NEWS RELEASE

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SEIDMAN CALLS FOR QUICK ACTION ON FSLIC; URGES INDEPENDENCE FOR DEPOSIT INSURERS

L. William Seidman, Chairman of the Federal Deposit Insurance Corporation, today called for early action to resolve the 100 or so thrift institutions in the worst condition, which he estimated would cost about $30 billion, and proposed a 10-point program for improving the nation's deposit insurance system.

Addressing the National Press Club in Washington, Mr. Seidman said the immediate priority should be to stop the losses taking place among the hopelessly insolvent thrifts. "While part of these losses constitute reserving for property value declines that cannot be eliminated, these institutions are reporting losses of over a billion dollars per month," he noted.

"By our estimates," Mr. Seidman observed, "and I have said many times onsite examinations are necessary to support these estimates, the worst twenty percent of the remaining insolvent institutions account for around 80 percent of the growth in losses. We need to close the worst first at an estimated cost of $30 billion. Once these 100 or so worst institutions are liquidated, the other problem institutions can be dealt with over a somewhat longer period. Until that time, these problem institutions must be supervised very closely."

The estimated $30 billion needed to address the big losers is probably more than the industry alone can bear, but "the thrift industry certainly can contribute its part," Mr. Seidman said. "The government must find the

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resources to meet this problem," he commented. "The funds for this effort can be financed over a period of time through a variety of available arrangements such as those proposed by The American Agenda under former Presidents Ford and Carter."

Mr. Seidman said resolution of many of the remaining insolvent thrift cases can take place after important supervisory and operational changes are made to the deposit insurance system. These changes are necessary if the deposit insurance system is to maintain itself in a financially sound condition in the years ahead.

"Our deposit insurance system has served us well for over 50 years. But it's time to give us the capability to function more like a private insurance company," said Mr. Seidman.

Mr. Seidman suggested that after the immediate problems in the thrift industry are resolved, Congress and the Administration formulate a program for retooling the nation's system of deposit insurance. These changes needed to the insurance system are identified in a new FDIC study, Deposit Insurance For The Nineties. Key provisions include:

- Federal deposit insurance is here to stay, thus efforts must be made to manage the system better.

- The federal insurer should be able to operate as much as possible like a private insurer.

- The federal insurer's primary mission must be to maintain the integrity of its insurance fund, preventing undue risk-taking by insured institutions, as was recommended by President-Elect Bush's Task Group on Regulation of Financial Institutions.

- The insurer should be separately budgeted, and not a part of the regular federal budget.

- The insurer should set insurance premium rates that reflect experience.

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- Like a private insurance company, the federal insurer should have the right to decide who shall have deposit insurance.

- All insured institutions should be regulated according to common accounting and supervisory standards.

- All financial institutions that "buy" federal deposit insurance should be obliged, in addition to paying premiums, to guarantee the insurer against any insurance loss caused by other banks owned by a common parent.

- A banking structure should be established that limits risk inside the banks to traditional banking activities.

- Improve risk supervision of financial institutions.

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Remarks By

L. William Seidman
Chairman
Federal Deposit Insurance Corporation

DEPOSIT INSURANCE FOR THE NINETIES

Before

The National Press Club
Washington, D.C.
November 30, 1988

Thank you for this opportunity to speak with you on the federal deposit insurance system, a subject few would have thought worthy of such a distinguished audience not many years ago.

Today we address the problems of deposit insurance because the system as a whole has developed a significant weakness -- costs far exceed income. The thrift industry's problems alone now demand funding on a massive scale. That funding requirement appears to exceed the combined resources devoted to Europe under the Marshall Plan, and the bailouts of Lockheed, Chrysler, Penn Central, and New York City!

The deposit insurance system's performance raises two pressing questions.

First, how can we improve the system to prevent excessive costs from reoccurring?

And second, how should we deal with the problems in the thrift industry and the insolvency of the thrift insurance fund?

I have deliberately put system improvement first. Before we address the urgent subject of how to deal with the thrift insurer's insolvency, we must know where the system is going. As they say, "If you don't know where you are going, any road will do."

For most of this year the FDIC has been studying ways to improve the deposit insurance system.

I've just come down the Mountain of Infinite Wisdom. And with me I have brought back a 300 page tablet addressing the first question.

To be merciful, I'll condense it into our "Ten Commandments" for a safer and less costly federal deposit insurance system. Perhaps modesty requires we call them recommendations for an improved system.

If they are not agreed to by all -- a distinct possibility -- we believe they should help focus the debate.

Let me begin with a bit of background.

Over its 55 years, the federal deposit insurance system has done a good job of protecting depositors and preventing banks runs, even during periods of great stress. People have had a safe place to put their life savings.

It has also helped small banks to compete with larger banks, fostering a decentralized banking system.

These are important benefits of the deposit insurance system.

But as I've noted, deposit insurance has developed costly defects in urgent need of repair.

The FDIC will end this year with about a $2 to $3 billion loss -- its first such loss. We have spent $7 billion in Texas alone since 1986.

The good news is that the FDIC will end the year with a net worth of approximately $15 billion, and expects to show a half-billion dollar increase in net worth in 1989. We are in a position to handle the problems we can foresee. But obviously we need to control the kinds of losses we've experienced in Texas.

Unfortunately, our sister insurance fund, the FSLIC, is less fortunate and is insolvent. It has been estimated that the cost of restoring it to solvency and a sound financial position will range between $50 and $100 billion.

Our own estimates tend toward the higher end of that range.

The deposit insurance system can be compared to a nuclear power plant. It can provide benefits. But as these costs show, safety precautions are needed to keep it from going out of control.

A deposit insurance system out of control has the potential to "meltdown" and damage the entire U.S. economy.

As a result of this review, we have developed our commandments.

First, federal deposit insurance is here to stay. Thus our efforts must be aimed at managing the system better.

Second, we must allow the federal insurer to operate as much as possible like a private insurer. This principle is central to improving the system.

Third, the federal insurer's primary mission must be to maintain the integrity of its insurance fund, preventing undue risk taking by insured institutions. **This was the essence of the recommendations of President-Elect Bush's Task Group on Regulation of Financial Institutions. We need an independent insurer whose turf and sole focus is preservation of a solvent fund. This structure instills a built-in conservatism into the supervisory process.**

The insurer should be independent of the industry it regulates and from chartering authorities -- each of which has its own separate mission. Of course, it should be subject to Congressional oversight, but independent of the appropriations process as the Bush Task Group recommended.

<u>Fourth, the insurer should be separately budgeted, and not a part of the regular federal budget.</u> Why? Well, because the federal budget system works backwards for an agency mandated to save for emergencies.

For decades the FDIC has been depositing its unspent premium income in the Treasury. We receive no taxpayer's funds. Are these deposits counted as savings? No, they are counted as income to the government rather than savings put aside for a rainy day.

When it comes time to make a withdrawal to deal with a banking problem, that action is treated as government expenditure. It <u>should</u> be treated as a payback of money on deposit.

Thus, the present system is designed so there is no reward for saving. Even worse, there is a penalty for using funds to stop problems early, while they are less costly.

Fifth, the insurer should set insurance premium rates that reflect experience. The deposit insurer, like private insurers, should be able to adjust its premiums to reflect its experience and costs on a continuing basis. While it would be helpful to do this on a bank-by-bank basis, we should start by charging all banks based on the fund's overall experience.

This sort of pay-as-you-go pricing system should help ensure that the deposit insurance fund maintains adequate reserves. It gives bankers a stronger economic incentive to take an interest in promoting firm and forceful supervision to control risk.

Sixth, like a private insurance company, the federal insurer should have the right to decide who shall have federal deposit insurance.

Today, terminating bank insurance can take two years or longer. Meanwhile, the insured institution often continues to deteriorate as losses mount. The insurer must have the clear authority to terminate insurance promptly -- that is in six months or less -- when the institution threatens the insurance fund. Of course, insured depositors must continue to be protected for a reasonable period once insurance is terminated.

<u>Seventh, all insured institutions should be regulated according to common accounting and supervisory standards.</u> GAAP accounting standards should govern unless more conservative standards are required.

<u>Eighth, all financial institutions that "buy" federal deposit insurance should be obliged, in addition to paying premiums, to guarantee the insurer against any insurance loss caused by other banks owned by a common parent.</u>

A multibank holding company cannot be allowed to leave federal insurers with the cost of its failed bank subsidiaries, while it walks away with its good banks.

<u>Ninth, we should move toward a banking structure that limits the risk inside the banks to traditional banking activities.</u> Nontraditional activities can be performed outside the bank in its affiliates or subsidiaries. Supervisory "firewalls" can be constructed to insulate the banks from risks associated with those operations. Such a change would contain the insurance risk, and at the same time allow financial firms the necessary freedom to offer a competitive array of products and services.

<u>And tenth, we must improve our ability to supervise financial institutions to control risks.</u>

Concentrations of risk in an institution's portfolios must be limited. FSLIC's and our experiences in the Southwest underscore that point.

Limiting concentration by improving portfolio diversification should involve several elements. Statewide, and hopefully someday, nationwide, branch banking should be encouraged. Diversification, not just by customer, but by loan type and region, should be promoted. And improved secondary markets through securitization should be fostered.

We suggest a new tool to help regulators assess and limit concentration. Establish regional committees comprised of representatives from different supervisory agencies to evaluate the levels of risk present in their respective areas. These Regional Economic Oversight Committees, in regular consultation with industry and academic representatives, should seek to anticipate competitive and economic developments that could lead to trouble down the road.

For example, banks and thrifts all rushed to build office buildings in Austin, Texas, at just about the same time. That resulted today in a city with a decent economy but high levels of unoccupied structures. Regulators and industry representatives working together might have helped prevent that race to folly.

Of course, we should never forget that maintenance of adequate capital is the bedrock of supervision. Once an insured institution's capital falls below an acceptable level, constraints must be placed on asset growth and the ability to engage in new activities.

Above all, supervision must be directed to strong, prompt action to limit risk and loss to the insurance fund.

These are our "Ten Commandments" for a safer and less costly deposit insurance system. A system that is designed to avoid the problems we face today.

Many have suggested that greater depositor discipline should be the first commandment.

While depositor discipline may be theoretically desirable, placing depositors at greater risk has not proven to be useful in practice. The problem is that depositor discipline sometimes works "too well"-- taking the form of bank runs, which pose a threat to the stability of the financial system.

Furthermore, if bank supervisors, with thousands of personnel, have trouble evaluating a bank's financial condition quickly and completely on a daily basis, how can we expect depositors to be able to do so?

In addition, it is not possible to increase significantly depositor discipline as long as all the major governments around the world prevent their largest banks from defaulting to deposits.

But while depositor discipline is limited, market discipline still remains to punish bank executives, owners, and holding company creditors of the financial institutions that fail. They lose their jobs and investments.

Until now, I have been talking about how to improve the system so the problems of the eighties won't be repeated.

Now I'll turn to possible solutions to the thrift problem. A problem almost as important for banks as it is for thrifts.

No federal insurance system can survive long unless all federal insurers are solvent.

Here are a few of our suggestions. They are given in a spirit of cooperation, and out of a desire to see action now.

First, stop the losses that are taking place among the hopelessly insolvent thrifts. While part of these losses constitute reserving for property value declines that can not be eliminated, these institutions are reporting losses of over a billion dollars a month.

By our estimate (and as I have said many times, onsite examinations are necessary to support these estimates), the worst twenty percent of the remaining insolvent institutions account for around eighty percent of the growth in losses. We need to close the worst first, at an estimated cost of $30 billion. Once these 100 or so worst institutions are liquidated, the other problem institutions can be dealt with over a somewhat longer period. Until that time, these problem institutions must be supervised very closely.

The total bill will be $50 to $100 billion, but the immediate need is for $30 billion to close the worst losers.

Even this initial cost exceeds the resources the thrift industry can shoulder, but it certainly can contribute its part.

Beyond that contribution, the government must find the resources to meet this problem.

Our study contains considerable analysis of potential funding methods. The American Agenda, headed by former Presidents Ford and Carter, outlines a way to spread the cost over a number of years. This proposal should be given serious consideration.

However, it's up to the Treasury Department and Congress to determine which alternative makes the most sense in the overall federal planning. The message today is, the situation requires $30 billion in 1989.

The next question is who gets the money, and who controls how it is spent.

It has been suggested that the FDIC's supervisory and liquidation skills might come in handy in assisting with the problem. We stand ready to help if this is considered desirable by the Administration and the Congress.

But we would prefer going it alone. The FDIC is one of the few examples of a government institution that has proven able to save for a rainy day. It has not only done so, but it has used its savings to weather one of the biggest storms ever, and emerge from the tempest, slightly damp but dry enough to be ready for the next storm.

Whether there should be some use of FDIC services, or even an administrative merger, is best left to others less prejudiced than we to decide. The urgent first requirement now is to move under appropriate controls to close the institutions that are costing the government ever-increasing billions each month.

In summary:

Cure the immediate damage being done by the continuing losses in the thrift system. Close the worst first with $30 billion and a sound plan for spending it.

Next, construct new methods of controlling the system against future problems -- we suggest our "Ten Commandments" as essential to that goal.

We invite your comments, suggestions, and criticisms of our work. But please, no physical violence.

And together, as President Wilson wisely recounted, "We shall deal with our economic system as it is ***, not as it might be if we had a clean sheet of paper to write upon, and step by step we shall make it what it should be."

Thank you.