TESTIMONY OF

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BEFORE THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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Thank you, Mr. Chairman, for the opportunity to address with this Committee the factors that have had a bearing on the operations and financial health of the thrift industry and the regulatory actions that have been taken in response. In that respect, with your approval, I would like to submit my full statement for the record. I would also like to acknowledge the assistance of Thomas P. Vartanian who collaborated with me in the drafting of this statement.

HISTORY AND BACKGROUND OF THE THRIFT PROBLEMS

The modern thrift industry was born with the enactment of three major pieces of legislation:

. The Federal Home Loan Bank Act of 1932

. The Home Owner Loan Act of 1933

. The National Housing Act of 1934

These pieces of legislation set the framework for a system of federally and state chartered institutions whose deposits were effectively insured by the federal government and which were regulated by state and federal authorities. The system generally worked well for an inordinately long period of time from the mid 1930s until the late 1970's. The success was based on the structural environment in which the institutions were operating. This period was characterized by relatively local markets, strong monopolistic, or oligopolistic positions by insured thrift institutions, and a lack of ready substitutes for insured deposits on the part of the consumer.

The first destabilization of the system appeared in the 1965-1966 era when increasing interest rates caused a fear of disintermediation from local financial institutions into major money center banks. Regulatory authorities responded by imposing broadly based interest rate limitations on depository institutions in the form of Regulation Q. Because of the historic precedence of thrifts paying higher rates than commercial banks, thrifts were granted a one-half of one percent advantage in the rates which could be paid on deposits. The imposition of Regulation Q seemed to temporarily solve the problems of depository institutions, but regulatory and Congressional authorities failed to fully appreciate the changing market conditions.

While the regulatory and legislative structure remained basically unchanged, the market place was changing at an ever increasing rate. Three factors were important in setting the stage for the later difficulties experienced by depository institutions: (1) the development of computers for financial institutions, (2) lower communications costs, and (3) the development of mass markets that became accessible through broadly distributed media channels.

The changing technology allowed for the development of close substitutes for the insured deposit. Money funds were put together which had invested in highly liquid riskless investments at market rates. These money funds sold shares which were clear substitutes for depository institutions' insured deposits and which were not subject to rate control. Communication and mass market development allowed outside competitors to enter previously protected local markets.

By the mid-1970s, financial institutions while experiencing relative stability in the cost of their funds, were subject to increasing volatility in the amounts of deposits available to them. Periods of rising interest rates caused the diversion of funds away from thrift institutions and commercial banks into the recently developed substitute instruments or directly into obligations of the United States Treasury or Agency securities.

Insured financial institutions in general were ill-equipped to deal with this changing marketplace. Previously because of the limited entry of insured institutions, and the relative isolation of individual marketplaces, financial institutions were able to earn relatively consistent profits with small probabilities of loss. Funds could be attained at prices which allowed profitable local investment and intermediation. Management of financial institutions tended to be process-oriented rather than innovative and technologically competent. Institutions were able to invest in relatively illiquid assets of long maturities, knowing that the movement in costs of their liabilities would be glacial, and that they were insulated from the competitive influences of outside operators.

The stage was set for immense operating problems if and when interest rate ceilings were removed. Supervision of financial institutions during this period of time was accomplished generally through moral suasion. Financial institution charters were of great value, because of the attractive monopoly rights to raise funds having the backing of the United States government at controlled costs.

The most sweeping deregulation and that for which the depository institutions proved to be least prepared was the deregulation of interest rates which occurred in the 1980 Depository Institutions Deregulation and Monetary Control Act. This legislation contained provisions which phased out deposit rate ceilings, authorized interest-bearing checking accounts for individuals and broadened the investment authority of thrift institutions into the areas of commercial loans, commercial paper, and corporate debt.

During the crucial period of deregulation and in fact continuing into the present time regulators, the public and management have operated on grossly inadequate financial information. Historical cost accounting allows financial institutions to carry long term assets at amortized original cost, providing little or no insight into the actual financial condition of the institution. From the late 1970s, into 1982, fully guaranteed government national mortgage association securities went from a market price of approximately par to a price level in the mid-fifties. An institution holding these securities or other long term governments or mortgage securities experienced an actual economic loss of forty five percent of assets. While this immense economic erosion was occurring, there was no reporting of it under generally accepted accounting principles. Mortgages, government securities, and other long term assets of investment grade continued to be carried at original cost, even though their ability to generate income fell far short of the economic rents necessary to maintain deposits in thrift institutions and commercial banks. Thrift institutions were especially hard hit by this development, having a greater proportion of their assets in long-term maturities, and having little or no liabilities in an interest insensitive form, such as checking accounts. By 1982, the real capital positions of all thrift institutions had been completely eroded, and virtually all thrift institutions had large negative net worths when their assets and liabilities were valued at actual market rates.

By 1981, regulators and Congress were faced with a thrift industry which had negative real capital, was experiencing operating losses at an alarming rate, and which was substantially antiquated, both in its authorities, and management preparedness to deal with a new environment. No one at the time fully appreciated or foresaw the implications of essentially insolvent financial institutions having the right to issue unlimited amounts of debt in the name of the United States government. Federal regulators undertook an effort to modernize the thrift institution charter to make thrifts better able to compete and provide a basis for viability in the future. The linchpin of this reformation was the Garn-St Germain Act of 1982. This legislation which provided substantial modernization of the charter, and increased opportunity for managerial flexibility along with modest deregulation of assets, engendered a striking response from state regulators.

State regulators having responsibility for state chartered thrift institutions, found that these institutions were relatively disadvantaged in comparison with the modernized federal charter. As a result of legitimate request from state chartered institutions, and a need to maintain state-chartered institutions to support examination and oversight activities, state regulators went into a massive mode of state deregulation, especially in the states of California, Texas, and Florida. Institutions were given relatively carte-blanche authority in terms of the deployment of their assets. An explosive and untenable situation had been created with the federal government being responsible for losses engendered in these associations while having limited discretion in terms of controlling risk-taking on the part of state-chartered institutions. State regulators, having no financial consequences of their own deregulation, removed many traditional constraints on the deployment of assets within state-chartered institutions.

The combination of unlimited access to funds, broad powers for state chartered institutions, the dearth of real capital, and regional depression led to the asset problems of the mid and late 1980s. The Pratt administration took place during the crisis period of early 1981 to early 1983.

The Pratt Administration

I was appointed Chairman of the Federal Home Loan Bank Board, the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), by President Reagan and confirmed by the Senate in April 1981.

The Pratt administration of the Federal Home Loan Bank Board, included the late Board member Andrew DePriete, Board member Jaime Jackson and Chairman Richard T. Pratt. The Bank Board was supported by an outstanding senior staff consisting of John S. Buchanan, Chief of Staff, Thomas P. Vartanian, General Counsel, D. James Croft, Head of Examination and Supervision and Charlotte Chamberlain, Chief Economist, Malcom Draper, Assistant to the Chairman, Stephen P. Terry, director of District Banks, and H. Brent Beesley, Director of the Federal Savings and Loan Insurance Corporation.

In 1981, the savings and loan industry was in a life threatening crisis. The cumulative effects of past economic accounting and regulatory circumstances placed the industry in a situation where even the strongest thrift institutions faced extinction. In 1981, all FSLIC insured thrift institutions experienced losses approximately equal to 70 basis points on their assets. During 1982, the rate of losses was occurring at approximately 60 basis points. This was an unprecedented cataclysm within the thrift industry and regulators and Congress had no previous experience with problems of this magnitude and severity. In monitoring the condition of the thrift industry, the Bank Board was aware that even the largest, most well capitalized, and best operated thrifts, were within 2 years of insolvency if the present circumstances were to continue. The Bank Board believed that under these circumstances a strong proactive program to modernize the industry to assist it in dealing with its then present problems and to provide a basis for future viability was imperative.

At the very outset, the Bank Board identified a comprehensive strategy that focused on five central themes:

1. Modernization of interest rate risk management tools to allow institutions to improve asset yields and their ability to respond to market factors more rapidly;

2. Buying time for the economy to improve and for institutions to restructure their balance sheets;

3. Enhancement of the thrift charter through the authorization of new powers to attract capital investment whether by mutual to stock conversion, acquisition or other forms of investment;

4. Resolution of problem cases on the least cost and most orderly basis; and

5. Restructuring of the deposit insurance system to reflect the dynamics of deregulation and market risk.

I. Modernization of Interest Rate Risk Management Tools.

When I was appointed Chairman in 1981, federal savings and loan associations had not yet been authorized to make variable rate mortgages. They were, at that time unfortunately, locked into duration and interest rate mismatching, almost by regulation. Without pointing fingers, suffice it to say that there is enough blame to be shared by Congress, the regulators and the industry for that fact. Thus, although the savings industry's liability (deposit gathering) side had been largely deregulated and, correspondingly, its cost of funds raised, its asset (lending) side was still restricted to fixed-rate, lower yielding mortgage investments. That was a formula for disaster and one requiring the promptest response by our Bank Board.

Within the first 30 days, our Bank Board began responding by publishing proposed regulations which were subsequently adopted into final form with unprecedented speed. A complete list of all those regulations is attached to my statement, which will be submitted for the record. The Bank Board's first adjustable rate mortgage regulation was adopted in final form by the Bank Board on April 23, 1981. The modern-day era of adjustable rate mortgage financing had begun.

This historic regulation was followed by new regulatory statements in 1981 and 1982 providing, for the first time, new investment authorities and interest rate risk management tools regarding, among other things, (1) futures transactions, (2) graduated payment adjustable rate mortgages, (3) balloon payment and reverse annuity mortgage loans, (4) financial options trading and (4) the formal validation of mortgage due on sale clauses.

II. Buying Time for the Economy to Improve

The Bank Board in 1981 decided that it was important to soften the financial shock on thrift institutions of the diverse, unfriendly characteristics of the economy at that time. This would permit the better institutions the time to make the appropriate changes in course and adapt to the new financial environment. So, for example, the Bank Board, by regulations (1) broadened the securities that could count as regulatory net worth, (2) allowed the long term amortization of certain discounts and matched losses from the sales of assets, and (3) permitted the realization of the appraised market values on real estate held in portfolio in excess of the historical cost book value.

III. Enhancement of the Thrift Charter

From the first day of my tenure as Chairman, it was apparent that it would be important to maintain and improve the relative value of the thrift charter vis-a-vis the range of competitive charters available to potential acquirors of and investors in regulated financial depositories. The culmination of this effort on the Bank Board's part was the enactment into law on October 15, 1982, of the Garn-St Germain Depository Institutions Act of 1982, and its implementing regulations.

The Bank Board's implementing regulations issued over the following 120 days included new demand deposit and consumer, commercial and real estate lending authorities. Also provided by these new regulations were leasing, corporate debt and commercial paper investment authorities meant to provide institutions with a broader array of asset yield and risk diversification capabilities.

Similarly, we viewed the infusion of new capital into the thrift industry as a pre-eminent goal to complement and document the value of the thrift charter. In that respect, our Bank Board overhauled the mutual to stock conversion regulations to simplify and streamline the normal publicly underwritten conversion, and to expand the conversion process to include supervisory and modified supervisory alternatives, including holding company conversions. In that respect, recognizing the shift from mutuality to stock form throughout the thrift industry, the Bank Board in 1982, allowed for the very first time, mutual institutions to be acquired by stock savings institutions in the now standardized merger conversion process.

IV. <u>Resolution of Problem Cases on a Cost Effective Basis</u>

In 1981, the average present value cost to the FSLIC of resolving problem cases was only slightly less than the estimated cost of liquidation of such failing institutions. A reason for the high ratio of supervisory acquisition costs to liquidation costs was the absence of effective problem resolution case alternatives, both in terms of the variety of structures and the number of acquirors that the Bank Board had been accustomed to use. Accordingly, we determined that FSLIC costs could be reduced if the FSLIC's tools were geometrically expanded. Our Bank Board, therefore, took the following actions:

1. Supervisory cases were prioritized, organized and marketed on an interstate basis, dramatically increasing the number of healthy thrifts that could bid for every failing institution;

2. Commercial and industrial companies were actively solicited to join the bidding process;

3. Commercial banks were, for the first time, invited and encouraged to acquire failing thrift institutions; and

4. The range of alternative structures for supervisory acquisition were expanded to include mechanisms other than the typical purchase and

assumption transaction.

As a result, the FSLIC began to resolve an unprecedented number of failing institution cases while reducing the attendant cost from approximately 75% of the cost of liquidation to approximately 25%.

V. Restructuring of the Deposit Insurance System

It was clear to me in 1981 that the deregulation of the thrift industry which was inevitable and that would be necessary to keep the industry competitive, was on a collision course with the flat rate premium deposit insurance system that is still in existence today. In that respect, we realized that the deposit insurance system would have to be restructured so as to recognize the diversity and degree of risk that institutions would assume. The Congress addressed this issue and commissioned a study of the deposit insurance system by the FSLIC and the FDIC in Title VII of the Garn-St Germain Depository Institutions Act of 1982. Our Bank Board tried to further this effort and begin to implement the findings of those studies by proposing, in early 1983, a variable rate FSLIC insurance premium system that would begin to correlate institutions' capital strength and their interest rate, credit and management risk with the amount of premiums that they would have to pay for their deposit insurance. This proposed regulation was abandoned by the Bank Board after I left the agency.

In the four years that followed my tenure as Chairman, the Bank Board shifted its supervisory focus credit quality, as opposed to interest rate risk, began to become the preeminent problem in the industry. Thus, the Bank Board adopted more restrictive regulations regarding (1) the use of brokered deposits; (2) liability growth; (3) investments in real estate, equity securities and service corporations; and (4) required net worth. In that respect, one regulatory challenge the Bank Board had and still does, is the implementation of these new regulatory limitations in a manner that will control the risk and potential losses to the FSLIC from these activities without unnecessarily restricting the abilities of good managers in the industry to succeed. In other words, the temptation to engage in least common denominator regulation in a deregulated environment creates a continuing tension that requires a sensitive balancing so as not to extinguish legitimate and beneficial entrepreneurial instincts in the thrift industry.

The Scope of the Problem 1988

The thrift problem of 1988 has at least three major components.

1. The present financial problems stemming from past operations.
2. The present competitive problems of the thrifts
3. Problems in the present structure and regulation of the industry.

While the present financial problems must be solved a failure to address the competitive and structural problems will result in a condition of chronic financial debilitation punctuated by recurring crises.

The Scope of the Financial Problem

The thrift industry suffers from both chronic and acute financial problems. To a large extent the acute problems are associated with a deterioration of asset quality. In turn asset problems can further be traced to states having either or both inadequate addressing of financial risk or a depressed economy. The accompanying exhibit provides information for the first quarter ending March 31, 1988 for both solvent and insolvent thrifts. Solvent thrifts held approximately $1.13 trilllion of assets while insolvent thrifts held $181 billion of assets. It is clear that as a group GAAP insolvent thrifts can never return to profitability from their own operations. The average insolvent thrift has only $.7610 of interest earning assets per $1.00 of liabilities. Assuming a cost of liabilities of 8% the average insolvent thrift would need a spread on its assets of 251 basis points simply to compensate for non-performing assets. While the net interest margin of GAAP solvent thrifts fell slightly short of the amount necessary to cover operating expenses GAAP insolvent thrifts fell 221 basis points short of the net interest margin necessary to cover operating expenses.

No one knows the amount of funds that will be necessary to solve the present financial problems. Probably the Bank Board is in the best position to make such estimates. The cost of solving present problems also depends on the course of the national economy, as well as the regional economy involved. Nevertheless some approaches to estimating the problem can be pursued.

The negative tangible net worth of insolvent thrifts was minus $22.7 billion at the end of 1987. This number might be taken as an absolute minimum amount necessary to solve present problems. I believe this number is too low for two reasons. First I do not believe that failures will be limited to presently insolvent thrifts. For example the average GAAP solvent Texas thrift has interest earning assets equal to 85% of its liabilities. It is unlikely that sufficient spreads are available to cover this shortfall. A second reason that I believe this number to underestimate the problem is that there are costs associated with problem resolution which are over and above the shortfall in tangible net worth. As a guesstimate I would add another 50% to the negative tangible net worth for problem thrifts that are GAAP solvent and perhaps another $10 billion to reflect the understatement of costs incorporated in negative tangible net worth. The sum of these figures is $44.01 billion. The level of negative income can also be used to attempt to estimate the cost of resolving the problem. The negative adjusted net income for insolvent thrifts in 1987 was negative $10.26 billion. Abstracting from taxes and other adjustments it would require an additional $102.6 billion of assets earning 10% to restore these institutions to a break even status. If one looks only at the operating income of institutions and assumes that nonoperating losses will be greatly limited in the future the negative income is $4.50 billion. However operating losses of insolvent institutions have been increasing and in the 1st quarter of 1988 amounted to $1.56 billion, annualizing by multiplying by 4, provides an implied annual operating loss of $6.24 billion. It would require $62.4 billion of additional assets at 10% to provide sufficient earnings to offset these losses.

Many approaches can be taken to estimate the size of the problem and reasonable estimates will change over time. I believe the shortfall to be in the $50 to $75 billion dollar range. Assuming the problem to be $60 billion and assuming a financing cost of 9% expenditures of $15.43 billion per year over the next 5 years would be required or expenditures of $9.35 billion per year for the next ten years.

<u>Paying For the Solution to the Thrift Problem</u>

At least three suggestions have been made for paying for the thrift problem; these are: 1. Let the thrift industry pay its own costs; 2. Merge FSLIC and FDIC and apply standardized premiums to all insured institutions; 3. Have the Treasury provide general funds for the resolution of the problem. I will limit myself to addressing the first proposal which is self funding of the problem by the healthy portion of the industry.

The healthy portion of the thrift industry cannot and should not be asked to solve the FSLIC's problems. The amount of funds necessary exceeds the total tangible net worth of $35 billion in healthy thrifts. If one assumes that the operating loss of insolvent thrifts will stabilize at a negative $6 billion per year this would require a yearly assessment of 72 basis points of insurance premium on the $832 billion of deposits held in GAAP solvent thrifts.

Competitive and Structural Problems

In addition to the acute problems associated with failed thrifts the industry is faced with a pervasive set of structural and competitive problems. Thrifts can be characterized as an industry searching for a business. The following table gives an indication of the earnings situation in thrifts.

	1984	1985	1986	1987	1988
All Thrifts					
Net Operating Income/ Assets	.10%	.35%	.43%	.29%	.05%
Adjusted Net Income/ Assets	.17%	.28%	0.07%	(0.51)%	(1.19)%
GAAP Solvent Thrifts					
Net Operating Income/ Assets	.18%	.59%	.93%	.81%	.50%
Adjusted Net Income/ Assets	.28%	.66%	.79%	.46%	.27%

When the figures for all thrifts are examined it is clear that the industry is struggling, having achieved marginal net operating income in the last several years and actually experiencing net losses in total. Even when only GAAP solvent thrifts are examined neither the absolute level or trend of the numbers is reassuring.

There appear to be several causes for the inadequate performance of the thrift industry, these are: 1. Eroding spreads between the thrifts traditional assets and the risk free returns earned on treasuries. 2. Increases in the cost of funds relative to treasury rates. 3. Escalating operating costs. 4. Increasing volatilities for both durations and yields on thrift assets and liabilities.

Chart 1 shows the spread between current coupon GNMA securities and the 10 year treasury rate. While the chart would indicate that spreads have remained relatively consistent I believe that other factors have effectively narrowed spreads. First the increasing capability of federal agencies and, perhaps to some extent, Wall Street has changed the balance between non-securitizable and securitizable loan production. As a greater percent of the industry's production has become securitizable the thrifts ability to earn a spread income has decreased. Second, it is possible that as interest rate volatility has increased the risk adjusted spread between mortgages and treasuries has decreased.

Chart 2 shows the trend in general and operating expenses of thrifts since 1971. The cost escalation since 1980 is substantial and in recent years G & A costs of associations have approximately doubled. The reason for cost increases has likely been a combination of the costs associated with offering new, and sometimes more costly, products and services and the costs of defending market share in a more deregulated and competitive market.

Chart 3 shows the relationship between the cost of savings deposits and the 3 month treasury bill rate. Since 1982 the cost of deposits has exceeded the 3 month treasury rate by an average of 107 basis points. The riskiest, or most aggressive, or weakest thrifts set the rates at the margin. The consumer is the lender of last resort. Because of federal insurance on deposits the consumer is driven to intelligently choose the highest paying thrift regardless of the prudence with which his funds will be deployed by the institution.

In short the thrift earned a large part of its income from assuming credit, liquidity, and interest rate risk in mortgage product. The increasing pervasiveness of federal agencies has removed much of the opportunity to earn returns from credit risk. The Agencies and Wall Street have liquified mortgage products to such an extent that the liquidity provided by thrifts is of less value. Interest rate risks have increased but the costs of thrifts bearing interest rate risks may have increased more rapidly than the revenues.

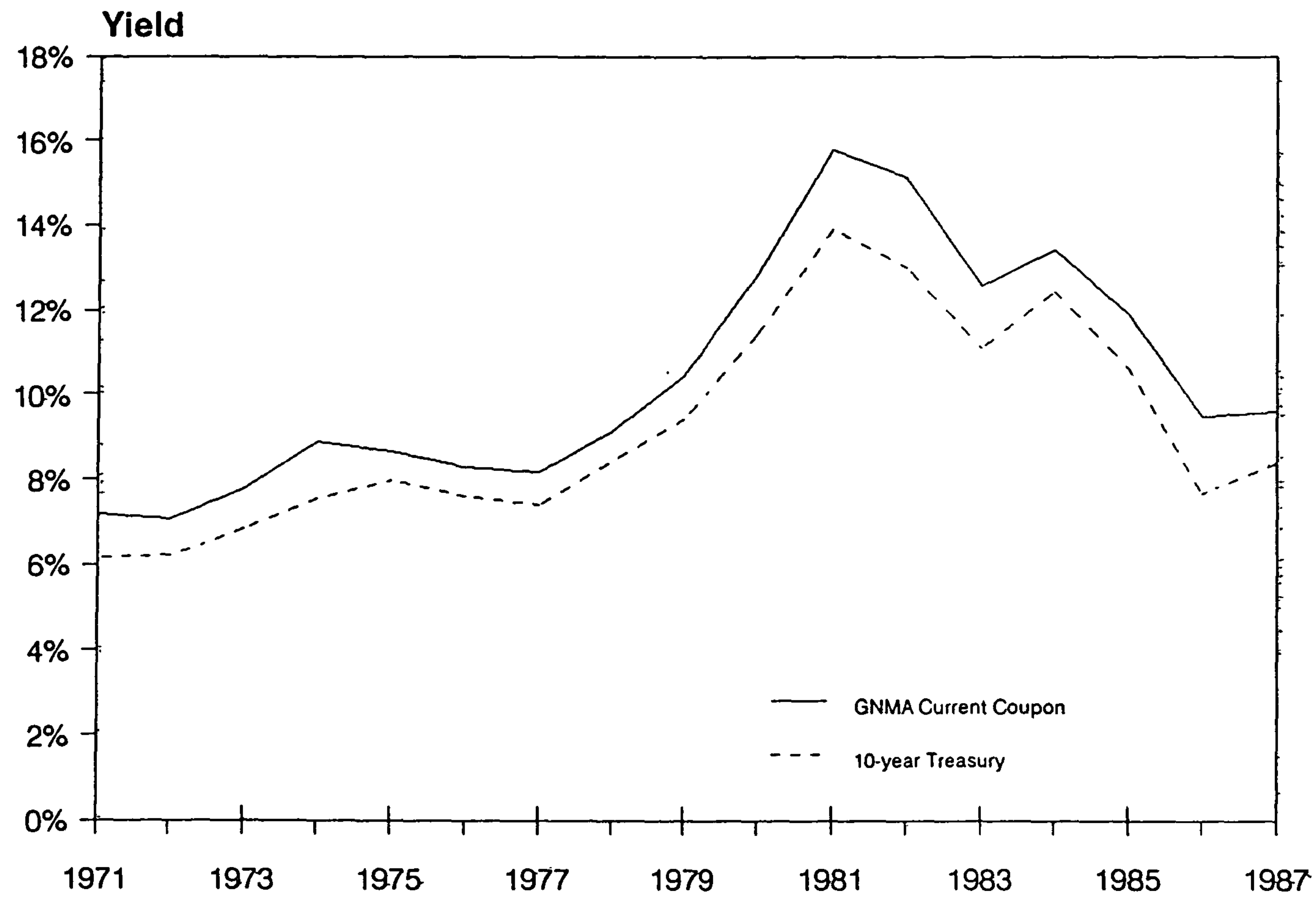
Other Structural Issues

Several other factors are to one extent or another exacerbating current problems.

1. The present accounting system does not provide adequate information for managerial or regulatory decision making.
2. All regulations which affect risk bearing should be under the purview of the FSLIC. State regulation which can affect FSLIC costs is anachronistic.
3. Insurance cost is based on insured deposits whereas risk to FSLIC is created by assets.
4. Using FSLIC insured funds to support secured borrowings increases risk to the FSLIC.
5. Government supported growth options for troubled thrifts in the form of risk controlled arbitrages at weak thrifts further threaten the thrift system through causing spread erosion.

Chart 1

GNMA Current Coupon vs. 10-year Treasury



Economic Report of the President, February 1988

Data Resources Inc.

Chart 2

Operating Expenses of FSLIC-Insured Savings Institutions Divided by the Total Assets of All Insured Savings Intitutions

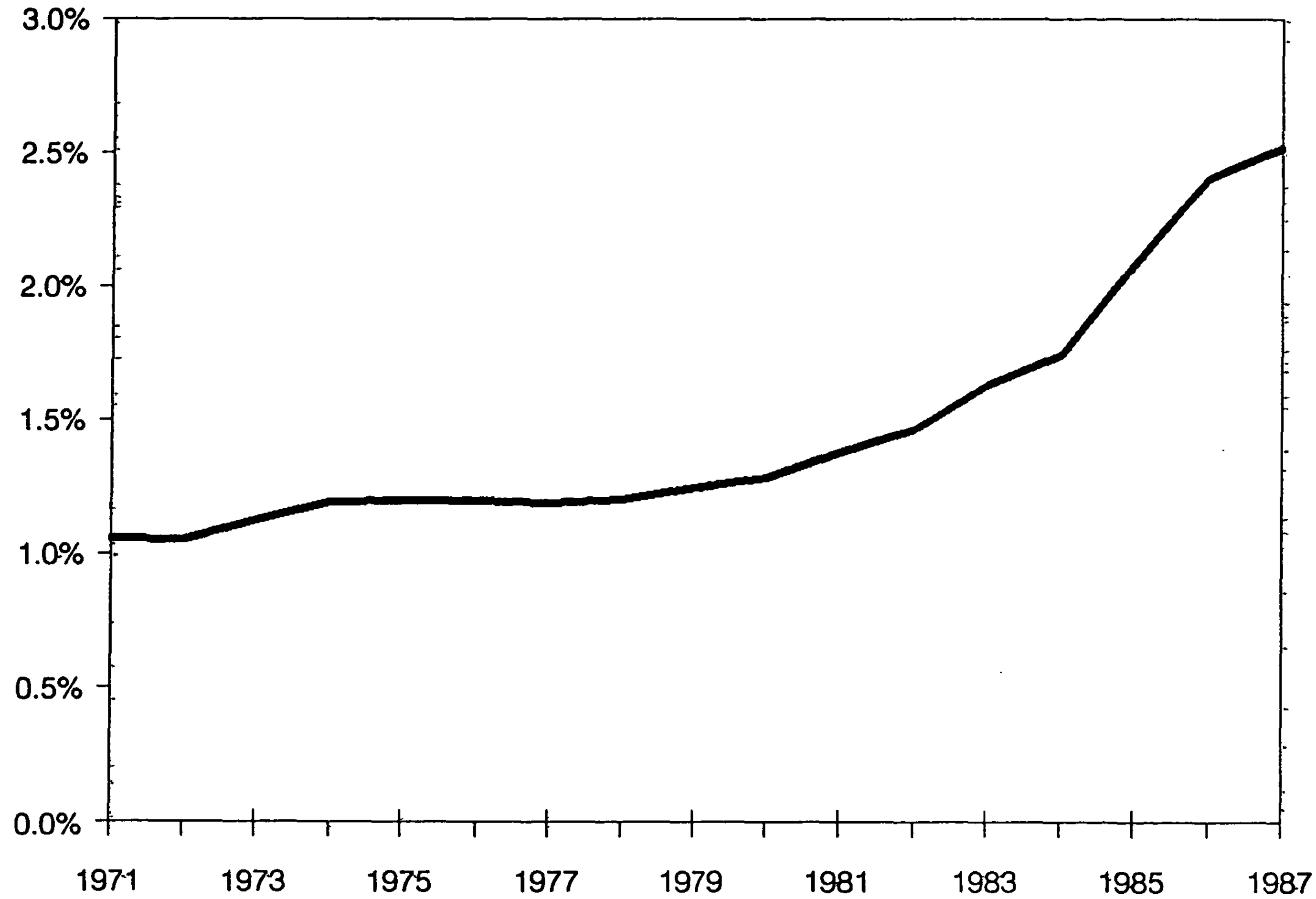


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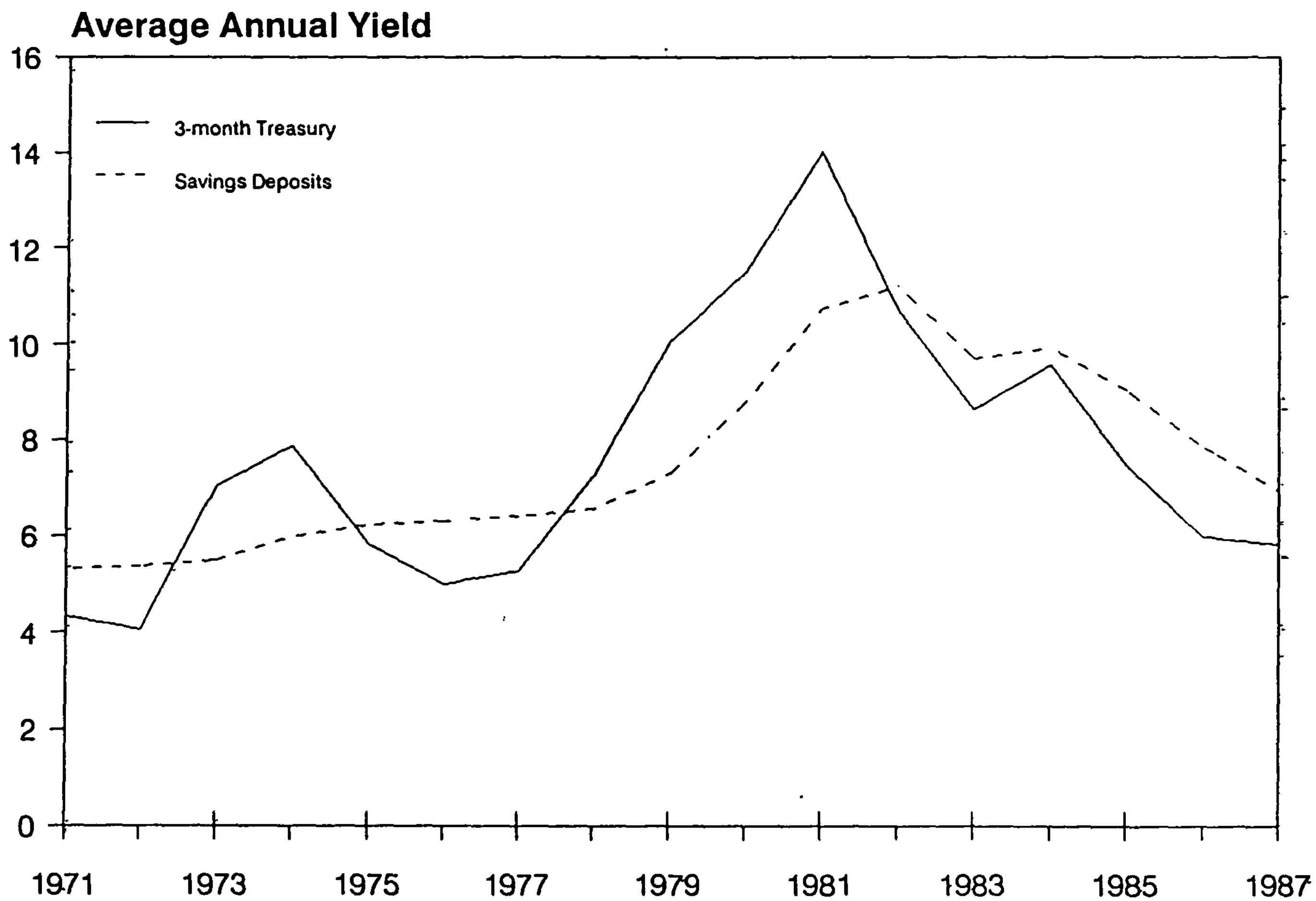
Chart 3

Savings Deposits in FSLIC- Insured Savings Institutions vs. 3-month Treasury



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