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[Current issues in thrift industry]

An address by

L. William Seidman, Chairman
Federal Deposit Insurance Corporation
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Current Issues

I am pleased and honored to address the National Council Management Conference.

Our meeting today is fortunate for me. As a new kid on the block, I am working my way through the wide range of issues confronting the financial services industry. Regardless of the type of charter your institution may hold, or whether we are regulators or regulatees, we share a common goal: a stable, sound and prosperous financial system. Being here gives me an early opportunity to hear some of your views about how that goal can be achieved.

I would like to take a random walk through some current issues in the thrift industry. Items include: (1) the certificate program past and future; (2) Massachusetts insurance conversion; (3) Funds' merger; (4) risk-related premiums and capital; and (5) business plans and FDIC.

I. The Certificate Program.

This audience scarcely needs to be reminded that thrift institutions have had too many tough years. Ironically, many of the industry's problems developed as a result of our Nation's long-standing commitment to housing. While this commitment was and is laudable, in practice it had adverse repercussions for the thrift industry. To ensure that there would be an adequate supply of mortgage funds, public policy consciously encouraged thrifts to lend long and borrow short. As long as there was only minimal pressure on deposit interest rates, the industry's underlying maturity mismatch problem could be ignored. However, during the late 1970s, the results of a poorly managed economy were manifested in a high inflation rate and rising interest rate levels. When these pressures resulted in rising deposit interest rates, the magnitude of the industry's problems became a painful reality.

The trauma faced by the thrift industry beginning in the late 1970s was responsible to a great extent for a significant number of legislative initiatives, including deposit interest rate deregulation, a wider array of permissible investments available to many thrift institutions and the net worth certificate program mandated in the Garn-St Germain Act of 1982.

Initially, the FDIC opposed the net worth certificate provisions of Garn-St Germain on the grounds that the program would provide no "real" capital to troubled thrifts, and would limit its flexibility in dealing with failing institutions. Because of these reservations, savings banks participating in the program were required to enter into an agreement with the FDIC regarding periodic preparation and submission of meaningful business plans, limitations on growth and a commitment to actively seek recapitalization from outside sources. To provide an incentive to recapitalize, the FDIC instituted a Voluntary Assisted Merger Program ("VAMP"), whereby the FDIC expressed a willingness to consider providing substantive assistance to facilitate the merger or acquisition of a participating savings bank.

Under the theory that things always continue in the same direction, the FDIC's initial fears may have proved to be well founded. However, as usual, events were to the contrary. Since Garn-St Germain, the interest rate climate generally has been favorable, with the most recent rate decreases bringing virtually all FDIC-insured thrifts above the break-even level. Of perhaps greater significance is the responsibility exhibited by management; generally, we have not observed savings banks attempting to recoup past losses by means of excessive growth or by upgrading asset returns by getting into high-risk ventures. And, at the risk of praising my predecessor, the FDIC's policies in the areas of capital adequacy and asset quality may have played some role.

In today's interest rate environment, thrift institutions have become a more attractive investment. Over the past few months, some of our most troubled thrifts have been acquired, some with FDIC assistance and others on a non-assisted basis. We currently are evaluating a number of other proposals. A common thread that runs through both the completed transactions and the current proposals is some degree of forbearance with respect to the FDIC's normal capital requirements. While we recognize that it is unrealistic to require meeting these requirements immediately, we are uneasy about allowing an institution to further leverage an already thin capital base to increase returns to the investors. We believe that future asset growth should be adequately capitalized.

In past transactions, capital levels and phase-in periods have been negotiated on an individual basis. This may always be the way matters will have to be handled. However, this has led to some degree of inconsistency. While consistency is the hobgoblin of small minds, we would like to develop an appropriate policy to deal with these issues in a consistent manner. While we hope to have a policy in place to guide potential investors and ourselves for future savings bank acquisitions, we will continue in the interim to deal with sales and mergers on a case-by-case basis.

2. <u>Massachusetts Conversion</u>.

Another development concerns the deposit insurance status of savings banks in Massachusetts. Until recently, deposits in many Massachusetts mutual savings banks had been fully insured by the Mutual Savings Central Fund (MSCF), an independent agency created by the State. MSCF had compiled a distinguished record during its more than 50 years in operation. But public confidence in private and state deposit insurors nearly has been destroyed by problems of State funds in Nebraska, Ohio and Maryland. Responding to this situation, Massachusetts earlier this year took the step of requiring savings banks to apply for federal deposit insurance through the FDIC and FSLIC. MSCF would continue to insure deposits over $100,000.

To facilitate the new insurance plan, MSCF is in the process of partially liquidating. It has committed to provide necessary funds to enable those banks applying to the FDIC to meet FDIC capital standards. Because Massachusetts law essentially prohibits MSCF from donating funds to any of the banks, it was necesssary to develop a capital assistance plan to get around that roadblock.

Under the plan that was worked out between MSCF and the FDIC, MSCF will provide capital assistance to MSCF member banks applying to the FDIC that do not meet FDIC capital standards. In return for this assistance, banks would issue Mutual Capital Certificates (MCCs) and/or Subordinated Notes ("SNs") to MSCF. For its part, the FDIC has agreed to count funds obtained through MCCs as primary capital and funds obtained through SNs as secondary capital.

The proposed MCCs are patterned after the instrument authorized by the Monetary Control Act of 1980 for institutions supervised by the Federal Home Loan Bank Board. Terms of SNs were designed to meet the definition contained in FDIC regulations.

Applications for FDIC insurance have been approved for 81 Massachusetts savings banks. To date, about 13 capital assistance agreements have been entered into and capital conditions have been satisfied.

In the time remaining, I would like to touch on two issues that are of interest to all financial institutions, regardless of the type of charter they hold: the first relates to the merger of the deposit insurance funds; the second relates to risk-related premiums.

3. <u>The Insurance Funds' Merger.</u>

Faced with a seemingly impossible task, the FSLIC has shown a remarkable ability to survive. It has had to support a massive industry restructuring. In dealing with the problems caused by credit risk, interest rate risk, and some irresponsible managements, the FSLIC has at times shown boldness and imagination despite its limited personnel and financial resources. On more than one occasion the FDIC has borrowed ideas from some of the solutions forged by FSLIC to treat ailing thrifts.

According to retiring head of the Fund Peter Stearns, the S&L Fund has serious financial troubles. He says that it is inescapable that at some point the FSLIC will require assistance. The fundamental question that needs to be addressed is from what source the necessary funds will be supplied. There are three alternatives, none of which represents an easy choice.

One alternative is to raise the funds from the S&L industry itself, in which case the principal burden would fall on the stronger institutions. Faced with this rather painful alternative, at least some of those institutions might elect to shift charters to avoid a special assessment.

A second alternative is to recapitalize the FSLIC Fund through federal tax dollars. As an independent insurer, I don't want to speculate about what it would be like to operate with congressionally appropriated funds. It certainly would be a step in the wrong direction in my opinion -- it would give the government rights which I would hope could be left to the private sector.

A third alternative -- one which has received considerable press in recent months -- is to merge the two deposit insurance funds. Frankly, we already have plenty to do at the FDIC, but we certainly want to do what we can to be helpful. I am sure a merger is the wrong approach for insuring financial institutions that undertake minimal commercial loan-making activities.

As far as the FDIC is concerned, we shall be ready to be of whatever aid we can be under the circumstances. If Congress decides we should take additional actions to be of assistance, we will be prepared to do so.

4. Risk-Related Premiums and Capital.

The aversion of policy makers to come to grips with difficult choices extends beyond the problems confronting the FSLIC. To date, the enactment of comprehensive reform legislation has proved to be an elusive goal. If the past is any guide, we may have to settle for a piecemeal approach. In such an eventuality, enactment of legislation authorizing the FDIC to implement a risk-related premium system would rank high on our "wish list."

For some time, the FDIC has felt that the present flat-rate deposit insurance premium system has unfairly subsidized riskier banks at the expense of the better managed institutions. To this end, we recently sent out for comment a proposed risk-related premium system applicable to commercial banks. We think that what the FDIC is proposing represents a workable system that can be improved as we all gain further experience in this area.

The FDIC has not made any proposal relating to a risk-related premium structure for FDIC-insured thrift institutions. Before we are able to formulate such a proposal, we must come to grips with the realities of the situation --

the problems facing many thrifts (low capital levels, excessive interest rate risk and earnings insufficient to recapitalize within a reasonable time frame) exist and cannot easily be resolved in a short period of time. While we have not resolved many of the relevant issues, the FDIC in the near future likely will propose a risk-related premium system for thrifts not dissimilar to the commercial bank proposal. However, implementation may be phased in over time, in much the same manner as the FDIC has applied capital regulations to the thrift industry.

At this point, it may be informative to briefly review the FDIC proposal relating to commercial banks. Under this proposal, the FDIC would use an objective statistical model, based solely on Call Report data, to classify banks as having either normal- or above-normal risk. In terms of determining which of the above-normal risk group does or does not get a full assessment credit, we will distinguish between those banks having composite CAMEL ratings of 1 or 2 and those which are rated 3, 4 or 5. The latter group -- those banks rated as above-normal risk and rated 3, 4 or 5 -- will receive no assessment credit. While banks having a composite CAMEL rating of 1 or 2 and which are rated as above-normal risk by the statistical test will receive the rebate, they will be immediately subject to additional financial review. If our analysts are satisfied that the bank is indeed a 1 or 2, the process will stop there. If the analyst finds significant areas of weakness in the bank, it will be promptly scheduled for an FDIC examination. These exam results will be available before the next risk-related assessment cycle begins so that these banks will lose their rebate in that next cycle in the event their CAMEL rating is lowered below a 1 or 2 and they fail the statistical test.

As I indicated earlier, the risk-related premium system for thrifts most likely will parallel this general framework. In fact, we could include savings banks in our statistical model and apply a uniform system to all FDIC-insured institutions. However, the risks presently inherent in the thrift industry are somewhat different than in commercial banks. Specifically, the commercial bank system does not include a measure of interest rate risk which, we believe, should be part of a system applied to thrift institutions. We will begin to collect information to measure savings banks' risk exposure beginning with the Call Report for year-end 1985. Unlike some proponents, the FDIC does not view a risk-based premium system to be a panacea -- just a substantial improvement over the <u>status quo</u>. It would be less arbitrary and considerably more fair than the current system. It would provide a significant, though not overwhelming, financial incentive for banks to avoid excessive risk-taking and to correct their problems promptly. Perhaps as important, it would send a strong signal to a problem bank's management and board of directors.

Another suggestion for regulatory change is a system of risk-based capital requirements. Some have posed this idea as a substitute for risk-based premiums. It seems to me there is no reason to take this position; they are not mutually exclusive. One deals with insurance premiums while the other deals with capital requirements of depository institutions. The risk-based capital requirements plan bases an individual bank's capital standard on the type of activities that the bank undertakes. Activities deemed to entail greater risk would require larger capital reserves while investment in low risk, highly liquid assets would need little or no capital.

It should be recognized that the agencies already employ risk-based capital standards. The federal banking agencies have for the first time in history adopted a uniform minimum capital standard for banks of all sizes. The minimum standard is applicable only to well-run banks. Banks with above-normal loan problems, weak earnings, poor management, excessive interest rate exposure, a high growth rate or sizeable off-balance-sheet exposure are required to meet a higher capital standard on a case-by-case basis.

Proponents of risk-based capital requirements note that it has special merit in that it weighs ex ante riskiness in a bank's operation. However, the manner in which risk-based capital requirements would operate are not clear at this point. It seems to me its usefulness will depend on how and what kind of assets are classified for risk. We shall be studying the suggestions of the other regulators on risk capital very carefully. The key to its usefulness is the ability of the regulators to judge risk by asset classification.

5. Savings Banks' Business Plans.

An issue in your industry which has recently been receiving some attention is the FDIC's request for business plans from savings banks designed to increase capital over time to meet minimum standards. Many have objected to the FDIC request because it, in effect, requires an institution to automatically admit to operating in an unsound manner if it does not achieve the capital goals set forth in its plan. This is an understandable objection. Our goal was to assure that institutions would make real progress in achieving their stated business objectives. We have to work with you to achieve this objective while avoiding requesting institutions to make unwarranted admissions against their interests. We will be working with your counsel on new language which will be satisfactory to all parties.

This is a good example of how important it is for a regulatory agency to be flexible where possible, and to listen to the positions expressed by the regulated, while, at the same time, assuring that the mission of maintaining the safety, stability and economic success of the system is promoted. So, I look forward to hearing your views. Our door will be open and we will listen.