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THE S&L BAILOUT: A POLICY REVIEW

BY

FREDERICK E. BALDERSTON

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THE S&L BAILOUT: A POLICY REVIEW

by

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## Executive Summary

The 1989 S&L bailout is the largest financial rescue in US history. Five elements of policy review are discussed:

- \* increased deposit insurance premium payments by S&L firms.
- \* future net worth requirements for S&L firms.
- \* The future role of the Federal Home Loan Bank System and its contribution to bailout financing.
- \* The future structure of Federal regulation and supervision, and preemption of state regulation.
- \* The system for monitoring and regulatory intervention to prevent a recurrence.

Each of these is discussed from several vantage points: the public policy concerns; the interests of the viable firms of the S&L industry; the concerns of marginal, poorly capitalized firms and of already-insolvent firms; and the interests of regulators.

## THE S&L BAILOUT: A POLICY REVIEW

This policy review of the 1989 S&L bailout examines the Bush Administration's proposal and its Congressional incarnation from several different and conflicting vantage points. First, the general public has a definite concern about the bailout. The general taxpayer will end by paying directly for a large part of the cost because debt service will be a charge on the Federal budget. Indirectly, millions of citizens will also pay for the bailout because both commercial banks and S&L's will pay higher deposit insurance premiums and will attempt to pass them on to consumers. Finally, a strong and efficient financial structure is essential to the national economy, and both the bailout itself and the efforts made to prevent a recurrence in the future are significant issues.

This policy review also seeks to identify the probable interests of three categories of firms: those having strong capital and sound management, which are the probably-survivable firms of the industry (2193 firms with \$921 billion in total assets at 12/31/88); at the other extreme, those in hopeless condition, labelled the "brain-dead" or the "zombie" firms (as of 12/31/88, 364 firms with \$114 billion of assets); and the marginal firms with between zero and 3% GAAP net worth (as of 12/31/88, 392 firms with \$316 billion of total assets).

Finally, it is necessary to take into account the special interests of the regulatory bureaucracy and the elected politicians who are close to it, for they have objectives of their own which need to be identified in a policy review.

A number of elements need attention in a policy review. The

real cost of the bailout is, strangely enough, not one of these, for its costs, in wastage of American society's resources, have already been incurred during the years from 1980 through 1988. The different ways of financing the total bailout costs will, however, have quite different price-tags and can be designed to impose different degrees of burden upon the taxpayer, the intermediate institutions (especially the Federal Home Loan Bank System) and the S&L firms. Several aspects of this incidence of financial costs are discussed below.

Here is a list of elements for policy review:

1/ Amount of annual bailout financing by increased deposit insurance premium.

2/ Future net worth requirements for S&L firms.

3/ Future role of the Federal Home Loan Bank System, and annual bailout tax on the System.

4/ Future structure of Federal regulation and supervision, and preemption of state regulation.

5/ System for monitoring and regulatory intervention to prevent a recurrence.

#### The S&L deposit insurance premium.

The total estimated cost of the proposed bailout is variously estimated at \$85 billion (General Accounting Office, 2/89), \$100 billion, or even \$125 billion. Some of the total figures reported in the press have added together the principal costs and the annual debt service payments on bond issue, whereas a more correct approach would be to estimate the present value of all the costs over the horizon of the bailout. If one-time

Federal financing were the sole source for this, the policies to avoid future disasters could be relatively independent of the bailout financing. Also, financing by direct Treasury outlay with an exception to Gramm-Rudman-Hollings would be less costly in interest rate (by 0.40% to nearly 1.0% in the rate) than the use of a special corporation for off-budget financing. But, in the Bush Administration's plan and its Congressional incarnations, FSLIC deposit insurance premiums contribute quite heavily to the stream of annual financing requirements.

The higher these premium costs are, the greater is the burden of viability, future capital adequacy and competitive robustness for the surviving firms of the S&L industry. Thus, there is a difficult trade-off: "make the industry pay" versus design a healthy S&L industry for the future. First we assess the premium increase question from the public policy standpoint. (See Barth (1989), Table 1, reproduced and attached here, for a breakdown of S&L firms' total assets and net worth positions.)

The currently GAAP-insolvent firms (364 of them) are in any case to be taken over and eliminated from the industry. The currently healthy firms (at 12/31/88, 2193 of them, with a total of \$921 billion of total assets) should be able to tolerate a modestly higher insurance premium than that paid by banks, but if it is very much higher, they will face competitive difficulties. These firms have at least 3% GAAP net worth as of 12/31/88, but they vary considerably in their likely ability to generate additional capital through earnings. Thus, it would be prudent to cap the deposit insurance premium at a rate each year that is only slightly higher than the rate paid by FDIC members and that



Table 1  
U.S. Thrift Industry: 1980-1988

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Number of Institutions	3,993	3,751	3,287	3,146	3,136	3,246	3,220	3,147	2,949
Total Assets (\$ Billions)	604	640	686	814	978	1,070	1,164	1,251	1,352
GAAP Net Worth (\$ Billions)	32	27	20	25	27	34	39	34	46
Tangible Net Worth (\$ Billions)	32	25	4	4	3	9	15	9	23
Net Income (\$ Millions)	781	(4,631)	(4,142)	1,945	1,022	3,728	131	(7,779)	(12,057)
Net Operating Income (\$ Millions)	790	(7,114)	(8,761)	(46)	990	3,601	4,562	2,850	907
Net Nonoperating Income (\$ Millions)	398	964	3,041	2,567	796	2,215	(1,290)	(7,930)	(11,012)
Taxes (\$ Millions)	407	(1,519)	(1,578)	576	764	2,087	3,141	2,699	1,952
Percent of Home Mortgages to Total Assets	66.5	65.0	56.3	49.8	44.9	42.4	38.9	37.8	38.6
Percent of Mortgage Backed Securities to Total Assets	4.4	5.0	8.6	10.9	11.1	10.4	13.1	15.6	15.4
Percent of Mortgage Assets to Total Assets	70.8	70.1	64.9	60.7	56.0	52.8	52.0	53.4	53.9
Stock Institutions	20.0	21.0	23.0	24.0	30.0	33.0	37.0	40.0	44.0
(% of Number of Institutions)	27.0	29.0	30.0	40.0	52.0	56.0	62.0	70.0	74.0
Federally-Chartered	50.0	51.0	51.0	51.0	54.0	53.0	54.0	56.0	58.0
(% of Number of Institutions)	56.0	63.0	70.0	66.0	64.0	64.0	64.0	65.0	71.0
GAAP Capital-to-Asset Ratio									
< 0%									
Number	43	87	237	293	445	470	471	520	364
Total Assets (\$ Billions)	0.4	14	64	79	110	131	126	183	114
Tangible Net Worth (\$ Billions)	0	(0.35)	(5)	(6)	(6)	(9)	(13)	(24)	(16)
0% to 3%									
Number	287	690	929	933	911	719	544	434	392
Total Assets (\$ Billions)	38	146	241	263	380	293	367	230	316
Tangible Net Worth (\$ Billions)	1	3	(3)	(3)	(3)	(1)	(1)	(1)	1
3% to 6%									
Number	1,959	1,801	1,315	1,222	1,092	1,173	1,150	1,002	968
Total Assets (\$ Billions)	383	379	319	382	399	507	541	537	639
Tangible Net Worth (\$ Billions)	18	15	6	7	7	9	12	14	18
> 6%									
Number	1,704	1,173	806	698	688	884	1,055	1,191	1,225
Total Assets (\$ Billions)	182	101	62	90	88	139	229	300	282
Tangible Net Worth (\$ Billions)	14	8	5	5	6	9	17	20	20
Resolutions									
Number	11	28	63	36	22	30	46	47	205
Total Assets (\$ Billions)	1,458	13,908	17,662	4,631	5,080	5,601	12,455	10,660	100,660
Estimated Present-Value Cost (\$ Millions)	167	759	803	275	743	979	3,065	3,704	31,180

Note: Resolutions do not include 18 "stabilizations" in 1988 that had assets of \$7,463 million and tangible net worth of negative \$3,348 million, and an estimated present value resolution cost of \$6,838 million.

tapers down to that rate as soon as possible.

Competitive cross-penetration of markets between banks and S&L's is intensifying, year by year. 1991 is the operative date for full interstate banking, and this is expected to unleash greatly intensified competition for deposits and for financial services generally. The S&L bailout needs to be designed to fit this new environment, which will present itself very soon.

In the House Banking Committee's version of the bailout legislation (H.R. 1278, Sec. 208), the specified deposit insurance premium rates, as percentages of total insured account dollars, are:

	<u>FDIC(BIF)</u>	<u>FSLIC (SAIF)</u>	<u>Differential</u>
1989	0.0833%	0.208%	0.124%
1990	0.0833	0.208	0.124
1991	0.15	0.23	0.08
1992	0.15	0.23	0.08
1993	0.15	0.23	0.08
1994	0.15	0.18	0.03

In addition, however, FDIC can increase annual premium payments to either fund if it may fall below 1.25% of the total of its insured accounts, and the total premium, through a series of small annual increases, could reach a maximum of 0.35%. (H.R. 1278, Sec. 208.) The respective insurance premium schedules for banks and S&L's of the proposal impose a differential on S&L's that appears excessive from the public policy standpoint, as it may impair the competitive viability of the healthy S&L firms. The differential is greatest, it should be noted, during the very

time-interval during which higher net worth targets are to be reached: from 1989 to 1991. (A differential of 0.124% or 0.08% may not seem like much, but the GAAP-solvent S&L's had three-year earnings rates of about 0.66% of total assets. See Kaplan, D.F., in FHLB of San Francisco, 1989, p. 97.) It would be worthwhile to consider cutting the proposed rates through 1993, taking the money from FHLB System earnings, as is discussed later in this report. In addition, banks' FDIC premiums could be augmented by 0.01% each year. This would equalize the rates as of 1994. The contingent premium increases should be abandoned entirely, in order to avoid impairing future viability of S&L firms and improve the prospects whereby these firms can enter the capital markets to raise more primary capital.

The policy preference of the healthy S&L firms would undoubtedly be to favor deposit insurance premiums no greater than those paid by their commercial banking competitors. While this is understandable, it is not consistent with the public's desire to minimize the taxpayer burden.

Much more critical is the impact of the deposit insurance premium on the marginal firms. There is a trade-off between the premium rate and the prospects for achieving the target amount of net worth reserves called for in the bailout plan. Marginal firms should certainly be required to pay a premium rate no lower than that charged the healthy firms. We return to the fate of the marginal firms when we discuss net worth requirements.

The Federal regulators have an interest in assuring that the near-term bailout is not underfinanced, for to have to reopen the political struggle over taxpayer financing would be

potentially dangerous to them. However, they are also likely to be sensitive to the impact of the deposit insurance premium on the marginal firms; the greater the burden, the greater the number of marginal firms that will either become GAAP-insolvent or attempt to recoup their fortunes through speculative lending behavior and, thereby, become candidates for regulatory intervention.

#### Net worth requirements for S&L firms

Higher net worth reserves are the crucial public policy requirement of the bailout plan for avoiding future disasters. Net worth is a "cushion" or first line of defense for absorbing the losses that a financial institution may incur. In addition, the owners of an equity position in the institution, having the most to lose, can be counted on to watch the institution's executives carefully. In the absence of net worth, in fact, the institution's control group is in the position of "moral hazard" -- it may be impelled to seek high-risk ventures, because if these win, its gains will be large, and if they lose, the deposit insurance fund must pick up the pieces.

The public policy objective is that S&L's attain the same net worth reserve position as that which is already mandated for commercial banks by 1991-92: 6% net worth to total assets. The US Senate passed its version of the bailout legislation on April 19, 1989, providing that at least 1.5% must be tangible capital. This is defined as core equity plus retained earnings, and it excludes "goodwill", which appears as a component of GAAP net worth. From the public policy standpoint, once again, the

important issue is to assure that the net worth cushion is real and that it gives the management and controlling interest a stake in prudent behavior; this means that the net worth target must be stated predominantly if not entirely in terms of tangible capital. William Seidman, Chairman of FDIC, has advocated that the standard to be attained be at least 3% of tangible net worth. As of early June, 1989, the House version of the bailout legislation was still in committee, and both the net worth standard and the date by which it should be met were subjects of controversy and intense lobbying.

The best-capitalized S&L firms have incentives to support a strict net worth standard, if they already meet it or can do so easily, for that will reduce risks of future disaster that would impair their own business position. A strict net worth standard would also force more firms to seek negotiated merger as a way out if they cannot meet the net worth standard. However, many S&L's, including some having high GAAP net worth, have substantial goodwill. Where this arose from the acquisition of a troubled institution with supervisory approval (and sometimes with FHLBB-approved subsidy) the S&L having such goodwill on its books is all but bound to feel that this component of net worth is blessed by the contractual obligations to which FHLBB agreed in the acquisition. At the same time, it is only too clear that intangible net worth fails to serve the public policy purpose in a satisfactory manner. A better public policy solution would be to permit the counting of goodwill for no more than 50% of the net worth requirement and to taper this percentage downward quickly -- say, over a five-year period or less.

Lobbyists also seek ways to affect the net worth standard by according generous interpretation to the value of various assets. For example, there is controversy in the bailout legislation hearings as to the valuation of retained rights for servicing of loans previously sold. Overgenerous or selective valuation turned out to be one of the difficulties of "RAP" net worth -- net worth according to Regulatory Accounting Principles -- as it developed during the 1980's, and it turned out to weaken the net worth standard to the point where many institutions that were de facto insolvent were able technically to satisfy the regulatory net worth standard and avoid restrictions on their operations. With the wisdom of hindsight, we can say that this was a major public policy mistake. It should not be repeated. Any balance-sheet item in a disputed category should be valued at its market-to-market value (that is, to have its book value based on a reliable and conservative market quotation or appraisal). This would dispose of most of the arguments.

Setting a higher general target for net worth is one important step, and relating the net worth standard to asset risks is the second. Both interest-rate risk and credit or default risk should be dealt with, by requiring adjustments of the net worth target by formulas that reflect general experience. As for asset default risks in real estate, each category of assets should be rated. It is well known that residential mortgages, especially on existing single-family houses, have the lowest probability of default; multi-family housing has a higher default probability; still higher average default probabilities

are associated with loans on commercial property, farm property, developed land, undeveloped land, and development and construction loans. Consumer finance -- instalment loans, home equity, and other consumer-focussed lending -- should have similar experience-based risk treatment.

Direct equity investments in projects have the highest risks of all and, if permitted at all, should be reserved for ex ante at the pre-tax equity percentage in the general market --roughly 20%. (See Balderston, 1985, pp. 165-167.)

Some industry spokesmen argue that these higher net worth requirements may force marginal firms out of the industry. Others point out that there is indeed excess capacity in the banking and S&L industries, and that if a firm cannot meet the market test by successfully raising capital to augment its net worth, it should expect to either shrink in size, so that its total assets and deposits are more in line with its net worth, or withdraw from the marketplace. While the marginal firms in the industry are the most vulnerable to closure as a result of a tough net worth policy, they are precisely the most likely group to create heavy losses to the deposit insurance fund if they are allowed to operate without adequate reserve capital. Their complaints as to this policy should be firmly resisted.

To summarize: the net worth standards should be set to be reached by a time certain, such as January 1, 1992; they should be defined to require a significant portion of tangible capital; intangible capital, such as goodwill, should be eliminated from net worth calculations on a tapered basis over no more than a five-year period; and the net worth requirement should be

adjusted for interest-rate and default risks.

These steps do not guarantee a greater and more effective focus on S&L safety, but they should certainly help.

Future role of the Federal Home Loan Bank System, and the tax on FHLB earnings to support the bailout.

The Bush Administration's plan provides that the Federal Home Loan Bank System be placed under the general oversight of the Secretary of the Treasury. Further, in various versions, either \$300 million per year or some other more or less comparable annual amount, would be taken from FHLBS earnings and applied toward debt service on the \$50 billion of special-agency bonds that are to be issued. Industry spokesmen point out that S&L's are currently obliged to subscribe for ownership of stock in the Federal Home Loan Banks, that this stock is a significant balance-sheet component, and that annual dividends from the System's \$1.2 billion of earnings are a definite contribution to the profit base of S&L firms.

The first public policy point to be made is that the Federal Home Loan Banks are Federal instrumentalities. In law and in principle, they are not private corporations. (See GAO, February, 1989, p. 89.) The recent attempts to resist a public policy obligation and role by certain Federal Home Loan Banks were misguided. During the past few years, for example, regional Federal Home Loan Banks have sometimes invoked a more severe standard of collateral for borrowings by institutions in trouble which faced withdrawal pressures than they applied to institutions that applied for expansion advances.



It was originally part of the essential design of the FHLB System that the twelve regional banks would be first-level sources of liquidity to counteract net withdrawals at savings institutions; secondarily, they could provide advances to support expansion of S&Ls' loan volume.

Those who favor a distinctive, specialized, and Federally-supported role for S&L's in residential mortgage origination and portfolio holding have recommended that the FHLB System not be placed under Treasury control, for they identify in Treasury a negative bias toward housing finance. (See K.T. Rosen, testimony to Senate Banking Committee, March 7, 1989; Sherman J. Maisel, testimony to House Ways & Means Committee, February 22, 1989.)

From the public policy standpoint, there are two main issues. First, it is worthwhile to review and determine whether to affirm the continuing role of the Federal Home Loan Bank System as a credit-supporting mechanism for a specialized housing finance industry. Because S&L's are portfolio mortgage lenders, they do need access to longer-term liabilities than are willingly provided by depositors. FHLB multi-year advances perform this stretch-out function. Also, FHLB advances make it possible for S&L's to obtain funds at lower costs than they would incur by themselves, because of the agency-security status of FHLB obligations in the capital market. Endorsement of a continuing Federal commitment to specialized housing finance would imply continuation of this FHLB System role and function.

Second, tapping FHLB System earnings to help pay the annual cost of debt service on bailout bonds is an indirect tax upon the

S&L's which are obliged to own FHLB bank stock in proportion to their mortgage holdings and accumulated advances. The greater the "bite", or annual contribution to debt service, the less is available to shore up S&L firms' profits through dividends received. While there is apparently no inherent objection to the legality of tapping these earnings, in view of the Federal agency status of the Federal Home Loan Banks, the weakening of the earnings stream of S&L's during the period of mandated capital build-up is undesirable. However, it appears reasonable, as recommended above, to take additional FHLBS earnings into the bailout process, in order to reduce and then eliminate the differential in deposit insurance premiums as between S&L's and their commercial banking competitors.

If the FHLB System is not placed under Treasury when the Federal Home Loan Bank Board is abolished under the pending legislation, there remains a question of how it should be located and governed in the Federal establishment. One solution would be to regard the System as a quasi-independent entity with a board of directors having a definitive majority of public interest appointees. This board would have powers of oversight of the regional FHL Banks and would operate the Office of Finance, which undertakes borrowings in the capital market. Even if this board of directors were placed technically in Treasury, it might have enough de facto autonomy to be able to fulfill the working functions of the System.

It should be anticipated that S&L executives would resist this solution, as they would undoubtedly prefer to maintain their

extensive influence over the lending policies and other features of the FHLB System. The extent of their leverage has in fact increased as the Federal Home Loan Bank Board has lost competence and credibility during the 1980's.

• Future structure of Federal regulation, and the preemption of state regulation.

The searing lesson of the S&L disaster is that excessively lax state regulation, and cross-purposes and jurisdictional problems between state and Federal regulators, decreased regulatory effectiveness, added to regulatory delays, and increased the eventual losses incurred by the S&L industry. Where various states, including especially Texas and California, enacted grossly permissive legislation to outdo Garn-St. Germain, they laid the basis for greater risk-taking and greater eventual losses. Pending Federal legislation should be so drafted as to remove all doubt that, in order to defend the deposit insurance fund, the Federal regulatory authorities have pre-emptive jurisdiction over the kinds of assets that insured S&L's can hold and other aspects of S&L operation. The Federal regulators should also be required in the legislation to set and enforce much higher standards of initial capital for newly chartered S&L firms, whether Federally-chartered or state-chartered and Federally-insured.

Where the Federal regulatory authority and organization should be domiciled is an interesting issue of administrative design. The collapse of credibility of the Federal Home Loan Bank Board makes that structure no longer defensible politically. FHLBB's mandate to oversee the entire span of deposit insurance,

the FHLB System, and Federal chartering and regulation became unwieldy, and some characterize it as conflicted because FHLBB was required both to promote housing finance and to exercise regulatory functions.

Had the Board been independent of industry influence, highly competent, and able to maintain its mandated functions without budgetary as well as political interference, the integrated pattern might have survived. Unfortunately, these conditions were not met in the actual operation of the agency. Political and trade association intrusions were frequent, from the engineering of mediocre appointments to numerous and all-too-successful attempts to weaken the content of administrative regulations and prevent their prompt and decisive application to individual cases. (Even as committees of the House of Representatives considered the bailout legislation, representatives of the industry lobbied intensively to weaken the net worth requirements by allowing extensive appeals for inclusion of goodwill in the net worth qualification. They almost succeeded, defeated only by a tie vote in the House Judiciary Committee. The issue was still in doubt when H.R. 1278 went to the House floor and confronted the possibility of weakening amendments.)

Moving deposit insurance into an administrative merger of FSLIC into FDIC is a reasonable interim step. Despite the difficulties of overcoming bank and S&L lobbying influence, it would now make sense to complete the merger of the two insurance funds after a relatively brief transition period, equalize the annual deposit insurance premium percentages, and maintain the

same standards of intervention into insolvent institutions for both banks and S&L's. We return to the issue of timely intervention in discussing the last of these elements of policy review.

Federal chartering and regulation of S&L's is sufficiently parallel to the tasks of the Office of the Controller of the Currency as to permit the borrowing of that agency's organizational arrangements within the Department of the Treasury. Thus, the Bush Administration's plan for a single Director, within Treasury, has appeal from the standpoint of public policy.

The industry groups most threatened by this shift are the insolvent and the marginal firms. These should not anticipate lenient treatment under the new regulatory organization if it is sufficiently armed with additional legislative authority, is adequately staffed, and is independent enough to resist political pressure. Less threatened, but not happy about their loss of influence on regulatory decisions, will be the larger and healthier firms.

As for the incumbent regulators, the shift of organization is inevitably distressing as it creates uncertainties about future jobs and authority. However, the credibility of the old framework has been damaged so extensively that its leaders are unlikely to be able to mount opposition to the changes that are contemplated in pending legislation and in the administrative decisions of the Executive Branch.

Elected politicians may at last become wary of accepting large-scale campaign money from the S&L industry; in a number of

individual instances, their past responsiveness to the pressures attendant upon campaign contributions resulted in serious weakening of regulatory oversight. His interventions on behalf of Vernon Savings and other Texas institutions may have contributed to the downfall of House Speaker Jim Wright. There is another well-documented instance of intervention, on behalf of Lincoln Savings of California and its CEO, Charles Keating, Jr. According to press reports, Keating and his circle have been extremely large campaign contributors to politicians of both parties. U.S. Senators Cranston, deConcini, Glenn, McCain, and Riegle went so far as to stage meetings with senior FHLBB supervisory officials from the FHLB of San Francisco. According to the Wall Street Journal's printed excerpts of a memo by William Black, General Counsel of the FHLB of San Francisco, these five senators attempted on April 10, 1989 to pressure the regulators into weakening their negative stance toward Lincoln Savings, which they felt was operating in an unsafe and unsound manner. (WSJ, June 13, 1989, p. A18.)

This firm was subsequently seized by FHLBB with very large anticipated losses. See also, for a searching review of Senator Cranston's prominent role in interventions on behalf of Lincoln Savings, an editorial in The Oakland Tribune on June 13, 1989. (The Oakland Tribune, p. A-10).

A system for monitoring and regulatory intervention to prevent a recurrence

The refrain of "never again!" resounds through recent discussions of the S&L bailout and its enabling legislation, yet many astute observers are concerned that the recent and forthcoming actions may fail to prevent a recurrence of financial disaster.

Separation of the deposit insurance fund's administration from the rest of the regulatory process will stiffen the resolve to defend the insurance fund even at the occasional cost of embarrassing the supervisory process. This is a good thing. Thus, from the public policy standpoint, administrative merger of FSLIC into FDIC will reduce future risks.

The tasks of regulation include licensing (issuance of charters and branch licenses); promulgation of regulations to set the framework of operation of financial firms and to implement broad legislated standards (such as the net worth requirements); examination and supervision of the regulated firms to evaluate the safety and soundness condition of firms and to assure compliance with standards; and, when necessary, restriction or intervention.

The Federal regulatory authority needs first to monitor real estate and mortgage market trends, region by region, in order to assess the risk exposures facing S&L firms. Examiners could then toward diversification of geographical lending risks and caution toward lending in economically shaky regional markets. Then the main focus of regulatory oversight must be on expert examination and supervision of individual firms.

Without retreating to the old pattern of detailed prohibitions and restrictions, modern financial regulation must nevertheless exhibit strength and sophistication in areas of oversight that are essential for the public: the maintenance of a viable and efficient financial structure; the protection of consumers through adequate disclosure; and the minimization of risks to the deposit insurance fund.

These tasks can be undertaken successfully only if the regulatory authority has the requisite powers to act and is competent, independent of political pressures, and well-staffed. (The year following the 1982 passage of Garn-St. Germain, then-Chairman Gray urgently requested increases in FHLB examiner positions and salaries, but OMB mandated an absolute decrease. Eventually, examiner staffs were decentralized to the FHLB regional banks, and a build-up and salary strengthening did occur -- but oversight had in the meantime been seriously inadequate.)

In the new legislation, merely adding to the civil or criminal penalties on paper is not likely to produce the substantive results that are needed from the regulatory process. Stronger regulatory powers are essential.

Misguided, speculative or criminally-inclined financial executives can inflict irreparable damage quickly. The regulatory monitoring system must therefore be able to detect incipient losses very early. A combination of frequent and reliable required reports from each firm, sophisticated computer models for projecting possible future losses, and very prompt follow-up in the field is needed to supplement the regular annual



examination process on which financial regulators have traditionally depended.

As has been usefully pointed out by George Kaufman (Federal Home Loan Bank of San Francisco, 1989, pp.198-205), very timely intervention and takeover of failing firms can greatly reduce the potential losses to the insurance fund. Some have recommended takeover before the zero-point of book net worth, on the theory that incipient losses will likely absorb some net worth during liquidation. A fully-automatic rule for such takeover would put regulated firms on notice and would reduce the potential for political interference.

To contain the cost of the bailout program at its currently-estimated level will require especially diligent actions if interest rates rise significantly in the next few years. Operating profits of surviving firms would be impaired. Rising interest rates, if combined with weakness in real estate markets and consequent increases in defaults, would push additional firms to the brink. Prompt intervention into such firms would be the only way to avoid a new wave of pressures upon the deposit insurance fund. The 1989 bailout legislation and program focus on past losses; they are not designed to withstand a near-term recession in housing and mortgage markets.

A favorite additional recommendation of financial economists is to require mark-to-market accounting on a frequent basis, so as to reveal to the firm's executives, investors, and regulators the true condition of the financial enterprise. There are, however, some problems attendant upon the large and rapid variations of market value of long-lived financial assets (such

as bonds and fixed-rate residential mortgages) when interest rates vary over a wide amplitude. Nevertheless, more emphasis upon mark-to-market accounting, together with enforcement of requirements for restoration of net worth position to required levels, would be helpful.

Another very real problem of real estate portfolios, however, is that the full dimensions of asset losses are revealed over a quite long time-interval -- in some cases, a period of years rather than weeks or months, as loans turn sour. The regulatory authority can maintain oversight in this context only by undertaking field checks of market conditions and the value of collateral and by employing sophisticated analysis to project future losses from early indications. Independent reappraisal of property collateral on a sampling basis is expensive, but it has great value both as prophylaxis against overstatement of value and as follow-up for changes in value as market conditions change.

Finally, the monitoring and oversight process entails willingness to restrict deposit growth and types of lending by any insured financial firm that is in weakened condition or is operating in an unsound manner, even if it has not reached the point of definitive intervention and take-over. The purpose is to curb a bad operation early enough to prevent the build-up of losses. Former FHLBB Chairman Edwin Gray, to his credit, pushed through a growth-restriction regulation tying deposit intake to a required net worth position; yet firms either inflated their book net worth to conform technically, or they may have simply

violated the regulation with relative impunity, thereby giving themselves time to expand their deposits and make increased volumes of (extraordinarily risky) loans. Clear-cut power to issue cease-and-desist orders, with enforceable penalties, should be available and should be used in such cases. The frequent demand of delinquent firms is for maximum due process with respect to alleged violations and then for maximum forbearance. Delay, brought about in this way, simply balloons the eventual losses.

There is an inescapable trade-off between timely and decisive intervention on the one hand, and the necessary size of the net worth buffer on the other. Ample and protracted due process has risks that can be offset only by requiring a much higher percentage of net worth reserves in relation to total deposits or total assets.

As if all this were not enough, the financial system is itself undergoing continuing changes through globalization, interpenetration of markets, and technological advances. These advances give rise to numerous new products and a continually more rapid pace of transaction-processing and informational support for financial decisions. Thus, there are ever-growing needs for sophistication in regulatory oversight.

To sum up: the current bailout is a step forward, but it is no guarantee, as it stands, against a recurrence of serious trouble.

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