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Testimony of Jay Janis

Before the

Committee on Banking, Housing and Urban Affairs

of the

United States Senate

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Mr. Chairman and Members of the Committee:

My name is Jay Janis. I am a former Chairman of the Federal Home Loan Bank Board, having served in that capacity in 1979 and 1980 at the time that deregulation of our financial institutions was launched during the Carter Administration. I have held various other positions at the Federal level, including Undersecretary of the Department of Housing and Urban Development (1977-79) and Executive Assistant to the Secretary of HUD during the Johnson Administration. I was President of California Federal Savings in 1981-82, and I am currently Chairman of the Board of Gibraltar Financial Corporation and Gibraltar Savings, a large California thrift association with $15 billion in assets. Also, at the request of the regulators, I chaired the Boards of Centennial Federal Savings and Flagship Federal Savings, two institutions in the Management Consignment Program (MCP). In my earlier years, I was a community developer and home builder in Florida.

I appreciate the opportunity you have given me to present my views to this Committee. I am always pleased to testify before old friends, even if the subject is the difficult problem of the Federal Savings and Loan Insurance Corporation (FSLIC). As I understand it, this is a two-part assignment: First, to discuss how the problem occurred; and, Second, to suggest how to solve it.

As to how the problem occurred, I would like to advance the "Theory of the Confluence of Adverse Circumstances." As to how to solve it, I would like to advance the "Theory of the Confluence of New People." Before explaining these theories, I think it would be useful to say a word about simple answers and to provide some historical perspective on the FSLIC problem.

No Simple Answers

Everyone appreciates a simple answer to a complex question. It would be nice to say that FSLIC's problems came about as the result of A, or B, or C. Some of the easy answers we often hear are the following:

* Deregulation was a flawed concept from the start.
* Deregulation was a proper concept but was poorly carried out.
* Domestic financial markets changed too rapidly for America's out-moded depository institutions to adapt.

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* Examinations and supervision failed--in part because regulators were overwhelmed--in part because OMB and Congress would not provide the extra staff that was needed.
* The world-wide crash in oil prices and the resulting depression in "oil patch" real estate markets that followed meant that financial institutions in the southwest could not possibly survive.
* The ultra-high interest rates and volatility in the 1979-1982 period that occurred as the result of Paul Volker's zeal to whip inflation proved to be calamitous for a business which was required by regulation to lend long and borrow short.
* The cupidity and venality of certain thrift executives--especially the high fliers who came into the business recently to take advantage of the new powers--brought the problem on themselves and the entire industry.
* The old-line managers in the thrift business, although skilled at making residential loans, lacked the expertise to cope with rapidly changing world financial markets, a whole host of new financial instruments, and the new powers that were granted.
* The absence of guidelines to deal with the anticipated effects of deregulation was a grave oversight.

Regrettably, none of these statements--taken alone--provides an adequate explanation of what went wrong with the FSLIC, nor for that matter do these statements comprise a complete list of all the possibilities! But they do provide a basis for putting together a theory about the causes of the problem.

What did happen, in my view, is that deregulation of our financial institutions, which began in the late 1970s, happened to take place at the same time that a number of other adverse circumstances occurred. If these other circumstances had existed alone, or without deregulation, they might not have resulted in disaster. Taken together, and combined with deregulation, the result was a critical mass explosion of monumental proportions--hence, my "Theory of the Confluence of Adverse Circumstances." Some call it the thrift crisis of the late 1980s in America. Others, who prefer accuracy, call it the FSLIC crisis.

Some Historical Perspective

A description of the events leading up to deregulation provides a useful perspective from which to view the

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current problem. Let me begin with a brief review of the modern era of thrifts in America.

The modern thrift era began during the Great Depression with the Congressional enactment of legislation that created a comprehensive scheme of federal regulation of what were then commonly known as building and loan associations. The 1932 Federal Home Loan Bank Act created the Federal Home Loan Bank System as a source of liquidity for member institutions and established the Federal Home Loan Bank Board as the system's federal overseer. In 1933, the Home Owners' Loan act authorized the Bank Board to grant federal savings and loan association charters and to regulate and supervise such associations. In 1934, the Federal Savings and Loan Insurance Corporation was created, as an analog to the Federal Deposit Insurance Corporation, to restore depositor confidence after the wave of building and loan failures that characterized the early depression years. Because the FSLIC was a de facto part of the Bank Board, this gave the latter regulatory responsibility over state-chartered thrifts that elected to have FSLIC insurance.

The fact that Congress created a separate federal regulatory, deposit insurance, and liquidity system for the thrift industry reflected the judgement of Congress that there was a need for a separate set of financial institutions devoted to "economical home finance." Nowadays, critics contend that the thrift industry was founded on a flawed base--long-term mortgages to be financed by short-term deposits--but no one disputes that the system served housing finance well for at least 30 years after its creation.

Then, in the 1960s, deposit interest rate control was extended to the thrift business as a way to keep mortgage rates low by putting a lid on what thrifts could pay depositors. (Rate control had come to banks in the 1930s.) This was an early warning that there were cracks in the system, and soon thereafter, various blue-ribbon commissions and various academicians began to study the problem. In the early 1970s, they put their collective fingers on two emerging problems: a) the danger of disintermediation stemming from a highly regulated depository institution system; and b) the inability of the U.S. financial system to keep pace with growing domestic and international competition. As a result of their findings, they sounded a call for DEREGULATION.

At first, policy-makers weren't listening. But, in the mid-1970s, as Wall Street's newest brainchild, the Money Market Mutual Funds (MMMFs), came onstream and no one saw fit to regulate their deposit gathering, the spectre of

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disintermediation loomed larger still and thrifts actually began to lose deposits at an alarming rate.

The regulators reacted ever so slowly. At first they granted permission to thrifts to issue longer-term certificates at somewhat higher rates. Later on, in 1978, they approved a short-term, competitively-priced six-month money market certificate. Policy makers felt they had no choice, since they wanted to ensure the continuing flow of mortgage credit into housing.

In the Carter years, the difficulties of perpetuating a tightly regulated set of financial depositories began to be recognized. A task force led by Treasury and HUD, which included all of the appropriate regulatory agencies, called for the initiation of deregulation of the depository system, and, in particular, for permission for institutions to be able to make adjustable rate mortgages (ARMs). The need for deregulation of America's depository institutions--along with certain other industries--soon became the Conventional Wisdom of its day.

The 1980 Depository Institutions Deregulation and Monetary Control Act was the culmination of the effort to deregulate deposits. In that Act, the phased, six-year deregulation of bank and thrift deposit rates was initiated through the good offices of one of the least known, but most colorful institutions Congress ever invented--the Depository Institutions Deregulation Committee or DIDC as it was called. (As a charter member of this Committee, I found myself out-voted by precisely four votes to one on nearly every occasion.*)

There was some small recognition that the deregulation of the asset side of the balance sheet had been neglected in the 1980 Act, and a few new powers were granted. Hurried attempts were made over the next two years to grant new asset powers in three major ways: 1) by Federal legislation; 2) by

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* This was because I wanted to slow down deregulation on the deposit side, since interest rates were at unprecedented levels and financial markets were gyrating wildly. Apparently, my fellow DIDC members--the Secretary of the Treasury, the Chairman of the Federal Reserve, the Chairman of the FDIC, the Administrator of the Credit Unions, and the Comptroller of the Currency (non-voting)--believed that deregulation, once launched, should be carried out without concern for these events or for the plight of the thrifts, which had been trapped in fixed-rate asset portfolios. In fact, the majority of DIDC members were in such a hurry to carry out deposit deregulation that for all practical purposes they completed the Congressionally- contemplated six-year phaseout a full two years ahead of schedule in 1984.

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action of certain state legislatures; and 3) by the 1982 Garn-St Germain Act. Now the stage was set for the "critical mass" explosion--the result of the confluence of adverse circumstances that had taken place over these few short years.

The Confluence of Circumstances:

Who could have predicted that the unplanned deregulation of the depository institution system would be launched:

at the same time that

* interest rates rose to unprecedented levels and financial markets were enormously volatile;

at the same time that

* thrift profits were squeezed and their capital base was eroded leaving them in a severely weakened condition to face the new competition resulting from deregulation;

at the same time that

* Congress and the regulators realized their error and rushed to give them new asset powers to allow institutions to diversify their portfolios and to correct the "backwards" way in which deregulation had been launched (i.e., liabilities ahead of assets, and, particularly, the fact that institutions had not been permitted to make ARM loans*);

at the same time that

* California--and then some other states--foolishly decided to give virtually unlimited powers to their state-chartered thrifts;

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* Beginning with FHLBB Chairman Tom Bomar in the mid-1970s, regulators told Congress that ARM lending was necessary, but Congress objected. During my tenure at the Bank Board, we finally authorized the Renegotiable Rate Mortgage (RRM) in 1980, based on the so-called Canadian rollover mortgage. I was personally excoriated for this action in especially bitter hearings before a House consumer affairs panel and also in the New York Times where I was referred to as "the Rasputin of the consumer movement." (And this was despite the fact that the RRM contained more consumer safeguards than the ARM, which came later.)

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at the same time that

* California and other states adopted a liberal chartering policy which opened the floodgates for the entry of individuals of dubious character, many of whom eventually engaged in fraudulent behavior;

at the same time that

* the OPEC cartel broke up, paving the way for a glut in world oil supplies, a plunge in world oil prices, unemployment and depression in the southwest, and a severe drop in real estate prices. (On a regional basis, the real estate devaluation and loss experience in some Texas cities was more severe than the Great Depression);

at the same time that

* old-line thrifts--already in a weakened capital position and searching desperately for higher earnings--were given new powers and new investment opportunities without adequate experience to handle them;

at the same time that

* the regulators of the thrift business--though struggling mightily to keep the system alive in the hopes of better days ahead--were understaffed, underpaid, undertrained, and just plain overwhelmed. In part, this was because lawmakers and the Office of Management and Budget failed to recognize the implicit dangers inherent in deregulation and because the pleas of regulators for more funds and more staff fell on deaf ears.*

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* As early as 1978, my predecessor, Robert McKinney, sounded the alarm before the House Appropriations Committee and was rebuffed in his request for additional examiners. His request was very specific: "... additional staff is imperative... if... OES is to continue to meet the workload requirements imposed by new legislation and activities, adequately examine the operations of the insured institutions and their service corporation affiliates, reduce the examination cycle to a more prudent level, perform the requisite special examinations in those instances where the insured institution is not responsive to supervisory efforts, and more closely monitor and analyze industry financial and operating data between examinations to identify developing problems at an earlier date..." (Source: Federal Home Loan Bank Board Justification for 1979 Estimates, Prepared for The Committee on Appropriations, House of Representatives, 1978.)

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So Whose Fault Was It?

Given the occurrence of this unfortunate confluence of adverse circumstances over a relatively short period of time, is it really any wonder that the thrift insurance fund is where it is today?

* Was it a failure of public policy making? You bet it was.
* Was it a failure of the Carter/Reagan Administrations to plan, step-by-step, the process that deregulation would take? You bet it was.
* Was it the failure of regulators and legislators who gave too much, too fast? You bet it was.
* Was it a failure of examinations and supervision to rein in the fast-buck artists and the failure of OMB to give them additional staff to do so? You bet it was.
* Was it a failure not to have stopped California and certain other states from opening the floodgates in terms of new powers and new charters because of the fear of offending the "States' Righters?" You bet it was.
* Was it the failure of some of the old-line thrift managers to deal wisely with the new powers? You bet it was.

This Raises the Multi-Billion Dollar Question: "Who Pays the Bill?"

Obviously, there is a shared responsibility here. One could debate endlessly as to precisely how to sort out the liability and where to pin the blame. But I'm not sure it matters a whole lot because no matter what amount is assessed to the thrift industry for its share of the blame, it is not sensible to extract more from the healthy part of the business than it can afford.* Otherwise, in the process of "fixing the problem," the two thirds or more of the business that is now healthy will be destroyed. That would certainly be self-defeating and poor public policy.

So far, the thrift business alone has been paying the bill. If attempts are made to bleed them to death as the tab mounts, they will not remain as viable entities and the industry will not survive. (The Bank Board has projected that the cost of the insurance premiums levied on thrifts, if the special assessment is continued through 1998, will total more in dollars than their collective GAAP capital as of March 31,

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* Besides, the well-managed thrifts can legitimately argue that they are victims, not perpetrators; and therefore any extraction from them should be minimal.

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1988.) In fact, if thrifts are pushed to the wall by heavy assessments in the future-- assessments that cut their earnings by, say, 10% or 20% or 50% or more, and thus severely erode their capital--they may follow the natural economic law of trying to earn back the lost money and take risky chances, which again would be self-defeating for themselves and for any government insurance fund. (What we run up against here is the "law of diminishing returns," and, like the law of gravity, no one has found a way to repeal it.)

Now, this question of who pays--and the equity or fairness inherent in the question--is at the heart of the second part of this assignment: that is, to answer the question: "How do we solve the problem?".

<u>Where Do We Go From Here</u>?

Unfortunately, most of the policy makers currently on the job have adopted positions which make it very difficult for solutions to be found. For instance, many of them have been saying:

* No Federal funds should be expended;
* Enough cash flow is available to handle daily needs from assessments, investment income from the portfolio, issuance of FSLIC notes, and recovery from receivership assets; and
* Capital is adequate over time from these same sources to cover future needs. (By now, it should be obvious to all that, although a range may be estimated, no one knows the real size of the problem with any certainty. This should come as no surprise given our volatile economy and our dynamic real estate cycles.)

For a solution to be found, there must be a change in the players--a change that in fact will occur in 1989 regardless of who is elected President. (This is my "Theory of the Confluence of New People.") Then, a new stage will be set and important new actors who we hope are realistic will be on that stage:

* There will be a <u>new 101st Congress</u>;
* There will be a <u>new administration</u> in the White House, Republican or Democratic;
* There will likely be a <u>new Treasury Department official</u> who will head up policy-making for banks and thrifts;
* There will be a <u>new chairman of the Senate Banking Committee</u> (and I will dearly miss the retiring one);

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* There may or may not be a new chairman of the House Banking Committee, depending on the vagaries of the election process;
* There will likely be some new regulators heading up the relevant banking and thrift agencies.

My "Theory of the Confluence of New People" is not meant as a negative statement about the capacity of the incumbents. Rather, it is a statement about the positions to which they have become wedded in an election year and the need for new people, with fresh viewpoints, to get the process unstuck. Given these new players, the question is, "How do they fashion a solution?"

A Blue-Ribbon Commission

I urge Congress to create a Special Blue Ribbon Commission to consider the restructuring of the depository institution system in America. I must emphasize that I am talking both about the FSLIC and the FDIC because it strikes me that the FDIC and their commercial banks are not in the clear on any of this either. I refer, in particular, to the problems of commercial bank lending in the "oil patch" and the unrecognized losses from LDC loans made by the larger banks that have not been universally recognized as yet by policy makers. I also hasten to point out that I am talking about the restructuring of the depository institution system in America, not the recapitalization of the insurance funds. A recapitalization or bailout of the insurance funds is merely a half measure. A restructuring of the depository institution system is a far broader charge. It is not a bailout, and it is precisely what is required, especially if one looks at the last 50 years of banking history in America, at the structural flaws in the creation of the thrift side of that business, and at the landmark deregulation that changed the world for depository institutions in America once and for all. To think of just recapitalization, instead of restructuring, would be the height of myopic policy-making.

I note with satisfaction that different bills have already been introduced in Congress to form such a Commission. My sense is that the Commission should number approximately 15 to 20 people consisting of:

* Senators and Congressmen from both parties
* Appointees from the new Administration
* Outside experts selected by Congress and the new Administration
* Executives from the thrift and banking business
* Regulators as non-voting advisors

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The Commission should be given:

- An independent staff (not Capitol Hill staff; they're too busy for full-time duty);
- Appropriations to pay for staff, travel, and minimum consulting and legislative drafting; and
- A 90-day mandate right after the first of the year (but with no public hearings) to produce a package that is ready to be put into statutory format immediately.

The Next Steps in the Process

Once the 90 days are up, the process is simple: The Commission would report its findings in the spring of 1989. Congressional hearings would begin, having been scheduled well in advance (with lawmakers' calendars cleared months before) for May and June. This would be followed by passage of the new legislation in both houses, followed by a conference in July, and then enactment by the magic date of August 10, 1989, the date of the expiration of the extended moratorium--a deadline Congress has imposed on itself. The schedule is tight, but I think it can be done.

It would be premature for me to make a judgement about what should be in the package itself. But I think I can suggest what some of the elements of the package might be that the Commission should study. Here are some of them:

Some Issues to Be Considered:

- a consideration of how much and how long a special assessment on the healthy part of the industry can be endured, without reaching the "point of diminishing returns"
- the amount of capital available in the FHLB system not previously used but committed for FICO bonding
- the incremental value in the appreciation of FHLMC stock when it is permitted to be sold beyond the thrift business
- the impact of tapping Federal Reserve Board funds from the interest that could be paid on sterile reserves
- the creation of a "HOLC/RFC" agency of a truly federal character (not the Federal Asset Disposition Association) for the holding and orderly disposition of troubled assets
- the dollars that are currently available in both the FDIC and the FSLIC funds and their short-term anticipated cash flows
- the true value of assets in various receiverships and the liklihood of their short-term availability
- the possible inclusion of QTL-qualified commercial banks as members of the FHLB system

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- the granting of variable premium authority based on factors such as liquidity, capital reserves, balance sheet riskiness, and current investment activities
- the steps necessary to bring additional capital into the business, including, among others, more efficient administrative processing of proposals, interstate branching rights, and charter powers
- the possibility of finding ways to equalize the advantage that mutual funds and, particularly, government secondary market agencies enjoy in providing credit at much lower cost than thrifts
- the ultimate cost of returning to the days before the 1986 Tax Reform Act, which converted thrifts from being low margin to high margin taxpayers
- the feasibility of granting favorable tax treatment for distressed real estate owned by depository institutions

and, of course, most important

- the amount of federal funds to make up the difference between all of the above and what's needed, and how these federal funds should be employed to minimize the impact on the budget

A Structure for the Commission's Work

No doubt the Commission will want to place all of these and other issues under three or more topical headings. One heading is sure to be "The Source of Money to Solve the FSLIC Problem." This will require totaling all of the potential sources of funds which can reasonably and fairly be used, and adding to that sum the amount of federal dollars necessary to deal with the problem.

A second heading will likely be "The Use of the Money." Under this heading, the Commission will have to consider such thorny issues as how much of the money to expend up front and how much to spend over time, and what mechanisms to use to reduce the impact on the federal deficit.

A third probable heading is "The Structure of the New Depository System." This will require finding answers to such key questions as: Should there be two separate insurance funds? Should there be two separate sets of regulators? Should there be two separate systems for state and federal charters? Should deposit insurance premiums be structured differently than they are now?

Certainly a fourth heading will be "Steps to Insure that the FSLIC Problem Will Not Reoccur." In this case, among other considerations, the Commission will need to explore whether the dramatic improvement over the past few

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years in the quality and quantity of examiners and supervisors provides adequate protection for the new federal dollars.

Although there may not be a specific heading to cover it, the Commission will surely discuss whether a separate and distinct thrift business should be perpetuated into the future. The very question is a reflection of current Congressional frustration: The size of the problem has been underestimated nearly from the beginning; Congress has concluded it was misled as to the ease with which it could be handled; and as the statistics got worse and the sensational news stories proliferated, Congress slowly has come to the determination that it might be dealing with a problem which would not yield to a simple resolution and which was far more vexing than anyone originally had contemplated. Compounding the frustration is the fact that the effects of deregulation in other similarly deregulated industries--trucking, railroads, airlines, stock brokerage, and telecommunications--were more easily understood and predictable.

Frustrations aside, my opinion is that the Commission will conclude that America continues to need a thrift business. Housing depends on it, and democracy depends on our citizens' potential to realize "The American Dream." This is another way of saying that there is an unwritten compact between our government and its people for decent, affordable housing for everyone.

Dozens of other nations have come to a similar conclusion about the need for a specialized system of housing finance-- private, public, or quasi-public to insure that housing is made available to its citizens.* For instance:

- Great Britian has its Building Societies
- Germany has its Bausparkassen, Mortgage Banks and Savings Banks
- Canada has its Trust Companies
- France has its Credit Foncier
- Italy has its Mortgage Credit Banks
- Spain has its Banco Hipotecario de Espana and Confederated Savings Banks

The Commission will have to acknowledge that these nations, and America since the 1930s, have recognized the impossibility of subjecting the individual home buyer/

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* For a complete list, see: Boleat, Mark; National Housing Finance Systems: A Comparative Study. London: The International Union of Building Societies and Savings Associations, 1985.

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borrower to competition from other, larger and more powerful entities for the available flow of credit dollars. Just as in the United States, these nations had to create a separate system of savings institutions devoted solely to mortgage finance.

Conclusion

Between now and the time the Commission goes to work, it is vital that this Congress ensure that nothing is done to preempt the next Congress' ability to put this type of package together. I have in mind the possible over-obligation of the FSLIC by its issuance of FSLIC notes and the threat of draining off the capital of the FHLB system by the non-payment of those notes. At the very least, legislation could make clear that the FSLIC notes would not be abrogated in the event of the merger or liquidation of the funds.

I believe that the 100th Congress has the opportunity to set the stage for the 101st Congress, and I commend you for these hearings. I hope from these deliberations that the necessary steps can be taken to ensure that a Commission goes to work in January, 1989 with a proper charge as to what its mission will be. With all due respect, I believe that making sure this happens is the highest and best use of your time between now and then. And I must tell you that I remain optimistic about this nation's ability to solve these problems and to position both our thrifts and our commercial banks to compete in a world of deregulated banking, commerce, and "economical home finance."