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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I am pleased to be before this Committee this morning to testify in support of H.R. 4603, a bill which would enhance the ability of the Federal supervisory authorities to address the unusual financial pressures many depository institutions are now facing.

It is no news to this Committee that the nation's thrift institutions are under severe earnings pressure. Fortunately, most of the institutions entered this period of strain with a sizeable capital cushion. Their assets remain sound and the aggregate liquidity of the industry -- both in a portfolio and cash flow sense -- is adequate. As a group, the management of the thrift institutions has shown flexibility and creativity in dealing with their problems. But, external events -- specifically inflation and the related extraordinary levels of interest rates -- have created particular problems for institutions whose portfolios are dominated by long-term, fixed-rate assets, such as residential mortgages. As the costs of deposits has escalated, the earnings of such institutions have vanished, with the result that the capital position of virtually all of them is being eroded.

The basic solution to this problem must be found in the context of success in the fight on inflation, bringing lower and more stable interest rates. But, as we work toward that end, we must also be prepared to deal with the possibility that an increasing number of thrifts, basically with sound assets and with satisfactory prospects, could find their capital depleted to the point of technical insolvency or failure, and some will face a need for reorganization and merger. The great mass of their deposits are, of course, insured,

maintaining customer confidence. But it has also become clear to me that the insuring and regulatory agencies need clarification and strengthening of certain of their powers to deal with the situation in an orderly way.

I would underline the fact that the present problem of the thrifts has emerged, in substantial part, as a result of general conditions in the economy and the money markets. Indeed, for many years public policy helped foster the heavy degree of portfolio concentration by thrifts in fixed-rate long-term instruments. Management is certainly relevant in appraising the performance and prospects of particular institutions, but in some cases even the best managed institutions have been caught up in the effects of the inflation and abrupt changes in interest rates in the last few years.

I also want to emphasize at the outset that I consider the acute problems of the thrift industry to be transitional in nature -- a factor recognized by the provisions of this bill applying temporarily. Economic policy is today directed toward dealing with the inflation problem that lies at the heart of the thrifts'problem. Although no one can predict the duration with certainty, the earnings squeeze facing thrift institutions will be temporary in nature. As older assets mature and are replaced by new ones, thrift institutions portfolio returns will rise; just in the last three years, for example, <u>average</u> portfolio returns have increased over 1-1/2 percentage points at S&Ls and over 1 percentage point at MSBs. New asset powers provided by the Depository Institutions

Deregulation and Monetary Control Act and more flexible mortgage instruments recently authorized by the Federal Home Loan Bank Board and in an increasing number of States, will also enhance the ability of thrift institutions to acquire assets with returns more related to market rates. And, as you are aware, the possibility of still broader powers for the thrifts is likely to be considered in coming months.

At the same time, there are a number of institutions that will require assistance during this difficult period, or will need to seek merger partners or other solutions. Part of our approach should be to provide reasonable support to those institutions that can and should survive problems not of their own making, recognizing that broadening of thrift powers provide, in themselves, no solution to the present problem.

Essentially, that is the long-established mission of the supervisory and regulatory authorities. The bill before you, drafted largely by the supervisory agencies, provides no fundamental change in the authority or role of those agencies. Rather, it simply provides the FDIC and FSLIC, under specified conditions, with more flexibility either to provide transitional assistance to thrift institutions that can survive during a period of financial stress or to broaden merger possibilities.

One provision of the bill would provide for the temporary infusion of capital to affected institutions through insurance fund acquisitions of subordinated securities of the institution being assisted, which will be repaid from future earnings. Such

authority already exists in limited form, but the language of the existing statutes, particularly with respect to the FDIC, did not really contemplate a situation like the present affecting the thrift industry so generally. Specifically, at present,the FDIC can provide such assistance when it finds that the particular institution to be assisted is "essential" to its community. In foreseeable circumstances, with a number of thrifts in a given area subject to severe pressures, no single such institution in the area may be "essential" to the community, but it seems clear that the community or region does have a clear stake in the maintenance of an effective presence of a number of thrift institutions.

The bill would provide that the Federal Deposit Insurance Corporation could provide assistance when "severe financial conditions exist which threaten the stability of a significant number of" insured institutions, provided that such assistance will "substantially reduce the risk of loss or avert a threatened loss" insurance fund. Thus, sound, and soundly-managed institutions could be assisted without the difficult finding that a particular institution is "essential," but only when the difficulties are general and arise from developments external to the institution, and when the insurance fund risks can be minimized. The past record and interest of the supervisory agencies seems to me to provide assurances that this additional margin of flexibility will be utilized with great care and prudence, and with appropriate safeguards to the public interest; it is not a generalized "bail out," and should not be viewed as such.

The cost to the Federal Government, both on and off budget, must be a consideration in evaluating different approaches to providing assistance. What is at issue here is not a generalized subsidy, but pin-pointed, limited, transitional capital assistance to essentially viable institutions undergoing temporary distress because of current financial circumstances. It looks to repayment over time. The approach is designed to ultimately save, not cost, the taxpayer money. The assistance would be provided only in circumstances in which it would, in fact, avoid large potential drains on the insurance funds themselves that would arise in the event otherwise sound institutions needed to be merged or liquidated.

There will inevitably be institutions whose prospects would be such that their long-term viability is questionable, even under more favorable economic circumstances. Consequently, this legislation would also specify guidelines under which the agencies would be given more flexible authority to arrange supervisory mergers between now and the end of 1982.

This includes expanded powers to facilitate conversion of mutual organizations to stock form as a prelude to mergers with stock organizations, and in specified circumstances and as a "last resort," would permit acquisition of thrifts by healthy out-of-state thrift institutions, or alternatively, bank holding companies. The Bill sets clear and specific ground rules for such mergers. Priority would be given first to institutions of the same type within the same state; second, to institutions of the same type in different states; third, to institutions of different types in the same states; and fourth, to different types in different states.

As you know, the Federal Reserve already has broad authority under existing law to approve bank holding company acquisition of thrifts. As a matter of policy and in the circumstances of recent years, we have refrained from exercising that authority. We have recognized the close Congressional interest in the subject, and recently submitted to the Congress a staff study examining the issue anew.

In transmitting that study, I indicated that in the absence of legislation, such as the bill before you providing specific direction concerning possible bank holding company takeovers of ailing thrifts, the Federal Reserve Board might well find it necessary in the public interest to act under its existing broader authority. In my opinion, the broader question of bank-thrift consolidation deserves attention in the months ahead in any event, but the Board at this time would much prefer to act within the more limited framework provided by the legislation before you.

The advantages of the "Regulators Bill" in these circumstances seem clear. The capital infusion provisions of the bill may help reduce the number of cases in which supervisory mergers are necessary -- but, when they are, the supervisory authorities would be provided with the necessary flexibility and criteria to deal with the situation.

The bill also provides limited power for the FDIC to arrange an interstate merger of a large failing commercial bank where an interstate merger would be neither possible nor desirable. Before exercising this authority, the FDIC would

be required to attempt first to find a merger partner within the same state, then in an adjacent state, and only then in other states. The FDIC would also be required to consult with the supervisory authority in the state in which the failing bank was located and take into consideration the competitive implications of an interstate acquisition.

I am aware of, and sensitive to the concerns of some, about even the most limited form of mergers or acquisitions across state lines. It is precisely for that reason the bill defines the circumstances in which such authority would be used, in effect compromising between the unsatisfactory alternatives of a sweeping change in existing law or policy or a crippling limitation on the ability of the insuring agencies to deal with the practical realities.

I also know that to some this bill appears too narrow in scope and short in duration to deal with the basic problem of the thrifts or structural change in the financial industry. That is true; it is not designed to do so. Our financial structure may be on the edge of far reaching and substantial change. In the months ahead the Congress will need to address the fundamental issues of which types of services can be provided by different types of financial institutions and in what geographic area, and the competition between "regulated" and "unregulated" institutions. I welcome that examination. But you realize those issues are unavoidably complex and contentious and they will, in my judgment, not be resolved easily. As important as they are, I would strongly

urge that the Congress not wait for their resolution to address the pressing, yet transitional, problems before the regulators. In my judgment, the legislation before you, limited in objective, modest in scope, and temporary in duration, is needed now, but in no way should prejudice your further examination of more fundamental issues.

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