Banks, thrifts and deposit insurance as seen against the backdrop of our national economy:

Remarks by

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It is my pleasure to be with you today, and to speak to you about banks, thrifts and deposit insurance as seen against the backdrop of our national economy.

Seeing so many dark business suits reminds me of a college reunion I attended not long ago.

It happened that at the reunion one of the students we all remembered as the slowest in the class arrived in a chauffeured Rolls Royce. It seems he had become a fabulously successful owner of a large retail concern.

Naturally, all of us were curious about how one that incompetent had made so much money. So, after we plied him with a number of drinks, we put the question to him.

"Just how were you able to put together this enormously successful business operation?", we asked.

"It was easy," he said. "I found a supplier who could make my product for one cent apiece. Then I sold them for five cents apiece. You just can't beat that four percent profit!..."

Pause.

That accounting lesson has proven especially useful for analyzing certain bank, and especially thrift, accounting practices.

Today, I'd like to begin by highlighting seven developments and trends in the banking industry.

First, is the record earnings the banking industry produced last year. The FDIC will release all 1988 results in our Quarterly Review tomorrow -- so this is a sneak preview of the best profit year in banking history.

Commercial banking's aggregate net income for 1988 was $25.3 billion.

Fourth quarter net income of $6.7 billion is also a new record. [It is $800 million over third quarter 1988, the previous high. This is the first time we have ever seen consecutive record-setting quarters.]

Industry profitability, reflected in a return on assets of 0.84 percent, hit its highest level since 1973.

Nonperforming assets are also down slightly in 1988 as Brazilian debt was brought current in the fourth quarter, and net charge-offs remained high.

These are impressive achievements by any standard, and I would not want to take anything away from them. But these encouraging results should be tempered by several other considerations.

Many of these considerations indicate that it will be difficult to repeat with a new record performance in 1989.

For one thing, 1988's earnings reflected many unusual nonrecurring events.

Thus, many of the largest banks booked most of their collections of past-due interest on Brazilian loans as income.

The losses of one of the most troubled in the industry -- First Republic -- were taken out of 1988's numbers after the FDIC took action -- making 1988 look better than ever.

Another factor, the increased deposit insurance premiums for banks now being considered in Congress may mean reduced future income.

Banks paid dividends totalling over $13 billion in 1988, up 24 percent from 1987. That amount represents 52 percent of the year's earnings. A more conservative approach would have provided a greater capital base to improve 1989's earnings.

The real question for 1989 is the state of inflation and the economy.

Second, paradoxically, in some ways, in 1988 the banking industry -- and its insurer -- each weathered one of their toughest years ever.

Record failures put the FDIC to the test. The FDIC's fund declined to about $14 billion by year-end after spending $7 billion in 1988.

That's a lot of money even for you folks on Wall Street. It involved handling 221 bank failures and assistance transactions, with total deposits of $37 billion and total assets of $54 billion.

We also booked the estimated cost of handling MCorp and TAB/NBC, representing another 61 banks with $23 billion in deposits and $30 billion in assets.

All together in 1988, the FDIC booked the cost of handling nearly the same amount of problem bank assets as our fund handled during its entire previous fifty-four year history combined!

So we think a $4 billion loss isn't that bad!! You can tell from that statement I've been in government too long.

Third, the good news is that we see fewer bank failures in 1989 and beyond.

So far this year we have only handled 30 failures and 1 assistance transaction, involving $1.7 billion in assets. While last year at this time, the tally ran at 38 failures and 6 assistance transactions, involving a large $3.1 billion in assets.

The number of institutions on our "problem" bank list -- one of the best indicators of future problems -- has also been declining steadily. It now stands at 1350, down from 1506 a year ago, and almost twenty percent lower than it stood during its high in 1987.

Most of the problems we still see are located in the southwest, especially in Texas. I'm happy to report that despite the difficulties of last summer's drought, Midwest banks turned in a strong overall performance.

Although still not in the clear, the failure trend rate bodes well for the banking industry, and the net worth of the FDIC. We even expect to make a profit -- however slim -- in 1989.

A fourth development that is in many ways a direct result of the problems and lessons of 1988 should be of special interest to bank analysts.

As part of the President's proposed legislation dealing with the thrift problem, the deposit insurer would be given an important new power to help control costs. All depository institutions that receive deposit insurance will have to guarantee the insurer against costs resulting from the failure of an affiliated bank.

In effect, these mandated cross-guarantees would eliminate -- for purposes of deposit insurance -- the distinction between multiple bank structures and multiple branch banking structures. Analysts will need to focus on the weakest, as well as strongest, link in any banking organization.

For, the stronger banks will not be free to walk away from their failing affiliates -- leaving the clean-up cost for the FDIC.

In fact, the whole relationship between banks and their holding companies may be in the process of important change.

A fifth issue involves loans to developing nations.

Our calculations indicate that the third world debt problem will continue to hurt bank's bottom lines in the period ahead.

Nevertheless, banks are clearly in a better position to deal with this problem now than they were in the early eighties.

Over this decade, primary capital in the nine money center banks that account for the bulk of our banks' third world debt has more than doubled, reaching $65 billion last year. At the same time, the outstanding third world debt held by these institutions has fallen by ten percent.

Regional banks have been even more aggressively reserving and writing-off significant portions of their developing country debt.

As a result, on average, the money center banks have reserves of 30 percent on their third world debt portfolios, and the regional banks have reserves of 50 percent.

This raises the question of what is the right level of reserving, on average.

We have studied debt-service capacity as a function of gross export earnings. Briefly, we estimated that assuming a country could direct 25 percent of its export earnings to servicing its external debt, reserves in the range of 30 percent are adequate if the bank intends to hold onto the debt.

Thus, owing to reserving, declining exposure, and increasing core capital, major money-center banks could write-off substantial portions of their outstanding loans to the largest developing country borrowers and remain solvent -- but of course less profitable.

And I have to say, as the banks' insurer, that is good news.

The strength of the banking industry reflected in this analysis will help facilitate market-based debt reductions -- as supported by Secretary Brady in his announcement on Friday. For, banks wouldn't likely chose to pursue this approach from positions of weakness.

Sixth, another situation to watch is the possibility of an emerging real estate loan quality problems in other parts of the Country. New England and the Southeast especially bear watching. None looks like Texas or Oklahoma, but as an insurer, we urge caution.

I want to stress that the condition of the industry in these regions is generally quite good -- but prudence -- not Go Go Growth-- should be their motto these days.

There is the growing tendency of banks to concentrate increasingly on real estate lending, rather than on traditional commercial lending. Three factors have helped establish this trend.

First, significant portions of the best commercial lending market no longer exist for banks. Commercial paper and junk bonds took care of that.

Second, commercial real estate lending, especially construction financing, offers potentially high returns. Of course, higher returns usually mean high risks.

Third, the new risk-based capital guidelines may also encourage banks to become more involved in residential real estate lending as they adjust their portfolios for the phase-in of these standards.

My seventh and final issue is what the thrift crisis will mean to banks and thrifts in 1989.

Let me first provide you some figures and statistics that help describe the thrift industry's health through third quarter 1988.

Third quarter losses for the thrifts declined sharply to $1.6 billion, down from $3.9 billion in each of the previous two quarters. Annualized return on assets for the third quarter was minus 0.5 percent, compared to minus 1.22 percent in the second quarter.

Some of these improvements resulted from the most troubled thrifts being taken over by the FSLIC, removing them from industry statistics.

The big picture on the Nation's 3,000 thrifts shows that the percentage of profitable thrifts continued to rise slowly.

Nevertheless, almost a third of the industry remains unprofitable, and hundreds are insolvent.

What these facts indicate is that -- despite some improvements -- the thrift industry faces a long climb back to financial health.

So what will the President's proposed solution to this problem mean to the thrifts and the banks?

For the banks, dealing with the thrift problem will mean greater financial system stability, and -- importantly -- lower costs of funds. That should help their bottom line.

For the thrifts, our crystal ball is somewhat cloudy. The maintenance of high deposit insurance premium rates will impair thrift profitability. Moreover, the proposed legislation would reduce thrift earnings by forcing write-downs of goodwill over ten years. At the same time, capital requirements for the thrifts will rise to bank levels, and income from the Federal Home Loan banks will be lost.

Almost 1300 solvent thrifts don't meet these tougher capital requirements. [And goodwill represents about half the thrift industry's capital!] We estimated it will take at least $20 billion of additional capitalization to bring these thrifts up to six percent.

While we are on the subject of the thrift problem, I thought I would take a few moments to address the FDIC's role in the proposed solution, and what we are doing now to deal with the thrifts that are insolvent under Regulatory Accounting Procedures.

First, let us give President Bush great credit for his leadership. In the opening moments of his presidency -- the "honeymoon" as it's called -- he moved swiftly to provide leadership for this difficult, complex and painful problem.

Operating in circumstances where statesmanship clearly needed to prevail over partisanship, and where the art of compromise required maximum application, the President boldly took the initiative and put forward a good plan.

The President's Plan is awaiting Congressional action. But the President has also directed that the FDIC take immediate action to help bring the thrift problem under control.

The FDIC is now leading a joint interagency effort to evaluate and oversee more than 200 RAP insolvent thrifts. In addition to the FDIC and the FSLIC, the Federal Home Loan Bank Board, the Fed, and the Office of the OCC are participating in this initiative.

One of the first priorities of these oversight efforts will be to evaluate the losses and size-up the situation at each institution.

We will not employ hard and fast rules in this area -- but instead we will use general guidelines and common sense.

-- strive to limit growth at these institutions.

[You may have heard the saying going around the Southwest that, "Rolling loans gather no loss." We are going to put our foot down and stop the roll.]

-- We will begin downsizing these institutions, reducing the need for high-priced brokered deposits.

-- We do not intend to conduct fire sales. But where possible, we will liquidate assets selling them for their fair market values.

-- We will be actively looking to identify and stop any abuse, waste, or fraud that may be present.

Finally, we will develop longer-term solutions to these problems. Our staff will recommend different approaches -- from liquidating the institutions to selling them to qualified purchasers. But our current job is a holding action only. We will not issue notes or enter into income maintenance agreements.

We hope prospective customers won't hesitate to express their interest to our Transaction group. But, I must caution, all transactions and agreements that require financial support will be contingent until funding is provided by the Congress.

[In some ways our situation reminds me of the guy who fell off a fifty story building. On the way past the 25th story, someone shouted, "How are you doing?"

The falling man yelled back, "So far so go-o-od."]

[Several groups have raised concerns about our asset liquidation operations, and have asked us to hold our real estate off the market and not sell till the price is right -- whenever that might be!

The FDIC's position is as it has been in the past -- that all real estate is <u>for sale</u>.

Importantly, we will try and sell these properties at current fair market values, and will <u>not</u> engage in dumping. If we can't obtain today's fair price, we'll hold on.

Government subsidized holding of properties off the market for higher prices actually can be detrimental to the real estate market and the local economy. Large amounts of property overhanging the real estate market, under asset maintenance agreements, creates uncertainty and retards economic recovery. No one knows when the government might open the flood gates.

The way the private sector can make rational economic decisions is to get property into private hands as promptly as possibly. However, even with such a policy, unfortunately, sales will take years.

Incidently, the FDIC is moving to make the sale of real estate easier by accepting terms. That includes all cash bids. So come in and see us. We'll have lots for sale.]

Having now dealt with banking performance and the FDIC's current involvement in the President's plan to resolve the problem of the troubled thrifts, I would like to conclude with some observations on the U. S. economy.

After all, and above all, the performance of the banking and thrift industries is tied to general economic performance. Emerging trends in some areas of the economy look like the end of the boom cycle.

And I am not one of those analyst who have been predicting doom for years now. I gave a talk two weeks after Black Monday that said the crash means a strong economy for the next year or so.

But the smell of a slowdown is in the air.

With the rise in inflationary pressure, interest rates have also edged higher. And that is bad for both the thrift industry and for economic expansion in general.

The slow, continual increase in short-term interest rates throughout 1988 has resulted in an inverted yield curve. Disturbingly, the inverted yield curve has forecast recession seven times in the past 35 years, and has only been wrong twice before.

In fact, the economy's growth rate is beginning to slow. During the Fourth-quarter GNP expanded by only two percent, down from the 3.8 percent of 1988 as a whole.

Debt levels in all sectors of our economy are running at or near post-World War II highs. Even more alarming, those past records were set in recessionary times, not during periods of economic upswing.

Examples: Total household debt was 86 percent of disposable income as of the third quarter 1988, matching the previous postwar high set in 1986. Consumer credit was 21 percent of disposable income, while the previous high was 23.6 percent also set in 1986.Total domestic nonfinancial debt now stands at $8.8 trillion, a post-World War II high. Total debt is 180 percent of GNP, also a record. Corporate debt as a percentage of net worth has expanded in that same period from 30 to 46 percent, another postwar high.

One of the most disturbing trends in this area is that the burden on corporate cash flow to debt service obligations is now above the level seen almost anytime since 1970, except during the 1982 recessionary period. The current nonfinacial corporate debt-service ratio (as measured by net interest payments divided by pre-tax earnings) stands at approxiamtely 32 percent, and has been rising gradually since 1985.The current period of increasing debt service ratios has occurred while corporate profits have been strong. Normally these ratios increase during economic downturns, such as the 1974 and 1982 periods.

The level reached in 1974 was 23.4 percent, while the level in 1982 reached a record 37 percent.
As the insurer of the banking system, we will be following that issue closely.

Thankfully, there is a still little known book just coming out that speaks to righting America's economic course. Entitled <u>COMPETITIVENESS: THE EXECUTIVES GUIDES TO SUCCESS</u>, it probably won't prove to be the economic equivalent of the Alchemist's Formula or the Philosopher's Stone, but nevertheless, I'm told, should be quite worthwhile reading.

It was written by -- let's see -- someone called S-E-I-D-M-A-N!

Of course I'm not allowed to promote on government time. But I've been in the private sector so much of my career I couldn't resist this opportunity to mention this "masterpiece."

We have our work cut out for us -- especially if you are an analyst or a bank regulator.

And we will need to exercise our best abilities -- in business -- in finance -- and in government -- to meet the full depth of the challenges ahead. Nothing less will do.

Thank you for your attention. Now I'd be pleased to take your questions.