Remarks By

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It is a pleasure to be able to talk before this important group of California thrift executives.

I always get a bit nervous when I get a late call to stand in for Chairman Seidman at these events. I try to hide it, but right before I came in, a woman came up to me and asked if I was nervous. I said, "Why do you ask?" "Because," she said, "You're pacing back and forth in the ladies room."

Well, enough of that.

First off, let me say California is quite a State -- and, I'm not just talking about the sunshine. Your State ranks number one in population. Only five nations worldwide have economies larger, or more diverse, than California's.

California is a major part of our country's economy, accounting for about 12 percent of our gross national product.

How well your State does impacts how well you do -- and vice versa. California has not escaped problems in agriculture, mining, and other traditional sectors. But, it leads the nation in job creation and has a strong economy, with estimated real growth of about 3.5 percent last year.

California is important to deposit insurers too. It accounts for about 10 percent of deposits insured by the FDIC and about 23 percent of FSLIC insured deposits. So, how you do has a big impact on how your insurance funds do.

So, how are you doing? Your brethren, the California banks, are doing a lot better than they were a few years ago. Profitability has shown significant improvement, and the level of nonperforming assets and chargeoffs has also improved. The number of California banks on our problem bank list has declined nearly 15% over the last year, though the percentage is still somewhat above the national average.

S&Ls have also seen some improvement, although earnings seem to be suffering as of late. I hope any downward trends can be arrested. While not without their problems, depository institutions in California -- like the State -- are doing relatively well, particularly in comparison to other banks in the western United States.

Your economy and the success of California's financial institutions places the thrifts and banks of the Golden State in a position that many others in the U.S. might well envy. So, as that great California philosopher, Sam Goldwyn, once said: "Don't bite the hand that lays the golden egg."

California has long been noted for being on the cutting edge of changes in American life.

As we all know, there are many changes going on in the world of financial services, and the size and diversity of your state will put you at the forefront for dealing with those challenges.

Just a short time ago, it seems, banks and thrifts were the only players in the arena. But since that time, we have been challenged by new competitors.

The money market funds, the insurance and investment companies, the home equity specialists, even department stores -- all are getting into financial services. Banks and thrifts face stiff competition, both for deposits and for loan customers. This increased competition has made it clear that banks and thrifts share many of the same concerns and characteristics.

While the bulk of this Nation's 14,000 commercial banks and the 2,300 federally insured thrifts remain sound, both industries are facing record failures and serious problem institutions.

Problems in the Southwest, particularly in Texas, have been acute for both banks and thrifts and for their insurance funds. Both industries have a vested interest in seeing these problems resolved and prevented from recurring. The impact of the hopelessly insolvent thrifts on the funding costs of healthier institutions is something that should trouble us all.

George Bernard Shaw once said that the English and the Americans were "two peoples separated by a common language." If he were observing the financial scene today, he might say that banks and thrifts are "two industries separated by a common business."

Both industries need to recognize common interests and find ways to work together to meet the new challenges that lie ahead. Both industries need to raise their joint voices to Congress as it wrestles with issues that could ultimately decide the shape of the financial services industry. We need to ensure fair and efficient competition, which will benefit providers and consumers alike.

Both industries need the flexibility to manage, to control, to diversify their risks. The problems that have hurt so many well-run banks and thrifts often were the result of the failure to diversify. Banks and thrifts should be allowed to diversify, geographically and by product line. Both industries share a need to expand the array of financial services.

Both indutries also share a common interest in maintaining a strong, yet flexible, supervisory system, especially as we move forward.

Last year, the FDIC outlined a concept of creating a supervisory "wall" around banks in order to safely allow greater diversification. We think our "Mandate for Change" makes sense, for banks and for thrifts as well. Someone once said, "Good judgment comes from experience, but, unfortunately, experience comes from poor judgment." We think the experience of recent years only supports the need for greater product diversification, coupled with strong supervision.

Having mentioned our common interests and problems, please allow me to give you a brief recap on how the FDIC came through last year.

1987 was a difficult year for the FDIC, though I'm pleased to say our preliminary numbers show we ended up just in the black, with about a $50 million increase in net worth. The roughly $3.3 billion the FDIC received from banks in premiums and interest last year, was just barely enough to handle last year's operating expenses, plus the cost of failures and assistance transactions. One reason -- a big one -- was the First City assistance transaction in Texas, for which we have set aside nearly $1 billion to cover our potential costs.

In 1987, FDIC handled 184 failed banks and assisted 19 other banks to keep them from failing. All told, the FDIC resolved, or committed funds to resolve, nearly $25 billion in bank problems last year. Our inventory of managed assets taken from failed banks held at about $11 billion, against which we carry a reserve of over $7 billion. We fight to keep our inventories down and, thus, keep our cash up.

The FDIC fund is just over $18 billion, including $16 billion in liquid U.S. Treasury investments. We are prepared to deal with any banking problem we foresee in 1988. With the number of banks on our problem list holding steady at a little under 1,600, this year's failure rate is expected to remain about the same as 1987.

The vast majority of our troubled and failing banks are located west of the Mississippi. Roughly 85 percent of last year's bank failures came as a result of troubles in the farm and energy economies. Moving forward, we expect to see fewer problems in the farm sector as things continue to improve there. The outlook is less favorable in the "oil patch." Overall, no unmanageable crises are in sight, despite some doomsayers' predictions to the contrary.

It seems that whenever I meet with bankers or people in the thrift industry, the subject of a merger of the FDIC and FSLIC comes up. As you may know, the FDIC does not advocate a merger.

First, there is logic to having separate funds, given there still are some basic differences in structure, marketing objectives, and risk characteristics between the two industries. Second, it is not clear what real purpose a merger would serve. If the issue is the adequacy of the FSLIC fund, it would be premature to draw any conclusions. As you know, Chairman Wall believes his resources should be enough. Should that work out not to be the case, why turn to the FDIC, or the bankers' insurance fund? As someone once jokingly asked, "Why not the Highway Trust Fund?"

Just because an outright merger of the funds does not seem to make good sense, the two insurance funds can find ways to help each other. Both funds are exploring and implementing other solutions to the problems in their industries, and those efforts need to be continued and strengthened.

We intend to work with FSLIC to develop cooperative programs. Areas like supervision and property disposal are good places for this process to begin. Both funds could also work more closely to deal with problems affecting regions, like the Southwest. We look forward to such increased cooperation.

The best solution to the problems in both industries is for thrifts and banks to work together to make both industries more competitive and profitable.

While we do not favor a financial merger between the FDIC and FSLIC, this does not mean we do not recognize and sympathize with the hardship placed on the many well-managed S&Ls, which must pay for the costly mistakes of a few. We also know many S&Ls are interested in converting to FDIC insurance and are exploring various avenues to accomplish this.

A bill being proposed in Sacramento, as I understand it, would establish a new type of state savings bank charter, with an aim to gaining broader powers for thrifts that convert to that charter. And especially important from the FDIC's perspective, the savings banks may want to switch to FDIC insurance.

FDIC coverage of such newly-converted institutions will be available in accordance with legally required and historical standards.

We are required by law to review all applications and evaluate certain financial and managerial characteristics, as well as ensure powers are consistent with the FDI Act and the community's needs are served. We must consider an applicant's financial history and condition, capital adequacy, future earnings prospects, and the general character and experience of management.

We will apply the same standards we normally do to any applicant. Institutions will have to meet the same minimal capital standards applied to banks, currently primary capital (basically tangible equity and loan valuation reserves) of 5.5 percent. The last time we looked, we estimated about 46 percent of the S&Ls met or were close to meeting that standard. In California, it was more like 43 percent.

Of course, that standard is the minimum for an institution in satisfactory financial condition. In evaluating financial condition, we will look at asset quality, liquidity, and interest rate sensitivity, among other things. Essentially, what we do is compile the same CAMEL rating used uniformly to rate banks. If a bank is a 1 or 2, it will generally be approved. If a 4 or 5, it will not. If a 3, well, it will depend if we can agree the fund is not unduly exposed -- that things are more likely to get better than worse. And that will depend heavily on our confidence in management's ability to control its risks.

Interestingly, the applications of S&L's for FDIC insurance has forced us to focus more heavily on how to evaluate interest rate risk. We are currently studying how much interest rate risk should be allowed; how much capital should be required to offset that risk; and, finally, if a "rate risk" problem exists, what the institution is doing to deal with the problem.

Interest rate risk is a big part of your business -- just like credit risk is for commercial banks. Not to say banks don't take rate risks (a bank in my boss' home state, Bank of the Commonwealth, was a good example of that), or that thrifts don't take credit risk (you can fill in your own example here).

The point is, how much of interest rate risk should the FDIC be willing to take on. We are wrestling with that very issue. There are federal and state laws (legal lending limits, etc.) designed to reduce credit risk concentrations. Obviously, they don't always work, but they help. No such rules apply for interest rate risk, and we don't know how one would ever go about constructing such rules. We must rely on our supervisory instincts and our experience. Fortunately, we have some. As you know, we long have insured a sizable number of thrifts, and we went through some rough periods in the early eighties.

We have looked at the relative levels of interest rate risk between FDIC-insured savings banks and S&Ls. We looked at rate gaps; i.e., the relative differences between the amount of its assets and the amount of liabilities that matured within different time horizons. Simply put, the bigger and the longer the gap, the more the risk. We found the gaps tended to be much larger for S&Ls. For example, the median gap over five years for S&Ls was six times higher than it was for savings banks (the gap was not quite so big for California S&Ls). Then again, the gap is an imperfect measure, and our data also were limited.

We are working to improve our capabilities in measuring rate risk. We are trying to establish a uniform approach for evaluating the acceptability of rate risk. Our current thought is to apply a uniform assumption about a change in interest rates and then measure what the impact on earnings and capital would be. This would serve as a first step review -- not as a conclusive test.

For example, one set of assumptions was that interest rates would rise by 400 basis points and stay up for four years. We wanted to see how many of our savings banks would be able to maintain a primary capital ratio of at least 4.5 percent.

Interestingly, we estimate over 90 percent would be able to. Even about 80 percent of our larger savings banks, which tend to have lower capital ratios, managed to stay above 4.5 percent. Most of those that didn't pass had less than satisfactory CAMEL ratings.

We have not applied comparable tests to S&Ls. But, based on what we know about capital levels and interest rate gaps, we would expect that fewer S&Ls would meet the standard. On the other hand, our savings banks results would suggest the approach is not an unreasonable one for evaluating rate risk in thrifts.

We have not yet reached any decisions on how we will go about measuring rate risk. Moreover, the need for a uniform approach is driven somewhat by the volume of applications. Currently that volume is very small and, of course, will stay that way until the moratorium is lifted later in 1988.

Also, I don't want to place too much emphasis on the use of standard interest rate tests. There are a lot of ways to manage and control rate risk, and even interest rate risk is only part of the picture. Each applicant will have to be evaluated in light of its particular circumstances.

You can be assured, though, that we will thoroughly review all applications we receive for FDIC insurance and apply our mandated criteria in a fair and reasonable manner.

I want to close by going back to my earlier thought. Banks and thrifts share a common need -- a need to manage change.

David Selznick once said, "It is a rare business that can expect to be serving exactly the same market with exactly the same products in ten years' time."

We need to be in a position to change, to adapt, to innovate, and to create. By working together, banks, thrifts, and your regulators can help create a level playing field, functional regulation, an effective voice in Congress and in state legislatures, and a financial services industry that provides more and lower cost services to consumers.

Bob Hope once said of Bing Crosby, "There's nothing I wouldn't do for Bing, and there's nothing he wouldn't do for me. We spend our lives doing nothing for each other."

Let's not let that happen to banks and thrifts!

Thank you.