

ECONOMIC COMMENTARY

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Excerpted below are highlights from testimony given by Robert Boykin at a special hearing of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, on March 11, 1989 in San Antonio, Texas. In his testimony, Mr. Boykin discussed the thrift crisis and the legislation recently proposed by President Bush to address this critical issue.¹

The Federal Reserve Bank of Dallas supports, in principle, the legislation proposed by President Bush for the reform and recovery of the thrift industry. *A satisfactory solution to the problems plaguing the thrifts is essential to ensure the economic well-being of the nation as a whole and particularly the Dallas Federal Reserve District (Texas, Louisiana, and New Mexico).* It is imperative that a solution to this crisis be reached as quickly as possible; the threat this situation poses cannot be allowed to continue. Removing this threat could contribute substantially to broadening the region's two-year old economic recovery.

The Impact of the Thrift Crisis on Banks and Healthy Thrifts

The thrift crisis has significantly increased the cost of funds for financial institutions in the District.² In Texas, interest premiums on deposits averaged 28 basis points for banks and more than 50 basis points for thrifts in 1988. Even sound, healthy Texas banks have paid an additional 10 to 20 basis points for funds in 1988, compared to banks in similar financial condition elsewhere.

The so-called Texas premium on deposits can be attributed to two factors. The first is the large volume of nonperforming real estate loans held by banks and thrifts. Banks have not yet managed to fully write down their real estate loan portfolios to current values. Consequently, questions persist regarding the value of these assets, making the financial condition of these institutions unclear. The second factor driving up the cost of funds at District institutions has been the aggressive pursuit of funds by insolvent thrifts. Insolvent thrifts bid up deposit rates to attract funds, forcing the healthy members of the industry to raise their own deposit rates in order to compete.

The Texas premium on deposit rates has affected the bottom line for commercial banks. This is illustrated by the negative return on assets at Texas banks for the past two years. As losses have mounted, the equity capital position of the District's banks has also fallen—from an average of 6.9 percent of assets in 1985 to an estimated 4.9 percent in 1988. Moreover, over the same period, the banks' primary capital position has declined from 7.8 percent of assets to 6.6 percent in 1988. This compares to the current regulatory standard of 5.5 percent for primary capital and suggests that District banks are approaching regulatory minimums. In fact, many banks have fallen below the regulatory minimum.

The upshot of this situation is that otherwise healthy banks and thrifts have been negatively affected by the continued operation of insolvent thrift institutions. It is likely that the District's

financial sector will continue to deteriorate until the situation is resolved.

The Need for Both Public and Private Capital

One aspect of the President's proposal is particularly important for the Southwest—namely, the need for both public and private capital in any successful restructuring of the thrift industry. Private capital provides a cushion for the deposit insurance funds and is essential if risk to those funds is to be kept within reasonable bounds. In the current environment, however, private capital cannot be attracted to the thrift industry without sufficient public capital. In short, there is a symbiotic relationship between those two components of capital. If the infusion of public capital falls short of what is necessary to attract private capital, the effectiveness of the public infusion will be nullified in the long run.

We have seen that point illustrated in the Southwest Plan. The recapitalizations undertaken thus far have resulted in a disappointingly small infusion of private capital into the thrifts. Consequently, the restructuring has been too dependent on federal assistance.

Another point should be addressed. Under the proposed legislation, thrifts are to be brought up to commercial bank capital standards over time. A large number of thrifts are currently solvent but not in robust health. Presumably, the worst of the thrift problems will be addressed under the plan now in Congress. But additional thought should be given to how these moderately healthy and barely solvent thrifts (and, to some extent, banks as well) can raise the required capital and, at the same time, compete with *publicly* recapitalized institutions.

Summary

The prolonged operation of insolvent thrifts constitutes an immediate threat to the deposit insurance fund, to solvent banks and thrifts, and to the stability of the financial system itself. Strategies that have been employed by insolvent institutions could both compound the problems of currently solvent institutions and lead to a new generation of bankrupt thrifts and commercial banks. Any delays in resolving the current crisis will only serve to increase the cost to taxpayers, to further undermine the public's confidence in the financial system, and to endanger the fragile economic recovery currently under way in the Southwest. We view the President's plan as one which can resolve the crisis, and we urge its prompt enactment.

¹ A copy of Mr. Boykin's complete testimony is available by writing the Public Affairs Department, Federal Reserve Bank of Dallas, Station K, Dallas, Texas 75222, or by calling (214) 651-6289.

² See Genie D. Short and Jeffery W. Gunther, *The Texas Thrift Situation: Implications for the Texas Financial Industry*, Federal Reserve Bank of Dallas, Financial Industry Studies Department (Dallas, September 1988), for a complete discussion.