, and I was here, as President Ford's Assistant for Economic Affairs, to discuss "Rediscovering Fiscal Responsibility" -- and to comment on the New York City fiscal crisis.

At that time I think we were talking about an amount in the range of $4 billion for refinancing and spending cuts.

Believe me, the irony of the timing of this second visit is not lost on me. For again today, I will discuss how we are trying to deal another financial misadventure -- but this time it is forty times the size of New York's problem. I assume based on this sequence you won't want me back again any time soon!

As you have by now surely surmised, I am going to be talking about the S&L problem -- how we got here, where we are, and where we are headed.

You know when you go to work in a visible government job you are usually handed three sealed envelopes by your predecessor with the suggestion that they be opened at each crisis during your term of employment.

I opened my first envelop when bank failures went above 200 in one year. On a single sheet of paper was written -- "Blame your predecessor." I did so and survived.

My second crisis arrived with the failure of the $30 billion dollar First Republic banks in Texas. I opened the second envelope. A single sheet said, "Blame it on the economy." It worked.

Now we have the S&L crisis and I have only one envelop left. So I took a peek at it today. My predecessor's final advice was: "Prepare Three Envelopes..."

I must admit, given all the turmoil and furor of our current economic circumstances, that might not be a bad idea.

But for now, it's on with business.

Let's take a look at how we got ourselves into the S&L mess.

First of all, there is enough poor judgement and buried ostrich heads -- and even good old fashioned misfeasance and malfeasance -- to go around. With the perfect wisdom of 20-20 hindsight, it seems clear that -- on a very large scale -- common sense and courage did not prevail.

It kind of reminds me, in fact, of a classified ad I saw in the Washington Post last Sunday. It read: "For sale -- complete set of encyclopedias. Never used. Teenage daughter already knows everything."

Historically, S&Ls were restricted to providing long-term fixed rate mortgages financed by short-term deposits. The savings and loan was at the heart of each American community, helping people finance the American dream of owning a house, while helping people save for the future. This process was strongly supported by deposit insurance. It allowed short-term rates to be set at low levels, and they were maintained by strict regulation.

The thrift industry prospered during the period when interest rates were relatively stable.

But the nature of the thrift business had always meant that S&Ls were vulnerable to rising interest rates.

In fact, the basic premise of the industry's strategy was that one could borrow short and lend long. One could use the rate curve difference to provide lower priced mortgages for the American home buyer. In this world, long-term interest rates were always higher than short-term rates.

However, this world was changing. In the late seventies, inflation was on the rise, and the Federal Reserve reacted by increasing interest rates. Treasury bill rates, which had averaged about 5.5% in 1977, rose to a peak of about 16% in 1981. S&Ls had to be allowed to pay higher interest rates on deposits or depositors would move their money elsewhere.

With nearly 80 percent of their assets in low-yield fixed-rate mortgages, and with the cost of funds rising rapidly, S&L interest margins deteriorated and profits dried up. The thrift industry's net worth began a long period of decline.

At this point, the basic interest rate risk in the S&L industry practice in lending long and borrowing short was exposed. The response to this revealed truth was most unfortunate.

What were the basic solutions proposed?

In summary, there were three parts:

(1) Allow thrifts to grow out of their interest rate mismatch with new products.

(2) Relax capital standards to the point of really requiring no capital.

(3) Limit supervision on this newly deregulated industry. In other words, get the government off the thrift executives' backs so they could become entrepreneurs and earn their way back to solvency.

While some thrifts exercised these new powers judiciously, many -- and particularly those with little capital to lose -- took large investment risks to try to recover their profitability.

It was the worst of all worlds. The thrift industry had now added credit risk to interest rate risk.

Mix this brew with lax supervision, reduced regulatory capital requirements, and slackened accounting standards and you have all the ingredients for disaster.

S&L supervisory staffs were overwhelmed as the S&L problem escalated. Attempts by the Bank Board to beef up its examination staff were repeatedly rebuffed -- a government wide freeze on new employees was in place.

Those in charge had missed a vital point. Deposit insurance gave an insured institution a federal government guaranteed credit card -- with no financial limits. Yes, deposit insurance allows an insured institution to borrow unlimited amounts simply by paying above market rates for deposits. Depositors know their money is safe.

When the government gave out its credit card, it had to supervise how the funds were used -- or suffer the consequences.

Unfortunately, the industry trade associations lobbied hard against a 1985 proposal by Treasury and the Bank Board for a completely self-financed rescue plan for FSLIC. Congress sided with the industry. They managed to cut the $15 billion plan to about $10 billion. But more importantly, they harnessed it to "forbearance" rules that further crippled the effectiveness of the regulators.

That was then. Now is now. Ironically, by our estimates, the $15 billion just might have been enough in 1985 to deal with the problem. Today, the bill looks like a minimum of $100 billion.

In summary, because of the combination of deposit insurance and the inherent interest rate risk in the thrift industry, substantial capital and strict supervision were essential. Unfortunately, neither were present.

Now we seek a way to minimize the costs resulting from these mistakes -- and a way to assure President Bush's promise of "never again."

With extraordinary leadership, President Bush -- just 16 days in office -- provided us with a sound program. Congress, under the leadership of Committee Chairmen Gonzalez and Riegle, deserves great credit for its speed in moving the President's program through its Committees.

Michigan Senator Don Riegle really did a great job in leading the legislation through the Senate in record time.

Of course, the Congress is still not finished, but it has moved with unusual speed and resistance to most special interest pleas.

As part of these efforts, the President asked the FDIC back in February to lead a conservatorship program to deal with the worst S&Ls while legislation embodying a comprehensive solution was being fashioned.

With the help of other regulatory agencies, we are now in control of 219 thrifts, with about $100 billion in assets, in 31 states. We also have another <u>60</u> institutions targeted for action.

We are finding that the loss in these insolvent institutions appears to be in the range of 40 percent of assets. This confirms the cost projections contained in the President's plan. That's the good news. The bad news is the losses are just as bad as we thought they would be.

I am pleased to report that our efforts to cut costs in the institutions under our control are progressing. We are already achieving cost savings of about $14 million per month, and anticipate another $105 million of savings on an annual basis. Part of these reductions resulted from reductions in the work forces of the institutions, now down by nearly 1000.

Our fraud squad is seeking out wrongdoers responsible for the conditions of these institutions. We have uncovered potential criminal violations in about 50 S&Ls, resulting in numerous criminal referrals to the Justice Department.

Some have worried that the FDIC's involvement with the S&L problem has placed an unhealthy drain on our resources and on our ability to supervise the banking industry. However, of the 500 examiners assigned to our conservatorship program today, all but at most 100 will be back at bank supervision by the end of June.

The short-term diversion of our examiners will mean fewer bank examinations in 1989 than we had originally planned, but we will still complete more than we did in 1988. We have a skilled and dedicated staff.

Well, that is where we are.

What comes next? It appears that the Congress will pass S&L legislation that provides:

-- Stronger capital requirements, with bank capital standards providing the jumping off point for these requirements.

-- Stronger GAAP accounting requirements, rather than the ill-fated "smoke and mirrors" of the past.

-- Stronger insurance supervision with the FDIC serving, at a minimum, as the backup supervisor of the thrift industry.

-- A comprehensive vehicle for handling insolvent S&Ls, the RTC -- incidentally handling about 3 to 5 hundred billion dollars in assets -- bigger than Citicorp, and almost big enough to be a Japanese bank.

-- Finally, an independent insurer, with a clear mandate of using its powers and supervisors to control risk-taking and possible costs to the insurance fund.

I believe that the new law will go far toward eliminating both the former causes and the return of the thrift crisis.

But the passage of this legislation is not the end, it is just the beginning of the pain of this historic mistake.

In the future, the cost of this problem has to be paid. Institutions will have to be closed. People will lose their jobs. Large amounts of property will be sold in difficult markets. The taxpayers will pay the costs.

But, and this is a big But, there is one continuing problem that must be addressed. That problem is the long-standing threat to thrifts inherent in the interest rate risk that the industry has traditionally accepted. Borrowing short-term money and lending it at fixed long-term rates is simply too risky for today's volatile economy.

The S&L industry will have to learn to contain interest rate risk or provide capital to absorb the risk. Otherwise it can not be insured at reasonable cost. If the FDIC is the insurer you can count on that being a primary objective of supervision.

Variable rate mortgages and loans, securitization of assets, and prudent management of liabilities must be used to mitigate interest rate risk.

Capital must be provided to cushion the risk involved. Only strong supervision will do the job.

Incidently, there is one S&L issue still being heavily debated by the Congress -- the method of financing the cost of this debacle. As insurers, we're not directly involved; but the heat of the debate reminds me of the time when Winston Churchill was in hot discussion with Lady Astor on the floor of the Parliament. Finally, in exasperation, the good lady said to Sir Winston, "If you were my husband, I'd poison your coffee." To which he replied, "Madam. If you were my wife, I'd drink it."

Thank you for your attention.

Now, if there is time, I would be very pleased to take your questions.