



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

SAVINGS BANKS IN A HOSTILE ENVIRONMENT:
AN FDIC ASSESSMENT

An address by

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I appreciate the opportunity to be with you today to discuss the circumstances facing your industry and to share our views about how the current challenges can be met. I will begin by discussing some of the underlying problems in the thrift industry. Then I will review the FDIC's recent actions in dealing with large troubled savings banks and contrast our actions with the alternative approaches some people advocate. Next, I will outline several constructive measures to deal with the problems of your industry. I will then describe how we propose to break the current impasse between the FDIC and the FSLIC on the issue of indemnification. Finally, I will offer some concluding thoughts and frame one of the most critical issues confronting your industry.

I. Current Problems and FDIC's Approach to Date

I need not dwell on the impact that continued high and volatile interest rates are having on mutual savings banks. Yields on earning assets have not kept pace with the cost of funds, and a significant volume of traditional savings money has been captured by new competitors such as money market funds, making it more difficult to upgrade asset yields. If 1980 -- with aggregate losses of almost \$250 million -- was a bad year for industry earnings, 1981 was a disaster. The industry's losses were more than \$1.4 billion in 1981, and 1982's figures are likely to be nearly as disheartening.

The level and volatility of interest rates have been unexpected and unprecedented; moreover, certain factors beyond the control of savings bank managers have made thrift institutions particularly vulnerable to the effects of the high rates. Perhaps foremost among those factors has been a national policy encouraging thrifts to provide long-term, fixed-rate real estate financing. Other public policies, such as usury laws, limitations on thrift diversification, prohibitions against due-on-sale clauses and the imposition of unconscionable franchise taxes, have further restricted your industry's ability to respond to a changing environment.

I must tell you, however, that savings bank problems have not resulted exclusively from public policies or unfavorable economic conditions. We have encountered a number of cases in which management decisions were made that were clearly contrary to the best interests of an institution or its depositors. In particular, certain investment strategies, which relied heavily on long-term bond positions, can only be described as speculative, representing a dangerous gamble on the future course of interest rates.

Another concern during this period of intense trial for the industry is the incidence of overly generous compensation arrangements and perquisites for some senior management officials. Contracts designed to protect and insulate

management by providing excessive compensation or severance allowances are difficult to justify. Such actions not only compound an institution's problems, they reflect unfavorably on the vast majority of you who faithfully serve your depositors in responsible fashion. It is and will be our policy to employ appropriate means to correct these practices wherever they are found.

Since last November, the FDIC has assisted nine mergers involving mutual savings banks with assets aggregating approximately \$14 billion. We have had two principal goals. The first has been to resolve the problems of the failing institution at a reasonable cost to the insurance fund without raising public concern about a large bank failure. Our second goal has been to insure that the resulting institution is financially sound and has the ability to compete effectively in its market and to continue to serve the credit needs of its community free of excessive government control.

While we take satisfaction in our accomplishments to date, our approach of handling failing savings banks through assisted mergers has been questioned in some quarters. We do not object to that; indeed, we welcome outside views and would be surprised if they were universally favorable.

Some members of the savings bank industry have argued that arranging assisted mergers is a comparatively unattractive and costly solution. This view has recently been given increased credibility as a result of a well-publicized "study" conducted by Wharton Econometric Forecasting Associates at the behest of members of the savings bank industry.

Our staff has reviewed the Wharton study and has found it seriously deficient. The study describes at great length the underlying macroeconomic assumptions and methodology used to forecast thrift earnings, but fails to provide important details regarding projected asset yields, funding costs, deposit growth and portfolio structure. The omission of such critical information precludes a thorough analysis of the study.

The most troubling aspect of the Wharton study, however, is its findings. The study projects that, using assisted mergers as the exclusive solution, almost 250 savings bank mergers would take place over the next three years at a cost to the insurance fund of \$20.3 billion. The study does not tell us the size of the institutions projected to fail, which makes cost evaluations very difficult. Based on our experience in dealing with some of our very worst problems, however, we estimate our cost would be less than \$20 billion to assist the merger of every insured savings bank in the

nation. In any event, the prospect that nearly two-thirds of all mutuals will fail by 1984 is not even remotely possible under the interest rate scenarios used in Wharton's model.

Even as it projects unrealistically steep costs for assisted mergers, the Wharton study suggests that cost-free accounting solutions are possible or that mortgage warehousing plans can produce similar results for only a small fraction of the cost of assisted mergers. We could not disagree more. We know that the nine mutuals we helped to merge had no realistic hope of survival without substantial assistance. Cashless solutions simply would not have worked. The study contains other deficiencies -- for example, the extent of industry losses necessary to cause two-thirds of all mutuals to fail is about double the size of the income subsidy projected by Wharton for the mortgage warehousing program, which is supposed to cover those losses. In sum, we believe the study grossly exaggerates the number and likely cost of assisted mergers and significantly underestimates the cost of other alternatives.

Our most recent assisted savings bank merger will, I believe, illustrate the relative merits of our approach as contrasted with the alternative of direct financial assistance. In evaluating the merger proposals we received for the Western Savings Fund Society in Philadelphia, our staff calculated the estimated cost of providing sufficient direct financial assistance under Section 13(c) of our Act to absorb Western's projected losses over a 10-year period assuming continuation of current interest rate levels. The estimated cost, on a present value basis, for the FDIC just to stabilize Western came to \$280 million. Using the same interest rate assumptions, we estimated the cost of our assistance agreement with Philadelphia Saving Fund Society, which acquired Western, at \$294 million. While the estimated cost of the merger was slightly higher than the estimated cost of direct assistance, the difference was not great and was, we believe, well worth it.

First, direct assistance to Western would not have resulted in a stronger institution. At the time of the merger, Western had all but exhausted its surplus account. Break-even assistance would have done nothing to alter that, and at the end of the 10-year period the institution would still have had virtually no surplus. In other words, while it would have been kept alive for the duration of the assistance period, once the assistance was terminated Western would have found itself in a precarious position for many years to come.

Second, because a significant amount of FDIC oversight is a sine qua non of direct assistance, Western would have been burdened with FDIC-imposed management and operating controls for the duration of the assistance. Not only is the notion of such direct government involvement philosophically distasteful, it could have detrimental practical effects.

Third, Western would have had difficulty retaining its present management and would have found it virtually impossible to attract competent recruits. If you are a bright young MBA, do you choose to join an institution limping along with a government subsidy or do you go elsewhere?

Fourth, significant economies will be achieved as a result of the PSFS merger. Redundant branch offices will be closed and duplicate operations will be curtailed.

The point is, sufficient direct assistance to stabilize Western could have been provided at a cost comparable to that of an assisted merger, but the result would have been a very marginal institution with a limited ability to attract and retain good management, whose capacity to grow and serve its community would be severely hampered -- in short, a financial cripple. Instead, we chose to merge Western into PSFS and provided sufficient assistance to insure that the acquisition did not weaken PSFS. The result was a stronger institution with the ability to effect numerous operating efficiencies, to grow and prosper without government interference and, consequently, to better serve the people of Philadelphia. To us, that was an obviously preferable solution.

In total we estimate that the assisted mergers to date will cost the FDIC approximately \$1.7 billion over the life of the assistance agreements, assuming interest rates remain near current levels. This sum is approximately the same as our estimate of the amount of direct financial assistance that would have been required to simply stabilize these failing institutions under the same interest-rate assumptions.

II. Blueprint for Constructive Action

Short of a dramatic and sustained decline in interest rates, there is no true solution to the current thrift industry problem. Nevertheless, we must proceed to address the problem simultaneously on two fronts. First, we must enhance our ability to deal with failing institutions. Second, we must correct the underlying structural weaknesses in the thrift industry to insure its long-run viability.

While numerous proposals for dealing with the thrift problem have been advanced, most address only part of the problem, or provide only temporary relief; some could even exacerbate the situation. What is needed is a comprehensive, multi-faceted plan.

A. Regulators' Bill and Capital Assistance Plans

To deal with our most immediate problems, we must have the legislation embodied in the Regulators' Bill. As you know, the Bill provides needed flexibility to arrange assisted mergers under Section 13(e) of our Act and broadens our authority to grant direct financial assistance under Section 13(c). We have recently revised portions of the Bill that apply to the FDIC, based on our experience over the last several months.

The amendments to Section 13(e) of the FDI Act will provide flexibility in handling the failure of a large firm. We have expanded the proposal introduced last year to cover not only a failed bank that is closed and placed in receivership but also an insured bank in danger of failure. Our experience indicates that in the case of a mutual institution it is generally preferable to avoid the actual closing of an institution when possible. The threshold size for employing interstate bidding has been lowered from \$2 billion to \$500 million or more in assets.

We continue to seek a revision to Section 13(c) of our Act, which will allow us to provide direct assistance not only when an institution is found to be essential to its community but when institutions are threatened by dire economic circumstances as well. We consider direct financial assistance a secondary tool to be used only where a solid merger cannot be arranged at a reasonable cost.

While I am on the subject of financial assistance, I want to make clear our position on the capital support or net worth guarantee programs that have been introduced in Congress. We believe such programs, which require the issuance of government guarantees upon an institution's satisfaction of certain prescribed criteria, are neither needed nor desirable for mutual savings banks.

The FDIC has ample financial resources to deal with problem mutual savings banks on a permanent, not a patchwork, basis. For that reason, we will oppose any legislation providing capital assistance for savings banks that is predicated exclusively on meeting a set of rigid criteria.

Our clear preference is for liberalization of Section 13(c), which will provide a flexible tool for granting financial aid when appropriate. When aid is provided under Section 13(c), it will be sufficient to truly address the problem at hand. The FDIC, so long as it has the resources and statutory authority to do otherwise, does not intend to litter the financial landscape for decades to come with crippled banks.

B. Other Actions Needed

The Regulators' Bill would provide us the tools we need now to deal with those institutions that clearly are not viable or will not weather current conditions without government aid. The comprehensive approach we are suggesting requires that we proceed in other areas as well.

First, the Garn Bill, or similar legislation, must be enacted to give thrifts expanded asset powers and to override state usury laws and due-on-sale clause prohibitions. Mandatory specialization is one of the underlying causes of the thrift industry's problems. In the emerging deregulated and increasingly homogeneous financial industry, thrift managers must be given the freedom to diversify and restructure their asset portfolios.

Second, we must proceed with deposit interest rate deregulation as promptly as possible. The DIFC, to which Congress has entrusted the task of overseeing that phaseout, has an extremely difficult and thankless task. We believe the cautious approach the Committee has taken to date has not resulted in insulating thrifts from increased liability costs; to the contrary, all depository institutions have continued to lose deposits to unregulated intermediaries. Banks and thrifts have been left to fight over shares of a dwindling pie, while money market funds have increased their holdings weekly. Although we are heartened by the DIFC's recent action on the 3½-year phaseout schedule, a new short-term instrument is needed to enhance your ability to compete with nondepository competitors.

Finally, changes in accounting rules may be warranted to provide the opportunity to restructure the asset side of your balance sheets. A possible change would involve moving from a historic-cost basis accounting system to a current-value system. We expect to have something out for comment on that shortly.

III. FSLIC Indemnification

Let me turn to the FDIC-FSLIC indemnification issue. Federal chartering of savings banks has not proceeded as originally envisioned by Congress. A major stumbling block has been the issue of indemnification against losses of the FSLIC by the FDIC. Because the agreement reached in May of 1979 between the two insuring agencies covers only "credit" losses and not "market" losses caused by high interest rates, the agreement has proved unacceptable to the FSLIC. As a result, the Federal Home Loan Bank Board has refused to permit savings banks to convert from state to federal charter. Since early this year our staff has worked diligently without success to renegotiate the current indemnification agreement.

We now believe a legislative solution acceptable to all exists. We have provided in our revised Regulators' Bill that state savings banks converting to federal charter retain their FDIC insurance. The converted bank becomes subject to regulation and examination by the Federal Home Loan Bank Board. The bank's relationship with the FDIC becomes the same as that of a national bank. We are convinced this solution to the indemnification problem is more than fair to the savings bank industry and deserves your enthusiastic support.

IV. Conclusion

About a year and a half ago the FDIC established a task force to review the problems of the savings bank industry and develop alternative approaches. Early on we considered various accounting and other techniques which might have allowed us to defer facing up to the problems. We rejected these approaches. We concluded that the problems in the savings bank industry were real and could only be corrected through real solutions. Paper solutions could only leave behind a debilitated industry for perhaps decades to come.

Our strategy has been to arrange assisted mergers with the most solid institutions available at a reasonable price. We have given sufficient assistance to insure that the acquiring firms remain strong.

We are convinced that the public has been well served by these nine assisted mergers. We are equally convinced that your industry is stronger as a result.

We estimate that the nine assisted mergers may cost the FDIC approximately \$1.7 billion over the life of the agreements. This is real money, not paper. We are satisfied that the FDIC has more than sufficient resources to continue to meet the savings bank challenge head on.

Some influential voices in your industry argue that our strategy is wrong. They do not accept as adequate that we have protected all depositors and other general creditors against any loss or inconvenience, maintained public confidence and strengthened the surviving institutions. They contend that we should also preserve individual institutions and the jobs of their managers and trustees.

That strategy might not be of more than passing concern to many of you if it were not for the fact that, if adopted, it would ultimately weaken the entire industry. Instead of merging firms with substantial FDIC assistance, these individuals would have us prop up the failing firms and paper over their problems. The weak and the strong would both grow weaker.

We take no pleasure in seeing savings bank officers and trustees lose their positions. Nor do we take pleasure in spending an estimated \$1.7 billion on nine bank failures. We wish the problems did not exist. The problems do exist, however, and the FDIC believes it has an obligation to confront them directly.

If the price we must pay to maintain the strength and vitality of our financial system is the expenditure of a large but reasonable sum of money and the loss of a handful of jobs, that is a comparatively small price. We do not minimize the pain involved for those affected, but we are convinced that it is outweighed by the benefits to the financial system and the public at large.

The decision is squarely before you. Do you want the strength of your industry and your communities maintained to the maximum extent possible? Or do you want to preserve institutions and protect jobs? The choice you make will have important ramifications for years to come.

Once again let me thank you for giving me this opportunity to appear before you to present what I know at least some of you feel is a controversial point of view.

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