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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

of the

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I am pleased to appear today before this Committee to outline the views of the Board of Governors on the legislation proposed by President Bush for the reform and recovery of the thrift industry. The Board supports this comprehensive package of proposals to strengthen the thrift industry, and depository institutions generally, as well as to prevent the serious problems of the thrift industry from recurring.

The proposals in the bill include:

-- greatly enhanced supervisory, regulatory and enforcement authority,
-- a new framework for resolving insolvent thrift institutions,
-- a separate insurance fund for thrifts under the administration of the FDIC, and
-- a strengthening of this new thrift fund, as well as the FDIC fund, through higher premiums.

In addition to this legislative program, a number of administrative measures have been taken, or are planned. As a first step to limit losses in insolvent institutions, more than 200 of them will be brought under federal control in the next few weeks. As part of this effort, we are contributing 150 Federal Reserve examiners to the overall task force.

Moreover, to help attract responsible buyers for troubled thrifts, and as a result of the important changes in the environment for interstate banking, the Federal Reserve Board intends to reconsider the tandem operations restrictions on applications brought to the Board for acquisitions of failed or failing S&Ls. In addition, we have made arrangements with the Federal Home Loan Banks and the FSLIC to support these basic sources of liquidity for the thrift industry.

I would like to focus my remarks today on the two major elements of the President's program: (a) the restructuring and reform proposals, and (b) the procedures for dealing with failed S&Ls as well as the funding required to cover losses incurred by these institutions. Before turning to this task, I believe it would be useful to recall why we are facing a thrift problem and to draw some lessons from its causes.

Today's thrift industry losses grew partly out of the vulnerability of a fixed rate, long-term, lender with relatively short-term liabilities, to changes in interest rates. As inflation, and interest rates, rose in the late 1970's and early 1980's, and as deposit rate ceilings were phased out, the resulting mismatch on the rising cost of deposit liabilities and the fixed return on mortgage assets produced substantial losses and a serious erosion of industry capital. Into this situation other elements were added. Expanded powers were mixed with inexperienced or dishonest management, brokered deposits that fed unchecked growth, lax accounting standards, seriously inadequate supervision, all within the context of adverse economic conditions. It is sobering how these factors led so quickly to insolvencies. In a short period, the serious, but manageable, maturity mismatch problem became the disastrous asset quality problem that we face today.

In evaluating this situation, I would not limit my emphasis, as some have done, to focusing only on the decline in regional economies and, in particular, on the drop in oil prices. The regional economic problems were real, but in assessing responsibility it is important to recognize that the oversupply in the real estate market in certain areas was at least partially a result of the lending by the S&Ls themselves. During the period 1982 to 1985, in the face of declining oil prices, commercial real estate loans of savings and loan associations increased by more than $57 billion (129%). In many cases these loans were made with an eye principally focused on front end fees, and without any reasonable assurance of repayment.

A comparison with the banking industry is instructive. While the banks do not have real estate equity investment powers, non-recourse lending by banks for commercial real estate development projects with thin borrower equity positions often puts the bank lenders in a position where they are very close to equity investors. Taking this into account, it is all the more surprising that the estimated cost of resolving the thrift problems in Texas will run around $40 billion. In that state, where the economic environment for banks and thrifts is identical, the costs for resolving the problems of the banking industry, with assets that are much larger than those of the thrifts, should amount to considerably less than $10 billion. Clearly, the large absolute difference in costs, and the even larger difference in costs relative to assets, is evidence the thrift industry experienced a systems failure, that is, a major lapse in public and private prudential standards.

To deal with these problems, the new program focuses on the supervisory and regulatory reforms designed to ensure that the mistakes that have so adversely affected the thrift industry, its deposit insurance fund, and the taxpayers will not be repeated. A number of important steps have been proposed.

A new insurance fund for thrifts will be established to be administered by the FDIC, separately from the insurance fund for banks, but with special powers for the FDIC to approve applications by thrifts for insurance, make examinations, initiate enforcement actions, terminate insurance on an expedited basis, and prohibit thrifts from exercising powers that could cause undue risk to the FSLIC insurance fund.

Moreover, the proposal puts a new emphasis on adequate capital for the thrift industry as a cushion against losses and as a restraint on excessive risk-taking. Accordingly, thrifts will be required to meet bank capital standards by June 1991, with the exception that they will be given 10 years to write off goodwill. For those institutions that do not meet this standard, growth can be restricted prior to the 1991 deadline, and must be prohibited after this time.

Our estimates indicate that more than a majority of the thrifts with positive tangible capital under GAAP standards could meet the existing bank primary capital requirements; on a risk-adjusted basis, we estimate that nearly two-thirds would meet bank standards due largely to the favorable risk-weight given to 1-4 family residential mortgages under the risk-based measure of capital.

If goodwill were to be immediately excluded from capital, the institutions falling below the standard would have to raise about $15-20 billion in capital to meet bank minimums. However, the proposed legislation, as noted, gives thrifts a 10-year period to write off the goodwill; thus, this major capital-raising effort can be spread over a number of years.

It should be emphasized that if losses continue or accelerate due to further credit deterioration or interest rate exposure, the industry's need for capital could be substantial. Those institutions that cannot meet bank capital standards as set forth in the proposed legislation would necessarily have their growth restricted or may be required to shrink their assets.

The Administration's program also takes major steps toward restructuring the thrift supervisory and regulatory framework. In addition to separating the insurance and regulatory functions, the proposal would create a new federal thrift regulator. The new regulator -- the Chairman of the Federal Home Loan Bank System (FHLBS), who would be under the Secretary of the Treasury in the same relationship as the Comptroller of the Currency -- should be more independent from the industry. Importantly, the FHLBS would be required to apply bank supervisory and accounting standards to the S&Ls.

Moreover, the boards of directors of the Federal Home Loan Banks will be reconstituted along the lines of Federal Reserve Bank boards. This should make them more responsive to the broader public interest. In contrast to present arrangements, most of the membership of the Boards will be drawn from outside the industry, including the Chairman and Vice Chairman of the boards, who will be chosen by the new chief of the Federal Home Loan Bank System. Finally, the Chairman of the FHLBS, as the new regulator and supervisor, would carry a mandate emphasizing safety and soundness, and would appoint the head supervisory agent at the Home Loan Banks who would be directly responsible to the FHLBS in Washington. These are both necessary and important reforms.

Another step recommended by the President, to which we attach great importance, is the requirement that savings and loans that do not meet the qualified thrift lender (QTL) test (60 percent of assets in residential-related lending) in the Competitive Equality Banking Act of 1987 must, after an appropriate transition period, become banks and be subject to the entire regulatory and supervisory regime applicable to banks and their holding companies. We believe it is fully appropriate to confine the benefits of thrift status, involving both access to subsidized long-term borrowing from Federal Home Loan Banks and tax benefits, to only those institutions that devote a major part of their assets to promoting home ownership.

Another important part of the reform package is the increase in insurance premiums for both thrifts and banks, as well as the authority for the FDIC to raise premiums for both types of institutions in the light of experience. For thrifts, where the fund is now insolvent and in need of rebuilding, premiums under the proposal will rise in 1990 from their present level of 20.8 basis points to 23 basis points in 1991, remain at that level for 3 years, and then fall to 18 basis points in 1994.

For banks the current premium of 8 basis points would increase 4 basis points in 1990, and another 3 in 1991; and then would be held at that level. However, when the insurance funds reach the target for reserves of 1.25 percent of insured deposits, rebates would again be possible.

The level of FDIC insurance reserves as a percentage of insured deposits has dropped in recent years to the present ratio of 0.83 percent, and it is important that this trend be reversed. The proposed premium increase for banks thus stands on its own merits, quite apart from anything that might be done about thrifts, as a necessary step to maintain the integrity of the FDIC fund against future contingencies.

Another element of the President's program is a funding package designed to provide sufficient financial resources to resolve current and prospective insolvencies among FSLIC-insured institutions. This function would be assigned to a newly created Resolution Trust Corporation (RTC), which would be managed by the FDIC and operate under the direction of the Oversight Board composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Attorney General. To accomplish its task, the RTC would be provided with $50 billion of funding -- the proceeds of bonds issued by a RTC Funding Corporation. These funds would be used to resolve insolvent thrifts that have not received assistance from FSLIC or which will become insolvent over the next three years. Principal would be repaid with the proceeds of zero coupon bonds purchased from thrift industry resources, and the interest on the bonds would be paid with thrift industry and, if necessary, Treasury funds.

The most recent data available (for September 30, 1988) indicate that about 470 thrifts, with assets of around $250 billion, are tangible capital insolvent. It seems prudent to assume that all of these institutions will require RTC assistance. We cannot know exactly what the resolution costs will be for these institutions, but based on FSLIC's estimates of the costs of its 1988 resolutions we estimate that it will cost around $40 billion to take care of these 470 institutions. Of course, many other FSLIC-insured institutions are at present thinly capitalized and some of these could well become insolvent during the three-year period for which RTC would be responsible for new insolvencies.

We have looked at the cost of resolving new and existing insolvencies under different scenarios, and under some, unlikely, circumstances the resolution costs could exceed $50 billion. However, in our judgment, all things considered, the $50 billion should be adequate. There is, of course, much that is unknown, and that is now unknowable, that will affect this judgment. Marginal adjustments may be necessary as experience is gained to take account of, for example, additional costs or recoveries. The critical point is that the fundamental approach is sound, and has the necessary flexibility to adapt to changes in circumstances.

Key to the RTC's ability to minimize costs is flexibility to pursue various resolution options. Such flexibility would permit the separate marketing of franchises and troubled real estate portfolios, which might broaden the market and thereby increase the values of both. In particular, in cases where no franchise value remains in an organization, the least-cost option would likely be liquidation rather than purchase and assumption. To reduce overall costs, the RTC must have the resources necessary to pursue this course.

When so much money is needed to make up for such large losses, partly from mismanagement, and in no small part due to fraud, is it reasonable to ask the taxpayers to pay any part of these costs?

It is. The basis for my answer goes far beyond the Congressional pledge of the full faith and credit of the United States behind insured deposits. The reason for public expenditure to support deposit insurance is the basic benefits to the economy as a whole that we derive from deposit insurance. The certainty and stability provided by deposit insurance benefits the nation as a whole, while it protects the individual from catastrophic loss. By giving the public confidence in the safety of its funds we avoid the deposit withdrawal and losses that disrupted the payments system and the savings and investment process in the 1930s. Losses of the kind that we face today should not happen, but with the gains to society as a whole that come with deposit insurance we must accept both the possibility and the reality that there will be losses to be borne by society as a whole.

Our job now is <u>not</u> to see to it that there are never any losses as a result of deposit insurance; to do so would require limitations and rules that would put depository institutions lenders, and the economy they serve, in a straight-jacket. Such a course would be costly to growth and efficiency. Our task is to see to it that the potential for losses is minimized to the extent possible, and that steps are taken to ensure that the preventable governmental, regulatory, supervisory and human failures that were the cause of the thrift industry losses do not happen again.

The Board attaches considerable importance to the provision of the proposed legislation that calls for the Secretary of the Treasury, in conjunction with the federal financial regulators, to undertake a study of the nation's deposit insurance system. There are major areas of concern about the system, focusing on its apparent bias toward excessive risk-taking, its tendency in the direction of differential treatment of small and large institutions, and the unintended expansion of insurance coverage through such techniques as brokering deposits that have been disaggregated into $100,000 segments.

A review, at both a conceptual and practical level, is needed of the consistency of an insurance system that evolved out of the Great Depression, on the one hand, with today's deposit-gathering industry of both small banks and giant modern financial services organizations that operate across markets and national boundaries, on the other. It will be no easy task. It must be done carefully and the recommendations implemented gradually to ensure a smooth transition to modified insurance arrangements.

Without in any way meaning to pre-judge the conclusions of the study I would like to discuss several matters that should receive attention.

First, I would note that all analyses of which I am aware have suggested that depositors are not effective at restraining imprudence or risk-taking at banks and thrifts. They cannot be expected to have sufficient information, and tend, in any event, to be either unresponsive or to run when faced with bad news. If the study confirms that view, the policy options that then must be seriously considered surely will include other ways to limit risk-taking, such as enhanced supervision, different insurance assessment techniques, or use of subordinated capital that would not be protected in case of failure. The large cost to the public of the legislation before you suggests that we must consider the potential benefits of requiring prompt recapitalization, merger, or closure of troubled insured entities whose capital is declining but still positive.

Second, attention should be given to determining whether specialized fixed rate residential lending institutions are needed today. This question is raised because of the costs and competitive distortions involved in subsidized borrowing from Home Loan Banks, the dangers inherent in special regulatory and supervisory regimes for subsidized depository institutions, and the continued vulnerability of a large element of the thrift industry to increased interest rates.

This question should also be considered because of the important changes in the mortgage market. In the past, home mortgages were a uniquely local product, almost always held to maturity by the original lender. Now, computers, modern telecommunications and financial engineering have vastly changed this market. In today's market, mortgages frequently are originated by a wide variety of intermediaries, bundled into securitized products, and sold to institutional investors in all parts of the country -- more than one-third of outstanding home mortgages are held in securitized form. This new environment may make it unnecessary to provide special government subsidized facilities for mortgage lending, and may make it possible to eventually bring all depository institutions under one regulatory and supervisory system. This issue should be given priority attention as part of the study of deposit insurance reform.

Third, in considering the reforms that should be developed, considerable attention has been focused on the expanded investment and lending powers that have been granted to state chartered thrifts. The study must examine the safeguards that should be developed for the future.

These safeguards should not require rigid prohibitions on types of activities that may be engaged in by depository institutions. Rather, as a first step, consideration should be given to requiring that non-banking activities of banks and thrifts take place in subsidiaries of holding companies to ensure that these activities are not subsidized by the federal safety net, and that this safety net will not be responsible for covering any losses that may arise from these non-banking activities. We have such a proposal under review at the Board. In addition, consideration should be given to amending and expanding existing law to limit risky non-banking activities in banks and thrifts.

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I would like to close my testimony by stressing that it is vitally important for Congress to move very promptly to consider and enact the President's proposals. We must make available the resources the regulators need to close insolvent thrifts. We must stop the continuing daily losses due to operating expenses that greatly exceed income, as well as to the higher than normal rates that they must offer to attract deposits. In operating in this way, they not only hurt themselves and the insurance funds, but, as they drive up rates, they also injure their competitors and the economy as a whole. Prompt action is essential to maintaining public confidence in thrift institutions and their insurance fund.