The Heritage Foundation Issue Bulletin

No. 126 | The Heritage Foundation • 214 Massachusetts Avenue • N.E. • Washington, D.C. • (202) 546-4400

August 13, 1986

CONFRONTING THE SAVING AND LOAN INDUSTRY CRISIS

INTRODUCTION

The Federal Savings and Loan Insurance Corporation (FSLIC), the federal insurer of savings and loans and many savings banks, in effect is bankrupt. In an effort to address this crisis of the $1.1 trillion savings and loan and savings bank industry (popularly known as S&Ls or "thrifts"), the Reagan Administration has proposed "The Federal Savings and Loan Insurance Corporation Recapitalization Act of 1986" (H.R. 4907 and S. 2491). This plan, now before the House and Senate Banking Committees, is seriously flawed. In its place, Congress should meld the thrift industry into the rest of the banking world.

Thrifts are a classic declining industry. By the close of last year, one-fifth of the industry's more than 3,000 members collectively were losing more than $10 million a day, and over one-third were either financially insolvent or nearly so. The failure of just a small number of these thrifts would bankrupt FSLIC.

Under the Reagan Administration's proposal, known as the "Recap Plan," FSLIC would receive an infusion of new capital by requiring the nation's twelve federal home loan banks to transfer up to $3 billion of past and future earnings to FSLIC and by the sale of $15 billion in long-term bonds. The bonds would be repaid by deposit insurance premiums paid by U.S. thrifts. The money raised would be used to sell or liquidate failed thrifts.

The Recap Plan will not generate enough cash to cover the full cost of liquidating all failed thrifts, and it will discourage new capital investments in potentially viable thrifts. It will fall at least $17 billion short of covering the costs of disposing of all failing thrifts. And because Congress has placed the full faith and

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

credit of the federal government behind federal deposit insurers, the taxpayer will have to cover the shortfall to prevent depositors from suffering any losses. The Recap Plan, meanwhile, also offers no long-term solution to the thrift industry's problems because it seeks to maintain thrifts as a separate type of financial institution, even though such artificial distinctions are obsolete in today's financial world. In short, the Recap Plan would work against the long-term interests of the healthier two-thirds of the nation's thrifts, maintain an obsolete industry, and delay a permanent solution of the FSLIC crisis.

As an alternative to the Recap Plan, Congress should allow stronger thrifts either to obtain their insurance from the Federal Deposit Insurance Corporation (FDIC), which insures bank depositors, or to be acquired by well-capitalized buyers, such as banks, insurance companies, or stockbrokers. Failing thrifts, on the other hand, should be sold or liquidated by the FSLIC. And once the immediate FSLIC mess is sorted out, Congress should adopt a private sector method for protecting depositors in deregulated financial institutions.

PROBLEMS IN THE THRIFT INDUSTRY

Traditionally organized as mutual, or depositor-owned, associations, thrifts were first set up in the 19th century to pool individual savings to make home mortgage loans. In an effort to encourage home ownership, Congress during the New Deal set up a panoply of supporting institutions for the thrifts, including the Home Loan Bank system to raise funds for its member thrifts and FSLIC to provide depositor insurance. Through a variety of special tax and regulatory provisions, thrifts became a key provider of readily available, low interest home mortgages. In fact, after 1966, federal regulations explicitly kept interest rates paid to savers by banks below the thrifts' interest rates. Over the last ten years, these special protections have broken down as new, higher yielding instruments, such as money market funds, have been developed, and special legal advantages, including interest rate regulations, have been repealed. This has left thrifts in a troubled position.

Last year, 18 percent of the nation's thrifts lost money. By fourth quarter 1985, 669 thrifts, or 21 percent of all thrifts, were losing money. Some 229 thrifts, with $55 billion in assets, were insolvent and losing money at a collective $2.7 billion annual rate. Another 220, with assets of $58 billion, were also insolvent, although turning a profit, and yet another 730 thrifts, with $291 billion in assets, had low net worths ranging between 0 and 3 percent of deposits.

The Federal Home Loan Bank Board has reported that the thrift industry had a 1985 net income of just $2.8 billion. Moreover, 39 percent of the industry's pre-tax income was attributable to nonoperating income--primarily sales of assets. Repossessed assets held by thrifts almost doubled during 1985, increasing from $4.3 billion to $9.8 billion, while expenses because of losses on loans during 1985 increased to $4 billion, up more than 50 percent from 1984. And even these thrift "earnings" for 1985 were overstated to the extent that repossessed assets were valued on thrift books at more than market value.

The industry's overall profit outlook for 1986 is not good. Disinflation in major sectors of the economy, most notably agriculture and commercial real estate, will continue to erode the value of collateral held by thrifts and reduce their net worths. The recent spate of mortgage refinancings, moreover, is rapidly lowering the spread between loan rates and the cost of deposits. New mortgages at lower interest rates will mean a tight squeeze on thrift earnings if interest rates start to rise once more.

The problems of the thrift industry have taken a toll on FSLIC. Since 1981, FSLIC has had to pay out over $5 billion because of some 250 thrift failures. Today, FSLIC is so short of funds that it has deferred closing or merging hundreds of insolvent or near-insolvent thrifts. The "present value"[1] of these prospective losses exceeds $29 billion, including $16 billion needed today to dispose of the 450 insolvent thrifts operating at the end of 1985.[2] It will cost at least another $13 billion to dispose of the 730 thrifts that are nearly insolvent. Against this $29 billion of unrecognized thrift

---

1. A present value calculation is the reverse of compounding interest on a savings account. Present value is the equivalent capital value today of future income or losses. Almost always, a dollar to be spent or received in the future will be valued in the marketplace for less than one dollar today. Why? Because the owner of an amount of money can normally expect to earn interest on the money over time. In present value computations, the interest rate is called the discount rate. Thus, a dollar to be received in five years, discounted at an annual interest rate of 8 percent, has a present value of 68.06 cents.

2. Bank Board Chairman Edwin Gray testified to the Senate Banking Committee on March 13, 1986, that "total resolution costs" for just 218 insolvent and unprofitable thrifts could easily exceed $12 billion. Gray added: "This $12 billion estimate, however, may be overly optimistic...."

insolvency losses, the FSLIC claims reserves, or net worth, of just $4.6 billion.[3] Thus the insurer for an insolvent industry is itself insolvent.

THE RECAPITALIZATION PLAN

The Reagan Administration recapitalization plan for FSLIC is pending before the Banking Committees in the House and Senate. The plan provides:

1) The Federal Home Loan Banks[4] would invest up to $3 billion in a newly chartered organization to be known as the Financing Corporation, which would be controlled by the Bank Board. Up to $1.8 billion could be invested immediately by the FHL Banks; the balance would come in over the next five or six years.

2) The Financing Corporation would sell up to $15 billion of long-term, nongovernment-guaranteed bonds in the capital markets.

3) Money invested by the FHL Banks in the Financing Corporation would be used to purchase up to $2.2 billion of "zero coupon" bonds.[5] The bonds would guarantee repayment of the long-term bonds when they matured.

---

3. FSLIC's last published financial statement is dated December 31, 1985. On that date, it reported total assets of $10.50 billion, recognized liabilities of $5.94 billion, and reserves, or net worth, of $4.56 billion.

4. The federal home loan banks (FHL Banks), one for each of twelve geographical divisions of the United States, are instrumentalities of the Bank Board. They serve two basic functions. First, they raise funds in the capital markets for lending to thrifts. On April 30, 1986, the FHL Banks had $91 billion in loans (called advances) outstanding to thrifts and had total assets of $115 billion. Second, they play an increasingly important role in the examination and supervision of thrifts regulated by the Bank Board and insured by FSLIC. Although the FHL Banks are owned by their member thrifts, the Bank Board closely oversees their operations. The FHL Banks earned $1.085 billion in 1985, $795 million of which was paid in dividends to their thrift stockholders. These dividends represented a significant portion of the thrift industry's 1985 profitability.

5. Zero coupon bonds, also called "zeros," pay no interest during the time they are outstanding, but are initially sold for substantially less than their face value and then pay their face amount at maturity. Thus, in effect, the buyer of a zero receives no interest until the bond matures. For example, a person might purchase a zero for $20 that would pay $100 in 20 years. The $80 difference between what he paid today and what he received in 20 years would represent 20 years of interest on his $20 investment plus interest on the interest.

4) Money raised by the Financing Corporation through the sale of the long-term bonds would be advanced to the FSLIC.

5) The special deposit insurance assessment, which thrifts have been paying to FSLIC since January 1985, would continue indefinitely. This assessment amounts to 0.125 percent of each institution's total deposits per year, payable quarterly.

6) FSLIC would spend up to $5 billion annually to resolve problem thrift cases through mergers or liquidations.

7) Part or all of the premiums that thrifts now pay to FSLIC would be diverted to the Financing Corporation to pay interest on the bonds it issued. Annual interest on these bonds would range from $800 million to $1.2 billion. The zero coupon bonds issued by the Financing Corporation would repay the principal amount of the bonds in 30 to 35 years.

8) FSLIC would repay to the FHL Banks, through the Financing Corporation, whatever amount the banks invested in the Financing Corporation, provided FSLIC met certain financial performance goals between 1996 and 2026.

PROBLEMS WITH THE RECAP PLAN

There are many serious problems with the Administration's plan. First, it would mortgage a substantial portion of FSLIC's future income to pay the interest on the $15 billion in long-term bonds issued by the Financing Corporation. Because these bonds would carry a higher interest rate than U.S. Treasury bonds, this funding technique could add over $1 billion to the cost of the plan. In fact, it appears that this particular technique was chosen for political, not financial, reasons in the belief that under Gramm-Rudman the obligations would not be included in the budget.[6]

Second, the plan would put an unnecessary financial drain on the nation's already troubled thrifts, ensuring even more trouble for them in the future by effectively making permanent the special 0.125 percent deposit insurance assessment first imposed last year. Thrifts thus would be put at a permanent cost disadvantage compared with banks and credit unions, which do not pay this assessment. Thrifts would be hurt also by use of FHL Bank capital in the plan, since thrifts rely on FHL Bank dividends for a significant part of their income.

---

6. The Congressional Budget Office has called the plan a "budgetary gimmick." Memorandum dated June 4, 1986, from Bob Sunshine of the Congressional Budget Office to Gregory Wilson, Minority Staff Director, House Committee on Banking, Finance and Urban Affairs.

Moreover, resorting to FHL Bank capital would mean subsidizing the weak thrifts at the expense of the healthy ones. In effect, the Recap Plan is a long-term, multibillion dollar subsidy from the thrift industry's winners to its losers.

Third, the Recap Plan would not provide enough capital to save FSLIC. The plan would generate $12 billion in resources, yet the FSLIC faces at least $29 billion in potential losses.[7] Unless drastic action is taken soon, taxpayers will bear that $17 billion shortfall. By January 1989, when Ronald Reagan leaves office, the shortfall will have grown by several billion more dollars.

Last, the Recap Plan assumes implicitly that the thrift industry will remain essentially intact, and hence that FSLIC-insured thrifts will be able to continue operating as a legally distinct type of depository institution. This assumption ignores the rapid changes in the financial world that are melding together previously disparate financial services providers. Executives in the better managed thrifts understand the melding now underway and are adapting to it. The Administration plan does not accommodate this process.

IS THE THRIFT INDUSTRY OBSOLETE?

As legally designated, special purpose lenders, thrifts have become obsolete. In fact, the use of thrifts to finance housing purchases long has been unsound financially, since thrifts borrow short-term to lend long-term. Mortgages are much more sensibly financed by long-term investors. The recent sharp upswing in fixed-rate mortgage lending by thrifts is only setting the stage for another round of insolvencies among those thrifts unwisely financing long-term, fixed-rate mortgages with short-term, variable-rate deposits. And from October 1985 to July 1986, fixed-rate mortgages climbed from 38 percent to 78 percent of all thrift mortgage originations.

The marketplace is already phasing out thrifts. Despite the efforts of federal regulators to prop up the industry, the percentage of residential nonfarm mortgages held by thrifts dropped from 59.3 percent at the end of 1974 to 44.4 percent at the end of 1984.[8] Maintaining an artificial legal distinction between thrifts and other types of financial institutions impedes marketplace consolidation and threatens the soundness of all depository institutions. American

---

7. Both figures calculated in present value terms.

8. 1974 data: 1976 Statistical Abstract (97th edition), Table 786; 1984 data: 1986 Statistical Abstract (106th edition), Table 841.

depository institutions need to consolidate. Their return on assets has been declining steadily, particularly for smaller commercial banks, and disinflation is taking a heavy toll on all depositories. Advancing technology and competition, meanwhile, are steadily reducing the need for large numbers of banking offices.

AN ALTERNATIVE PLAN FOR THRIFTS

The Congress should consider a thrift plan that takes these developments into account. Such a plan would encourage the merging of banks and thrifts and would liquidate the FSLIC.

1) Shift thrifts into the banking industry.

Existing, healthy thrifts should be brought immediately into the banking community and transferred into a new thrift division within FDIC. This would give the institutions their best opportunity of surviving and prospering within the broader banking industry now evolving in the U.S. Every FSLIC thrift should be given a deadline to either transfer to FDIC or find a buyer, the approximately 669 thrifts currently losing money receiving the shortest deadlines. FSLIC should then close thrifts experiencing the largest current monthly losses, followed by those with smaller losses.

Such transfers in turn would mean that FDIC's reserves would be insuring a larger base of deposits. The additional deposits insured by FDIC, however, would be in those thrifts least likely to fail. These thrifts, of course, would pay insurance premiums to FDIC.

Thrifts placed under the FDIC umbrella would have to meet FDIC's capital requirements. Thrift managers thus would have to raise the capital necessary to qualify for FDIC insurance or go out of business. This life-or-death choice should increase the flow of new capital into those thrifts with the best chance of surviving as free-standing institutions. Even some thrifts with net worths as low as 2 percent or 3 percent should be able to raise sufficient capital to qualify for FDIC.

The rules governing mutual-to-stock conversions should be liberalized to give existing mutually owned institutions an incentive to convert to stockholder-owned thrifts, through which they could raise the additional capital needed to join FDIC. At the start of this year, 67 percent of all thrifts, representing 44 percent of all thrift assets, were still mutually owned.

The special division set up within FDIC to receive thrifts formerly insured by the FSLIC should be phased out in five years. This would give thrifts sufficient time to adapt to the general banking environment. As the new risk bearer, FDIC would have to be

the regulator of the thrift division, replacing the Bank Board. Federally chartered thrifts would switch either to a state charter or to one issued by the Comptroller of the Currency, the federal office responsible for federally chartered banks.

2) Impose an "exit fee" on thrifts leaving FSLIC.

A massive shift of healthy thrifts poses an obvious problem: reduced premium income for FSLIC. Yet the Administration's plan would force profitable, well-capitalized thrifts to pay for the losses incurred by failing thrifts. While this is normal insurance practice, in the case of thrifts, it means a threat to sound financial institutions because of the inherent weakness of the existing government deposit insurance programs and the federal policy of shifting wealth from savers to purchasers of homes.

The federal government does not normally assess successful members of an industry to pay for insolvency losses experienced by the failing members of that industry. Steel "minimills," for example, have not been taxed to underwrite the $7 billion in losses suffered by the major steel producers since 1981. The same is true of the textile industry. And Ford and General Motors were not assessed special taxes to bail out Chrysler.

Successful thrifts, and thus their stockholders, however, have benefited over the years from being able to raise funds at a lower cost than they could have otherwise without federal deposit insurance, and without FSLIC's implicit claim on the U.S. Treasury.[9] Therefore, it might make some sense for them to bear some of the burden of relieving FSLIC's crisis. This could be accomplished by an "exit fee." Originally proposed by Bank Board Chairman Edwin Gray, a tax-deductible fee would be paid to FSLIC by each departing thrift upon transferring to FDIC. A fee equal to 0.5 percent of the thrift's average deposits over the last three years would be a reasonable exit charge.

Switching viable thrifts to the FDIC is better than simply merging FDIC and FSLIC, as some have proposed. For one thing, FDIC's pockets are not deep enough to absorb FSLIC's looming losses. For another, switching thrifts into FDIC would avoid the personnel and policy-meshing problems entailed in a merger. And unlike a switching policy, a merger would not put any pressure on thinly capitalized thrifts to raise capital immediately. Finally, a merger would not separate sound thrifts from failing thrifts; this separation is vital if sound thrifts are to prosper while failing thrifts are disposed of as efficiently as possible.

---

9. Edward J. Kane, The Gathering Crisis in Federal Deposit Insurance (Cambridge: MIT Press, 1985), Chapter 4.

3) <u>Permit anyone to buy a thrift</u>.

Under current law, all acquisitions and mergers of FSLIC-insured institutions must be approved by the Bank Board. The Bank Board has been very reluctant to approve acquisitions of thrifts by out-of-state or nonthrift institutions, especially when the thrifts are not yet financially troubled. Where the Bank Board is itself trying to dispose of a failed institution, federal law requires it to favor other thrifts in the same state as the acquirers. Despite this, bank holding companies increasingly have been purchasing both failing and successful thrifts. The Bank Board continues, however, to strongly resist purchases of even failing thrifts by insurance companies and stockbrokers.

All restrictions on who can buy a thrift should be removed. This would reduce the number of thrifts that FSLIC itself would have to liquidate or sell. Even if unable to raise the capital needed to transfer into FDIC, many thrifts would have some "going concern" value as an acquisition target. The stockholders of marginal thrifts, or depositors in the case of a mutual, should be given the opportunity to wring out this value and save FSLIC the cost of bailing out the institutions. Buyers, of course, would have to invest sufficient capital in their acquisition to meet FDIC standards and pay the exit fee to FSLIC.

Ending buyer restrictions is crucial to trimming FSLIC's insolvency losses. In a sample of 106 thrifts that failed between December 1981 and October 1985, FSLIC's insolvency loss was five times greater in thrifts it liquidated (33.8 percent of the assets involved) than in assisted mergers (6.9 percent of the assets involved). With a wider selection of buyers, FSLIC's losses might have been significantly lower. Thus an aggressive "buy and transfer" policy should reduce the FSLIC bailout cost by many billions of dollars.

The most likely buyer of a marginal thrift would be a nearby depository institution, either another thrift or a commercial bank seeking to expand its market share. This type of acquisition generates operating economies for the acquirer, particularly by reducing its brick-and-mortar costs through the consolidation of nearby branches and by spreading marketing and administrative costs over a larger deposit base. This would be good for the financial services industry as a whole, since it would spur a consolidation of banking facilities, particularly in small towns and cities that can barely support one bank branch, much less two or more free-standing

depositories. Some larger marginal thrifts might even agree to be purchased by two or more institutions.[10] Buyers would gain market share and achieve significant cost savings through the consolidation process. And FSLIC should capture some of this benefit when selling these thrifts, thus holding its insolvency losses in these cases to the barest minimum. Since there are 2.5 commercial bank offices for every thrift office, and 80,000 banking and thrift offices nationally, finding buyers for most marginal thrifts should be no problem.

Other buyers exist for weaker thrifts. One major group would be the banks and thrifts seeking to enter new geographical markets. Another would be financial services firms of all types seeking to acquire a depository institution as part of their broadening involvement in financial services. Specifically, stockbrokers, realtors, and insurance companies should be allowed to buy a thrift unable to make it into FDIC. Nonfinancial services firms, such as utilities and manufacturers, which are increasingly buying thrifts, could also be expected to purchase weaker thrifts.

To facilitate this acquisition process, Congress should remove all tax disincentives to FDIC transfers and outright thrift sales in those cases where the lost tax revenue would be less than the cost to FSLIC of blocking the transaction. Many states object to freer acquisition rules on the grounds that institutions whose headquarters are out-of-state will not address local concerns adequately. Although the evidence shows such objections to be groundless, state restrictions on interstate banking nevertheless could be accommodated if the state were called upon to pick up the difference between the actual insolvency costs to FSLIC and the lower losses to be borne if an out-of state purchaser were to step in. In that way, locally owned institutions could still be protected, but not at federal expense.

4) Liquidate FSLIC and dismantle the thrift industry.

FSLIC should be liquidated after thrifts have been transferred to the FDIC, sold, or liquidated. At such a time there would be nothing left for the Bank Board to regulate. The twelve Federal Home Loan Banks likewise should be liquidated once the thrift industry has been folded into the banking community. Commercial banks have been able to fund themselves very well without the assistance of a federal intermediator of funds. Liquidating the FHL Banks would also fit in with the broader trend of getting the federal government out of the credit allocation process.

---

10. For example, this division process has occurred twice in Connecticut in the last seventeen months, with the twenty-two offices of two failed thrifts being sold to fourteen other banks and thrifts. American Banker, April 17, 1986.

MINIMIZING THE COST TO TAXPAYERS

Resolving the thrift crisis would involve some cost to the taxpayer. While the thrift industry, as any other industry, should survive or fail without taxpayer involvement, Congress already has committed itself to supporting the industry with taxpayer money. In 1982, both houses of Congress passed resolutions stating that for deposits up to the statutorily prescribed amount (currently $100,000) "...federally insured depositories are backed by the full faith and credit of the United States."[11] Since FSLIC is the federal agency through which this backing is delivered, FSLIC does have an unlimited claim on the U.S. Treasury. If Congress reneged on its 1982 pledge, the credibility of the American banking system would be severely damaged--particularly outside the United States, where foreign branches of U.S. banks hold over $300 billion in deposits. Further, thousands of individual depositors, who had deposited their money relying on Uncle Sam's promise, could lose their savings. The federal guarantee of FSLIC was a mistake, but it is one that cannot be undone in the near future. Since tax revenues already are committed to saving the thrifts, the plan for doing so at least must minimize the cost to the taxpayer.

PREVENTING A RECURRENCE OF THE PROBLEM

In addition to resolving the present crisis, Congress should take steps to ensure that the problem does not recur.

In this regard, Congress must begin to reexamine the entire depositor protection mechanism. Shifting healthy thrifts to FDIC is a necessary and urgent step, but still a stop-gap measure. Central to long-term reform must be the introduction of risk-sensitive deposit insurance pricing. The FSLIC crisis would never have occurred had thrifts been subject to such a pricing system. However, truly risk-sensitive prices can be set only in a private, competitive marketplace.[12]

---

11. This language appears in both House Concurrent Resolution 290, adopted by the House of Representatives on March 19, 1982, and in Senate Concurrent Resolution 72, adopted by the Senate on March 17, 1982.

12. Catherine England and John Palffy, "Replacing the FDIC: Private Insurance for Deposits," Heritage Foundation Backgrounder No. 229, December 2, 1982. For a description of how one such privatized mechanism might work, see Bert Ely, "Private Sector Depositor Protection Is Still a Viable Alternative to Federal Deposit Insurance," Issues in Bank Regulation, Winter 1986.

CONCLUSION

The FSLIC problem is the national version of the Ohio and Maryland savings and loan deposit insurance crises. The solution in those cases was to save the healthy thrifts by shifting them to another deposit insurer and disposing of the basket cases at the lowest possible cost to the taxpaying public. The same solution is called for here. Thus, healthy thrifts now insured by FSLIC should be moved to FDIC and pay an "exit fee" to FSLIC. To minimize the costs of resolving the problems of troubled thrifts, all restrictions on thrift acquisitions and mergers should be lifted. Lastly, FSLIC and the thrift industry itself should be dismantled and folded into the larger banking community.

Although the financial structure of thrifts always has been flawed, they long have met a widely perceived public need. But time, technology, and the rapidly evolving financial marketplace have passed them by. Coupled with an equally flawed depositor-protection mechanism, the artificial structure of the thrift industry is the root cause of the FSLIC crisis. The crisis will not end until fundamental reform takes place.

Congress faces a pressing need and a window of opportunity. Resolving the FSLIC crisis at the lowest possible cost to the American taxpayer presents the need. The opportunity thus afforded is the chance to unshackle U.S. financial services for the 21st century.

Prepared for The Heritage Foundation
by Bert Ely,[13]
a Washington-based corporate
financial consultant

13. Data in this paper pertaining to FSLIC and the thrift industry have been taken from a paper by the author titled: "Bailing Out the Federal Savings and Loan Insurance Corporation." Copies of the paper can be obtained from the author by writing to P.O. Box 21010, Alexandria, Virginia, 22320 or calling 703-836-4101.