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Statement of

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before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

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Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to testify on the current condition of the savings and loan industry. I have studied the industry extensively since 1980, when I was a senior staff member in the economic studies program of the Brookings Institution. I am currently manager of the mortgage research department of the First Boston Corporation, where my current responsibilities include evaluating the impact of the savings and loan situation on the secondary mortgage market, advising thrift institutions on asset-liability management, and analyzing investment opportunities.

At the Committee's request, I am appearing today as an industry expert. I will express my personal views only as I am not appearing on behalf of First Boston.

My testimony will be in three parts, corresponding to three of the questions that the Chairman has posed to the witnesses: How should the cost of dealing with the problem of the savings and loan industry be financed? What is the need for, and the viability of, a separately regulated thrift industry? What regulatory and structural changes are necessary to ensure that the problem does not recur?

Financing the Costs

It is my opinion that:

1. *The largest share of the costs should be paid out of general revenues. Theoretically, these payments could be accounted for by restating financial results for the years in which these liabilities were incurred.*

2. *Deposit insurance premiums should be equalized for banks and thrifts.*

3. *Specific taxes on the thrift industry would be counterproductive and should be avoided.*

4. *Involving government sponsored enterprises in the thrift industry recapitalization would yield a relatively small amount of resources, but would reduce efficiency and raise costs in housing finance generally, and should therefore be avoided.*

No single cause was responsible for the reduced earnings and widespread failures of thrifts during the 1980s. The relative contributions of the various factors are difficult to distinguish, and may vary substantially from case to case. There are two parts to this issue.

First, why did large numbers of thrifts lose money and ultimately fail? This is a legitimate matter of concern for the individual institutions involved and for the thrift industry as a whole.

Second, why have these thrift losses and failures imposed high direct and indirect costs on healthy thrifts, government agencies, the banking system, and the economy? I believe this issue should be the focus of public sector involvement.

The failures could have occurred without imposing a burden on other firms or sectors of the economy. The crisis has so far spawned substantial indirect costs and the likely prospect of a large direct cost. Failing thrifts have bid up deposit costs and impaired the health of solvent banks and thrifts. FSLIC insurance premiums were raised 150 percent. That the thrifts' problems did create spillover effects should be the main concern for public policy. Such costs raise interest rates, reduce investment, and therefore impair future economic growth.

Individual thrift institutions may have contributed to their own demise, but were not responsible for the growth of the FSLIC's liabilities beyond its resources. Contributing causes to the public crisis were the depletion of the industry's net worth in the early 1980s, the existence of federal deposit insurance, inadequate examination and supervision, and a lack of coordination between state and federal authorities. Most important, however, was the federal regulators' inability or unwillingness to close institutions prior to insolvency.

To the extent possible, the government should seek restitution from those thrift owners responsible for the risk-taking and the costly failures. There were also failings in the regulatory process, so part of the cost rightly should be paid by the government. These government liabilities have been incurred over the past decade, and thus should not be consided "new" expenditures.

Furthermore, as a practical matter, there will have to be federal contributions, regardless of whether the ultimate cost turns out to be $50 billion or $100 billion or more. While depository institutions derive substantial benefits from the deposit insurance system, additional insurance premiums on the thrift industry might be counterproductive. The current disparity between bank and thrift premiums represents a serious competitive inequity, and this should be addressed. But higher premiums overall, even if levied equally on banks and thrifts, might raise the incidence and cost of financial institution failures by raising operating expenses and by encouraging disintermediation.

Seeking additional resources through the Financing Corporation or the Federal Home Loan Bank System, without Congress providing the agency with additional funds or credit support, would similarly be inappropriate. To do so would depress the value of outstanding agency debt and raise financing costs, which ultimately are paid by the thrift industry. The repercussions in the capital markets could have a deleterious effect on the cost of housing finance to homebuyers.

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Separate Thrift Industry

It is my opinion that:

Thrifts will continue to play a major role in the provision of housing finance. Thrifts cannot be viable if compelled to hold home mortgage loans as their principal assets, because developments in the secondary market have lowered most mortgage rates below thrifts' costs. Regulation of thrifts should be rationalized to permit, but not require, thrifts to invest in home mortgage loans.

Thrift institutions engage in a variety of mortgage-related activities. They originate and service whole loans, and they trade and hold both whole loans and mortgage related securities. Mortgage-related revenues come from origination and servicing fees, coupon interest, gains on sales, and miscellaneous sources such as prepayment penalties and escrow accounts. The legal definition of a thrift, however, is quite narrow: an institution that, once chartered as a savings institution, holds a specified percentage of total assets in mortgages and/or mortgage-backed securities.

Of course, if these regulations were removed, there would be little substantive distinction between thrifts and banks. That event, some would say, is tantamount to abolishing the thrift industry and would result in flooding of the market with the $1 trillion in mortgages held in thrift portfolios. However, the thrift industry, as a statutory definition, must be distinguished from the 3,300 individual thrift institutions that comprise it. The firms themselves, and their mortgage assets, would remain intact if their industry definition were changed. Many, if not most, would choose to continue their specialization in mortgage-related activities, but it would be specialization by choice rather than by regulation.

Substantial diversification away from mortgages has already taken place. Among the many activities engaged in by thrifts, traditional single-family mortgage lending (portfolio investment) is the only activity to have a clear decline since the beginning of the 1980s. Mortgage banking activity has increased, as evidenced by an increase in the ratio of loans serviced to loans held from 3% in 1980 to 24% in 1988. Some thrifts have shifted their asset mix away from mortgage loans toward investment securities (other than mortgage-backed securities). Such assets have contributed a greater share of income in recent years. The share of assets devoted to real estate development has increased nearly 50 percent since 1980. Thrifts are also beginning to offer a full range of nonmortgage loans, paralleling the services provided by commercial banks. The share of nonmortgage loan assets has increased substantially, as the revenue share from those sources has doubled.

The modern thrift industry was established to provide a source of funds for housing that would be both deep and reliable. Since more than half of all mortgages are now held by nonthrifts, the issue of depth has become moot and reliability has become the test of the thrift industry's contribution. Because they must hold a certain percentage of their assets in mortgages and because of the advantages conferred by their thrift status, it is said, thrifts will supply funds to the market when other participants will not.

Analysis suggests that thrifts may actually be less reliable lenders than market participants who have no particular advantages or incentives in holding mortgage loans. It appears that the constraints on thrift operations offset the motivation to increase lending when funding is tight.

In a recent paper, a colleague and I examined thrifts' share of mortgage originations over the business cycle. Mortgage funds become more difficult to obtain when interest rates are high, so if thrifts have an advantage one should observe an increase in thrifts' market share when interest rates rise. The opposite seems to occur.

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From January 1973 through September 1979 (immediately prior to the shift in Federal Reserve monetary policy), mortgage rates averaged less than 10%. During this period, savings and loan associations accounted for 50 percent of the 1-4 family mortgage originations by dollar amount. S&Ls also purchased slightly more loans than they sold, raising their net share of acquisitions to 51 percent of the total.

From October 1979 through June 1982, mortgage rates averaged nearly 15%. Gross originations by S&Ls declined to 42 percent of the total. Furthermore, sales substantially exceeded purchases, lowering the net acquisition share to 35 percent.

Since July 1982, mortgage rates have trended irregularly lower. Thrifts' share of gross originations has not recovered, however, remaining near 40 percent. Net sales have driven net acquisition down to about 26 percent of the total.

In recent years, mortgage lending has been intermittently profitable for thrift institutions. Traditionally, thrifts funded higher yielding long-term mortgage assets with lower yielding short-term funds, paying expenses and a return on capital with the yield spread. Despite a recent narrowing of the maturity gap between assets and liabilities, the effective duration of thrift assets is still longer than that of thrift liabilities. Thrifts earn a positive spread from portfolio loans when interest rates decline or remain stable. When interest rates rise sharply, the typical thrift loses money. So thrift performance, even in recent years, is largely dependent on whether interest rates have risen or fallen. Historical performance measures are therefore not a good indication of the profitability of portfolio lending in general.

Expected profitability of mortgages is further complicated by their complex cash flows. Because mortgages amortize and pay interest periodically, investors are exposed to substantial reinvestment risk. If market interest rates decline, mortgages may be refinanced, depriving lenders of anticipated interest income. As a result, the yield (internal rate of return) of a mortgage, computed at the time it is acquired, overstates its expected total rate of return.

New techniques for the valuation of the complex options embedded in residential mortgages now make it possible to compute ex ante expectations of portfolio profitability. Through these methods, I found that, for most of the 1982-88 period, thrifts could not anticipate profitable investment in conforming fixed-rate mortgages.

Large-scale investment in adjustable rate mortgages has occurred too recently to perform a similar analysis for ARMs. Over the last year adjustable rate mortgages have offered higher risk-adjusted returns than comparable fixed-rate mortgages. Even higher expected returns are available on less liquid instruments such as mortgage strips, collateralized mortgage obligations, nonconforming mortgages, and non-agency pass-through securities. These investments have been sources of profits in the past, but cannot be expected to remain profitable as those markets become more liquid.

In recent years, thrifts could expect barely to break even on their investment in mortgages. It is not a paradox, however, to say that the mortgage lending business, viewed in its entirety, may be profitable. Mortgage lending entails many steps, of which holding the pure loan in portfolio is only one. Thrifts have profited from the non-investment aspects of the mortgage business.

The development of a secondary mortgage market and a variety of mortgage-related securities has removed many of the obstacles faced by investors who wished to invest in mortgages. Thrifts no longer have a comparative advantage in holding "unfamiliar" and "illiquid" long-term amortizing mortgages, and may even be at a disadvantage because of their portfolio restrictions. But mortgage securities have not greatly affected the other attributes of mortgages, and it is in these areas that thrifts continue to excel.

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Thrifts have profited from mortgages as the result of unexpectedly favorable interest rate moves, superior underwriting abilities, efficiencies in loan servicing, fees collected for loan origination, and intermediation between more and less liquid instruments. They may also have benefited from below-market liability costs, marketing and cross-selling advantages, and imperfect consumer information. Of course, none of these profits require the mortgage loan to be held in the thrift originator's own portfolio.

Under current conditions, the thrift industry will never attain consistent profitability, a fair return on invested capital, and a stable role in the provision of housing finance. If nothing is done, the industry will decline and impose further costs on the deposit insurance system. Three alternatives suggest themselves: (1) make mortgage investment more profitable for thrifts; (2) make mortgage investment less profitable for non-thrifts; (3) remove the requirement that thrifts invest in mortgages.

Increasing the profitability of thrift mortgage investment. Thrifts can continue to seek out the new and less liquid mortgage instruments that historically have provided an attractive rate of return. However, all such instruments ultimately lose their advantage. This strategy would require too high a rate of turnover to be consistent with large thrift holdings of mortgages. Other approaches would entail some form of direct or indirect (tax) subsidy to encourage thrifts to hold mortgages.

Decreasing the profitability of non-thrift mortgage investment. The advent of mortgage securities has been the factor most responsible for the reduction of mortgage yields. Limiting the ability of the federally related agencies to issue and guarantee mortgage-backed securities would clearly raise mortgage yields. This cost would be paid directly by mortgagors, and would decrease the availability of housing finance.

Removing thrift portfolio restrictions. The only viable solution for the future is removing the requirement that thrifts hold 60 percent of their total assets in housing related instruments. Thrifts need the flexibility to adjust their portfolios in response to changing market conditions. They would likely continue to be active participants in the origination and servicing of loans. Even if the share of mortgages in their portfolios were to decline, the impetus for growth and investment in thrifts would likely increase the aggregate mortgage holdings of the industry. Coordination or consolidation of bank and thrift regulation is a necessary component of this approach, as thrifts come to be identified more by the functions they perform than by the charter they hold.

Regulatory and Structural Changes

It is my opinion that:

1. *Coordination of state and federal regulation, examination, supervision, and enforcement should be improved. Disagreements between state and federal regulators on matters of safety and soundness should be resolved in favor of the deposit insurance agency.*

2. *Financial institutions should report financial results on the basis of current value accounting, at least for regulatory purposes.*

3. *Capital requirements should be adjusted to protect the deposit insurance agency from loss in the event of insolvency.*

4. *Regulators should intervene -- through liquidation, receivership, or conservatorship -- before the market value net worth of a financial institution reaches zero.*

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State-federal coordination. By legislation and regulation, many of the federal restrictions on thrift assets were removed between 1980 and 1984. State-chartered institutions were frequently granted comparable powers when rules for federal thrifts were relaxed. Many states went beyond the powers approved at the federal level.

When thrifts began to implement their new powers, they faced three types of challenges: unfamiliar assets presented unfamiliar risks, late entry into a market left thrifts with the marginal credits, and market conditions became adverse just as thrift participation began. Many thrifts lost money as a result of their exercise of new asset powers.

Due to bad timing and other factors, problems occurred with assets newly authorized by both federal and state governments. Certainly the state authorities in many instances went beyond what the federal government was willing to grant. But where institutions had taken advantage of new powers to diversify their assets prior to the interest rate surge of the early 1980s, they registered better performance than thrifts with traditional portfolios for several years. That is because the riskiness of an asset is relevant only in the context of the entire portfolio. Whether these new assets increased or decreased risk depended on the covariances of their returns with those of traditional assets in the portfolio. From 1980 to 1984, 20 percent of FSLIC's problem cases were due to low asset quality and the balance largely to interest rates. Thereafter, 80 percent of the problems were attributed to poor asset quality.

The impact of federal and state powers is differentiated not in the effect on individual thrifts' profits, but rather in the growth of the problem beyond the thrifts immediately affected. The expansion of federal powers was sufficiently modest that it was within the existing ability of regulators to monitor. At the very least, the supervisory authority was party to the discussions on granting the new powers. When state regulatory authorities granted new powers to state-chartered institutions, and particularly when those powers went substantially beyond that which federally chartered thrifts were permitted, a gap was opened between the activities permitted and the ability of regulators to monitor those activities. Misjudgment, bad luck, and outright abuse were more likely to occur, especially among insolvent institutions, and less likely to be detected. The problem was the lack of coordination between liberalization at the state level and supervision at the federal level.

Beginning in 1984, the percentage of problem state-chartered institutions began to rise. Additional costs were incurred when federal efforts to curtail losses at failing institutions were constrained by state authorities. Increased investment flexibility should have been synchronized with increased surveillance by the federal deposit insurance agency. The dual banking system makes this type of coordination difficult if not impossible. Some of the public costs of resolving the thrift crisis may be traced to the right of state governments to make decisions without bearing full responsibility for the financial consequences.

Current Value Reporting. Early signs of problems were evident at least 15 years ago. The book value of thrift net worth declined through the 1970s while interest rate volatility increased. Analysts warned of the implications of relying on Regulation Q and of funding long-term assets with short-term liabilities. Had mark-to-market reporting techniques been in place, thrift managers and regulators would have been alerted to the deteriorating real financial condition of the industry.

The regulators could have avoided claims on the deposit insurance funds by addressing the maturity mismatch earlier or by intervening when net worth was still positive. Instead they took the opposite approach. Regulatory capital requirements were repeatedly lowered. Phase-in and averaging rules further reduced minimum net worth levels. Relaxation of accounting standards made these limits even less binding. Even so, many institutions failed to meet the requirements, yet were not closed. By 1986, over 18 percent of FSLIC-insured thrifts failed to meet regulatory net worth requirements, and 79 percent would not have met the stricter rules that had been in effect until 1980.

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The decision by regulators to allow institutions with low or negative market-value net worth to remain in operation during this period was essentially a bet that interest rates would decline. For several years, the bet did not pay off, and the agencies paid out claims. Market yields fell beginning in mid-1982, although it was 1986 before the market value of thrifts' mortgage holdings return to par. By then it was too late to recoup most of the losses. The depletion of FSLIC capital was a necessary condition for the subsequent inability of the agency to close institutions as quickly as it desired.

Capital. Capital serves two purposes. It provides an incentive for the owners to balance risk against return, as described above. It also provides a buffer for the insurance agency against uncertainties in the valuation of assets and liabilities.

The thrift industry's real capital position had been lagging behind its growth in assets for a decade by the time interest rates started moving up in 1978. At the beginning of the 1970s, net worth exceeded 7 percent of assets on a book value basis and was nearly 5 percent on a market value basis. At the end of 1979, book value net worth was less than 6 percent of assets, and although the liquidation value of the thrift industry's assets was still slightly positive, it had gone below zero by the end of 1980. This was a necessary condition for the risk-taking activity that followed.

A sound deposit insurance system must incorporate measures to protect against excessive risk-taking. When the insured party reaps the gains of success without bearing the costs of failure, there is little incentive to act prudently. This "moral hazard" problem, as it is called, is usually avoided through deductibles, wherein the insured shares in the loss, and limitations on the insured's scope of action. In a deposit insurance system, capital serves the function of the deductible and regulations are intended to limit risky behavior. When real capital is depleted, as it was at many thrift institutions by 1983, institutions have an incentive to increase leverage and take on risky assets -- that is, investments with a high variance of returns. At that point, regulation is the only bulwark against moral hazard, and rules were being relaxed rather than tightened at the time.

Closure rule. As the net worth of thrift institutions was depleted during the early 1980s, many institutions slipped below regulatory capital minimums. At that point, they could have come under strict supervisory control, and in the absence of financial recovery ultimately they would have been closed or merged. Had this procedure been followed, thrift losses and failures would still have occurred but costs in excess of the FSLIC's existing resources would have been limited if not entirely avoided. Instead, the capital requirements were reduced from 5 percent to 4 percent in 1980, and to 3 percent in 1981. Also, goodwill and appraised equity capital were added to assets, while losses on loan sales were partially excluded. The FSLIC provided net worth certificates, income capital certificates, and mutual capital certificates to problem institutions. These measures inflated regulatory net worth by over $13 billion relative to GAAP net worth. Yet even institutions that failed to meet these relaxed rules were permitted to remain in operation. The agency was unable or unwilling to close large numbers of thrifts. By the time the magnitude of the problem was recognized the FSLIC's resources were no longer adequate, its staff was insufficient for the number of problem cases, and its preferred method for handling problems -- assisted mergers -- was losing popularity among potential buyers. On average, insolvent thrifts remained open for nearly twelve months before they were closed.

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