FDIC

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

OFFICE OF THE CHAIRMAN

SAVINGS BANKS' PROBLEMS: WHERE WE HAVE BEEN AND WHERE WE ARE HEADED

An address by

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When I appeared before your convention in Atlanta last spring, the majority of your banks were operating in the red, losses were rising, and the outlook was decidedly unfavorable. I stressed the importance of enactment of then-pending legislation to broaden the FDIC's powers to deal with failing institutions. I also emphasized the need for expanded thrift powers and for action by the DIDC to hasten deposit deregulation.

Things have changed considerably since last spring. Instead of a gloomy outlook, the prospects for the savings bank industry are much improved. The Garn-St Germain Depository Institutions Act of 1982 has brought about many of the regulatory changes we had been seeking. An even more important development from the standpoint of the savings bank outlook has been the dramatic decline in interest rates during the past several months. If interest rates stay at present levels during the next several months, we expect the industry as a whole to break even by about March of next year.

Today I will focus on the earnings picture for savings banks, on the new deposit instrument recently approved by the DIDC, on possible further changes in deposit interest ceilings, on the approach the FDIC has taken in handling troubled savings banks and, most importantly, on the policies we will follow as a result of the new authorities contained in the Garn-St Germain legislation. I will then say a few words about some accounting issues of interest to many of you and the federal-charter option.

Savings Bank Earnings

During the first three quarters of 1982, FDIC-insured savings banks lost more than $1 billion, an annualized rate of about one percent of assets. If we were to eliminate the sale of buildings and other transactions to boost surplus, the losses would be even greater. The monthly figures collected from large savings banks indicate that earnings improved considerably in September and October, a trend we expect to continue.

During the third quarter, the cost of funds at large savings banks averaged about 10.2 percent. That figure has been coming down as borrowing costs have declined and as six-month and jumbo certificates have been rolled over at lower rates. In October the cost of funds at large savings banks was about 9.5 percent. If rates stay at present levels, the cost of funds will likely drop below 9 percent in early 1983. This would enable most savings banks to go into the black.

Recent rate declines have reduced average asset yields, particularly for savings banks with heavy liquidity. That should be offset several fold over the next few months by declines in the cost of funds.

What has been unfortunate has been the inability of the industry to raise yields significantly during the past two years despite an extraordinarily high rate environment. Cash flow has been limited by operating losses, low turnover in mortgage portfolios, and deposit outflows.

The deposit outflows may have been due in part to depositor concern about the weakness of specific savings banks or the thrift industry in general. The competition from money market funds and other unregulated competitors has been an even more important factor. This artificial constraint on deposit growth will be eliminated with the introduction of the new money market deposit account a week from today.

Deposit Ceiling Deregulation

The members of the DIDC have faced a dilemma from the beginning. If banks and thrifts had been given greater freedom to compete with money market funds, deposit growth would have been higher, but more passbook funds would likely have shifted and the cost of funds probably would have risen faster. It is no secret that I have generally been on the side of faster decontrol; it seems clear that most savings banks would be better off today if they had enjoyed the cash flow to put more loans on their books during the past couple of years.

We believe the new money market account will improve deposit flows. It should stop outflows to money market funds and, over time, should bring a good deal of money back to thrifts and commercial banks.

There may be some significant transfers to this new account from other deposits within the same institution. Transfers from passbooks will likely be large, as will transfers from maturing six-month certificates. Much will depend on how the new account is priced and structured. We may see some very aggressive pricing initially, but based on our experience with other accounts, we believe most institutions will quickly settle down and price sensibly.

With the introduction of this new account, the DIDC must take a good look at the restrictions on other deposit instruments. There is no point in having a higher minimum denomination on the six-month or other certificates than on the new, deregulated instrument.

Perhaps it is also time we consider accelerating the current phaseout schedule for time deposits. The Garn-St Germain Act mandates the elimination of all differentials by no later than January 1, 1984. With the phaseout schedule in place, the new ceiling-free instrument in effect, and the differential eliminated, there may not be much point in maintaining any ceilings after January 1, 1984.

FDIC Assistance

During the last 14 months the FDIC has assisted 11 savings bank mergers involving assets of about $15 billion. Several considerations dictated the way we handled these transactions. We were most concerned with maintaining public confidence in the industry. We placed failing institutions into stronger hands and provided sufficient tangible assistance so that acquiring institutions were not weakened. In requiring the departure of top management and trustees of the failing institutions, we facilitated smooth and orderly takeovers by management of the acquiring banks.

We wanted to keep our costs down and be as fair as possible to potential acquirers, so we used a competitive bidding process. In order to obtain the benefit of future declines in interest rates and encourage more aggressive bidding, we entered into arrangements where a considerable part of the assistance was tied to the future spread between the yields on acquired assets and the cost of funds. The original estimated cost of effecting these transactions was a fraction of the market depreciation of the assets of the failing savings banks, and recent rate declines will enable us to substantially lower our original estimates.

We avoided propping up existing institutions for several reasons. First, prior to the enactment of the Garn-St Germain Act our authority to provide such assistance was extremely limited. Second, in those few instances where we have provided this kind of assistance in the past, the transactions have not worked particularly well. Third, there exists, within and outside our agency, a negative feeling toward the fairness and appropriateness of so-called "bail outs". Finally, we felt that assisted mergers of failing savings banks would strengthen the industry as a whole.

We were aware that our policies would not be universally acclaimed. In view of the tragic circumstances confronting so many savings banks with long and proud traditions of public service, and the necessity of fashioning a program that would be fair and helpful to the entire industry, no course of action could have been devised to please everyone.

We are satisfied with the results to date. A series of sound mergers was arranged at a reasonable cost. The acquiring banks were not weakened, nor subsidized beyond what was necessary to justify the acquisitions. We did not litter the landscape with financially crippled firms. We did not inject our agency into the business of subsidizing and operating private institutions. Finally, not one depositor suffered any loss or even inconvenience, and public confidence in your industry and our agency was maintained.

Circumstances have now changed. The most seriously troubled institutions have already been merged out of existence. Rates have declined substantially, improving the outlook for most of the remaining banks. Finally, Congress has passed Title II of the Garn-St Germain Act, which prescribes a net worth certificate program.

Our policies will be modified to reflect these new circumstances. For savings banks in need of assistance, we have structured a plan that we believe will meet the needs of both the industry and the FDIC. Basically, we plan to utilize the provisions of Title II of the Garn-St Germain Act, supplemented by incentives to encourage voluntary mergers.

Before addressing the specifics, let me take a moment to explain why we have chosen to grant assistance under Title II. High on our list is our interpretation of Title II as representing the clear preference of Congress. It would be difficult to justify granting either more or less assistance in the face of this statement of Congressional intent.

Of equal importance is our desire to minimize the effects of FDIC assistance on the normal functioning of markets. We do not want to dictate market structure or competitive positioning within any market.

Finally, Title II exempts issuers of net worth certificates from state and local franchise taxes. For just those savings banks operating in New York City, this exemption could reduce costs by more than $100 million over the initial three-year life of the Title II program.

We plan to follow both the letter and spirit of the Title II provisions.* Savings banks will be eligible to issue net worth certificates to cover a percentage of their

*See Appendix A for the full text of the FDIC's Title II Assistance Plan.

losses if their surplus-to-asset ratios are 3 percent or less. The net worth certificates will be subordinated and will be considered part of an institution's surplus account.

The FDIC will continue to purchase additional net worth certificates every six months, using the same formula, from those institutions which are initially eligible and from those which subsequently become eligible. While the FDIC will not purchase additional certificates after three years, those previously issued will generally remain outstanding for seven years from the date of issuance. Savings banks with positive earnings will be required to devote a portion of their earnings to retiring the outstanding certificates.

We will reserve the right not to buy certificates where we believe mismanagement or unsafe activity exists. We will also reserve the right to exclude from coverage operating expenses deemed excessive.

For many of you who receive assistance, the exemption from state and local franchise taxes will be an important savings. However, the plan will offer no additional boost to income. By covering a portion of losses, the plan will prevent or forestall book insolvency; it will buy time.

Whether this will be enough to turn around savings banks that might otherwise fail depends on a number of factors, primarily on what happens to interest rates during the next few years. If interest rates average a point or two below present levels, the additional time would facilitate almost everyone's survival. If rates average present levels or slightly higher, we believe that most of the assisted savings banks -- approximately 35 would be eligible by the end of this year -- would become profitable by or before the end of the three-year period. A few others could do so if they were particularly successful in paring costs, improving noninterest income, or profitably expanding deposit volume.

We continue to believe that in many cases important benefits can be attained by merging institutions: duplicate branches can be eliminated, senior management can be cut or improved, marketing programs can be enhanced, and data processing operations can be made more efficient. This brings me to the second portion of our plan.

When it makes good economic sense, we want to facilitate continued mergers of savings banks. A few firms may have to be merged out almost irrespective of what happens to rates. Others will have been so debilitated by losses that mergers may be the only practical longer-range solution to their problems.

As an inducement to seek out appropriate partners, we will entertain voluntary, assisted merger applications involving savings banks where at least one of the partners is eligible for or receiving Title II assistance. Our assistance would be in the form of interest-bearing notes from the FDIC, income maintenance payments, cash, or any other imaginative form of assistance proposed that we think makes sense.*

We continue to have a strong preference for proposals in which weak institutions are merged into stronger ones. We will not rule out altogether providing tangible assistance for mergers between two savings banks eligible for Title II assistance, but these proposals will receive very close scrutiny so we can satisfy ourselves that the resulting entity will have a reasonable prospect of remaining a viable competitor at a reasonable cost. If, however, two or more banks eligible for Title II assistance submit an acceptable merger plan involving no assistance other than that available under Title II, it will likely receive favorable consideration.

We intend to "shop" voluntary merger proposals involving tangible FDIC assistance to determine whether someone else can offer a more attractive proposition. If we receive a better offer, which is economically sound, the savings bank to be merged out may accept the better offer or it may continue receiving Title II assistance as long as it remains eligible to do so.

In providing assistance, we will favor proposals which include a recapture of future earnings to keep the ultimate cost to the FDIC at a minimum and to prevent assisted institutions from gaining a long-run competitive edge over unassisted savings banks.

We will not automatically require the resignation of the trustees and top two management officials of the weaker savings bank under our voluntary merger plan. However, as a matter of efficiency, we will expect reductions in senior-level management and will insist that the resulting board of trustees be comparatively small.

Both the Title II Assistance Plan and the Voluntary Merger Plan are effective immediately. Copies of the plans are available for your review and informal comment. As always, we welcome your thoughts and will consider any suggestion as to how the plans might be improved.

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*See Appendix B for the full text of the FDIC's Voluntary Merger Plan.

Accounting Issues

I would be remiss if I did not say at least a few words today about some accounting issues. We received a great deal of pressure over the past year to allow loss-deferral accounting. We resisted this pressure for several reasons.

First, as deficient as the current historical cost-based accounting conventions are, they do reflect generally accepted accounting principles, and an individual agency should tread very cautiously in overriding them. We must endeavor to maintain order and consistency in the presentation of financial statements so they may be more readily understood by all readers.

Second, we have attempted to be open and straightforward in handling troubled savings banks and have tried to avoid creating the perception that problems were being masked. We believe our agency's credibility has been maintained, if not enhanced, during these critical times.

Finally, we felt that adoption of loss-deferral accounting in a high-rate climate could have caused more harm than good in the savings bank industry. Our reasoning was simple. Interest rates were likely to decline at some point. If they did not, new accounting techniques would not be much of an answer to the industry's severe difficulties. If they did decline, savings banks would be better served by holding their long-term assets until the decline occurred rather than locking in large losses by selling in a high-rate climate. A loss-deferral rule would have had some positive effects, such as permitting most savings banks to improve their liquidity and a few to switch out of significant portfolios of tax-exempts, but we perceived those benefits to be of limited value to the industry as a whole.

We have under consideration a loss-deferral rule which is coupled with a current value accounting system with respect to future additions to savings bank investment portfolios. I wish I could tell you whether and how we intend to proceed on these issues. I cannot because we have not yet decided.

The loss-deferral rule bothers us less today than a year or so ago due to the interest rate declines. Moreover, our proposal has been carefully written to avoid "paper" profits which would distort reported earnings. On the other hand, the case for the rule has been weakened by adoption of the net worth certificate program.

The current value accounting requirement for future investments has appeal. We are very dissatisfied with the historical cost-based system, particularly in a deregulated, volatile-rate environment. However, implementation of such an accounting change would be complex, and we question the wisdom of our agency acting unilaterally. If we were convinced the accounting profession would move forward in this area with deliberate speed, we would not even consider acting on our own.

Federal Charters

The last subject I want to touch on before closing is the matter of conversion by state-chartered savings banks to federal charters. I have been asked our agency's stance on the subject many times in the past month or so.

The FDIC's official and unofficial position on the issue of charter selection is one of complete neutrality. We have been proponents of the dual banking system for many years and were pleased to see it extended to savings banks. The Garn-St Germain Act, for the first time, makes the federal-charter option a reality for virtually all savings banks by incorporating our suggestion that they be permitted to maintain their FDIC insurance when converting to federal charters.

Some state legislatures have in the past placed unrealistic restrictions on state-chartered savings banks. The banks had no alternative but to accept those restraints. Now they do.

We believe each savings bank should pursue whatever charter option is in its best interests from a business standpoint. We would only add a couple of caveats. First, it is an important decision which should receive thorough evaluation. Second, you might give your state legislature a reasonable opportunity to react before converting, as it is possible the state will adopt a law that is even more favorable than the new federal legislation. Finally, do not convert to federal charter under FDIC insurance on the premise that the basic regulatory standards under which you operate will be relaxed perceptibly.

Conclusion

I have covered a broad range of policy issues today including deposit deregulation, procedures for handling troubled savings banks, accounting issues, and our attitude toward charter conversions. In dealing with these and other difficult questions affecting your industry, we have been guided by several precepts:

* We have endeavored to take the longer view -- to avoid the temptation to apply a "quick fix" which might prove detrimental over time.

* We have tried to be innovative and practical in our approach to problems.

* We have made every effort to be fair and forthright in all of our dealings.

* We have endeavored to do what we sincerely believed was in the best interests of the savings bank industry, the financial system, and the depositing public.

* We have tried to minimize our intervention in the functioning of the marketplace.

* We have strived to maintain public confidence in the financial system and the FDIC.

We must leave it to historians with the benefit of hindsight to judge whether our decisions have been wise. I am convinced our guiding principles have been correct, and I assure you we will not deviate from them as we address the problems and issues ahead.

Thank you for allowing me this opportunity to once again appear before you. Working together, we have made great strides in resolving the difficulties of your industry over the past year or two, and I have no doubt about our ability to continue our progress in the months and years ahead.

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