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HOW TO TAKE SAVINGS AND LOANS OFF THE SICK LIST

(Updating *Issue Bulletin* No. 126, "Confronting the Savings and Loan Industry Crisis," August 13, 1986.)

The Federal Savings and Loan Insurance Corporation (FSLIC), the federal agency that insures savings and loan deposits, is heading rapidly toward insolvency. According to the most recent reports, FSLIC faces a potential shortfall of more than $20 billion in funds to cover the liabilities of insured thrifts, despite "rescue" legislation enacted last year. Some analysts put FSLIC's unfunded liability at as much as $64 billion. Congress now is urgently exploring ways to cover this shortfall. To avoid a succession of FSLIC crises in the future, however, lawmakers also must address the inherent problem of the federal insurance system through such steps as introducing "risk-based" premiums.

Potential $21.8 Billion Loss. The Competitive Equality Banking Act (CEBA), enacted last August, allowed FSLIC to borrow $10.8 billion to bolster its rapidly depleting coffers. Yet FSLIC still is in trouble. The Federal Home Loan Bank Board, FSLIC's parent agency, estimates that 345 Savings and Loans (S&Ls), also known as thrifts, were insolvent at the end of last year.[1] These S&Ls' liabilities exceed $15 billion. Worse, under the accounting system used almost universally in the private sector, known as "Generally Accepted Accounting Principles," an additional 165 thrifts would be classed as insolvent, hiking FSLIC's total potential insurance loss to $21.8 billion.

FSLIC maintains that it has sufficient assets to cover this bill. Yet FSLIC's total liability soon may balloon even higher. According to a report issued last week by the General Accounting Office (GAO), an additional 435 institutions are barely solvent.[2] The GAO estimates that eventually it will cost between $26 billion and $36 billion to rescue the insolvent thrifts. Other experts,

[1] Robert E. Taylor, "FSLIC's Negative Net Worth Expanded in '87 to $11.6 billion From $6.3 Billion," *The Wall Street Journal*, April 19, 1988, p. 4.

[2] Testimony of Frederick D. Wolf, U.S. General Accounting Office, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, May 19, 1988.

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such as Bert Ely, a Virginia-based thrift consultant, maintain the total bill could be as high as $64 billion.

Making matters worse, after this August the thrifts now insured by FSLIC legally will be able to convert themselves into banks and obtain insurance from the Federal Deposit Insurance Corporation (FDIC), the federal insurer for banks. FDIC charges much lower premiums than the financially strapped FSLIC. The expected departure of many of FSLIC's healthier members, taking with them their insurance premiums, will put additional strain on FSLIC finances.

Several proposals have been advanced to deal with this mounting crisis. Among them:

The "Southwest Plan." The Federal Home Loan Bank announced an ambitious plan this February to resolve thrift problems in Texas, the state with the largest rate of insolvency. The plan later may be used in other Southwestern states. Under the plan, groups of small, insolvent thrifts will be merged with larger, healthy thrifts. Eventually such mergers will reduce the number of thrifts in Texas by about 40 percent. To sweeten the mergers, FSLIC not only will pay each acquiring S&L the difference between the assets and debts of the sick thrift it takes over, FSLIC also will cover losses due to nonperforming loans until loan payments resume or the loan can be sold. The Federal Home Loan Bank Board expects the plan will cost between $6 billion and $7 billion; in the long run, says the Bank Board, money will be saved. Despite its financial realism, the Southwest Plan has serious flaws. FSLIC does not have sufficient cash available for the proposed mergers, and so is relying on unsecured notes. But some potential investors, worried about FSLIC's own condition, are reluctant to accept FSLIC notes. Moreover, some of the acquiring thrifts under the plan may themselves be insolvent when examined under more stringent private sector accounting principles. A reason for this is that potential acquirers must be based in Texas. FSLIC does not plan to allow better capitalized banks and thrifts from outside the state to acquire Texas S&Ls. Thus the plan may be a case of the weaker joining the weak.

Merging FSLIC and FDIC. Another proposal is to merge FSLIC with the far stronger Federal Deposit Insurance Corporation. This plan, supported by former FDIC Chairman William M. Isaac, would provide an additional $18 billion for bailing out insolvent thrifts. But many bankers question the fairness of forcing their industry to pay for the problems of S&Ls. Moreover, FDIC may need all of its existing funds simply for its own banking industry problems caused by bad foreign loans and the depressed energy and real estate markets. An FSLIC-FDIC merger, therefore, simply could weaken the banks without saving the thrifts.

Easing Regulatory Restrictions. A third approach would attempt to ease the thrift crisis by reducing the regulatory restrictions on thrift operations. This would provide thrift managers with more flexibility to tackle their problems and make weak S&Ls more attractive to acquirers. Legislation incorporating this proposal (S. 2073 and H.R. 3906) would give thrifts increased commercial lending authority, among other regulatory reforms. Proponents of this plan maintain that if the thrift industry is to survive, S&Ls must be able to reduce their risks by diversifying their product.

Although further deregulation of the thrift industry is a sound policy, it should proceed cautiously until policymakers solve the fundamental cause of the problem: the perverse incentive of federal deposit insurance. FSLIC provides insurance to all its members at a fixed price, without regard to past management performance. This gives thrift managers considerable incentive to pursue risky business strategies, hoping for large profits but inviting large losses, because they can count on FSLIC to foot the bill if their strategy turns sour.

Any bailout plan will be little more than a band-aid until this fundamental flaw is corrected. Says Bert Ely, FSLIC will continue to "suffer large losses...[as] the drunk drivers of the banking and thrift worlds pay the same price for their deposit insurance as...their sober brethren."[3] To remedy this, Congress must combine short-term steps to defuse the current crisis with an overhaul of the deposit insurance system. The key element in such a reform should involve replacing the system of flat-rate premiums with premiums based on the risk associated with the thrift's management policies and investment portfolio. Under such a system, managers no longer would be able to disregard risk and count on a bailout by the FSLIC. Risk-based premiums, combined with further deregulation, would encourage sound management without impeding the innovation needed to permit thrifts to operate more efficiently and competitively.

Preventing Recurring Crises. A resolution of the current FSLIC crisis is urgently needed to restore confidence and to avoid a serious collapse in the S&L industry. The proposals now being considered might defuse the immediate crisis, but they provide no guarantee that a taxpayer bailout ultimately can be avoided. They would do nothing, moreover, to prevent such a crisis from recurring. Any action to resolve the immediate crisis therefore must also include steps to reform the deposit insurance system itself.

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[3] Testimony of Bert Ely, Ely & Company, Inc., before the U.S. Senate Committee on Banking, Housing and Urban Affairs, May 19, 1988.