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ONLY STRUCTURAL REFORM CAN SOLVE THE LONG-TERM SAVINGS AND LOAN CRISIS

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One of the first and most difficult problems facing George Bush is the savings and loan crisis. Pressure is mounting for a taxpayer bailout of the strained federal insurance system for the savings and loans, or "thrifts" – at a cost of perhaps $100 billion to the taxpayers. While some bailout seems inevitable, the more important issue is whether it will be joined by needed structural reform of the deposit insurance system to eliminate the long-term causes of the crisis.

Under the current federal deposit insurance system, depositors at financial institutions are insured, up to $100,000, on each account they hold. For banks, this coverage is provided by the Federal Deposit Insurance Corporation (FDIC); for S&Ls, by the Federal Savings and Loan Insurance Corporation (FSLIC). The insurance guarantee ultimately is backed by the U.S. taxpayer, as the U.S. has pledged its "full faith and credit" to the insurance system if the insurance funds become depleted. It now looks like the taxpayers will have to make good on this pledge. Over 20 percent of the nation's 3,000 thrift institutions are technically insolvent, presenting an insurance bill of as much as $100 billion, a sum far exceeding the limited resources of FSLIC. It is unclear where the money for this bailout will come from. One suggestion, among many, is tapping existing limited federal revenues. Another, even worse, would tax bank deposits, a move that could discourage saving.

Subsidizing Risk. Some policy makers are blaming the industry's current troubles on deregulation during the 1970s and early 1980s. In fact, however, the problem is just the opposite – reform of the industry did not go far enough. From the 1930s through the 1970s, the savings and loan industry was bound tightly in a regulatory cocoon, insulating it from competition and strictly limiting its business activities. By the 1970s, it had become apparent that U.S. banking rules were limiting U.S. financial institutions severely in an increasingly competitive international business world; new financial instruments, such as money-market accounts, began to challenge the protected position of the thrifts. In response to this, the 1982 Garn-St. Germain Act allowed thrifts to invest funds in a wider range of activities, giving them the power to compete in the new market.

The problem, however, is that while policy makers deregulated the industry, they continued to subsidize risk through the federal deposit insurance system, which gives little or no consideration to the riskiness of the institution's investment portfolio. Thus a thrift that invests recklessly in high-risk speculative land deals pays the same premium for insurance as one that invests cautiously in residential housing. In fact, because institutions making riskier investments

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generally offer higher interest rates, depositors are encouraged to keep their money in them, secure in the knowledge that, should the thrift go under, the government will bail them out.

Several ideas have been advanced to deal with these perverse incentives. Among them:

◆ ◆ **Tie insurance premiums or regulatory requirements to the risk associated with each institution's lending portfolio.** This would force thrifts with speculative investments to pay higher insurance premiums to cover the increased risk for the FDIC and FSLIC. Such a step, however, may not be sufficient because of the inability of regulators to assess risk accurately.

◆ ◆ **Reduce the amount of insurance per depositor.** Each account in a thrift is now insured up to $100,000. As Ronald Reagan's Council of Economic Advisors recently proposed, this could be lowered to $40,000 or less. The limit also could be applied to individual depositors, rather than each account. In this way, large depositors would have the incentive to monitor the performance of financial institutions, in the same way that stockholders monitor publicly traded corporations. To be effective, however, federal insurers would have to end their current policies under which the troubled institutions are reorganized at federal expense, thus in effect providing 100 percent coverage to depositors and other creditors.

◆ ◆ **Establish "narrow" banks.** Under a plan suggested by Brookings Institution economist Robert Litan, investments by federally insured financial institutions would be limited to low-risk assets, such as Treasury securities. Other institutions could make loans and invest in other activities, but they would not be eligible for federal guarantees. In this way, institutions could not use the federal guarantee to engage in risky activity, but consumers still would have the option to invest elsewhere at their own risk.

◆ ◆ **Cap the total federal guarantee and issue tradeable insurance certificates.** Under the current system, there is no limit to the total size of the federal deposit guarantee. Under a plan proposed by Competitive Enterprise Institute President Fred Smith and Financial Services Project Director Melanie Tammen, the total federal liability would be capped at the present level, which is now about $2.7 trillion, and each institution would be assigned its pro rata share of the guarantee, in the form of insurance certificates. Financial institutions then would be allowed to use these certificates to insure some or all of their accounts, or trade them to other institutions, subject to insurer approval. High-risk institutions, however, and those expanding their liabilities, likely would be forced by depositors to keep their insurance — or buy more — thus establishing a clear cost for risk-taking. In this way, a market for deposit insurance would be created.

A massive taxpayer bailout of the savings and loan system seems inevitable because of the mistakes of past decades. But any legislation authorizing a bailout also must address the underlying problems that created the crisis. These have been caused not by the beneficial and necessary deregulation of the industry, but by the continuing taxpayer subsidy of high-risk investment decisions by financial institutions. George Bush should insist on steps to end this perverse subsidy before any taxpayer funds go to aid the savings and loan industry.

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