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Statement by

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for the
Subcommittee on General Oversight and Investigations
of the
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Mr. Chairman, and distinguished members of the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affairs:

I am pleased to appear before you to discuss the failure of the Rhode Island Share and Deposit Indemnity Corporation (RISDIC). The situation in Rhode Island is very serious and it is useful to explore fully why this problem occurred, and how similar problems can be avoided in the future. In that effort, I will summarize the impact of the crisis on individual citizens in Rhode Island and on the economy of the state. I will then review actions taken by the Federal Reserve Bank of Boston in response to the financial problems experienced by the loan and investment companies, banks, and credit unions insured by RISDIC. I will conclude with the lessons that should be drawn from this experience.

IMPACT OF THE CRISIS

Even before the collapse of RISDIC, serious problems were emerging in the Rhode Island economy. Rhode Island, like other New England states, had been suffering an economic decline well before the national recession. The decline began with a prolonged decline in the manufacturing sector, but this weakness radiated to other sectors of the economy. The slow growth in state revenues in Rhode Island, and in other New England states, has forced state and local governments to increase taxes and cut services. These problems were compounded by the collapse of the real estate and construction bubble. The rapidly rising real

estate prices of the mid 1980s reversed direction and began to fall. The median sales price of an existing single-family home in Providence, which had been \$133,000 in the fourth quarter of 1988, had fallen to \$120,000 by the fourth quarter of 1990. The falling real estate prices not only eliminated a major source of wealth to consumers, but also magnified the effects of the national recession. Employment in construction and real estate-related occupations normally declines during economic downturns; however, the size of housing inventories and the softness in real estate prices were unusual even for recessionary periods.

These problems have been obvious to the citizens of Rhode Island. In December of 1990, before the failure of RISDIC, the unemployment rate was 7.5 percent, 1.4 percentage points higher than the national average. Personal bankruptcies in 1990 numbered almost twice those of the prior year. Business bankruptcies also increased sharply in 1990, to triple the number in 1989. By any measure, the "misery index" of the citizens of Rhode Island was already high going into the RISDIC crisis.

The failure of RISDIC at the beginning of this year clearly exacerbated an already dreary economic situation. Initially, it is estimated that over 350,000 accounts were frozen as a result of the RISDIC failure in a state with a population of only slightly more than one million people. Individuals were deprived of access to their funds and businesses could not finance inventories and payrolls, resulting in severe dislocations that affected the entire citizenry of the state.

In relative terms, the crisis was much more severe than the two highly publicized private insurance failures in Ohio and Maryland in 1985. While the total shortfall between deposits and assets is unclear, estimates range between 150 and 450 million dollars, roughly 9 percent to 27 percent of total 1990 state government general revenues. In comparison, the shortfall in Ohio and Maryland was roughly 1 percent of each state's general revenues.

It is still too early to estimate the full economic impact of the RISDIC financial collapse on Rhode Island. Nonetheless, the relatively few economic data available for the first quarter of this year are not encouraging. Personal bankruptcy filings for the first quarter were almost 50 percent higher than the average for 1990. The 121 housing permits issued in February were far below the 1990 monthly average of 260 permits. The unemployment rate in February was 7.9 percent compared to 7.5 percent in December. The RISDIC crisis has clearly worsened an already bleak economic outlook for Rhode Island.

The Federal Reserve is deeply concerned with the severity of the economic problems in Rhode Island. Roughly \$1.2 billion remains frozen. The situation is all the more tragic in that many of these problems could have been avoided had earlier warnings been heeded.

EARLY WARNINGS

The Federal Reserve Bank of Boston had been concerned for

some time with the financial viability of private insurance funds located in individual states. This concern increased with the failure of private thrift insurers in Maryland and Ohio in early 1985. Their experiences convinced us of the need to monitor carefully the financial health of privately insured institutions in the First District. Examination of financial data on RISDIC itself and on RISDIC-insured institutions raised serious doubts about the financial viability of the private insurance fund. Among the institutions RISDIC insured, several clearly could not have qualified for federal insurance in 1985. Further weakening the fund, some of RISDIC's strongest members were qualifying for federal insurance and leaving the RISDIC insurance pool.

Even without a pool of risky members, substantial concerns with RISDIC would have remained. RISDIC expanded deposit insurance coverage to accounts exceeding \$100,000 in 1985, and continually allowed members to engage in risky lending practices that were not acceptable to federal insurers of credit unions or to other private insurers. Because of the small size of the insurance pool, losses from large institutions could only be met by substantial additional assessments on its remaining members. Furthermore, since all the institutions were located in the same area, made loans to similar borrowers, and had large positions in other RISDIC insured-institutions, all were likely to experience problems at the same time.

This lack of diversification, and the knowledge that RISDIC's riskiest institutions were also its largest, led senior

officials of the Boston Federal Reserve Bank to initiate discussions with Rhode Island government officials on the status of RISDIC insured institutions. Specifically, on March 21, 1986, Frank Morris, the former president of the Federal Reserve Bank of Boston, along with the senior vice president of its Bank Supervision and Credit Group and the vice president of the Bank Supervision Division, met with Governor Edward DiPrete and his chief of staff. The purpose of the meeting was to highlight the recent collapse of private insurers in Ohio and Maryland and to urge passage of legislation requiring federal insurance for all RISDIC members. Governor DiPrete seemed receptive and subsequently supported legislation requiring federal insurance.

Federal Reserve officials in Boston continued to correspond with the Rhode Island Director of Policy about the legislation requiring mandatory federal deposit insurance for RISDIC members. Reserve Bank staff reviewed drafts of bills and monitored their progress. Our early involvement with RISDIC ended, however, with the defeat of the bills requiring federal deposit insurance.

Our warnings also seemed less urgent, in part, because of the economic boom in Rhode Island during the mid 1980s. Of course, the boom only postponed, rather than prevented the realization of RISDIC's problems. Unemployment in Rhode Island dropped to a low of 2.3 percent in December 1988, and Rhode Island experienced unprecedented increases in real estate prices. The rapid expansion of the Rhode Island economy, along with lax regulatory oversight of the composition and growth of credit

union assets, enabled RISDIC-insured institutions to aggressively expand their lending. Many of the largest RISDIC-insured institutions experienced loan and deposit growth well in excess of 100 percent between 1985 and 1990. Such a rapid expansion of lending is frequently accompanied by a relaxation of credit standards, and requires even greater vigilance by regulatory authorities. But, there was no commensurate increase in the number of supervisory staff to conduct bank exams and monitoring at the Department of Business Regulation or at RISDIC. While the rapid growth of RISDIC-insured institutions and the lax regulation appeared harmless during the boom, it amplified problems once the economy started to decline.

By the end of the 1980s it was apparent that the rapid expansion of real estate activity was not sustainable. The small increases in population and slow growth in personal income had not kept pace with real estate prices. Real estate values throughout New England were decreasing, challenging even New England's best-managed institutions. The economic climate was devastating to institutions that had grown excessively by engaging in imprudent lending practices, and that included many RISDIC-insured institutions.

CRISIS PREPARATIONS

With the precarious financial situation of many New England depository institutions and the announcement in the fall of 1990 that RISDIC had closed Heritage Loan and Investment Company, just

four months after closing Jefferson Loan and Investment Company, the Federal Reserve Bank of Boston became concerned that other RISDIC-insured institutions might also be insolvent. Boston Federal Reserve officials met with the Superintendent of Banking on November 20, 1990, to receive a briefing on the status of RISDIC and RISDIC-insured institutions. The staff obtained the bank examination and financial data necessary to begin analysis of the financial condition of RISDIC institutions and contacts were initiated with the Rhode Island Credit Union League (RICUL) and the National Credit Union Association (NCUA). In addition, I initiated the first of many contacts with Governor-Elect Bruce Sundlun to discuss the closure of Heritage Loan and Investment Company and the problems in other RISDIC insured institutions.

As a result of these discussions, we developed plans to provide emergency cash shipments to institutions experiencing deposit runs and to provide discount window loans, should either action be required. For the most troubled institutions, daily liquidity reporting was implemented and Federal Reserve staff conducted on-site visitations. It was essential to have an effective mechanism to alert the Federal Reserve in the event of unusually large deposit withdrawals. We also implemented contingency plans for delivering emergency shipments of currency, including arranging for transportation and storage with the appropriate security necessary for the bulk transfer of currency. Discount loan preparations included informing RISDIC-insured institutions of the collateral and other requirements necessary

to access the discount window, evaluating the availability of each bank's collateral, assisting in the execution of borrowing agreements for discount window loans, and establishing a potential field warehouse and the legal documentation required for securing the assets used as collateral.

These efforts were coordinated with other regulators and with the incoming and outgoing administrations in Rhode Island. In addition, an officer of the Bank Examination Department was loaned to the state of Rhode Island to serve as a liaison between the Federal Reserve Bank and Rhode Island officials. Toward the end of December, senior staff of the Federal Reserve Bank of Boston were in daily contact, including weekends and holidays, with RICUL, the NCUA and senior Rhode Island officials to monitor the situation and to discuss possible resolutions of the RISDIC problem.

CONTAINMENT

As you know on January 1, 1991 newly elected Governor Bruce Sundlun announced the closing of all 45 credit unions, banks, and loan and investment companies insured by RISDIC. My strong view, albeit personal, is that Governor Sundlun acted decisively and appropriately. The bank holiday protected small and poorly informed depositors from having the only remaining deposits in these insolvent institutions. The focus of Federal Reserve activities immediately became the protection of the payments mechanism and the prevention of any spillover to institutions

with insurers other than RISDIC. The closings required the Federal Reserve Bank of Boston to decide how to process checks drawn on RISDIC-insured institutions and how to process and settle direct deposit checks sent to closed RISDIC institutions through the automated clearinghouse (ACH).

After consultation with Rhode Island state officials, it was decided that checks drawn on the 22 closed institutions that qualified for federal deposit insurance would be paid and delivered to RICUL. Banks sending checks for collection on closed RISDIC institutions that would remain closed because they were unable to qualify for federal insurance were notified that drafts on those institutions would be returned with the stamp "Unable to Present at This Time." In addition, depositors' access to an ATM network posed unique problems that were resolved after consultation with officials of the state of Rhode Island and the ATM network.

ACH transactions, essential sources of income for many citizens, were expected to be particularly large at the beginning of the month because of the delivery of Social Security payments. It was essential that actions be taken to ensure payment of direct deposits in closed RISDIC institutions. After conferring with representatives of the U.S. Treasury, the Social Security Administration, and the Rhode Island Division of Banking, it was decided that Citizens Trust Company would act as agent for receipt and disbursement of direct deposit payments destined for closed RISDIC institutions that did not qualify for federal

insurance. For the 22 institutions reopening the week starting January 7, 1991 with federal deposit insurance, ACH transactions were processed so that they would be available to customers when the institutions reopened after the bank holiday. Several Reserve Bank staff were dispatched to aid Citizens Trust Company with the task of authenticating and reconciling individual payments. In addition, the redirection of payments required significant reprogramming; in January and February alone, over 10,000 electronic credits were redirected. These actions ensured the minimum of disruption for depositors of closed institutions who received direct deposits, many of whom have limited income and depend on direct deposits, such as Social Security payments, to survive.

The January 1st closing of the 45 RISDIC institutions raised concerns that disruptions might become more extensive as depositors became less confident about banking institutions in general. Depositor anxiety was increased by rumors of the impending closure of Bank of New England and the uncertainty over the form the closure would take. The highly charged atmosphere made depositors particularly sensitive to pronouncements by public officials and the press. The mere picture of an institution, even one totally unaffiliated with RISDIC, in a national media report on the RISDIC crisis was sufficient to result in large cash withdrawals.

Not surprisingly in this unsettled banking climate, a number of financial institutions in Southeastern Massachusetts and Rhode

Island required emergency cash shipments. Despite snowstorms and the presence of jittery depositors, the timely delivery of cash shipments contained the deposit runs to a relatively few institutions. During the month of January the Federal Reserve Bank of Boston delivered 30 emergency cash shipments totaling \$319.7 million. Once it became clear that depository institutions insured by sources other than RISDIC were not facing liquidity problems, the runs stopped.

We hope the Federal Reserve Bank of Boston has played a useful role in reducing the hardships suffered by the citizens of Rhode Island as a result of the RISDIC crisis. Our early warnings were not successful in averting the problem. But after the seriousness of the recent situation became apparent, we carefully monitored the situation so that we could offer assistance when it was required. Our actions to facilitate transactions despite the closure of 45 institutions, our emergency shipments of cash, and the assistance we have provided depository institutions, other regulators, and Rhode Island officials helped to minimize the disruptions caused by this unfortunate financial crisis.

IMPLICATIONS FOR POLICY

While the RISDIC crisis is far from resolved, it has already highlighted the need to reconsider several broad policy issues. The first two relate directly to flaws in RISDIC insurance. The last three relate to banking and regulatory matters in general.

First, deposit insurance within narrow geographic boundaries, particularly in small states such as Rhode Island, does not rest on a sufficiently diversified economic base. In contrast to federal deposit insurance, which is well diversified because it has a large number of members that are geographically dispersed, RISDIC had neither large numbers of member institutions nor a diverse geographic distribution. As a result, many member institutions were susceptible to similar risks, and the largest institutions composed a sizable percentage of the total insurable pool. The three largest RISDIC insured institutions accounted for 49 percent of total member deposits. Losses at any of the large institutions imperiled the entire fund which could not be replenished by the limited resources of the remaining institutions.

Second, many depositors are unaware that private insurance is not guaranteed by the Federal government and, at least not directly, by the state. In contrast, federal insurance has the full faith and credit of the United States government as the ultimate guarantee that depositors will always have access to their funds. Depositor misperceptions have forced states whose private insurance collapsed, to assume the obligations of the private insurer. These assumed state obligations have been reinforced by the names and advertisements of the private insurance funds.

Third, states should reexamine the resources allocated to bank examination and supervision. Failure to adequately monitor

RISDIC-insured institutions was all but inevitable, given the limited resources appropriated for bank regulation in Rhode Island. State regulators depended on the private insurer and on outside audits because of the limited state resources. While in good times cuts in monitoring and supervising banks provide an attractive source of possible state savings, particularly since such cuts are unlikely to enrage special interest groups, these so-called "savings" are dwarfed by the eventual costs to the states when state-regulated banks experience financial difficulties.

Fourth, the benefits to the financial system of having the Federal Reserve involved in the many aspects of banking were clearly demonstrated in this crisis. The supervisory and operational expertise of the Federal Reserve was essential in quickly responding to potential problems in the payments mechanism. This quick response prevented wider systemic problems and minimized the disruptions to the payments system for the citizens of Rhode Island.

Fifth, coordinated action by state officials and federal regulators was essential in preventing a more serious financial disruption at the time of the RISDIC crisis. Greater contacts between elected officials and federal and state banking regulators should be encouraged and might help avert future problems in the financial services industry.

CONCLUSION

In summary, the collapse of RISDIC has been a major disruption to the citizens of Rhode Island. Unfortunately, no costless solution to this problem exists. The liabilities of RISDIC insured institutions substantially exceed their assets, and this deficit is likely only to get larger as resolution of the RISDIC crisis is delayed. Depositors in some closed institutions have yet to receive any of their funds, and in other closed institutions depositors have received very limited payouts. However, these institutions have some assets with value. The state of Rhode Island needs to move quickly to give depositors access to as much of their funds as is feasible. The Federal Reserve Bank cannot be a source of capital to eliminate the shortfall. However, we are prepared to work with state officials in any appropriate way including providing liquidity to viable depository institutions.

As the national economy pulls out of the recession, New England's economic outlook should improve. While the New England economy is likely to lag the national economy by up to six months, we expect to see moderate economic growth by the end of this year. The regional economy will also be strengthened by the upcoming resolution of banking problems elsewhere in New England. These positive developments should help restore the economic climate that will allow resolution of Rhode Island's current financial crisis.

Thank you.