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Remarks by

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It is a pleasure to address this meeting of the National Council of Savings Institutions. The thrift industry has played a vital role through the years in the nation's capital markets. In the past decade, you have surmounted tremendous challenges. Despite many success stories that can be reported, there can be little doubt that much remains to be done by your industry and by those of us in Washington.

Changes in the thrift industry have taken place against a background of a rapidly shifting financial system. Ongoing flux in that system will determine the manner in which savings flows will be channeled and housing credit will be provided in the future. We shall all be involved in shaping this system. In doing so, it is important that we appreciate the broad economic forces that have contributed to the current situation, as well as the lessons that can be learned from the experiences of other countries in providing housing credit.

Traditionally in this country, specialized housing lenders have provided long-term mortgage credit at fixed rates and have funded these loans with shorter-term deposits. Obviously, such a practice is viable in the long run only if interest rates are stable and short-term rates generally remain below long-term rates. In the financial

environment of the 1950s and early 1960s such conditions existed, and a fixed-rate mortgage lender could flourish.

The past two decades, however, have been a period of anything but price and interest rate stability. The upward trend in inflation through the late 1970s was accompanied by rising and more volatile interest rates. Depositors and lenders sought to protect their principal from rapid erosion in value as the period of relatively stable prices receded from memory.

Although inflation has dropped sharply from peaks in the late 1970s and early 1980s, large fiscal deficits and the corresponding heavy borrowing requirements by the Treasury have limited the decline of interest rates. Moreover, the inflation experience and accompanying interest rate volatility of the earlier period left deep scars. The long-held belief that the United States by its nature was, with the exception of wartime, an inflation-resistant country, has been undercut. The public is now acutely aware of the state of price stability and sensitive to various inflation indicators, be they reliable or not. At the same time, interest rates have come to respond promptly to shifting sentiment on inflation as well as to prospective budget developments.

The legacy of inflation, large deficits, and a vulnerable thrift balance sheet structure has been a period of pain, dislocation, and wrenching adjustment. As

inflationary expectations came to be embedded in the structure of interest rates, and as interest rates rose across the maturity spectrum, the industry faced disintermediation. Regulatory ceilings prevented depositories from competing successfully for retail funds against open market instruments or obligations of new institutions such as money market mutual funds. Legislative and regulatory relief took the form of deposit deregulation, beginning in mid-1978 and largely completed in 1983.

While thrifts were being given more control over their deposit base, however, spread problems were worsening. Interest expense tended to rise rapidly, reflecting the preponderance of short-maturity liabilities on balance sheets. Returns on assets rose only sluggishly, reflecting the difficulties of restructuring portfolios dominated by slowly amortizing, fixed-rate mortgages carrying below-market yields.

These circumstances have led to much structural change in the industry, with which you are all too familiar. Many individual institutions simply could not cope with these problems. The thrift mortality rate rose dramatically until disinflation and the attendant decline in market interest rates improved spreads.

Even as this relief was forthcoming, though, other problems emerged in the thrift industry. Asset quality problems replaced spread problems as a factor threatening

the viability of a significant percentage of institutions. In some cases, the asset quality problems stem from imprudent or reckless lending practices. In other instances, they had their roots in regional disparities in economic performance that left areas such as oil-producing states mired in recession.

It is interesting to note that the traditional savings bank industry, concentrated in the Northeast, has largely avoided serious asset quality problems. So have many traditional savings and loans located east of the Mississippi River. The most difficult problems in the savings and loan sector, posing the largest claims on the FSLIC, are located west of the Mississippi. Many local economies in this area have not fared well, and there have been many examples of lending excesses.

It will take time to fully resolve the problems of these segments of the thrift industry. When they are resolved, however, it is unlikely that we will see the thrift industry in the same form we did a few decades ago.

In this regard, I think it is important to appreciate that the housing finance system in the United States is by no means the only method of providing credit to home buyers. Indeed, there is relatively little uniformity across countries in the structure and behavior of housing markets. The relative roles of the public and private sectors differ substantially across nations. The degree to

which depositories provide housing finance, or specialize in it, also varies, as does the importance of a secondary market for mortgage-related instruments. It is noteworthy that housing policies in many countries encourage home ownership with a variety of inducements such as direct government subsidies to home buyers, subsidized loans for low-income citizens, and income-tax deductions for mortgage interest.

Some portfolio lenders abroad have been more successful in the 1980s than our own. In a few cases, this success has been fostered by lower inflation, while in other cases, the degree of interest rate risk has been less than here. West Germany, Japan, and the United Kingdom provide good examples of this diversity.

The housing finance system in West Germany is complex. Most borrowers obtain a package involving several sources of financing for a single home purchase. This might include a contract savings plan in which investors make regular contributions to a special fund over several years to become eligible for a loan. In addition, a borrower might obtain loans through a savings bank or a mortgage bank. Savings banks use funds from retail deposits to make either variable- or fixed-rate loans with five- to ten-year terms. Mortgage banks tend to make longer maturity fixed-rate mortgages, raising funds by issuing mortgage bonds with terms and maturities similar to those of the underlying

loans. These mortgage banks are subsidiaries of other, less specialized, financial institutions.

Under this system, both depository lenders and mortgage banks, by matching maturities of assets and liabilities, have more protection from interest rate risk than is generally the case in the thrift industry in the United States. Moreover, lower rates of inflation in West Germany clearly have worked to ensure stability in their housing finance system.

The housing finance system in Japan, like our own, has been built on long-term lending at fixed interest rates funded by short-term borrowing. The major specialist housing lender in Japan is a public-sector corporation, however. Funding for this corporation comes through a postal savings plan in which individuals acquire a tax-favored, short-term claim. This arrangement is vulnerable to inflation and volatile interest rates, but the Japanese, like the Germans, have been more successful in curbing inflation and have had, as a consequence, more stable interest rates.

The British inflation experience has been similar to our own. However, their mortgage lenders have not faced the same problems. The predominant British housing lenders are the mutually structured building societies. These

institutions fund their mortgage portfolios through short-term deposits, similar to passbook accounts, that have yields that can vary with open market rates.

The important feature of the balance sheets of the building societies is that both assets and liabilities are variable rate. Loan agreements have virtually no limits on the size and frequency of rate adjustments. Despite wide swings in interest rates over the past decade, this financial structure has helped building societies avoid the liquidity and spread problems that plagued our own thrifts.

We have made progress introducing more variable-rate lending along the lines of the British portfolio lenders. Experience thus far, however, demonstrates a reluctance on the part of some home-buyers in this country to accept adjustable-rate mortgages, especially when interest rates are relatively low. This presents a continuing challenge for portfolio lenders to devise strategies for attracting borrowers to these instruments. A good many thrifts, indeed, have been quite successful in that effort. But I suspect, as well, that there will be a continuing need for the industry to search for innovations that will reduce vulnerability to the spread problems attending fixed-rate lending.

Those of us in Washington must continue working toward a sound economic and financial climate in which the thrift industry can once again prosper. For the Federal

Reserve, this means maintaining progress toward an environment of price stability in which the forces of economic growth can be fostered and sustained.

But, prudent monetary policy is not a sufficient condition for a stable, noninflationary financial climate. Fiscal policy must also play a role. Large deficits have put considerable pressure on credit markets. In recent months, we have seen all too clearly how disappointments on the deficit front can adversely affect psychology throughout the financial markets.

Congress and the Administration have taken steps to move toward budgetary balance. The importance of credible deficit reduction cannot be overemphasized. Financial markets around the world will continue to be subject to shocks so long as there has not been a reasonably complete resolution of these problems. I hope the current initiatives will be the first of several steps towards increasing bipartisan cooperation in support of a long-term policy of eliminating budget deficits and the associated claims on the nation's and the world's saving.

Indeed, we should consider whether our nation's long-term interests and those of the rest of the world might be best served by a budget policy aimed at augmenting private saving through budget surpluses. Our inability to raise the nation's private savings rate in recent years has necessitated large borrowings of other nations' savings.

There is a limit to what foreign savers can be expected to finance of the gap between the level of capital investment that will be needed if we are to be competitive and our current level of domestic savings.

Even as we come to grips with our budgetary problems, it is important to realize that the inflationary experiences of the 1970s and early 1980s have radically, and perhaps permanently, altered the financial landscape facing thrift institutions. Depositors are sensitive to the potential for erosion of principal through inflation with long-term fixed-rate instruments. This represents an impediment to institutions traditionally committed to fixed-rate lending.

In addition, we cannot forget that we now are increasingly a part of a global economy and thus are exposed to influences that previously were not very significant. An increasing number of sectors are affected by the world markets. Movements in interest rates abroad and exchange rates are rapidly transmitted to our credit markets. In particular, the housing sector has come to realize that developments abroad can have an important bearing on the domestic economic outlook. Owing in large part to the growing securitization of mortgage credit, our mortgage markets are more tightly linked to credit markets at home and abroad. Mortgage lenders now must keep a close eye on

external developments as well as those at home in setting lending terms.

We can applaud many of the regulatory changes and market innovations that have been developed to help the thrift industry deal with spread problems in this changed environment. A variety of techniques effectively allow thrifts to shorten the maturity of their assets or lengthen the maturity of their liabilities. More innovations are likely to come.

Some of these changes have come as a result of deregulation. Deposit rate ceilings no longer constrain thrift institutions from bidding for deposits in maturity ranges they deem appropriate. Changes in regulation and some shifts in borrower attitudes have opened the door for adjustable-rate mortgages. ARMs are well suited for reducing spread problems, but they have not yet become the liquid investments that eligible fixed-rate mortgages have. The housing agencies recently have taken measures to strengthen the secondary market for ARMs. This is an encouraging development that holds further promise for the thrift industry.

In addition, thrifts have begun to make use of a host of new instruments including interest-rate swaps, futures, and options for managing interest rate risk. To date, however, their use appears to have been limited to a relatively small segment of the industry. Moreover, even

these instruments cannot eliminate all risks. Sharp interest rate movements earlier this year demonstrated that, used improperly, some of these new products are themselves very risky.

Questions also have been raised about the protection provided by derivative instruments under turbulent market conditions such as the October stock market crash. Better insight into the attributes of derivative instruments likely will be gained by the various investigations now underway. In any event, strategies using these hedging instruments can be quite complicated and require considerable skill on the part of managers.

The increasing securitization of fixed-rate mortgages and certain consumer receivables also has been a promising development. Mortgage pass-through securities have enabled long-term fixed-rate mortgages to be held in a more liquid form, while CMOs and REMICs provide a means for acquiring mortgage assets with maturities more closely aligned to those of deposits.

Many of these innovations, and the process of deregulation itself, were in part a response to the debilitating effects of inflation. The result of these changes, and those to come, is an evolving thrift industry operating in a new financial environment. Even in a world of price stability, the thrift industry of tomorrow will not be the same as that of yesterday.

Commercial banks and other financial intermediaries, too, face major challenges. Technological changes, such as developments in computer and communications technology, have irreversibly altered the relative competitiveness of all depository institutions. Nondepository organizations are now able to collect and evaluate data concerning creditworthiness and credit risk. In many cases, borrowers and lenders now can deal with each other directly, rather than rely on the intermediation of banks or thrifts. Thrift institutions, in particular, are well aware of the changing nature of competition. They face competition not only from commercial banks but also from mortgage bankers and the open market generally.

In dealing with these new market realities, our job in Washington is to foster an environment in which the federal safety net protects against systemic risk to depository institutions and the payments mechanism, provides protection for insured depositors, and encourages competitive markets in the provision of financial services. The benefits of competition can best be achieved in a world in which the safety net is not used to protect individual institutions or particular types of depositories. Rather, financial institutions of all types must meet a market test for the kinds of intermediation functions they provide. Such a system will contribute most effectively to the efficient allocation of resources in the economy.

Thrift managers also have a job in the development of this financial environment. Careful and prudent management remains an essential ingredient for the success of the industry and for a stable source of credit to the housing industry. Thrift managers must realistically address some of the past problems of their industry and contribute in a meaningful way to the public policy debate about the future. The hands-on experience that you have accumulated is vital to constructively dealing with the many problems currently on the agenda. Managers and regulators can contribute most effectively to this process if they are willing to take a broad, long-term view of issues rather than dealing with problems in a piecemeal fashion.

Nevertheless, any progress in solving the problems of the thrift industry and shaping a new financial system will be transitory unless we provide a stable economic and financial environment in which all types of institutions can flourish. First and foremost this requires ample fiscal discipline as an essential element of policies to foster sustained balanced growth and to maintain progress against inflation.