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"FORBEARANCE" FOR INSURED S&Ls

BY

FREDERICK E. BALDERSTON
EHUD RONN

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by

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"FORBEARANCE" FOR INSURED S&Ls

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Executive Summary

Forbearance is intended as relief from regulatory pressures for S&Ls and other financial institutions that have inadequate net worth reserves and are in trouble from operating losses. There are good reasons for recent policy actions to increase capital standards. At the same time, it is appealing to soften the impact of tighter regulations when doing so might worsen economic conditions in an economically-depressed region.

It is necessary first to demonstrate that an institution should be eligible for forbearance. Then, forbearance should be granted only if the institution agrees to restrictions upon its management actions and is willing to provide the regulators with other protections for the deposit insurance fund.

Recent forbearance proposals -- especially those embodied in H.R.27, which passed the US House of Representatives in May, 1987 -- include: (1) reference to an economically-depressed region; (2) relief from capital standards for institutions not troubled on account of fraud or speculative mismanagement; (3) relaxation of accounting standards; and (4) provision of procedures for appeal from regulatory decisions that an institution or a borrower considers onerous. The bill does not meet reasonable public policy criteria for forbearance.

If enacted into law, H.R.27 would increase the eventual cost of resolving the problems of troubled institutions, hamstring regulation, and increase risks of general financial collapse.

"FORBEARANCE" FOR INSURED S&Ls

The plea for "forbearance" echoes through the land. Banks and S&L's in depressed regions of the US, it is argued, should be allowed lenient treatment of accounting for delinquent loans and other troubled assets and should be accorded temporary exemption from capital standards.

Following forbearance actions during 1986 by the Federal agencies that regulate commercial banks, the Federal Home Loan Bank Board issued a statement in February, 1987 announcing a formal policy on forbearance for insured S&L's that are troubled. (Federal Home Loan Bank Board, News release, February 27, 1987, 9 pages, mimeo.)

A little of the history must be recalled in order to put this policy statement into context. Lists of troubled banks and troubled S&L's lengthened sharply during the 1978-82 period, when interest-rate risks had a severe impact. Since that time, default risks have become the greater source of difficulty. Institutions that grew rapidly sometimes reaped trouble; in occasional instances, insiders mismanaged their institutions in a highly speculative fashion or with fraudulent intent; and deregulation brought wider asset-choice powers, resulting in a span of new opportunities to make mistakes if management did not prepare well for the types of new business that could be garnered. Broader authority to do business in diverse markets, as provided in the Garn-St. Germain Act of 1982 and in numerous relaxations enacted by the states, also meant new opportunities to increase asset

risks, in order to exploit the deposit insurance contracts between insured S&L's and the FSLIC.

The Federal Home Loan Bank Board (FHLBB) and US Treasury, noting the alarming depletion of the uncommitted reserves of FSLIC, brought forward a recapitalization plan calling for a bond-financed infusion of $15 billion over a several-year period, in addition to the regular and special assessments on all insured institutions for deposit insurance.

S&L industry spokesmen opposed what they regarded as the excessive size of the recapitalization package, and they lobbied for a smaller recapitalization to be utilized in a shorter timeframe. Regional factions in the industry also employed political leverage with their Congressional delegations to plead for a forbearance policy as a part of their price for supporting the recapitalization plan. Thus, a paradox: FHLBB was simultaneously attacked by representatives of the majority of institutions, which feared a high-cost solution, and by the weak institutions in economically-depressed regions, which feared the imposition of tougher standards that would drive them out of business. Indeed, the recapitalization bill that passed the House of Representatives in May, 1987 -- H.R. 27 -- contained both a low size of the recapitalization fund and a sweeping set of forbearance provisions. The implications of these will be discussed below.

Tighter capital standards for financial institutions

Federal Reserve Board Chairman Paul Volcker, FDIC Chairman William Seidman, and FHLBB Chairman Edwin Gray all agree that higher capital standards are needed in the increasingly volatile economic environment in which financial institutions must operate. The Federal Home Loan Bank Board has now set a general capital standard whereby net worth must be at least 6% of total assets if an insured S&L is to be in good standing; at lower levels, the institution may face restrictions on the direct investments in real estate it may undertake.

The purpose of these higher capital standards is to shore up the safety of the individual institution and the financial system as a whole. The FSLIC's dwindling reserve position has been only too well publicized as a result of news reporting of a GAO study. (US General Accounting Office, 1986.) FDIC faces implicit rather than explicit hazards, in that its more than $19 billion of reserves give the appearance of being sufficient to handle the appreciable number of small banks that fails each year. But the big hazard, behind the veil, is the banking system's exposure to large-scale international defaults, as well as to farm loans and energy loans that went sour.

Not as much discussed, but just as surely a cause for public policy concern, is the enormous default exposure of the Farm Credit System. Some informed guesses indicate that of the aggregate outstandings of approximately $80 billion in working capital financing, farm residential loans, and farm mortgages, as much as $20 to $30 billion may be in jeopardy.

Capital reserves are a buffer against adversity and can absorb the first big wave of asset write-downs in banks, S&Ls and other financial institutions. They thus serve as a way to protect the depositor or other holder of the prime liabilities of these institutions. They are the first line of defense before the deposit insurance funds would have to intervene for protection of the small to medium-sized (less than $100,000) account-holder. They also may damp off risks of the propagation of interconnected financial institution collapses, against which the deposit-insurance funds serve as a major second level of protection. The Federal Reserve and the US Treasury then must serve as the ultimate guarantors of the viability of the nation's financial institution structure.

The troubled institution in a depressed region

The general case for forebearance may be simply stated (though proving that the case is valid is another matter). First, the collapse of a financial institution in a depressed region could worsen the regional situation and impede recovery. Second, lending-institution relationships with business borrowers are complicated and are dependent upon a history of good performance; to establish a replacement for such relatiionships is often difficult and time-consuming for smaller business borrowers, especially in areas remote from big-city financial centers.

Third, with a grace period during temporarily adverse market conditions, the institution may be able to recover viability at a low private and social cost -- mainly measured in the delays of paying debt service or meeting capital reserve standards -- as

compared with the very high private and social cost of closure or assisted disappearance. Typically, the deposit insurer faces significant transactions costs as well as write-off losses when an institution must go through the liquidation process.

Polar cases of financial institutions in a depressed region

At one extreme is the financial institution that incurs accelerating risk as the result of insider fraud or speculative exuberance. There is a series of practical and timely indicators for this. (A list is given in Balderston, "The Frequency of Audit and Examination", 1986, unpublished.) This type of institution is likely to reach insolvency quickly when regional economic conditions turn bad.

At the other extreme is the financial institution that remains safely afloat even while surrounding economic circumstances deteriorate. Many such institutions exist in depressed regions, either because they start out with ample capital reserves or because they are cautious in their lending behavior and asset-management and do not become over-exposed to the adverse business environment of the depressed regional economy. It is of very great interest, in fact, to see what is the entire statistical distribution of S&L's in a depressed region: how many are essentially trouble-free, how many are at death's door, and how many are at various intermediate stages. (It is worth noting that some firms in a large population of financial institutions will become insolvent every year even under conditions of "normal" operation in a "normal" environment, because there are bound to be a few losers in the game of taking

normal risks for normal returns. Thus, it is necessary to implement a policy of forbearance by finding evidence that the incidence of trouble exceeds some norm. Also, it is necessary to design a scheme of forbearance so that it will not simply encourage imprudent behavior in the future and cause a demand for additional forbearance in the future.)

Proponents of forbearance do not profess any patience for the fraudulently operated institution, and they do not worry about the safe institution. The case for forbearance focusses upon the intermediate category of institutions that are not beset by fraud but are, nevertheless, in some trouble.

Table 1A shows late-1986 data, for selected states and for the US, of the ratio of regulatory net worth to total assets and the ratio of net earnings to total assets. As the left-half of the table shows, 251 insured S&L's having total assets of $66.7 billion nationwide had negative net worth as of December 31, 1986; at the other extreme, 1,727 S&L's with net worth of 5% or more had $551.1 billion in total assets. The industry's total assets at that date were $1,165.3 billion. Thus, 47.3% of total industry assets were in the "safe" category, and 5.7% were in negative net worth institutions, generally regarded by industry analysts as hopeless cases. Also, 74 S&L's with $25.1 billion of total assets had net worth ratios between zero and 1.0%, and many of these would be prime candidates for forbearance under H.R. 27. (It should be noted that "regulatory net worth" (RAPNW)differs from "net worth according to Generally Accepted Accounting Principles" (GAAPNW) in that the Federal Home Loan Bank Board has

TABLE 1A

Insured S&Ls, By State

Net Worth/Total Assets and Earnings, 1986

State	Regulatory NW/TA, 12/31/86 ($ billions)								Total	Annualized earnings as %TA, 4th Qtr. 1986					
	<0.0%		0-3.0%		3.0-5.0%		>5.0%			<0.0%		0-1.0%		>1.0%	
	#firms	$TA	#firms	$TA	#firms	$TA	#firms	$TA	$Assets	%firms	%TA	%firms	%TA	%firms	%TA
California	27	11.7	13	41.3	58	89.4	118	168	310.4	24.1	9.3	27.8	52.5	48.1	38.5
Colorado	5	0.5	3	0.2	30	7.9	18	7.2	15.9	47.4	57.6	34.3	35.2	18.5	7.4
Florida	13	5.9	13	6.8	44	35.1	79	34.5	83	28.2	23.1	53	47.5	18.8	29.4
Georgia	2	0.1	9	4.1	18	3.7	38	8.2	16.2	12	6.5	46.3	68.6	41.9	24
Illinois	17	3	40	9.4	92	21.4	118	33.1	65.3	24.3	15.6	40.4	51.9	17.5	39.4
Michigan	4	1.3	3	1.6	22	24.9	22	7	34.8	17.6	7	66.7	86.4	15.7	6.6
Oklahoma	12	1.7	14	2.9	12	1.5	15	3.8	10.1	71.7	67.8	26.4	32	1.9	0.2
Texas	23	8.9	57	17.2	67	33	98	27	97.3	59.5	63.7	24.6	28.6	16	17.8
US, Total	251	66.7	346	144.2	1206	403	1727	551.1	1165.3	25.8	21.7	41.1	50.5	33.2	28.7

Note: "Net worth" is regulatory net worth. TA is $ billions of Total Assets.

Source: Federal Home Loan Bank Board data, processed by US League of Savings Institutions.

permitted adjustments that have the effect of increasing the reported net worth of an insured S&L; the amount of the increase is generally about one percentage point. Under GAAP net worth, the nationwide number of firms having negative net worth as of 12/31/86 was 458, with $125.3 billion in total assets.)

Figures 1 through 5 show comparisons of the fraction of state total assets in each category of GAAP Net Worth to Total Assets for the US and for selected states. These comparisons illustrate how different, in different states, are the relative sizes of the two lowest categories: negative net worth and net worth ranging from zero to 1.0 percent.

The right half of Table 1A shows annualized net income for 4th Quarter 1986. In the US, 25.8% of institutions, having 21.7% of total industry assets, had negative 4th-Quarter earnings, whereas 1/3 of firms with 28.7% of industry total assets had annualized net income amounting to 1.0% of assets or more. During 1986, the percentage of the industry's firms with negative net income increased steadily, quarter by quarter, from 18.3% of firms in the 1st Quarter to 25.8% in the 4th. Given the generally good macro-environment of 1986 -- low interest rates and buoyant national income and employment -- the worsening quarter-to-quarter trend is worrisome.

The data of Table 1A and the figures show that Texas and Oklahoma, as two possible candidates for forbearance, do indeed have a high incidence of trouble. Negative net worth S&L's accounted for 9.1% of total state S&L assets in Texas, 16.8% in Oklahoma, and only 3.7% in both California and Michigan. (The overall US figure was 5.7%.) Fourth-quarter earnings of 71.7% of

Figure 1

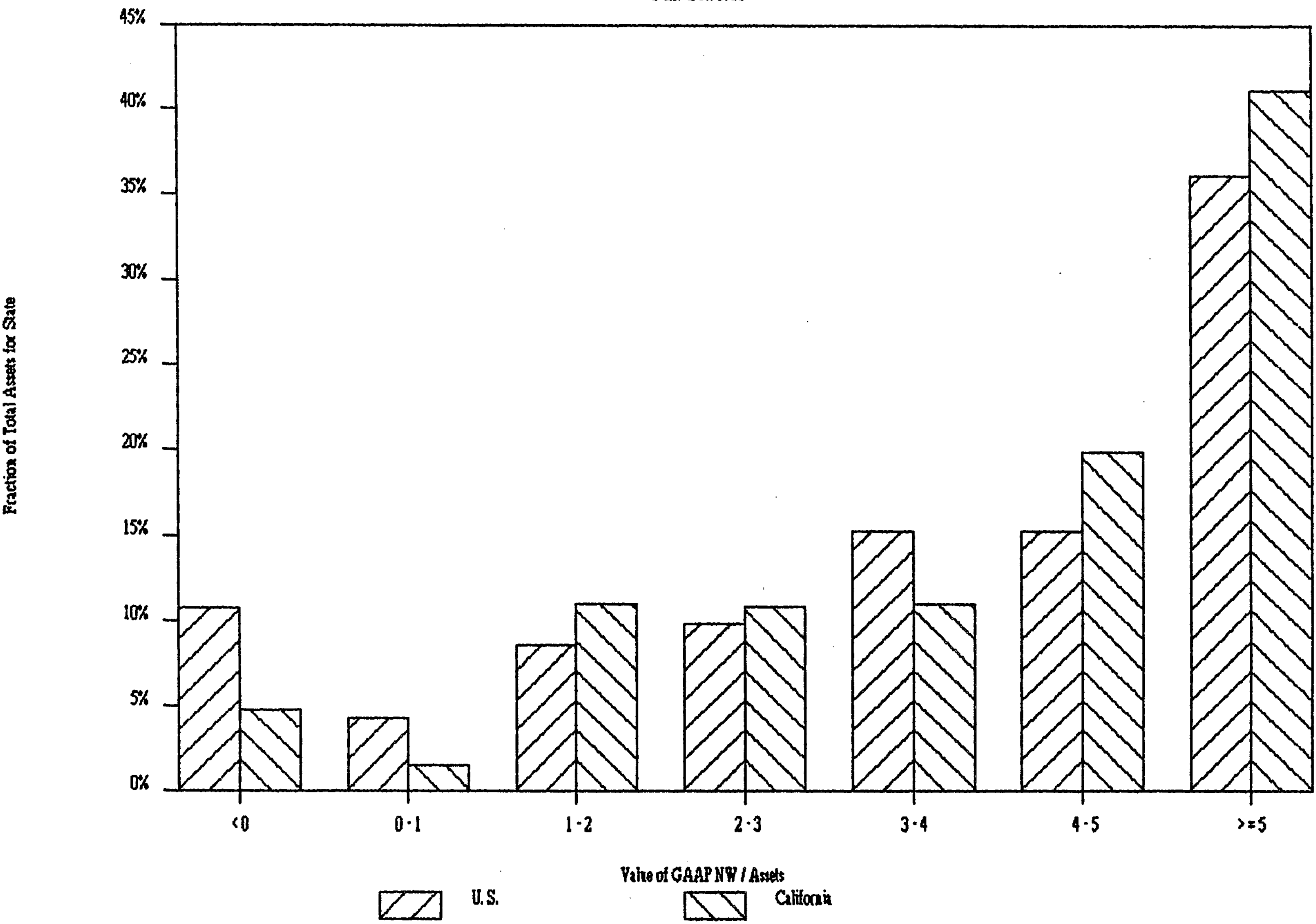


Figure 2

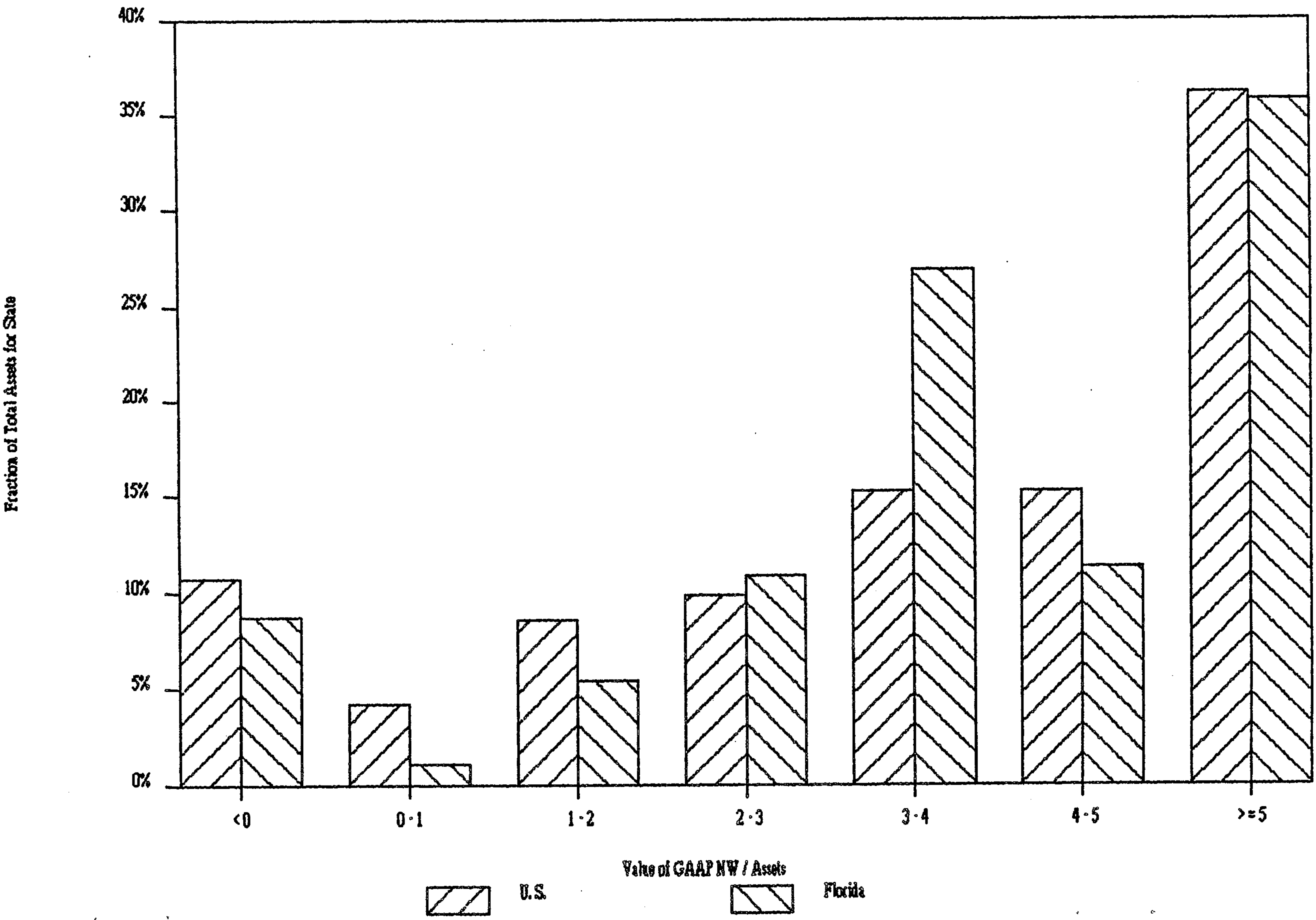


Figure 3

Comparative Frequencies of NW / Assets

Date: Dec. 1986

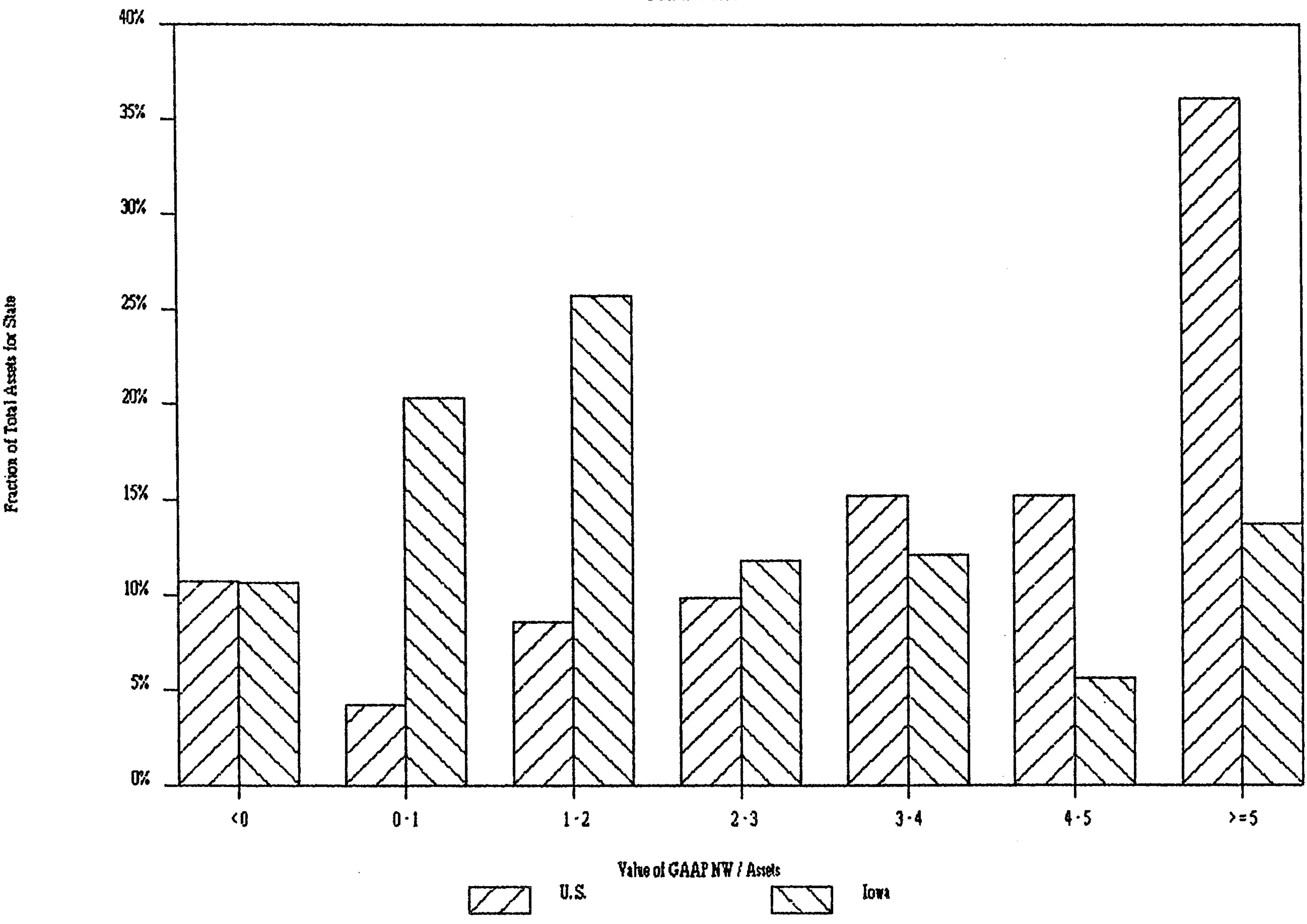


Figure 4

Comparative Frequencies of NW / Assets

Date: Dec. 1986

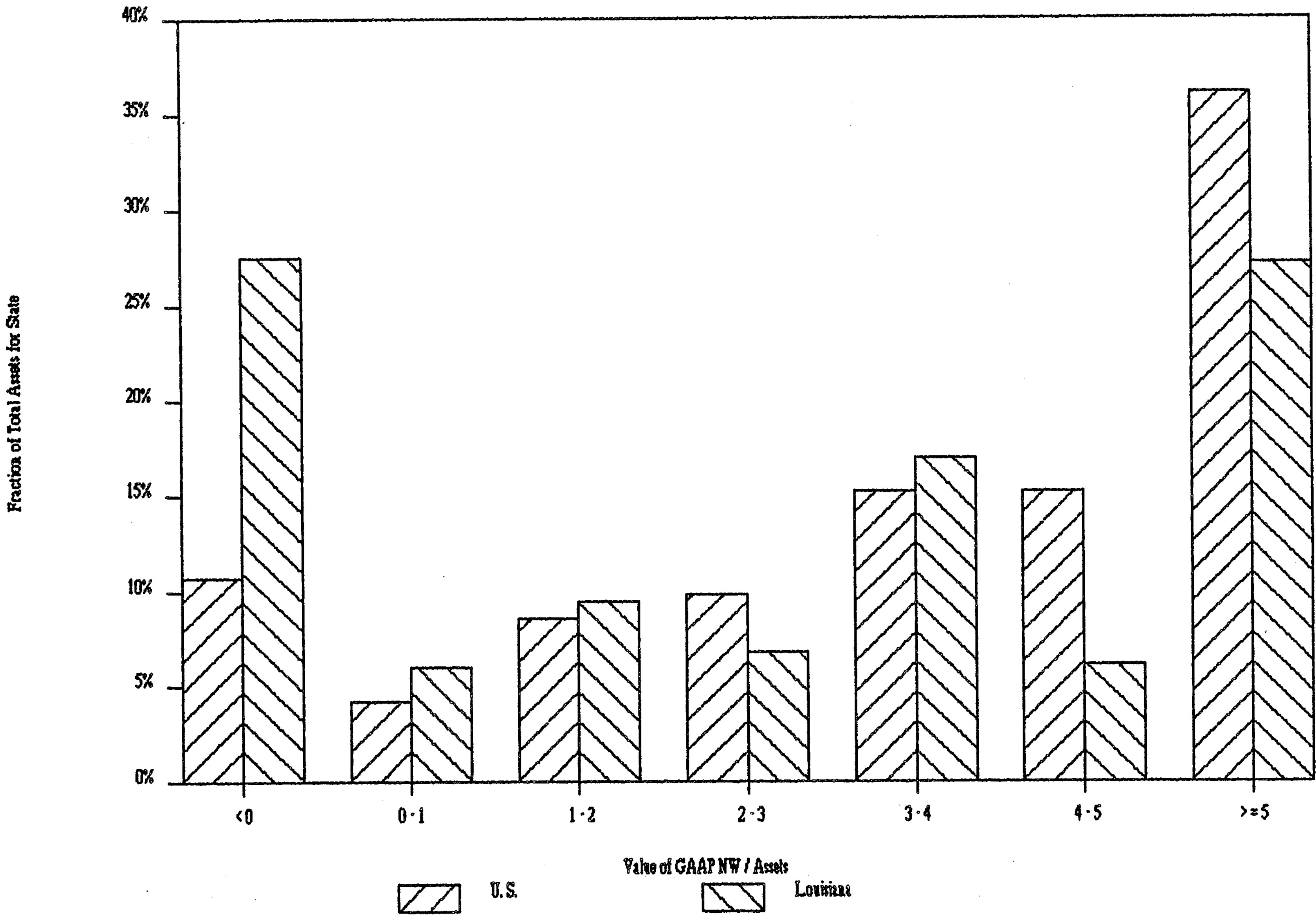
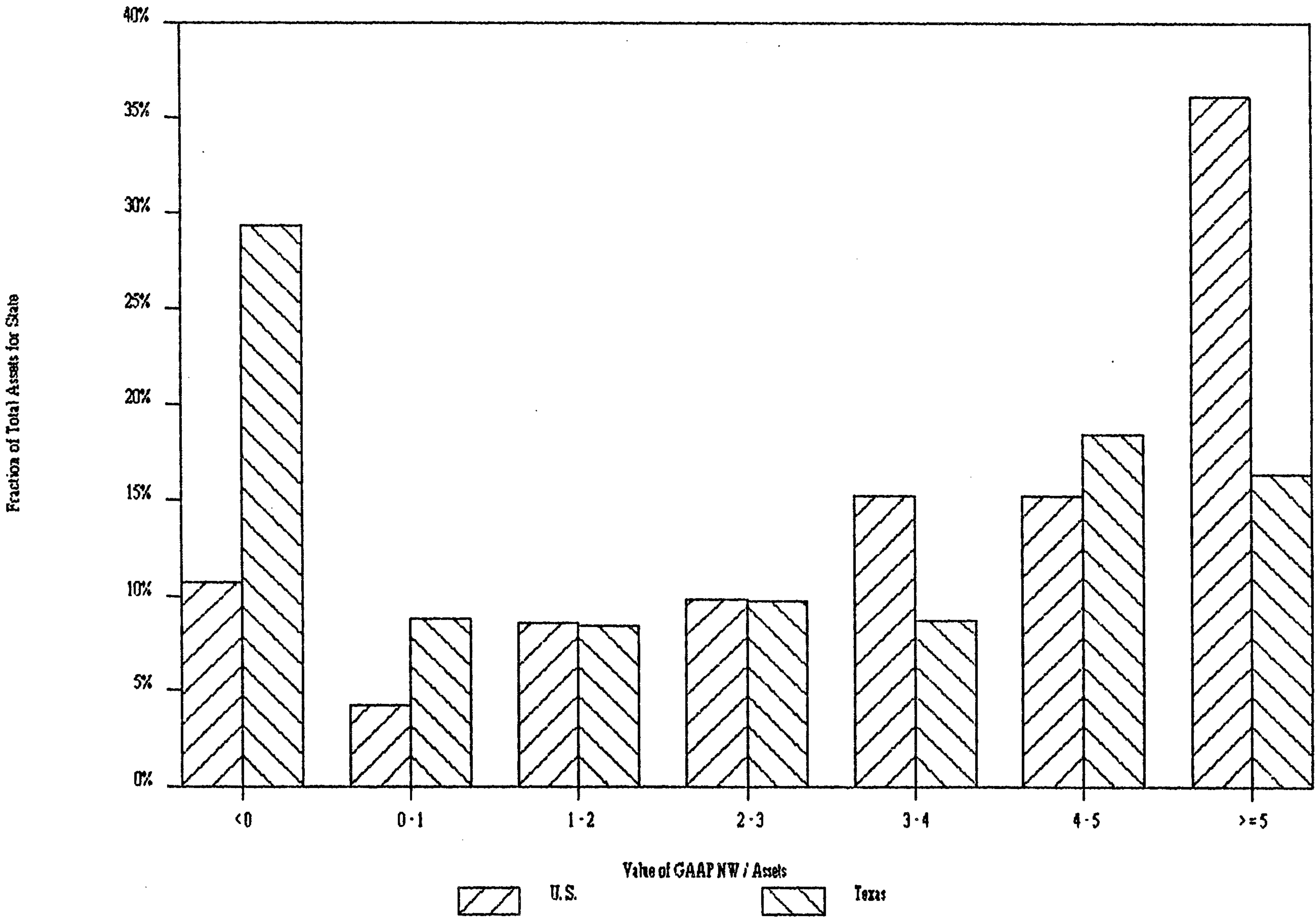


Figure 5



Oklahoma's firms and 59.5% of Texas' firms were negative, far above the national average of 25.8%.

Even though firms in the lower tail had dismal 1986 results, many firms in Texas and Oklahoma were in relatively good condition: in Oklahoma 27 firms with over one-half of state total assets had regulatory net worth of 3.0% or more, and in Texas 165 firms with over 60% of state assets were in this category. Thus, it is difficult to claim from this evidence that the entire universe of firms in a depressed economic region was in trouble; to some extent, firms appeared to have self-selected trouble!

It should be noted that the methods of reporting for the data just discussed classify assets according to the headquarters location of each reporting institution. Thus, a savings institution located in Iowa might have in its portfolio loans on property in other states besides Iowa.

Types of forbearance for the intermediate categories

Forbearance means, first and foremost, the use of accounting maneuvers to make the situation look less bad: stretching out the interval over which the "hit" of bad loans must be taken through write-offs that reduce operating profits and lessen net worth; or allowing the selective write-up of some assets while leaving all else the same, as was done when the FHLBB permitted insured S&Ls to revalue their office buildings at current market while keeping other assets at book value.

Secondly, the capital standard is softened, stretched out or waived under forbearance proposals, so that the institution is

not exposed to the triggers of restriction or intervention that would normally be activated by a substandard capital ratio.

Third, the institution that enjoys forbearance can receive normal or even exceptional credit accommodation from the Federal Reserve or the Federal Home Loan Bank. This access to liquidity eases its relations with borrowers, and the institution is protected (up to a point) in the event of a "run".

Finally, forbearance may involve help from a supporting institution that takes away or sterilizes the assets whose status is causing problems. In the 1930's, the Reconstruction Finance Corporation had this important function, and with its help, many financial institutions rode through the worst of times. The Home Owners' Loan Corporation had the role of enabling residential mortgage borrowers to restructure their mortgage debt, with similarly ameliorative consequences, both for the borrower and for the lending institution. (See Kendall, 1962, pp 145-146)

Acid Tests for Forbearance

In order to limit the relaxation of standards to "reasonable" cases, it is necessary to define both the market conditions of the depressed region in which the institution is located and the criteria that an institution should satisfy in order to gain the advantages of forbearance over its competitors in the industry.

1. Market conditions of the depressed region

First, the economics of the depressed region should display generally depressed conditions, in the sense that overall unemployment (not merely unemployment in one industry sector) is

considerably greater than the national average and greater than it was for this region in a recent time-period. Second, there should be reason to suppose that the region will recover within an easily foreseeable time; if the depressed conditions are likely to be protracted, or permanent, little good will come of offering relaxation of standards to the ailing financial institution, for it is unlikely to recover strength in a permanently bad market. Institutions involved in real estate finance face a particular problem if a metropolitan market or a region has accumulated a large excess supply of housing or other real estate, with a period of time (the length of which should be estimated) required for absorption of the excess supply.

Tables 1B through 3 give some general macroeconomic indicator data for the states and for the US as a whole for recent years. From these data and other relevant series, it is possible to focus attention upon the differences in economic conditions for each state or region, as against the average performance of the US economy. While macroeconomic indicators for some of our selected states showed softness, in no instance was state personal income lower in 1985 than in 1983, and in several states the trend in unemployment was the same or better than for the US as a whole. In Louisiana, Oklahoma and Texas, however, there was a dramatic decline in housing starts from 1983 to 1985 -- while the US total remained in a narrow range. Clearly, the housing sector showed extreme performance in a few states.

TABLE 1B

General Macroeconomic Indicators

STATE	% UNEMPLOYMENT OF THE LABOR FORCE			POPULATION (IN THOUSANDS)			STATE PERSONAL INCOME (MILLIONS OF DOLLARS)		
	12/84	12/85	12/86	1983	1984	1985	12/83	12/84	12/85
ALABAMA	11.6	8.3	9.6	3,960	3,989	4,021	38,383	41,069	43,748
ALASKA	10.3	10.2	11.2	482	505	521	8,993	9,104	9,608
ARIZONA	4.3	6.1	6.7	2,977	3,072	3,187	34,513	38,209	42,023
ARKANSAS	9.2	8.7	9.1	2,325	2,346	2,359	21,991	23,804	24,940
CALIFORNIA	6.9	6.3	6.3	25,311	25,795	26,365	368,584	401,628	434,585
COLORADO	5.3	6.2	7.7	3,149	3,190	3,231	43,211	46,280	48,649
CONNECTICUT	4.4	4.6	3.4	3,140	3,155	3,174	50,074	55,099	59,007
DELAWARE	5.4	4.6	3.7	606	614	622	7,907	8,549	9,137
FLORIDA	6.1	5.6	4.6	10,754	11,050	11,366	136,652	148,398	159,885
GEORGIA	5.5	6.2	5.7	5,733	5,842	5,976	64,341	71,264	77,290
HAWAII	5.9	5.1	4.2	1,019	1,037	1,054	13,377	13,903	14,962
IDAHO	6.9	7.8	8.6	988	999	1,005	10,469	10,912	11,449
ILLINOIS	8.6	8.3	7.0	11,491	11,522	11,535	150,954	164,704	173,178
INDIANA	8.8	7.8	6.4	5,474	5,492	5,499	60,705	66,450	69,474
IOWA	7.3	8.1	6.4	2,904	2,903	2,884	32,172	35,163	36,142
KANSAS	5.4	5.1	5.4	2,427	2,440	2,450	30,836	32,971	34,478
KENTUCKY	9.3	9.5	8.5	3,714	3,720	3,726	36,333	39,272	40,913
LOUISIANA	9.8	11.3	13.4	4,441	4,461	4,481	47,660	49,811	50,318
MAINE	5.9	4.9	4.3	1,145	1,156	1,164	50,074	55,099	59,007
MARYLAND	4.9	4.4	4.2	4,301	4,349	4,392	60,505	66,551	71,426
MASSACHUSETTS	3.9	3.9	3.1	5,766	5,798	5,822	82,883	91,138	98,006
MICHIGAN	10.6	7.6	7.6	9,054	9,058	9,088	111,306	120,741	125,791
MINNESOTA	7.1	6.8	5.5	4,145	4,163	4,193	51,789	57,300	59,767
MISSISSIPPI	10.3	9.4	11.7	2,583	2,598	2,613	21,917	23,364	24,568
MISSOURI	7.0	6.6	6.1	4,963	5,001	5,029	58,610	63,853	67,832
MONTANA	7.4	8.2	8.0	816	823	826	8,927	9,394	9,285
NEBRASKA	4.3	6.0	5.2	1,596	1,605	1,606	18,794	20,257	21,393
NEVADA	8.0	8.6	6.0	897	917	936	11,957	12,981	13,896
NEW HAMPSHIRE	3.5	3.0	2.5	959	978	998	12,694	14,069	15,524
NEW JERSEY	5.4	5.4	3.9	7,468	7,517	7,562	114,765	125,023	134,354
NEW MEXICO	7.4	8.7	9.3	1,402	1,426	1,450	14,154	15,230	16,106
NEW YORK	6.5	5.9	5.4	17,685	17,746	17,783	251,326	274,273	292,482
NORTH CAROLINA	6.7	4.2	4.8	6,077	6,166	6,255	63,350	69,863	74,662
NORTH DAKOTA	5.8	6.4	6.6	681	687	685	8,122	8,663	8,627
OHIO	9.2	8.5	7.9	10,738	10,740	10,744	127,854	137,363	144,597
OKLAHOMA	6.7	7.1	7.9	3,311	3,310	3,301	38,204	39,917	40,785
OREGON	9.6	8.9	8.2	2,660	2,676	2,687	30,964	32,909	34,594
PENNSYLVANIA	7.3	7.3	4.7	11,891	11,887	11,853	144,874	154,084	161,634
RHODE ISLAND	5.3	4.5	3.7	956	962	968	11,974	13,031	13,763
SOUTH CAROLINA	6.9	6.4	5.9	3,258	3,302	3,347	31,421	34,143	36,261
SOUTH DAKOTA	5.1	6.0	5.0	699	705	708	7,159	7,818	7,967
TENNESSEE	8.7	7.8	7.6	4,689	4,726	4,762	47,093	51,436	54,827
TEXAS	5.6	6.3	8.7	15,816	16,083	16,370	195,842	211,060	223,868
UTAH	6.4	5.9	6.0	1,595	1,623	1,645	15,505	16,671	17,523
VERMONT	5.2	4.6	4.5	525	530	535	5,685	6,184	6,678
VIRGINIA	5.0	5.3	4.7	5,559	5,636	5,706	71,886	78,921	84,998
WASHINGTON	9.8	8.3	8.3	4,305	4,349	4,409	56,955	59,114	62,560
WEST VIRGINIA	16.1	12.5	11.6	1,963	1,951	1,936	18,500	19,237	19,707
WISCONSIN	7.7	7.4	7.1	4,747	4,762	4,775	56,699	61,010	63,750
WYOMING	5.6	8.0	9.7	516	513	509	6,317	6,501	6,866
NATIONWIDE	7.0	6.7	6.3	234,284	236,495	238,740	2,937,388	3,182,876	3,379,652

TABLE 2
Housing and Real Estate

STATE	HOUSING UNITS STARTED (IN THOUSANDS) 1983	1984	1985
ALABAMA	18.9	20.1	24.1
ALASKA	12.7	7.5	5.9
ARIZONA	62.6	73.1	70.5
ARKANSAS	12.5	12.7	13.8
CALIFORNIA	166.5	212.9	251.5
COLORADO	50.0	41.9	34.8
CONNECTICUT	15.3	18.8	22.4
DELAWARE	3.4	4.3	4.1
FLORIDA	180.4	196.7	185.9
GEORGIA	72.2	80.0	80.7
HAWAII	5.3	5.3	6.6
IDAHO	4.1	4.3	5.0
ILLINOIS	34.2	35.0	37.8
INDIANA	20.2	23.5	22.8
IOWA	7.9	7.7	5.8
KANSAS	16.8	18.9	13.8
KENTUCKY	14.9	15.7	17.9
LOUISIANA	40.2	30.8	21.5
MAINE	4.6	6.8	9.2
MARYLAND	36.0	36.9	39.1
MASSACHUSETTS	22.4	26.5	35.5
MICHIGAN	23.4	30.1	34.9
MINNESOTA	28.2	30.4	28.5
MISSISSIPPI	12.7	13.9	12.3
MISSOURI	22.5	30.8	31.2
MONTANA	2.6	3.4	3.1
NEBRASKA	6.7	7.1	5.4
NEVADA	15.1	12.9	13.7
NEW HAMPSHIRE	7.9	12.5	15.3
NEW JERSEY	36.7	43.7	51.1
NEW MEXICO	11.1	16.2	12.2
NEW YORK	36.2	43.4	60.0
NORTH CAROLINA	53.6	62.7	71.6
NORTH DAKOTA	5.5	3.9	3.1
OHIO	31.6	33.5	34.8
OKLAHOMA	50.2	28.5	14.7
OREGON	8.9	8.6	10.3
PENNSYLVANIA	35.9	40.2	47.3
RHODE ISLAND	3.7	4.4	4.9
SOUTH CAROLINA	28.9	33.1	32.2
SOUTH DAKOTA	3.1	4.5	2.5
TENNESSEE	37.5	42.4	46.4
TEXAS	317.5	222.1	155.5
UTAH	13.0	18.2	15.8
VERMONT	5.1	7.4	5.0
VIRGINIA	53.8	62.8	58.9
WASHINGTON	27.6	29.4	34.0
WEST VIRGINIA	2.5	2.8	2.0
WISCONSIN	17.9	19.3	18.9
WYOMING	2.8	2.0	1.7
NATIONWIDE	1,702.9	1,749.9	1,736.3

TABLE 3

Regional Economic Sectors in Trouble

STATE	FARM REAL ESTATE VALUE OF LAND & BLDG PER ACRE 1984	1985	1986	MANUFACTURING EMPLOYMENT (IN THOUSANDS) 12/84	12/85	12/86	VALUE/BARREL OF CRUDE OIL (DOLLARS PER BARREL) 1983	1984	1985
ALABAMA	809	769	761	349.0	354.3	356.0	30.07	29.39	25.96
ALASKA				7.6	8.0	7.9	17.92	18.13	17.15
ARIZONA	295	265	231	178.8	182.0	185.5	30.00	28.00	27.00
ARKANSAS	933	849	705	212.3	210.1	213.9	28.28	28.15	25.82
CALIFORNIA	1,918	1,726	1,571	2,064.8	2,088.7	2,064.5	22.61	22.09	22.13
COLORADO	468	435	357	194.2	191.2	184.1	28.92	28.09	25.64
CONNECTICUT	2,814	3,208	3,721	427.5	403.9	395.7			
DELAWARE	1,866	1,642	1,757	72.2	71.9	70.4			
FLORIDA	1,608	1,527	1,435	516.6	522.3	522.8	31.10	31.00	30.00
GEORGIA	910	865	822	553.1	559.4	567.8			
HAWAII				20.9	21.6	21.8			
IDAHO	814	749	644	54.4	55.3	53.5			
ILLINOIS	1,800	1,314	1,143	971.0	971.1	922.2	29.12	28.76	26.90
INDIANA	1,594	1,259	1,058	618.8	603.6	599.0	29.06	28.72	26.82
IOWA	1,499	1,064	841	209.5	204.1	199.4			
KANSAS	583	466	387	177.3	173.2	173.7	28.45	27.99	25.33
KENTUCKY	1,007	906	870	260.6	255.2	257.0	28.6	28.24	26.19
LOUISIANA	1,351	1,256	1,005	184.3	173.5	166.3	30.02	29.67	27.24
MAINE	750	856	993	109.0	107.0	105.5			
MARYLAND	2,185	2,097	1,887	217.0	214.4	209.1			
MASSACHUSETTS	2,081	2,372	2,752	691.6	655.5	615.6			
MICHIGAN	1,223	1,052	936	965.6	993.0	995.8	28.93	28.54	26.17
MINNESOTA	1,083	823	609	378.0	368.8	367.4			
MISSISSIPPI	939	835	752	219.8	223.8	221.8	26.76	27.26	25.51
MISSOURI	856	659	606	433.3	430.3	416.6	31.2	27.50	27.00
MONTANA	264	222	204	22.1	20.9	21.5	28.8	28.07	25.29
NEBRASKA	617	444	364	88.7	87.2	86.0	28.58	27.83	25.43
NEVADA	254	229	199	21.5	22.1	22.7	23.8	25.80	26.00
NEW HAMPSHIRE	1,244	1,419	1,646	126.9	123.1	117.7			
NEW JERSEY	3,234	3,525	3,913	733.5	716.1	693.2			
NEW MEXICO	182	163	134	36.8	37.5	37.8	29.26	28.69	26.78
NEW YORK	842	808	824	1,333.8	1,281.9	1,235.0	28.19	27.70	25.19
NORTH CAROLINA	1,380	1,242	1,130	824.8	829.8	836.6			
NORTH DAKOTA	439	360	317	15.4	15.3	15.4	29.27	28.39	25.32
OHIO	1,444	1,126	1,013	1,130.5	1,123.6	1,106.3	28.14	27.71	25.11
OKLAHOMA	699	566	481	174.1	169.9	159.5	29.67	29.11	26.27
OREGON	698	579	521	194.9	196.3	192.7			
PENNSYLVANIA	1,642	1,510	1,450	1,108.8	1,072.3	1,035.7	28.28	27.71	25.05
RHODE ISLAND	2,926	3,335	3,869	120.7	120.8	120.7			
SOUTH CAROLINA	927	899	872	378.8	363.0	364.1			
SOUTH DAKOTA	338	250	215	28.6	27.3	28.9	29.10	28.36	25.80
TENNESSEE	1,044	982	992	496.8	485.0	496.6	32	28.00	27.50
TEXAS	593	652	541	1,005.9	996.9	944.8	29.35	28.87	26.80
UTAH	571	514	478	96.0	93.0	90.6	28.12	27.21	24.13
VERMONT	893	1,017	1,180	49.2	49.6	50.7			
VIRGINIA	1,114	1,091	1,146	422.4	425.9	425.3	32.25	27.28	27.00
WASHINGTON	961	923	812	284.2	294.8	302.1			
WEST VIRGINIA	667	554	537	90.5	88.4	86.8	27.27	26.90	24.35
WISCONSIN	1,046	847	711	515.9	512.9	509.7			
WYOMING	197	177	154	8.5	7.9	8.2	27.19	26.73	24.67
NATIONWIDE	782	679	596	19,557.0	19,272.0	19,173.0	26.19	25.88	24.08

TABLE 3 (continued)

Regional Economic Sectors in Trouble

STATE	CRUDE OIL PRODUCTION (THOUSANDS OF BARRELS)			FARM ASSETS (BIL. DOL.)			FARM DEBT (BIL. DOL.)		
	1983	1984	1985	1983	1984	1985	1983	1984	1985
ALABAMA	18,746	19,804	21,581	12.7	12.3	12.2	2.5	2.4	2.2
ALASKA	625527	630,401	666,233	0.4	0.4	0.5	z	z	z
ARIZONA	237	215	175	12.5	11.5	10.1	1.9	2.0	1.9
ARKANSAS	18849	18,730	19,044	19.8	18.3	15.9	4.2	4.2	4.0
CALIFORNIA	404688	412,020	423,877	75.2	69.3	63.7	17.8	17.8	16.4
COLORADO	29050	28,845	30,246	21.1	19.7	16.9	4.8	4.7	4.8
CONNECTICUT				1.9	2.3	2.2	0.3	0.3	0.3
DELAWARE				1.6	1.4	1.5	0.4	0.4	0.3
FLORIDA	19,476	14,462	11,458	24.8	23.8	22.6	4.3	4.2	4.0
GEORGIA				16.8	16.3	15.7	4.8	4.6	4.3
HAWAII				4.0	4.2	4.2	0.3	0.3	0.3
IDAHO				16.0	15.0	13.1	3.7	3.6	2.4
ILLINOIS	29,200	28,868	30,265	65.4	51.4	46.9	11.3	11.2	11.6
INDIANA	5,321	5,526	5,168	34.8	29.4	26.1	7.6	7.4	7.1
IOWA				68.6	53.6	45.8	16.8	16.3	15.8
KANSAS	71,594	75,729	75,407	38.5	32.4	28.8	8.8	8.4	8.4
KENTUCKY	7,886	7,777	7,790	20.6	19.5	18.9	4.1	4.1	3.8
LOUISIANA	479,569	515,268	508,239	17.2	16.3	13.6	3.4	3.4	3.2
MAINE				1.9	2.0	2.2	0.4	0.4	0.4
MARYLAND				9.7	7.5	6.9	1.2	1.2	1.1
MASSACHUSETTS				1.9	2.2	2.5	0.2	0.3	0.2
MICHIGAN	31,736	30,554	27,300	20.5	18.4	17.3	4.4	4.4	4.3
MINNESOTA				48.0	39.8	32.7	11.8	11.7	11.4
MISSISSIPPI	31,455	32,776	30,641	17.8	16.1	14.9	4.2	4.2	4.1
MISSOURI	269	285	243	36.4	30.2	28.6	7.1	7.0	6.7
MONTANA	29,225	29,761	29,768	21.0	18.1	16.4	4.5	4.3	4.1
NEBRASKA	6,380	6,452	6,943	41.1	32.2	28.6	10.8	10.3	9.8
NEVADA	810	1,907	3,039	2.9	2.6	2.3	0.4	0.4	0.4
NEW HAMPSHIRE				0.9	1.1	1.2	0.1	0.1	0.1
NEW JERSEY				4.2	4.5	4.8	0.5	0.5	0.5
NEW MEXICO	75,169	79,336	78,530	10.0	9.1	7.7	1.4	1.4	1.3
NEW YORK	831	840	1,071	13.5	13.2	13.0	3.5	3.1	2.9
NORTH CAROLINA				20.6	19.1	17.5	4.1	4.0	3.7
NORTH DAKOTA	50,690	52,652	50,857	25.6	22.4	20.6	5.8	5.7	5.8
OHIO	14,971	15,271	14,988	31.3	26.2	23.9	5.2	5.1	4.9
OKLAHOMA	158,604	168,385	162,739	30.1	25.5	22.7	6.0	5.6	5.6
OREGON				16.6	14.3	13.1	3.5	3.4	3.2
PENNSYLVANIA	4,282	4,284	4,851	20.0	19.0	18.4	3.0	3.0	2.8
RHODE ISLAND				0.3	0.3	0.3	z	z	z
SOUTH CAROLINA				16.8	16.3	15.7	4.8	4.6	4.3
SOUTH DAKOTA	1,172	1,340	1,596	21.7	17.8	15.9	5.4	5.3	5.0
TENNESSEE	1,056	920	786	19.6	19.0	19.3	3.1	3.1	2.8
TEXAS	902,676	904,774	888,831	99.6	108.0	92.6	13.6	14.0	14.1
UTAH	29,534	34,689	40,792	8.3	7.6	7.5	1.1	1.1	1.1
VERMONT				2.4	2.6	2.8	0.4	0.4	0.4
VIRGINIA	65	32	26	15.1	15.0	15.4	2.2	2.3	2.1
WASHINGTON				20.3	19.6	18.0	4.0	4.1	4.0
WEST VIRGINIA	3,628	3,524	3,555	3.6	3.2	2.9	0.4	0.4	0.4
WISCONSIN				30.8	27.1	24.0	7.6	7.4	7.1
WYOMING	118,303	124,269	128,514	8.5	7.8	6.9	1.3	1.2	1.1
NATIONWIDE	3,170,999	3,249,696	3,274,553	1,061.0	956.0	867.0	216.0	213.0	205.0

Table 4 shows trends, from 1983 through 1986 in mortgage delinquencies and substandard loans of FSLIC-insured institutions. This could be regarded from one point of view as a trend in the market environment of these institutions -- but from another standpoint, it can be said that the institutions themselves may have caused a major part of the poor financial performance of mortgage markets in the states most obviously affected. Further, the reporting method results in the classification of loans according to the state in which the institution has its headquarters. Thus, some loans held by a California institution might be on property located in Texas, but the delinquency data reporting would put these in California.

2. Eligibility criteria applying to the institution

As we have already seen, "forbearance" is applicable as a policy only to intermediate cases: institutions that are not in solid condition, but also, institutions that have not been driven to desperate case by fraud or gross mismanagement. In principle, then, only those institutions should be eligible that display positive signs of recoverability.

Some additional practical criteria can be suggested. To the extent that the asset-base can be assessed quickly, it should not contain non-earning assets in such quantity that, on a cash-flow basis, interest due and payable on deposit liability cannot be paid. Book net worth should be sufficient to absorb at least some loan losses in each fiscal quarter, so that not all losses need to be plowed ahead into the future.

Operating expenses should be not far from the industry average as a percentage of total assets.

TABLE 4

Mortgage Delinquencies, Percent of Housing Stock, 1983-86

State:	12/83	12/84	12/85*	12/86
California	1.80	1.78	2.93	3.07
Colorado	2.37	2.21	4.14	4.47
Florida	1.71	2.16	3.45	3.60
Illinois	3.85	3.01	2.72	2.73
Michigan	1.61	1.37	1.14	0.92
Oklahoma	2.02	3.19	7.16	12.90
Texas	1.79	3.88	6.07	16.91
US, Total	2.13	2.28	3.10	4.37

Source: Federal Home Loan Bank Board.

Data are for all FSLIC-insured institutions.
Data for second half of 1986 subject to revision.

*Change of definition in July, 1985 increased the percentage for US from 2.57 in 6/85 to 2.63 in 7/85, and by varying amounts for individual states.

3. Evaluating the institution that operates in multiple markets, some depressed and others not.

Given the geographical basis of Congressional representation, the political pressure for forbearance is usually based upon pleas for the rescue of an important, economically-depressed region. Some institutions, however, take on exceptional risks and incur exceptional losses not because they are located in the depressed region but because they seek out high-return assets in the depressed region, and these assets subsequently cause trouble. This, for example, was an important part of the story of Continental Illinois Bank. (See Sprague, 1986.)

In other instances, the institution may have branch organizations in several states or regions, some of which are depress and others, not. Whether these institutions can qualify for forbearance becomes a question of the mix of their exposure as between the depressed and the normal market environments. As interstate operation of banks and S&Ls becomes more widespread, the applicability of a forbearance policy to these multi-maraket institutions will, accordingly, be a difficult issue. Conceptually, a forbearance policy is based upon the presumption of adverse local impacts on local institutions of poor economic conditions.

Conduct of the institution after forbearance is granted

During the period of recuperation for which forbearance is provided, the institution should be expected to operate within narrow limits of liability-growth and asset expansion. "Growing out of trouble" should be regarded as an impermissible strategy,

for it is likely to be an illusion for the ailing firm. The institution should also be enjoined from "speculating" out of trouble. That is, it should agree with the regulatory authority that it will not engage in those categories of lending and investing that are exceptionally risky within its region, and it will not acquire loans or other assets in those categories outside its region. Similarly, off-balance-sheet commitments that are made in order to obtain high front-end fees can quickly become dangerous to the troubled institution, and it should be required to whittle down existing items and avoid entering into new commitments.

With respect to possible diversification moves, the institution should be required to obtain special permission from the regulatory authority for acquisitions or direct investments, whether within its region or outside it. The institution should be ineligible for intra-industry mergers in which it would emerge as the controlling interest, for its condition creates a prima facie case that the incumbent management performed inadequately. (Statistical evidence of the proportion of healthy institutions in the region, as against institutions in trouble, should be assembled and cited as the basis for such a prima facie case.)

The institution should also position itself so as to resist short-term liquidity binds. That is, it should reduce or eliminate reliance upon highly volatile or high-cost sources of deposit inflow, and it should be required to eliminate as quickly as possible any amounts of deposits that are above the deposit insurance limits, for this money is likely to depart at the first

rumors of serious trouble in the status of the institution. (This problem exacerbated the crisis of Continental Illinois Bank in 1984, for it accumulated very large deposit liabilities in the form of US and Eurodollar CD's in excess of the insured limit. (Sprague reports that approximately ninety percent of total deposits of the bank were uninsured.) The result was that a serious run developed as soon as the weakened condition of the Bank became a subject of extensive rumor. See Sprague, 1986.)

In its plan for recovery, the institution should be required to show that it has put its equity-holders as well as its management at risk -- that is, the equity-holders should be on notice that, in the event of necessary liquidation or forced merger, the value of their interest will be the first thing reduced or eliminated. The institution should be encouraged to issue subordinated debt (or,even, new equity) in order to shore up its net worth position. It has even been suggested that the regulatory authorities could legitimately require, as part of a forbearance package, that the equity-holders accept potential liability beyond the value of their original equity investment, in order to protect the insurance fund against "one-way" bets.

An important problem for the regulatory authorities is that the troubled institution may be prone to heavy risk-taking in a gamble to recover position quickly. If it succeeds in high-risk lending or investing, it will be sound again; if not, its carcass will be the responsibility of the deposit insurance fund. Thus, the regulatory authorities will of necessity have to maintain exceptional surveillance of the troubled institution for which forebearance has been granted. Its management should

expect to be required to file a detailed recovery plan, report progress at frequent intervals, and submit readily to on-site monitoring and inspection.

If forbearance is granted, and more particularly, if capital assistance or liquidity provision is required on an interim basis, a reasonable quid pro quo would be the issuance of stock warrants to the lending authority such that the institution's control could pass rapidly and smoothly to the authority in the event that the institution's situation worsened appreciably. An issuance of warrants as a means of quick and definitive assumption of control should be an important element of a forbeareance policy, especially in view of the difficulties that can arise in dual regulation, where FSLIC can take some actions only with the legal acquiescence and participation of the state regulator.

These suggested provisions for restricted operation of the troubled institution have three purposes. First, they are intended to provide a monitored path to recovery. Second, they place the controlling interest and management of the troubled institution under exceptional surveillance in view of the short-term risk that the institution's condition may worsen rapidly, forcing quick intervention. Third, they have a prophylactic intent, in that "forbearance" will thereby be accompanied by sufficient inconvenience and equity exposure as to provide object lessons in favor of prudent operation to institutions that are watching the fate of the troubled competitor. (A very real issue for the health of the depository-institution sector is to

maintain a market-like discipline in the face of a felt necessity to prevent the full operation of the most draconic penalty of the market: bankruptcy and liquidation.)

Actions by the regulators and the support institutions

The troubled institution in a depressed region may well need a showing of governmental support if it is to continue to operate more or less normally in the face of rumors of impending collapse. Thus, the regulatory authorities need to be able to point to deposit insurance as an iron-clad guarantee, up to the limits of the coverage provided by law. They must also be able to provide vigorous liquidity support (from the Federal Reserve and/or the Federal Home Loan Bank System) so that incipient runs will exhaust quickly. (This is one of the hazards of the protracted debate over FSLIC recapitalization, and the consequent spread of public uneasiness concerning depletion of FSLIC reserves; as a matter of principle, deposit insurance works well only if it is a promise that the public is sure can be kept.)

More problematical is the question of lifting bad assets out of the troubled institution (at a price) so that what remains can be managed in essentially normal mode. This function, performed by RFC during the worst years of the Great Depression, was contemplated for a time in the proposals for a highly capitalized Federal Asset Disposition Association (FADA) for the savings and loan industry. But the FADA that came to pass has the much more limited role of serving as managing agent for the bad-asset workout process and not as the owner of these assets. Correspondingly, FADA does not have the deep pockets that would

be necessary for the holding of bad assets during a protracted workout period.

Procedural paralysis of the regulatory process: fatal defects of H.R. 27

The Bill that passed the House of Representatives in May, 1987 was unusual in that it mandated elaborate restrictions upon the Federal Home Loan Bank Board in its regulatory functions. The Bill differs very materially from the Senate version, which did not contain forbearance provisions.

H.R. 27's Title II provided, first of all, that FHLBB would have to approve forbearance from capital standards for an insured institution that had regulatory net worth of 0.5 percent or more of total assets if the institution is in an economically-depressed region or is a minority institution, and if the weak condition is not the result of "imprudent operating practices", provided that the institution submits to FHLBB a plan to improve its capital.

Second, if the insured institution has less than 0.5% regulatory net worth, the onus is on FHLBB to determine whether the same conditions have been met, and to determine whether the institution has "reasonable prospects" of recovering. FHLBB has already faced significant requirements of assembling evidence as a pre-condition of moving on an insured institution, and these capital forbearance provisions assure that many very weak institutions would continue to operate, without any accompanying restraints upon their modes of operation after receiving forbearance.

The regional Federal Home Loan Banks are also barred from removing these weak institutions from membership on account of their weak condition.

But the most serious restrictions upon regulatory action reside in the provisions of H.R. 27 for appeal of supervisory decisions. In Sec. 22B, the affected institution may appeal a supervisory decision concerning the appraisal value of any loan's property collateral, and for this appeal purpose, there would be appointed an independent arbiter to review such decisions. If not satisfied, the affected institution can appeal the decision up to the Federal Home Loan Bank Board itself.

Another provision in the same section extends to the individual borrower similar rights of review and appeal from requirements to meet the terms and conditions of a loan.

If these provisions were to be enacted into law, they would necessarily have the effect of delaying, or even nullifying altogether, the decisions of regulatory authorities relating to prudent management of the assets of FSLIC-insured savings institutions. The problems of the savings and loan industry and of FSLIC have become serious because state and federal regulators did not take restraining actions fast enough, and because the pattern of deregulation in 1982 and thereafter gave greatly widened scope to speculative behavior. The procedural paralysis that would be induced by H.R.27's appeal provisions would be certain to weaken regulatory oversight and vastly increase the eventual public cost of dealing with the problems of the industry and of FSLIC.

Has forbearance worked well on previous occasions?

Since the massive Federal interventions in the financial structure during the collapse of the Great Depression, there have been other episodes in which the financial regulators have eased the burdens of struggling institutions. For example, during a period of cyclical recession in the dominant manufacturing sector of one midwestern state, the state-level financial regulator worked with the governor to assist local financial institutions and to encourage them to stretch out loan terms for their borrowing publics. More generally, the Federal regulators enacted numerous relaxations of regulatory standards during the 1979-82 difficulties of the S&L industry, including the redefinitions for "regulatory net worth" already referred to. Most of the insured savings institutions that had negative earnings during 1981-82 did recover from their problems of negative spread; interest rates moved downward in the second half of 1982 and rescued them.

The US General Accounting Office has concluded that the subsequent record of institutional recovery is, however, rather mixed. (US GAO, May, 1987). Its report points out that 222 insured S&Ls had negative GAAP net worth in December, 1982. By Fall, 1986, 77 of these had ceased to exist (liquidated, merged, etc.), 65 attained positive net worth, and 80 remained insolvent by GAAP net worth standards. (US GAO, 1987, p. 1)

The politics of forbearance

The 1986-87 moves toward forbearance in banking and in the savings and loan industry are in part responses to intense

regional lobbying pressures in the United States Congress. That is, the regulatory authorities would not have been at all likely, on their own initiative, to depart so drastically from the process of tightening capital standards and accounting rules that is their normal and natural response to the onset of widespread trouble in financial institutions.

Thus, forbearance measures must be thought of as a compromise position that is often thrust upon the regulators through political pressure, not as a policy that is positively _designed_ to serve as an ideal response to a public need. Therefore, the regulatory authorities should be expected to exact whatever _quid pro quo_ they can so as to retrieve at least part of their position as defenders of the public's interests. In essence, forbearance increases the potential scope of the costs that the public will have to eventually absorb as the result of losses, explicit or implicit, arising in financial institutions.

Conclusions

From the standpoint of public policy, H.R.27 would set a bad direction for the regulation of the savings and loan industry and for the recapitalization of its deposit insurance fund.

- It would invite a greatly increased eventual public cost of resolving the problems of institutions that are now insolvent.

- It would fail to protect the deposit insurance fund from gambling behavior by the management and controlling interest of an already-troubled institution that saw speculation as its way out.

- It would provide precisely the wrong signal as to what is an appropriate criterion of financial institution management, for it would reward imprudence and incompetence and penalize competence and financial strength, by providing forbearance on net worth capital standards.

- In the guise of procedural fairness, it would envelope the regulatory authority in paralyzing steps of review down to the regulatory and lender's actions on individual transactions.

- It would set a level of recapitalization of FSLIC too low to be effective, and by doing so would invite frequent, detailed and poorly motivated political interventions into the regulatory process.

- It would provide too little recapitalization of FSLIC to resolve even a fraction of the known and currently urgent supervisory cases, and by doing so will force the postponement of needed actions, increase the eventual cost of resolving them, and in the meantime keep alive a form of subsidized competition that does damage to soundly-operated savings institutions.

- It would increase the probability of a generalized collapse of public confidence in the American system of depository institutions.

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