PRESENTATION TO THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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TABLE OF CONTENTS

THE "HAVE NOTS" THAT ARE POTENTIAL "HAVES"

XII GAAP INSOLVENT FSLIC THRIFTS--INTEREST EARNING ASSETS/INTEREST BEARING LIABILITIES > 90%--SELECTED FINANICAL INFORMATION AT DECEMBER 31, 1987

XIII GAAP INSOLVENT FSLIC THRIFTS--INTEREST EARNING ASSETS/INTEREST BEARING LIABILITIES > 90%--HISTORICAL FINANCIAL STATEMENTS

XIV GAAP INSOLVENT FSLIC THRIFTS--INTEREST EARNING ASSETS/INTEREST BEARING LIABILITIES > 90%--HISTORICAL AND FORECASTED FINANCIAL HIGHTLIGHTS

STATE OF THE THRIFT INDUSTRY

INTRODUCTION

This presentation explores the overall condition of the thrift industry, provides an assessment of the causes of its current difficulties, discusses the outlook for the viable portion of the industry and discusses the ability of the regulatory system to deal with industry problems.

Only thrifts insured by the FSLIC are included in this presentation. All financial information presented was derived using computer tapes purchased from the Federal Home Loan Bank Board ("FHLBB"). Such tapes contain final financial information through June 30, 1987 and preliminary financial information for periods after June 30, 1987. Since amended reports may be filed by thrifts after preliminary tapes are released by the FHLBB, the financial information included in this presentation may differ somewhat from information prepared by the FHLBB for other forums. However, such differences are not expected to be significant enough to affect the validity of the analysis or conclusions reached in this presentation. The selected financial information, historical financial statements and forecasted financial statements were prepared using the Thrift Analysis and Forecasting System ("TAFS"tm), a micro computer software system developed by Ferguson & Company.

For the financial analysis presented, the industry is divided into groups which have positive estimated capital as determined in accordance with generally accepted accounting principles ("GAAP") and groups which have negative estimated GAAP capital. GAAP is defined as "estimated" because certain adjustments are necessary to convert from capital as determined under regulatory accounting principles ("RAP") to GAAP capital. All of these adjustments cannot be determined from an examination of the periodic financial reports filed by thrifts with the FHLBB. Currently, thrifts are permitted to file their financial reports with the FHLBB using either RAP or GAAP.

Under current FHLBB regulations, as required by the Competitive Equality Banking Act of 1987 ("CEBA"), the thrift industry will generally be required to convert to GAAP for purposes of all financial reporting on January 1, 1989. The use of GAAP for such reporting will facilitate the analysis of the industry's financial condition and results of operations and should enable the financial statements reported by one thrift institution to be comparable with financial statements reported by any other thrift institution. For this reason, GAAP has been used in the financial analysis included in this presentation.

Theoretically, a financial institution does not need capital in order to exist or to generate net income. As a financial intermediary, the major activities of a thrift involves the purchase of money and the resale of such money at a profit. Therefore, the composition of a thrifts' balance sheet has more impact on its earning power than does the amount of its capital, regardless of the basis used in measuring such capital. For example, the higher the ratio of interest-earning assets to interest-bearing liabilities, the more likelihood that a thrift can generate net income. Conversely, the lower this ratio becomes the more difficult it is for a thrift to generate net income. This simple analysis, of course, assumes that the thrift has a reasonable interest margin between its interest-earning assets and interest-bearing liabilities, a reasonably stable interest rate environment exists, its expenses fall within acceptable limits and credit risk, i.e. uncollectible loans, is small.

Therefore, in an industry with sound management and an effective regulatory and supervisory structure, minimum capital requirements mandated by thrift regulators should be adequate to provide assurance that if a thrift experiences unforeseen losses, a cushion exists to protect the Federal Savings and Loan Insurance Corporation ("FSLIC") from having to cover those losses.

Forecasted financial statements are presented throughout this analysis for various segments of the thrift industry. These forecasted statements do not attempt to project elements of non-operating income and non-operating expenses, except for amortization of loan losses, because such elements are almost impossible to forecast based upon available historical information.

OVERVIEW OF THE INDUSTRY

At December 31, 1987, the 3,141 thrifts insured by the FSLIC had total assets of over $1.2 trillion. Exhibit I shows the geographical dispersion of these thrifts and Exhibit II presents aggregate financial highlights and historical financial statements.

The industry had a dismal performance in 1987 and reported a net loss in the amount of $6.3 billion. Moreover, estimated GAAP capital as a percentage of total assets decreased to its lowest point in several years as did the ratio of interest-earning assets to interest-bearing liabilities. However, several factors had a negative impact on the industry during 1987. During the early part of 1987, the thrift industry was directed to write-off approximately $800 million receivable from the FSLIC secondary reserve. The industry felt the impact of tax law changes which took away many of the benefits enjoyed by real estate syndicators, developers and investors. Regional economies in certain areas of the U.S. continued to deteriorate, resulting in provisions for losses on assets totaling almost $8.2 billion. Finally, little progress was made in resolving the growing FSLIC caseload of insolvent thrifts and the net losses of these thrifts continued to accumulate. It is widely recognized that the funding needs of these insolvent thrifts have a substantial impact on the cost of funds of solvent thrifts as well as on commercial banks.

In spite of the poor performance reported by the thrift industry during 1987, a substantial portion of the industry was profitable, probably has an adequate level of capital and is forecasted to generate a positive net operating income during the next three years. Therefore, the industry can be analyzed by dividing its members into two distinct segments; the "haves" and the "have nots."

The "Haves"

At December 31, 1987, 2,634 thrift institutions had positive GAAP capital. This group accounted for 84% of the total number of institutions and 89% of the assets. Exhibit III lists the geographical dispersion of these thrifts and Exhibit IV lists aggregate financial highlights and historical financial statements.

This group of thrifts reported net income of over $3.7 billion in 1987, a reduction of 45.18% from 1986. Its GAAP capital as a percentage of total assets has increased each year since 1984 and its return on average assets showed an increase in both 1985 and 1986 but dropped significantly in 1987. However, a key ratio, interest-earning assets to interest-bearing liabilities increased in 1985 and 1986 and dropped only slightly in 1987. The net interest income for this group, expressed as a percentage of average assets, increased for the fourth straight year.

Forecasted financial statements and related projection assumptions for these thrifts, along with comparative historical financial statements, are included in Exhibit V. A five percent growth rate and a stable interest rate environment is assumed. Of course, other assumptions would produce different results. Asset and liability maturity information is not released by the FHLBB to vendors who purchase industry financial information so it is not possible to evaluate the extent to which the industry is subject to interest rate risk. However, most analysts believe that any significant increase in interest rates would have a devastating effect on the capital position of the industry.

Net operating income, expressed as a percentage of average assets, is expected to grow during each of the three years covered by the projection period. Also, the ratio of interest-earning assets to interest- bearing liabilities is projected to continue to increase as well as the level of GAAP capital. However, many of the thrifts included in this group are located in areas of the U.S. that have experienced an oversupply of commercial and residential real estate and have seen a substantial deterioration of real estate values. Therefore, if deterioration of property values in these areas continues, the viability of thrifts located in these areas could be threatened. Also, the possibility always exists that adequate loss reserves have not been provided by thrifts located in these economically depressed areas or by thrifts in other areas who have purchased whole loans or participations originated in these areas. If adequate loss reserves have not been provided, the capital levels reported could prove to be illusory.

The "Haves" Watch List

In spite of capital ratios reported by the GAAP solvent thrifts, a further analysis of this group is necessary. Included in this group are 169 thrifts that have a ratio of interest-earning assets to interest-bearing liabilities of less than 90%. It becomes increasingly difficult for a thrift to generate net operating income as that key ratio declines. This group represents five percent of the total number of institutions and nine percent of the assets of all thrift institutions. Exhibit VI shows the geographical dispersion of these thrifts and Exhibit VII shows the aggregate financial highlights and historical financial statements. This group has a GAAP capital to total assets ratio of 3.19% as compared to 4.91% for all solvent thrifts, or 35.03% less. Its net interest income expressed as a percentage of average assets was only .83% as compared to 1.93% for all solvent thrifts. Also, its operating expenses expressed as a percentage of average assets was 2.22% as compared to 1.94% for all solvent thrifts.

Forecasted financial statements and the related projection assumptions for these thrifts, along with comparative historical financial statements, are included in Exhibit VIII. Inasmuch as this group will be under pressure to increase its capital ratios, liabilities were projected to remain constant. However, one can see from the Historical & Forecasted Balance Sheets presented that liabilities in the forecasted scenario did, in fact, grow. This growth occurred because these thrifts are, as a group, projected to continue experiencing net operating losses with the result that additional liabilities will be incurred to cover cash flow shortfalls and to maintain regulatory mandated liquidity levels. Obviously, the level of GAAP capital will continue to deteriorate. Throughout the projection period, the ratio of interest-earning assets to interest-bearing liabilities continues to deteriorate. Inasmuch as many of the thrifts in this group are located in economic areas of the country that are considered to currently be depressed, the deterioration of these thrifts could occur much faster than projected if property values continue to deteriorate or if repossession of real estate continues at the current pace.

While the thrifts discussed in the preceding paragraph pose no immediate threat to the FSLIC fund, public policy considerations seem to dictate that they be encouraged to recapitalize themselves, change their operational strategies or seek a well capitalized merger partner. In the event these actions cannot be accomplished voluntarily, the FSLIC should be prepared to seek its own solution before thrifts in this group deteriorate to the point where the FSLIC has to provide loss coverage to facilitate closures or mergers. Also, thrifts facing insolvency have the temptation to hit a "home run" in order to restore capital to acceptable levels. If a "strikeout" occurs, FSLIC is left to pick up the tab.

The "Have Nots"

At December 31, 1987, 507 thrift institutions had negative GAAP capital. This group accounted for 16% of the total number of institutions and 11% of the assets. Exhibit IX lists the geographical dispersion of these thrifts and Exhibit X lists aggregate financial highlights and historical financial statements.

This group of thrifts obviously pose a grave danger to the solvency of the FSLIC fund. Its GAAP capital deficit, both as a percentage of total assets and dollar amount, has increased every year since 1984 and its net operating losses have continued to increase for each of the years presented. Its ratio of interest-earning assets to interest-bearing liabilities has also decreased each year since 1984. The yield/cost spread for this group was only 1.32% as compared to 2.35% for all GAAP solvent thrifts. This is because the insolvent thrifts have a lower yield on earning assets and a higher cost of funds than do the solvent thrifts. The insolvent thrifts experienced a deficit net interest income, expressed as a percentage of average assets, of .71% while all solvent institutions experienced a positive net interest income of 1.93%. Additionally, operating expenses, expressed as a percentage of average assets, was 2.48% for the insolvent thrifts as compared to 1.94% for the solvent thrifts.

Forecasted financial statements and the related projection assumptions for these thrifts, along with the comparative historical financial statements, are included in Exhibit XI. This group will be under extreme regulatory pressure to curtail liability growth. However, inasmuch as insolvent financial institutions generally are under liquidity pressures, it can be seen from the Historical & Forecasted Balance Sheets presented that liabilities in the forecasted scenario continue to grow significantly. Again, this growth is necessary because this group will not have the liquidity to fund their net operating losses and will be forced to attract new deposits in order to do so. Also, in the projection scenario, additional service corporation losses are not projected. However, inasmuch as a substantial portion of service corporation activity in thrifts is related to real estate development activities, this assumption may not be reasonable. Net operating losses, expressed as a percentage of average assets, are projected to increase during each of the three years covered by the forecasted statements. Also, the ratio of interest-earning assets to interest-bearing liabilities is projected to continue to decrease. Finally, to the extent that adequate loan loss reserves have not been provided, the actual operating losses experienced by these institutions could be considerably worse than projected. Obviously, the FSLIC must either close or otherwise dispose of these institutions as quickly as possible.

The "Have Nots" That Are Potential "Haves"

In spite of the poor condition of the GAAP negative thrifts, a further analysis of this group is necessary. Included in this group are 131 institutions that have a ratio of interest-earning assets to interest-bearing liabilities greater than 90%. This group accounted for four percent of the total number of thrifts and two percent of the assets. Exhibit XII shows the geographical dispersion of these thrifts and Exhibit XIII shows the aggregate financial highlights and historical financial statements. The ratio of their GAAP capital deficit to total assets is 2.61% as compared to 13.36% for all GAAP insolvent thrifts. Their net interest income, expressed as a percentage of average assets, was a positive 1.49% as compared to a negative .71% for all insolvent thrifts. Also, the yield/cost spread for this group is 2.30% as compared to only 1.32% for all insolvents. Additionally, operating expenses for this group are significantly lower than for all insolvent institutions. While this group is insolvent when measured by GAAP standards, it may be possible for these thrifts to generate net operating income.

Forecasted financial statements and the related projection assumptions for these thrifts, along with the comparative historical financial statements, are included in Exhibit XIV. This group is projected to generate a small net operating income. The liability growth requirement during each of the three years covered by the projection is small and the ratio of interest-earning assets to interest-bearing liabilities is projected to remain relatively constant. However, it should be noted that, inasmuch as many of the thrifts in this group are located in economic areas of the country that are considered to be economically depressed, they could deteriorate rapidly if property values continue to decrease and repossessions of real estate remain at current levels.

These thrifts pose a current threat to the FSLIC fund and public policy considerations would seem to dictate that these thrifts be encouraged immediately to recapitalize themselves, change their operational strategies or seek a well capitalized merger partner. In the event no voluntary resolution can be found, the FSLIC should be prepared to seek its own solution before the thrifts in this group deteriorate to the point where the FSLIC has to provide loss coverage. However, it is questionable that these thrifts pose any more threat to the FSLIC than those GAAP solvent thrifts with a ratio of interest-earning assets to interest-bearing liabilities of less than 90%. In fact, they may actually pose less risk.

Location of Problem Institutions

When considering the condition of the thrift industry, it seems to be widely believed that most of the existing problems in the industry are in Texas. An analysis of Exhibit IX clearly demonstrates that substantial problems exist in thrifts located outside of Texas. While the total assets in Texas constitute only 32% of the total assets of GAAP insolvent thrifts, the negative GAAP capital in Texas constitutes 48% of the total negative GAAP capital of all GAAP insolvent institutions. However, because of the severe economic problems which currently exist in Texas, these percentages could increase.

CAUSES OF THE CURRENT DIFFICULTIES

The current problems of the present thrift industry can be traced back to the 1930s. For several decades, the industry was able to successfully mismatch the maturities of its assets and liabilities. With only moderate inflation, the earnings of the industry generally were reasonably predictable. However, the fragility of the underpinnings of the industry quickly became painfully apparent in 1979 when interest rates soared and, very quickly, the industry was swimming in red ink. The industry experienced substantial disintermediation until the liability side of the balance sheet was eventually deregulated. By 1982, when federal institutions were given significant new asset powers, its capital had been severely reduced. During these years, several hundred thrift institutions were either closed or merged with healthier institutions. As a result of the assistance provided in connection with these closures or mergers, the resources of the FSLIC fund were substantially reduced.

With the new asset powers in hand, it appeared to many observers and to many industry leaders that the problems of the industry had been solved. Never again would the industry be locked into regulations which required that most of their investment activities be of a nature which would require a mismatch between the maturity of assets and liabilities. Along with the new asset powers granted by Congress, the FHLBB also provided new tools to thrifts to assist them in restructuring their balance sheets and rebuilding their net worth. These tools allowed the use of purchase accounting in mergers and acquisitions, deferral of loan losses incurred in connection with the disposition of low rate loan portfolios and the use of appraised equity capital. In addition, capital requirements were lowered.

For a short period of time, it appeared that the thrift industry was on the road to recovery. The industry attempted to take maximum advantage of its new asset powers and the more permissive regulations issued by the FHLBB. Many thrifts commenced marketing commercial real estate loans, commercial loans and consumer loans on a massive scale. Also, many thrifts formed real estate development companies and/or entered into joint venture arrangements with real estate developers. In order to rebuild their net interest income, many thrifts developed a strategy of rapid growth so as to dilute the percentage of its loan portfolios that were locked-in at low interest rates and/or had long maturities. The liabilities necessary to fund this rapid growth were obtained by offering rates higher than the competition, by the solicitation of brokered deposits or by setting up money-desk operations. Many thrifts did not have the expertise or grew too rapidly to use their investment powers wisely. The fast growing thrifts contributed substantially to the over-building and ultimate deterioration of certain regional economies, primarily in Texas and other parts of the southwest.

However, it is not reasonable to blame only the thrift industry for the problems which were created during the years following deregulation. While the industry was aggressively taking advantage of its new asset powers, few changes were taking place in the supervisory arena. The examination and supervisory functions at that time were separated, with the examination staff being employees of the FHLBB. The FHLBB was operating under severe budgetary and salary restraints and was unable to attract and retain an adequate staff of qualified examiners to cope with the growing list of fast-growth problem thrifts. Very quickly, the industry was changing from one that was relatively simple to one that was becoming fast-paced and increasingly complex. The supervision function was carried out by each of the twelve Federal Home Loan Banks. All in all, it was a cumbersome system that did not respond quickly to crisis resolution. The examination function was transferred to the district banks in mid-1985 but, by then, the situation was out of control.

When the examination function was transferred to the individual Federal Home Loan Banks, the budgetary and salary restraints were substantially alleviated. Subsequent to the transfer, it appears that substantial progress has been made in attracting quality examiners, some of whom have been recruited from the federal banking agencies. In addition, a substantial effort has been made to develop and implement high-quality training programs. However, because of the rapid growth in numbers of examination personnel, it will take several years to build a staff with heavy examination experience.

By the time the magnitude of the problems existing at the insolvent thrifts had been quantified, it was obvious that the FSLIC had neither the financial nor human resources to handle its caseload. Almost concurrently with passage of the necessary legislation to recapitalize the FSLIC, a new chairman and one new board member were taking office at the FHLBB. As expected, it took time for the newcomers at the FHLBB to familiarize themselves with the magnitude of the task at hand and to build their support team. Also, a tremendous amount of FHLBB resources were required to draft the numerous and comprehensive regulations required by the CEBA.

In summary, the cause of the current difficulties in the thrift industry cannot be traced to any one source. They have been caused by many factors.

OUTLOOK FOR THE VIABLE PORTION OF THE INDUSTRY

The outlook for the viable portion of the thrift industry is very difficult to quantify and, to a considerable extent, is closely linked to the disposition of the current insolvent thrifts. Continued publicity concerning the problems of the thrift industry and the FSLIC has been very injurious to solvent thrifts and has driven up the rates this group has to pay for savings deposits and other borrowings. Also, the cost of funds for all solvent thrifts is being driven up because they are forced to compete with the liquidity requirements of insolvent thrifts. In addition, the asset yields of solvent thrifts are being driven down by the necessity of competing with the insolvent thrifts for investment opportunities. Also, solvent thrifts find it necessary to pay a rate premium over the rates paid by commercial banks. It is believed that disposition of the large number of insolvent thrifts will tend to make this differential disappear or become smaller.

During the early part of this decade, we experienced hundreds of "interest-rate risk failures" and in recent years, we have experienced a tremendous number of "credit-risk failures." We may now be about to experience something which might come to be called "deregulation failures." Increased competition from many sectors of the economy has caused net interest spreads to narrow while at the same time, thrift operating cost ratios have soared. For the year ended December 31, 1987, net interest income for all GAAP solvent thrifts, expressed as a percentage of average assets, was 1.93% while total operating expenses was 1.94%. It is difficult to believe that other operating income, primarily derived from fees charged to thrift customers, will be adequate to cover net non-operating expenses, income taxes and still provide a reasonable return on equity. It appears that, in order to remain viable, the solvent thrifts will find it necessary to increase spreads and/or substantially reduce their operating expense ratios. Of course, other alternatives are to enter other lines of businesses or successfully develop and market new products.

In a world of electronic technology, high speed communications and the breakdown of legal and regulatory barriers to interstate banking, an efficient and effective financial system will require a far smaller number of financial institutions. In short, we are an "overbanked" nation with too many financial institutions and branches. A substantial consolidation of the current number of financial institutions, both thrifts and commercial banks, should help to improve the long term viability of the industry.

In addition, a period of prolonged higher interest rates would cause even the GAAP solvent thrifts to hemorrhage badly. To help insure its long term viability the industry has to continue restructuring its balance sheet to protect itself from undue interest rate risk.

Finally, the viability of the industry is largely dependent upon the strength of the U.S. economy, the level of interest rates and the strength of the real estate sector of the economy. However, because a substantial percentage of the assets of the industry is located in regional areas where the economy is considered depressed, the outlook is also partially dependent upon the economic recovery of those regional areas.

ABILITY OF THE REGULATORY SYSTEM TO DEAL WITH THE PROBLEMS

Because of the number of insolvencies which currently exist in the thrift industry and the budgetary and salary restraints under which the FHLBB has operated in the past, it is difficult to assess the ability of the regulators to deal with the problems that exist today. While almost no one will dispute the observation that massive problems remain unresolved today, few close observers of the FHLBB will dispute the fact that the agency simply has operated under budgetary restrictions that precluded it from building and staffing the organization with the resources necessary to deal with the challenges of deregulation and the rapid growth of the industry. Therefore, even if provided the resources today, the FHLBB still would have a huge backlog of cases to resolve and the job is too massive to complete overnight. A systematic and accelerated resolution of the current caseload of the FSLIC still will require financial and human resources substantially in excess of those currently available to the FHLBB and the FSLIC.

The Southwest plan has gotten off to a slow start. However, the FSLIC has beefed up its coordinating and negotiating teams within recent weeks. The substantial number of negotiations currently underway with potential thrift acquirers leads one to hope that a substantial number of the insolvent thrifts in Texas and other parts of the U.S. will be disposed of within the next few months.

CONCLUDING COMMENTS

It should be clear that deferring a comprehensive attack on the problems of the industry not only increases the ultimate cost of resolution, but also may call into question the safety and soundness of the entire financial system.

Unless a prototype plan for dealing with the massive number of insolvent thrifts is developed quickly, the FSLIC will drop further behind in dealing with problem institutions. It should be apparent from the forecasted financial statements included throughout this presentation that there are an additional number of thrifts likely to become insolvent within the foreseeable future.

There is no doubt in my mind that the resources available to the FSLIC will be inadequate to dispose of the insolvent thrifts. Also, there is still not a clear picture of what the cost will be to resolve the problems of institutions insured by the Federal Deposit Insurance Corporation ("FDIC"). There are indications that problem assets and problem institutions in the banking industry could easily match or exceed the present resources of the FDIC.

Consequently, the next President of the United States and Congress will again have to wrestle with the subject of deposit insurance for all types of financial institutions. In the meantime, it seems appropriate for Congress to reassure the world financial markets that the full faith and credit of the U. S. Government does stand behind the insurance funds. This would substantially reduce the cost of funds for many, if not the majority of financial institutions and restore to profitability many marginally profitable institutions, both in the banking and thrift industries.