Speeches FDIC

LIBRARY
JUN 26 1989
FEDERAL DEPOSIT INSURANCE CORPORATION

The savings & loan debacle:

Remarks by

L. William Seidman
Chairman
Federal Deposit Insurance Corporation

Before

New York Financial Writers
New York, NY

June 21, 1989

Ladies and gentlemen, it is an honor for me to be here this evening with this distinguished group: the peerage of financial writers.

Tonight, I would like to outline for you my observations on the S&L debacle -- how it originated -- where we now stand -- and what the future may bring.

This S&L financial problem is one more costly than the Marshall Plan, Chrysler, New York City, and Penn Central bailouts, all combined, and by a mile! In fact, it will probably cost every man, woman, and child in the U.S. about $1000 each!

Let's take a brief look at how we got ourselves into the S&L mess.

Historically, S&Ls were restricted to providing long-term fixed rate mortgages financed by short-term deposits. This process was strongly supported by deposit insurance.

The thrift industry prospered during the period when interest rates were relatively stable.

But the nature of the thrift business had always meant that S&Ls were vulnerable to changing interest rates.

In fact, the basic premise of the industry's strategy was that one could borrow "short" and lend "long." One could use the yield curve difference to provide lower priced mortgages for the American home buyer. In this simpler time, long-term interest rates were higher than short-term rates.

However, as we know, the world has changed. In the late seventies, inflation was on the rise, and with it, interest rates soared. S&Ls had to be allowed to pay higher interest rates on deposits or depositors would move their money elsewhere.

At this point, the basic interest rate risk in the S&L industry was exposed. The response to this revealed truth was most unfortunate.

What were the basic solutions proposed?

In summary, there were four parts:

(1) Allow thrifts to grow out of their interest rate mismatch with new products that did not depend on the yield curve differential.

(2) Allow special regulatory accounting that misstated the facts, and, for all practical purposes, eliminated capital requirements.

(3) Limit government supervision of this newly deregulated and capital starved industry. In other words, get the government off the thrift executives' backs so they could become entrepreneurs and earn their way back to solvency.

(4) Increase the amount of deposit insurance to $100,000 to keep the money in the thrifts.

While some thrifts exercised these new rules judiciously, many -- and particularly those with little capital to lose -- sought fast growth with <u>large investment risks</u> to try to recover their profitability.

It was the worst of all worlds. A substantial part of the thrift industry had now <u>added credit risk</u> to interest rate risk.

Mix in this brew lax supervision, reduced regulatory capital requirements, slackened accounting standards, and virtually unlimited deposit insurance, and you have all the ingredients for the disaster that has occurred.

So what are the broader lessons for today from this most costly event?

First, get the facts. Don't allow devices like phony accounting to obscure the situation and distort the truth.

Both the government and the private sector failed to learn the magnitude of the thrift crisis until it had reached huge proportions.

Second, use the real facts to develope a plan. As Alice learned on her way through Wonderland, when you don't know where you're headed, any road will do. In this case, no strategy was developed to meet the basic problem of low capital, lack of market discipline, and rate risk.

Further, the government refused to realize that deposit insurance gives insured institutions a government guaranteed credit card to raise money for any purpose.

Remember, unpleasant facts require tough decisions.

Finally, act on the facts -- procrastination will make it worse. Haul down the flag that states: "Not on my watch." It's a flag that flies over too much of the Washington scene.

In the context of the S&Ls, the painful answer of tougher rules and closing down insolvent institutions was never accepted.

Tough decisions require action.

So much for looking back -- where do we stand today?

With real leadership, President Bush -- just 16 days in office -- provided the Congress with a sound program. Congress, under the leadership of Committee Chairmen Gonzalez and Riegle, moving with unusual speed has improved the plan. Each house has passed a bill and the conference should begin in the next couple of weeks.

The legislation is designed to correct the mistakes of the last decade. It does make the tough decisions necessary for future safety.

First, the bills require stronger capital for thrifts, with bank capital standards providing the baseline, and tangible capital required of all institutions.

Second, the bills require factual accounting, rather than the ill-fated "smoke and mirrors" of the past. Goodwill will be phased-out tangible capital.

Let me say a word about goodwill as used in the context of the thrift industry.

Goodwill normally was meant to be a balance sheet adjustment to account for circumstances where the value the of enterprise exceeds the value of assets on the books. As applied by the thrift industry, however, it measures the shortfall when the value of the enterprise is less than the assets on the books. That's not goodwill -- that's bad will, or maybe better, ill will.

Third, the bill requires double supervision for S&Ls, with the FDIC serving as the backup supervisor for the thrift industry. There will be an independent insurer with a clear mandate for using its powers and supervisors to control risk-taking and minimize costs to the insurance fund.

An important feature of this supervisory process will be to restrict growth until adequate capital is on hand.

Finally, fourth, the bill provides for a comprehensive vehicle to handle insolvent S&Ls -- the Resolution Trust Corporation. I want to stress the key <u>importance</u> of this institution.

The RTC, which I estimate may have to handle at least three to four hundred billion dollars in assets -- has a massive challenge ahead of it.

To give you a view of the size of the job, the FDIC in its entire existence has dealt with about 160 billion dollars in assets.

It appears that the FDIC will have to play a role in operating the RTC -- though that role is still being determined.

In the interim, we have assumed a conservatorship role in over 223 thrifts in the last several months. We expect that number to increase to almost 300 by the time the President signs the S&L bill.

Let me stress that the FDIC will not be significantly diverted from its bank supervisory functions by this undertaking. First of all, most of the work in the S&L area will fall on our non-supervisory people -- leaving over 95 percent of our bank supervisory personnel free to concentrate on supervision. Moreover, as far as we can foresee at this time, the FDIC is going to have a much better year in 1989 than we had in 1988.

1988 was our most challenging year ever, requiring us to book the cost of handling over $80 billion of assets -- about what we handled in all our previous years combined. In contrast, we anticipate handling about $10 billion of assets in 1989, or about 12 percent of what we handled last year. These numbers reflect an anticipated 150 to 180 bank failures. We make this prediction on the basis of the decline in our problem bank list -- now at 1,282, down from its high of 1,624 in June 1987. We expect our bank fund to grow by a modest amount this year.

Looking to the future, the new legislation should go far toward eliminating both the former causes and the likelihood of a return of the thrift crisis. Unfortunately, the future is when we will feel the real pain for this historic government error.

Institutions will have to be closed. People will lose their jobs. Defaulting borrowers will be sued. Large amounts of property will be sold in difficult markets. And of course, the taxpayers will bear the burden through future taxes.

And -- and this is a big And -- there is one continuing problem that must be addressed in the future.

The current legislation will go far to address the problems of the past in the thrift industry by returning discipline to the system. But an underlying structural problem remains in many institutions. That is the threat to thrifts inherent in the interest-rate risk that has been assumed by the industry.

The challenge for the nineties for much of the thrift industry and its regulators will be to deal with this inherent mismatch problem -- otherwise the thrifts will not be able to obtain deposit insurance at reasonable cost.

As insurers, we are gearing up for this job. We recently changed our examinations procedures to improve our monitoring of interest-rate risk and liquidity problems. The regulators are considering ways to factor interest-rate risk into the risk-based capital formula.

The thrift industry must help by seeking to control rate risk. Approaches available include the increased use of variable rate mortgages and loans, securitization of assets, and management of liabilities.

Ultimately, we must recognize that as long as we mandate the existence of a class of depository institutions that specializes in long-term assets and thus prevent diversification, we will have an interest-rate sensitive breed that needs lots of capital and our closest supervision.

In closing, I commend all of you on your good work -- bringing understanding of these admittedly complex issues to the American public.

Without that information, the public's voice would never have made it through the barrage of lobbyists and special interests who stalk Washington's streets as they did during the recent vote on the S&L legislation in the House. You did a great job on the capital issue!

I hope you will be able to tell your readers that their government is now doing a creditable job at addressing this historic S&L problem. We at the FDIC will be doing our best to make that a credible statement.

I thank you for your kind attention this evening.