"Banking economy in the State of California"

Remarks by

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It gives me great pleasure to speak with the California Bankers Association.

It's always a pleasure to visit the great state of California.

Things are going much better for your state than Daniel Webster predicted 150 years ago.

At that time he lamented: "I have never heard of anything, and I cannot conceive of anything more ridiculous, more absurd, or more affrontive to all sober judgment than the cry that we are profiting by the acquisition of New Mexico and California. I hold that they are not worth a dollar."

Today's dollars are certainly not worth what they used to be, but its safe to say that California bankers have clearly helped prove old Daniel wrong.

My speech writer recently gave me his best effort on a speech addressing fixing deposit insurance for this meeting. He was right on target.

The speech presented a solution which:

1) solved the S & L problem without use of tax money;

(2) insured thrifts would operate in a safe and sound manner;

(3) returned to rebates on bank deposit insurance premiums;

(4) created a level competitive playing field between banks and thrifts;

(5) and returned depositor discipline without allowing bank runs.

It was a real winner. Unfortunately, he left for a better job before filling in the details.

California's economy continues to be one of our nation's healthiest. And this health is reflected in the performance of most of California's banks compared to banks in other western states.

On the other hand, there is still room for improvement compared to banks across the country.

Generally, your profitability levels and asset qualities are high. But this strength needs to be translated into improved cushions against future problems. Earnings need to be plowed back into capital.

For the first nine months of 1988, Return on Assets for California banks was 0.9 percent. That compares to 0.92 percent nationally, and 0.68 percent in the West.

Your Return on Equity of 11.14 percent exceeded the national average, and was almost 40 percent higher than other western banks.

Another positive trend in earnings is that your worst performers are not suffering the losses they experienced in 1985 and 1986. They still have a ways to go, but many are back in the black.

Asset quality has also improved. Net Charge Offs-to-Loans was 0.55 percent, compared to the national average of 0.73 percent.

These numbers don't look too bad compared to national averages. But it should be kept in mind those averages are weighted down by exceptional problems, especially in the Southwest.

Compared to healthy banking sectors around the country, California banks only score a C+ on earnings and charge-offs.

But given the fierce competition in your market, and the difficult years earlier in the decade, you certainly deserve an "A" for effort.

The area of most concern is capitalization.

Improvements in earnings and asset quality have yet to be translated into increased capital levels.

Your Equity to Assets ratio was only 7.8 percent, compared to the national average of 8.6 percent. Only nine states can post a lower capital level.

And your Primary Capital ratio was only 8.92 percent, well below that national mark of 9.44 percent, or even the western state's average of 9.18 percent.

Your capitalization has improved little in the last seven quarters, and these ratios still have a ways to go to regain the levels achieved in the mid-eigthies.

Employing growing earnings to improve capital levels should be a prime goal for California bankers in the year ahead.

Something that underscores the improving trend in California banking was the dramatic reduction in bank failures in 1988. After five years of increasing failure rates -- culminating with eight failures in 1987 -- only three banks failed last year.

Daniel Wall -- woops, I mean Webster -- might even be surprised by those rosy numbers.

The FDIC's goal for 1989 is to help design an improved deposit insurance system for the nineties. At the same time we need to maintain the solvency of your insurance fund.

We recently released a report, entitled "Deposit Insurance for the Nineties: Meeting the Challenge."

The FDIC undertook this review because of a growing realization that deposit insurance requires some fundamental changes to meet todays and tomorrows challenges.

When circumstances change, its important to adapt to the new environment to avoid further losses. Lee at Gettysburg, the British on the Somme, the Germans at Stalingrad all learned that bitter lesson.

Today I would like to provide you with some ideas and concepts that were brought forward by this process, and then discuss a number of the report's most important conclusions.

Virtually all agree that deposit insurance has accomplished its basic goals of maintaining stability and confidence in the banking system, and that these goals are vital to our nation's economy.

And let us not forget, deposit insurance has also helped maintain a flexible and responsive banking system. It has facilitated a decentralized financial system where new and smaller banks can compete against larger institutions.

In other words, the community banker has no better friend than a sound deposit insurance system.

But, while deposit insurance has provided many social and economic benefits, the events of this past decade have made painfully clear that the deposit insurance system has created potentially staggering costs.

For 1988 alone the FDIC will show over a 20 percent reduction in its fund, down to less than a $15 billion net worth. This is the first operating loss in our 55 year history. While we expect to make a profit in 1989, changes are necessary to ensure sound future operations.

The potential costs of deposit insurance are even more obvious at the FSLIC. The cost of dealing with this immense problem is in the $75 to $100 billion range -- and probably toward the higher end of that scale.

The system needs to contain its costs, or it will have to lose many of the benefits it provides.

Our study concludes that the following principles are required to provide a sound deposit insurance system -- for both banks and thrifts.

First, deposit insurers should be made as financially and organizationally independent as possible. The insurer must be sensitive to the concerns of chartering authorities and the industry it insures -- but, it must have the freedom to control costs.

To ensure political independence, the insurer should be self-funded. It should have a budget separate from the general federal budget.

But, importantly, the insurer should be controlled with respect to its ability to obligate general federal revenues. Extensive use of notes and guarantees, creating servicing obligations far beyond its own capacities to afford, is unsound financial management.

An unsound financial management can create a backlash that takes both your trust fund and our independence.

Second, the insurer must be given certain basic tools that would be available to a private insurer to control costs. These include:

-- The ability to promptly terminate insurance privileges when an institution is operating in an unsafe manner. By promptly, I mean 3 to 6 months. If insurance is terminated, current deposits would retain insurance protection, but new deposits would not receive such coverage.

-- The ability to set standards for insurability.

-- The authority to examine and assess risk at all insured institutions.

-- The power to require all federally insured institutions owned by a common parent to indemnify the insurer against any losses resulting from the failure of an affiliated bank.

The FDIC prefers this option to an earlier proposal that would have required the consolidation of affiliate banks.

Third, to ensure adequate resources, the insurer should have additional controls over its revenues, including:

-- The power to adjust premiums, within prescribed limits, to reflect experience and costs on a continuing basis.

-- The power to assess borrowings that are secured by assets -- assets that otherwise would be available to the insurer in the event of failure.

-- The power to require that institutions obtaining insurance pay an entrance fee sufficient to maintain the ratio between the insurance fund and insured deposits.

-- The power to borrow from both the Treasury Department and the Federal Reserve.

We also offer other recommendations:

First, the FDIC seeks clear authority to distinguish between depositors and nondepositor claims in failure-resolution transactions. This approach differs from previous calls for depositor preference statutes in that nondeposit creditors would maintain their pro rata rights to the assets of the failed institution.

Such creditors may have to wait along with the FDIC for assets to be liquidated, while depositor liabilities are transferred to another institution.

Second, the FDIC continues to advocate moving toward a system where nontraditional activities can take place outside the bank in subsidiaries or in separately capitalized affiliates. Under such conditions, banking organizations should be allowed to become involved in a wide variety of activities, and be owned by many more types of institutions.

Third, the experience of the past several years demonstrates that regulatory agencies must work their supervisory capacities.

Regulators must improve their understanding of risk diversification, and the competitive and economic environments in which banks operate.

We must improve our ability to anticipate problems. In this regard, the increased use of brokered-deposits will be a red flag for supervisors to promptly review the reasons for a bank using the banker's drug -- brokered deposits. Moreover, the FDIC plans to work with other regulators, industry representatives, and academics to develop regional oversight committees.

Our study also outlines three possible restructuring plans to deal with the problems at the FSLIC. Briefly they are:

(1) A <u>stand-alone</u> FSLIC, (2) an <u>administrative merger</u> of FSLIC <u>into</u> the FDIC, and (3) a <u>comprehensive reform</u> of the deposit insurance regulatory structure.

We favor the stand-alone option.

A stand-alone FSLIC envisions the creation of a separate FSLIC that is independent of the Bank Board.

The Bank Board would continue to charter and supervise federal thrifts, and would operate both the Federal Home Loan Bank System and Freddie Mac.

The newly-separated FSLIC would generally mirror the FDIC. It would directly supervise all state-chartered thrifts and be responsible for all liquidation activities related to FSLIC-insured institutions. The FSLIC would not be subject to the appropriations process.

District Federal Home Loan Banks would no longer examine or supervise thrifts. Instead, their role would be confined to providing liquidity for institutions meeting housing-related lending criteria. System membership would be available to any depositor institution meeting these criteria.

The second option is an administrative merger of FSLIC into FDIC. There would be common management and an administrative board over separate FDIC and FSLIC funds.

Two new members would be added to the FDIC Board, including the FHLBB Chairman and an additional director. In addition to administering the two separate funds, the new FDIC would supervise state-chartered thrifts and state-chartered banks that are not members of the Federal Reserve System. It would also perform all liquidation activities for insured banks and thrifts.

From a public policy perspective this approach may have some merit. The FDIC's expertise could be brought to bear on the thrift problem. Addressing this problem is good for thrifts and banks.

However, as FDIC insured institutions, you should keep in mind that there are risks associated with this approach. Banking industry resources -- in the form of higher premiums -- or the FDIC's fund -- could become part of the picture.

Increased regulation of the banking industry and the FDIC could form another unwelcome result.

Our third option calls for <u>comprehensive reform</u> of the deposit insurance regulatory structure.

The administrative functions of the FSLIC and the FDIC would be merged into a new corporation. The OCC would assume responsibility for chartering and supervising federal thrifts, and the Federal Reserve would supervise thrift holding companies.

The Bank Board would continue to oversee the Federal Home Loan Bank System and Freddie Mac, under the umbrella of the Department of Housing and Urban Development or the Federal Reserve.

There are certainly benefits to such an approach.

One alternative we do not favor is the Bank Board's plan for a reinsurance agency. That plan calls for a new government agency to oversee the nation's three federal deposit insurance funds, headed by the Secretary of Treasury. The three funds would pay premiums to this new agency. This new agency, would, in theory, cover the kinds of catastrophic losses the FSLIC now faces.

In our view, the last thing we need around Washington is another layer of government regulation. The FDIC's study suggests ways to provide the insurer with adequate funding without the cumbersome and costly addition of a new agency.

Moreover, it is critical that the insurer remain independent of the appropriations process and short-term political pressure. Moving the insurance agencies under Treasury won't help there.

Our study also reviewed the problems facing the FSLIC, including the dilemma of how to provide funding to deal with the hundreds of insolvent thrifts.

It appears that the federal government will have to absorb much of this cost, since the thrift industry cannot shoulder the burden alone. We also see no reason for banks to be singled out to pay for their competitors' problems.

Our study reviewed various proposals for dealing with this problem. To make any solution practical, it is important to minimize its impact on the federal budget. It's up to Congress and the Administration to decide which approach is best.

President Reagan's last budget proposes a step toward paying for the thrift problem. That budget proposal includes $64 billion in funding over six years for resolution of insolvent thrifts insured by FSLIC, and notably $25 billion for 1989 and 1990. Several approaches for raising this funding are also outlined, including increasing FICO borrowing authority.

The Administration is also developing a comprehensive plan to resolve this problem, which should deal with both funding and reform aspects of this issue.

The Department of Treasury is leading this effort, and is expected to submit a plan to the Bush Administration shortly after the inauguration.

In the next several weeks I will be testifying on the Hill a few times on thrift crisis.

Clearly, Congress is making this issue of highest priority. Hopefully, this attention will result in a comprehensive solution.

Everyone wishes for a crystal ball. Unfortunately -- like the philosopher's stone and the alchemist's formula -- they are hard to come by.

But my personal crystal ball would suggest that, with the recommendations in our recent report on deposit insurance reform largely accepted and put in place, our federal system of deposit insurance will weather the storms.

For the FDIC, I look toward a much better year in 1989. To the credit of both the insuring institutions and the banking industry, I believe we have gone to school on our recent past, and that we will now apply that wisdom and experience to our future operations.

I know you will all agree with me on the key importance of doing so to the future economic stability of the nation.

Thank you.