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Statement by

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Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

May 26, 1982

I am pleased to appear before you today to present the Federal Reserve Board's views on S. 2531 (the Capital Assistance Act of 1982) and S. 2532 (the Deposit Insurance Flexibiity Act). The Board welcomes Senate consideration of the issues raised by these two interrelated bills, supports their objectives, and urges prompt Senate action to increase the ability of the agencies to address the current financial problems facing the nation's thrift institutions.

As this Committee well knows, the present difficulties of the thrift industry, which S. 2531 and S. 2532 address, reflect the combination of rising deposit costs and portfolios composed largely of long-term fixed-rate assets acquired in periods of lower interest rates. As a result, such institutions in the aggregate have suffered significant operating losses and their capital position is being sharply eroded. The problem reflects the general conditions of the economy and the money market, as well as the long-run effect of public policies that have fostered portfolio concentration by thrifts in fixed-rate, long-term residential mortgages, rather than endemic poor management. The Board's view is that disinflationary policies will continue to succeed, contributing to lower and more stable interest rates, and a reversal of the pressure on thrift earnings and capital. The run-off of older portfolio assets and the growing use of alternative mortgage instruments will also work to improve earnings. In the interim, however, special measures are required to bridge the gap until more normal operating conditions are restored.

During the transition period, the regulatory agencies need the tools to support those institutions with sound assets and satisfactory prospects, and to continue to reorganize or merge those that will not be able to operate profitably even in normal circumstances. By providing additional flexibility to the regulators, the bills provide the agencies with the powers necessary to deal with the transitional problems faced by depository institutions--especially the nation's thrifts.

The bills before the Committee do not fundamentally alter the basic authority or role of the agencies, but rather provide the framework for assistance programs for those depository institutions that, with some support, would likely survive a period of financial stress, and broaden merger possibilities for those institutions that probably cannot. The bills remove certain existing impediments, under carefully prescribed circumstances, that experience shows limit the ability of the regulators to deal with the practical realities facing them. Up to the present time the regulators have been able to respond to the problems under existing authority. However, the Board is concerned that future circumstances may make it extremely difficult--if not impossible--for the agencies to find satisfactory solutions in specific instances under existing statutory limitations. Prudence dictates the removal of those existing limitations that may result in more costly or inefficient solutions or which have the potential to widen the market impact of financial distress of a few depository institutions.

S. 2532 is very similar to the regulator's bill which Chairman Volcker recommended and endorsed in testimony on S. 1720 before this Committee last fall. The bill now before the Committee has two main elements. First, it broadens the authority of the FDIC and FSLIC to provide financial assistance to distressed institutions if such assistance will be less costly to the insurance funds than assisted mergers or liquidation. Currently, the FDIC can only provide such assistance when it finds that both the particular institution to be assisted is "essential" to the community and that the assistance is less costly than other alternatives. The present statutory test may hinder the ability of the FDIC to assist institutions, particularly in markets where a large number of depository institutions operate. In these heavily served areas, the "essentiality" test might be difficult to meet even though the failure or liquidation of one or more institutions might adversely affect confidence in the financial services industry generally. Under S. 2532, the FDIC would no longer be constrained by the essentiality test. Rather, it could in addition provide assistance to institutions that are likely to be viable in the long-run when "severe financial conditions exist which threaten the stability of a significant number of" insured institutions. Such assistance is conditioned on a finding that it will "lessen the risk to the" insurance fund and will be less costly than liquidation.

Second, S. 2532 provides clear and specific guidance as to the circumstances under which failing thrifts can be acquired by out-of-state institutions or, as a last resort, in those circumstances where merger with another thrift is not practicable, by bank holding companies. In order to facilitate mergers, the bill also overcomes limitations in some states that prohibit mutual thrifts from converting to stock form.

Earlier this year the Federal Reserve authorized the acquisition of a financially distressed non-FSLIC insured savings and loan by a bank holding company, as Chairman Volcker previously indicated might be necessary if the Board were faced with an emergency situation. The Board has also returned a proposed application by a bank holding company to acquire a thrift because the major activity which the applicant proposed to undertake through the thrift--equity real estate development--is not permitted to bank holding companies. Other bank holding companies recently have expressed interest in acquiring thrifts, some of which are not in critical condition. Consequently, the Federal Reserve continues to believe that it is desirable for the Congress to provide guidance on bank holding company acquisitions of thrift institutions. S. 2532 would provide this guidance.

The legislation would also authorize, under carefully prescribed circumstances, the acquisition of a failing large bank by an out-of-state bank or bank holding company. For several years, the regulators have asked for such authority because of their concern that in the event of failure of a large bank there may not be an in-state institution capable of acquiring the failing bank. Some observers have been concerned that such authority--as well as bank holding company acquisitions of financially distressed thrifts--might be used as a back door method of undermining the principles established by the McFadden Act and Douglas Amendment. However, the prescribed procedures and limitations of the bill assure that this provision will be used solely for the resolution of serious individual problems and not to facilitate a wholesale restructuring of the financial system.

The Board views the thrust of the Capital Assistance Act of 1982 (S. 2531) as a logical and desirable extension of the capital assistance authority of the Deposit Insurance Flexibility Act (S. 2532). Capital infusion to institutions that have a reasonable prospect of viability when interest rates decline provides an efficient and cost effective tool as an alternative to immediate liquidation or merger of financially distressed institutions. Capital infusion provides time for such institutions to rebuild their capital position from future earnings. However, capital assistance should not be used to maintain the existence of institutions that find themselves in difficulty because of mismanagement or speculation, since they would be unlikely to recover even under favorable circumstances in financial markets. S. 2531 explicitly addresses the latter concern by prohibiting capital infusion to cover losses arising from mismanagement or speculation.

More generally, assistance is not automatic for all low capital institutions incurring losses. The bill provides desirable discretion to the agencies to assure that assistance is provided only to those institutions that have reasonable prospects for viability at lower interest rates. For these depository institutions, the bill establishes an initial schedule for capital infusion related to net worth and actual losses--the lower the net worth the higher the amount of capital infusion that may be provided. However, the size of capital assistance called for by the schedule is always less than actual losses, and hence continues to bring market discipline to bear. The bill therefore is not intended to allow a widespread "bailout" of financially distressed banks or thrifts, and indeed the terms and conditions under which capital assistance may be provided assure that such bailouts will not occur.

S. 2531 recognizes that no single schedule can adequately take into account all of the practical issues that the insurance funds may encounter. It therefore permits the funds to depart from the initial schedule and provide less or additional assistance if the situation demands it. However, in no instance may assistance exceed an institution's losses for the "immediately preceding period." While the approach established by the bill appears to be adequate to meet the forseeable temporary needs of depository institutions, the Board would support additional flexibility that would permit, in carefully circumscribed instances, larger amounts of capital infusion if it would ultimately result in less cost to the insurance funds. For example, there may be specific situations in which it is desirable to raise the capital ratio of an institution with very low capital to a specific level, such as 2 percent, and maintain it at that level for a period. The Board believes that it is important that a capital infusion program provide the insurance funds with discretion and flexibility to fashion assistance programs to meet the unique needs of individual institutions. Generally, S. 2531 provides considerable discretion, but the Committee may wish to consider minor modifications to assure that a specific capital ratio can be achieved and maintained where desirable in individual cases.

Without a capital infusion program, the number of assisted mergers and perhaps even liquidations would likely be larger, involving commitments by the insurance funds, all of which may show up as current or future federal expenditures. While capital infusion under this bill requires no current outlays, the notes issued by the insurance funds to the assisted institutions may involve interest payments that will be reflected in the budget. However, by forestalling the need for mergers or liquidations of institutions that can be viable in the long-run, both current and future budget expenditures should be reduced. Indeed, by regarding capital assistance as net worth for statutory and regulatory purposes, the bill may prevent the need to merge or liquidate institutions that would otherwise be required to be closed under State law. Still, it should be noted that Congress at some later date may find it necessary to consider providing supplementary resources to the insurance funds to help cover their obligations incurred under S. 2531.

In conclusion, let me reiterate that the Federal Reserve believes that the expanded authority along the lines authorized by these two bills is urgently needed, given the temporary circumstances faced by depository institutions. No one knows how long these difficulties will continue, but without such legislation the Board is concerned that situations could develop in which the regulators would be unable to address the problems of particular distressed institutions in a prompt and cost-effective manner. The Federal Reserve believes that there should be no question about the ability and willingess of the Government to assure the continued smooth functioning of our financial system as required in the public interest. Consequently, the Board supports the objectives of these bills and urges prompt action by the Senate along these lines.

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