

For release on delivery
10 00 a m , E D T
September 21, 1995

Statement by
Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Banking and Financial Services
U S House of Representatives
September 21, 1995

I am pleased to be able to appear here today to offer my thoughts on the proposed legislation to recapitalize the SAIF insurance fund, to merge SAIF and BIF, and to merge the thrift and the commercial bank charters

As I suggested to this subcommittee at the beginning of August, two insurance funds with sharply different premiums cannot be sustained. Such a structure is inherently unstable. Competitive depository institutions cannot differentiate themselves by the quality of the deposit insurance that is offered because it is the same insurance regardless of whether it is from BIF or SAIF. In either case, it is government-mandated and government-sponsored deposit insurance. For identical insurance, it is rational that depository institutions seek the one available at the lowest cost. If a substantial difference in deposit premiums exists between SAIF and BIF, the institutions paying the higher premium will pursue insurance offered by the other insurance fund unless there is some other reason to remain with their current fund. In the process, the disadvantaged fund becomes increasingly vulnerable to insolvency as its premium base declines. The only winners created by the looming deposit premium difference between SAIF and BIF deposits will be those depositories able to "game" the system, and leave SAIF first. The solution to this problem is to end this game and merge SAIF and BIF.

A prerequisite to merger of BIF and SAIF is to put SAIF on a sound basis. There seems to be a general agreement to accomplish this recapitalization by a special one-time assessment on those deposits currently insured by SAIF. The merging of a recapitalized SAIF with a sound BIF would then consolidate the FICO bond obligation of SAIF into the new insurance fund and effectively obligate past BIF members to participate on a pro-rata basis.

Discussions about merging the BIF with a recapitalized SAIF insurance fund and sharing the FICO interest obligation among the members of both deposit insurance funds raise the question of retaining separate bank and thrift charters. If a persuasive public policy case could be demonstrated to maintain two charters, a merged BIF and SAIF would have to adjust to this structure. However, not only has the policy necessity for residential mortgage specialization at thrifts been diminished, but also such narrow portfolio focus has induced excessive portfolio risk.

As I indicated to this subcommittee last month, while thrifts were dominant and innovative mortgage lenders in the post-World War II years, by the 1970s, market forces and technology began to erode the original mortgage financing purpose of specialized thrifts, and, hence, of their charter. Equally important, events over the last decade have been associated with market forces and innovations that have reduced the relative yield on the standard residential mortgage, while at the same time other market forces have made deposit rates increasingly competitive. In such an environment, significant questions are raised about the risk profile and economic viability of any institution that by law or regulation is required to place most of its assets in mortgage instruments and fund them in the deposit market.

Two conclusions are clear. First, the nexus between thrifts and housing largely has been broken without any evident detriment to housing finance availability. Second, a public policy that induces -- let alone requires -- thrifts to specialize in mortgage finance threatens the continued viability of many of these entities -- particularly those without wide and deep deposit franchises, tight cost controls, and the ability, when necessary, effectively to originate and sell standard mortgages that

cannot profitably be held long-term. A broader charter for thrifts -- such as a commercial bank charter that lets them hold a wider range of assets -- thus would seem to be good public policy and the bill before you confronts the challenge of creating one charter.

The specific details of a charter consolidation must blend economic, market, and legal ingredients. The specific blend is less important than making measurable progress in developing a set of insured depository institutions subject to as identical set of rules and incentives as possible. For thrifts, this means a trade-off between current permissible activities and greater portfolio flexibility and viability. For banks, the historical inequity created by competition from insured depository institutions with wider permissible activities and opportunities would be reduced, if not eliminated. For public policy, the potential greater diversification of thrift portfolios could strengthen and make more flexible that class of depository institution. With a legislative thrust to shift thrifts to more bank-like operations, it seems prudent and reasonable that thrifts be supervised and regulated as banks. To facilitate such supervision and regulation, the bill before you creatively establishes a mutual commercial bank category, to ease the shift from thrift to bank status for many institutions, and permits states to continue their thrift charter but treats such entities as if they were commercial banks for federal purposes.

A common charter will not accomplish its objective without elimination of tax rules that not only induce mortgage specialization but also penalize thrifts that try to adopt more diversified portfolios. The special bad debt reserve treatment that provides tax benefits -- and, hence, subsidy -- to mortgage lending by thrifts no longer serves a perceivable public policy function and, hence, should be

removed going forward. Moreover, the tax recovery of the reserve buildup from this past tax subsidy should be eliminated. In reality, this reserve was always a subsidy and never really a true bad debt reserve. The possibility of any significant recapture of lost tax revenue to the U S Treasury has been hypothetical at best because of the tax-induced high marginal cost to thrifts of reducing their mortgage portfolios and, as a result, triggering the so-called bad debt recapture. Indeed, without a fresh start, the current bad debt recapture provisions would be a significant barrier for entities that wish to diversify. A penalty should not be charged institutions striving to respond rationally to market realities, and to legislation designed to induce portfolio diversification.

The Board realizes that legislation will require compromises and skillful craftsmanship. But we should not lose sight of first principles. A deposit insurance system that focuses the attention of banks and thrifts on the relative status of their funds, and a system that rewards those who can jump ship first, is, to say the least, counterproductive. What is needed is a deposit insurance system whose status is unquestioned so that the depositories can appropriately focus their attention on the extension and management of credit in our economy. A merger of BIF with a recapitalized SAIF accomplishes that objective and provides the Congress with the opportunity to strengthen and rationalize our depository institutions. Congressional action to provide a more bank-like thrift charter and bank-like taxation would be consistent with market trends and stronger depositories and should not reduce mortgage credit flows. There are several variations of the bill structure and timing implementations that would effectively resolve the current difficulties affecting our deposit insurance system. The bill before you is one of them. It would

strengthen our deposit insurance system and create a
framework for the evolution of thrift institutions
