Remarks by

L. William Seidman
Chairman
U.S. Federal Deposit Insurance Corporation

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Thank you for inviting me to join you this morning.

I'd like to congratulate the Empire State's savings bankers.

Among your number are some of the strongest FDIC insured savings banks in the nation. For the first half of 1988, 95 percent of New York's savings banks were profitable!

Many of your institutions have done remarkably well at recovering from the interest problems of the early eighties.

But, I think I should temper this congratulations with a few words of caution concerning some of the danger signs we have seen developing lately. We want to help maintain the progress you have been making.

On the whole, your institutions are less profitable than they were during this same period last year.

While your net charge-offs remain low, they seem to be rising slightly.

We also have noted an increase in your nonperforming loans, a strain on your liquidity, and particularly disturbing, a high asset growth rate outpacing your capital expansion. It's important to remember that we are going to continue to require our current capital standards as a floor even after risk-based capital becomes effective.

We have seen some danger signs in asset quality developing as some of you have increased out-of-area lending, LBO financing, and off-balance sheet activity.

Generally your ability to handle interest rate changes has greatly improved over the last several years, especially when focusing on the three to five year window, but progress still needs to take place in the shorter term area.

More effort could be made to restructure portfolios to reduce the imbalances, including through the development of new adjustable-rate products. Securities transactions could also be better tailored to reducing rate sensitivity, including improved mark-to-market accounting.

We have become increasingly concerned that some institutions are attempting to balance their portfolios with IO's, PO's and CMO residuals, but without adequate knowledge of how to manage these very complicated instruments. How many of these approaches will perform in different interest and economic environments is still unknown.

On the funding side of the ledger, there are also danger signs flagged by increased reliance on repos, out-of-area deposits, and jumbo CDs, which can all pose rate and funding risk.

The bottom line is we are happy how well things are going for your banks. But we hope you will keep on top of these issues, promote diversification in your asset portfolios, maintain controlled asset growth, and stay away from new instruments or products in which you lack expertise.

I'd like to take a few moments to focus on one of the problem areas I just mentioned, growing LBO financing by banks.

Overall debt levels in our country have already hit alarming levels.

Just the spectrum of <u>categories</u> where our debt stands at a postwar high, underscores the seriousness of the problem.

These categories include: the total debt of the domestic nonfinancial sector; corporate debt-to-net worth; corporate debt-to-income; and household debt to net worth.

One area of that debt problem that we see as becoming more serious is the rapid increase in the debt burden being run up by our corporations.

From 1984 through the second quarter of 1988, just the net <u>interest paid</u> on debt by the corporate nonfinancial sector increased more than 31 percent. During the same period, corporate gross <u>income</u> increased by only 13.3 percent.

In large measure, this increase in the corporate debt burden can be attributed to the growing popularity of leveraged buyouts.

One just needs to look at the paper each morning, and read about mammoth deals like RJR Nabisco, to see the unprecedented extent of this issue.

To date, bank lending for leveraged buyouts has reached the $150 billion level -- or about <u>half</u> the $300 billion of debt corporate America has taken on as a consequence of leveraged takeovers. Generally this lending takes place as senior obligations, but we are seeing a disturbing trend where these lenders are taking less senior positions, such as through junk bonds.

A Federal Reserve survey of 60 senior loan officers found that lending to finance leveraged buyouts accounted for nearly 10 percent of <u>all</u> commercial loans at banks with assets of $7.5 billion or more; and 5.5 percent at banks with assets of less than that level.

LBOs can present potential for money-making, and are consequently attractive to banks.

There are short-term profits from large initial fees, <u>and</u> long-term profits from interest rates floating several points above the prime.

In addition, LBO lending has filled the gap in loan demand for many banks created by the near-disappearance of what <u>had</u> been three major markets: energy-related lending, certain real estate lending, and loans to Lesser-Developed Countries.

But this type of lending also poses significant risks.

The major risk, of course, is what happens if the economy turns down, and these borrowers no longer have the cash flow to support their debt.

One doesn't have to be Paul Erdman to visualize the consequences of such an occurrence. A Princeton survey of 1,500 corporations recently concluded that, if the U.S. has an economic downturn of the moderate magnitude of the one in 1974, ten percent of the companies surveyed might go bankrupt because of their unserviceable debt.

To the extent these bankruptcies result in bank failures, these problems will end up on the books of the FDIC.

Both Fed Chairman Greenspan, and Comptroller Clarke, have expressed concern about LBO lending. Their concern has been echoed by many in the private sector, and many on Capitol Hill.

Fed Chairman Greenspan wisely advised Congress to look again at the tax incentives that have helped propel the current trend toward LBOs.

This is certainly an area we all need to pay closer attention to -- looking at risks as well as rewards. The FDIC will be focusing on portfolio concentrations in LBO financing in its supervisory reviews ahead.

Growing bank lending activity in the LBO area is just one of the many changes taking place in our banking system, particularly changes that involve increased competition and risk.

One of my colleagues went so far as to say that being a bank regulator today reminded him of an add for a lost dog he had recently seen.

The notice read: "Reward offered for return of large, spotted dog. Has three legs. Missing left eye and right ear. Tail broken. Recently neutered. Answers to name of 'Lucky'."

I'd like to make three observations that I hope will be useful lessons for the future of the financial system.

First, has been the lesson of the FDIC and FSLIC insurance funds. The response of both funds to the lack of financial market discipline, has taught us that deposit insurance is a powerful tool, which, if misused, has the potential to severely damage the financial system.

Deposit insurance, in effect, gives banks and thrifts the ability to borrow on the credit of the Federal government.

Our deposit insurance system can be compared to a nuclear power plant. It can provide benefits. But at the same time, safety precautions are needed to keep it from going out of control.

A deposit insurance "meltdown" could damage the fabric of our whole economy. One has only to look at the savings and loan industry to see the magnitude of the financial problems of deposit insurance misused.

Thus, the FDIC has been reviewing the role of deposit insurance in the current banking environment.

I would like to share with you a few of our major conclusions:

First, we must develope better supervisory mechanisms to control risk to the insurance fund.

This challenge is perhaps the key to the future of deposit insurance.

As we enter an era where banks will need broader powers to compete, <u>supervision</u> needs to adapt to change.

Our experience in the Southwest has demonstrated that risks can come in many forms.

Some of these risks supervision can address.

For example, many banks in our Southwest were the best capitalized and most profitable in the U.S. -- <u>just a few years ago</u>. But their troubles started when they <u>over concentrated</u> their business in such areas as energy or real estate.

Largely because of this, the nine largest banks in the Southwest have had to be restructured.

As regulators, we certainly can't tell banks where to allocate their credit.

But bank supervisors have learned that concentration must be identified as a warning signal, and diversification is required.

If this had been done in Texas early on, our losses certainly would have been much lower.

A second conclusion is that it will be very difficult to control risk in today's environment through increased market discipline.

Can we <u>further</u> promote safety by implementing <u>both</u> statutory and <u>de facto</u> deposit insurance ceilings; changes in coverage to include only <u>short term</u> deposits; or the introduction of private coinsurance on deposits?

So far each of these proposals have serious, if not fatal, defects -- either political or substantial.

Another conclusion in this area is that we can price deposit insurance to help control risky behavior.

We must derive a different pricing formula that will be practical and workable. Pricing based on fund experience is an avenue to be explored.

A second lesson we have learned from this decade is that the U.S. banking system is significantly handicapped when compared to its international -- and indeed other financial services -- competitors.

As we move into full world competition we can not handicap our banks as competitors.

Let me quote from a great new book, "Competitiveness: The Executive's Guide to Success". It starts off as follows:

"Survival of the fittest is the dominant theme today in the jungle of unregulated world competition. In this new, no-holds-barred battleground, in which the soldiers are businesses, governments, cartels, and ideologies, America's corporate managers must be tougher, leaner, and more skilled. To succeed, in short, they must become the best competitors."

You know our handicaps:

First, Glass-Steagall.

Second, geographic limitations.

And third, separation of commercial and banking activities.

This weakens the capital resources of our banks, especially when compared to resources available to banks in other countries.

<u>A third lesson of the eighties involves the old issue of "too big to fail,"</u> and particularly its relationship to bank holding companies.

When Continental Illinois, a bank with over $30 billion in assets, got in trouble in 1984, the FDIC stepped in and took over the operation. We didn't allow it to fail, although senior management lost their jobs, and shareholders their investments.

This year we were faced with a similar problem. That problem was First Republic BankCorporation in Texas, a bank holding company about the same size as Continental, but with more than 40 subsidiary banks.

Here, in contrast to our action in Continental, we <u>did</u> allow First Republic's subsidiary banks to fail, and then we closed and sold them to an outside investor. We also declared the holding company outside the safety net. The result was that we allowed First Republic's holding company to default on its obligations to bondholders and shareholders.

We have pursued the too-big-to-fail policy, or maybe better labeled the too-big-to-default policy since First Republic's banks did fail, because banks are special to the economy and the payments system, and any failure of one of our largest banks could destabilize the economic system.

Such an action could also destabilize the international financial system, and put American banks at a competitive disadvantage against their foreign competitors that are protected by their governments.

Some of the largest banks have argued that the risks of allowing larger banks to default are worth taking. But it is certainly easier to advocate taking risk from the sidelines, than when you have The Watch.

The bottom line is that nobody really knows what might happen if a major bank were allowed to default, and the opportunity to find out is not one likely to be appealing to those in authority or to the public.

Another words, the too-big-to-default policy is likely to be here to stay.

Given that conclusion, we have found that several criteria must be examined when deciding whether a bank is too-large-to-fail, including the institution's size, its insured and exposed liabilities, the cost to the FDIC, and the impact a particular banks's failure would have on the stability of the financial system.

Beyond articulating these broad criteria, it is neither wise, nor practical, to set forth rigid rules in this area.

Based on this position, that is, that bank holding companies can default, but large banks can't, what is the position of the bank holding company director? Does he protect the holding company, or its banks. That, of course, is the MCorp situation today.

Why under these circumstances don't we revert to the old way, the rest of the worlds' way, and stop regulating capital at the holding company level. There are two powerful political forces allied against this conclusion.

First, the Federal Reserve whose turf in the bank regulatory world will be emasculated by "freeing" holding companies.

And Second, bankers, who now are the only business men in our country effectively protected from the likes of the Ichans and Pearlmans, and their LBOs.

In closing, many bank regulators, lawmakers, bankers, and others, are working hard to take the lessons of the eighties, and use those lessons to create a better, safer, and more competitive breed of bank for the next decade, and beyond.

We have already seen banks responding to the lessons of the eighties.

Overall bank profits has improved sharply so far in 1988, and set new records for the first two quarters of the year with $10.5 billion in net earnings.

The surge of bank failures brought on in recent years has crested, and is now in decline. As far as we can tell, no new failures of "megabanks" are on the horizon for next year.

1989 will be the year in which Congress deals with banking problems. The insolvent thrift insurance fund requires such action.

But banking legislation also means the opportunity to get some action on other lessons of the eighties. I wish you good luck and success.

1989 will be the year to preach the lessons learned to the Congress, and the new Administration. But first, of course, we all would have to agree as to what the lessons are. And here I have a simple, straightforward, answer.

As Gore Vidal put it, "There is no human problem which could not be solved if people would simply do as I advise."

Thank you.