June 23, 1988

MEMORANDUM TO: Alice Rivlin
FROM: Gillian Garcia
SUBJECT: The S&L Problem -- I. The Present Situation

Over the past 12 years, when under the Chairmanship of Senator Proxmire, the Senate Banking Committee has held annual hearings to monitor the condition of the banking industry and oversee its regulators. The hearings are intended to keep Congress abreast of industry problems and avoid unpleasant surprises.

At the start of the preparations for this year's hearings, there was a presumption that S&Ls would not provide interesting material because the Federal Savings and Loan Insurance Corporation (FSLIC) had been recapitalized in the Competitive Equality Banking Act (CEBA) of August 1987. In the event, two of the three days of hearings were devoted to thrifts, and they attracted a lot of attention.

The hearings showed that while the majority (78 percent) of thrifts in the industry are strong enough to survive or thrive, another part (5.4 percent) is highly vulnerable to bad economic news, and an unpleasantly large chunk (16.4 percent) is insolvent. The activities of those that are most seriously insolvent are prejudicing the viability of the others. Many Senators have concluded, therefore, that this problem will need prompt attention early in the new administration.

SIZE OF THE PROBLEM

At the outset of the hearings, GAO declared FSLIC to be insolvent for the second year in a row. Allowing for $17.7 billion in unavoidable payments on failed thrifts, FSLIC's deficit is now $13.7 billion -- twice as much as last year, despite recap. Industry experts who testified, however, assessed the cost of clean-up higher than $17.7 billion. Their estimates ranged between $26 and $64 billion. R. Dan Brumbaugh Jr., a Brookings BPEA author, recently assessed the cost of resolution at $75 billion.

I calibrate this wide range of potential costs to FSLIC against a conservative estimate of $47 billion as the likely loss realizable on the assets of insolvent thrifts. (At the end of 1987, there were 515 thrifts (over 16 percent) of the industry that were book-value insolvent under generally accepted accounting principles. These thrifts had $180 billion in assets on their books. On average over the past three years, the Bank Board has lost 26 cents on each dollar of book assets in its resolutions.)

The figure, $47 billion, is probably the lower bound of realistic estimates, unless Texas recovers, because:- (i) the number of insolvent thrifts continues to grow; (ii) so does the value of their assets; (iii) the percentage resolution cost experienced by FSLIC is rising -- it was 15 percent in 1984 and 40 percent last year -- because insolvent thrifts continue to make large operating as well as nonoperating losses.

THE URGENCY OF THE PROBLEM

The problem needs to be dealt with promptly because it is escalating rapidly. Bert Ely, one of the witnesses, estimated that the cost of cleanup is compounding at a 15 percent annual rate. Certainly thrifts nationwide lost $6.8 billion in 1987, which equals over 14 percent of their regulatory capital. The loss in the first quarter was $3.8 billion, twice last year's annual rate. The longer we wait, the more resolution will cost.

Earlier in the decade when high interest rates were the thrifts' main problem a (questionable) argument could be made for waiting for rates to fall and allowing thrifts to recover. That argument for waiting is certainly <u>not</u> valid today. Interest rates have fallen, yet many S&Ls are now in worse condition than they were even in 1982, because the industry's most immediate problems are fraud and bad assets. (The industry in general is also still exposed to interest rate risk so, if interest rates were to rise at the end of the business cycle, thrifts' situation would deteriorate even further.)

The numbers of insolvent thrifts have risen each year from 222 with $63.5 billion in assets at the end of 1984 to 515 with $180 billion three year later. Research by GAO and others has shown that few thrifts given forbearance (i.e. allowed to continue operating with no or very low capital) have recovered. Many have just become hopelessly insolvent, adding to the final cost of resolution. Rapid deterioration argues for speedy resolution.

<u>FORBEARANCE</u>

The call for prompt and decisive action, differs from the Bank Board's and the U.S. League of Savings Institutions' position. They attribute the industry's losses to regional problems. If this were true, one might again make a case for forbearance and wait for recovery. However, evidence presented below, research by the Bank Board's own staff, and that reported recently by the Comptroller of the Currency (for banks) dispute this explanation.

<u>LOCATION OF THE PROBLEM</u>

The Bank Board talks as though the problem is confined to Texas and other energy-producing states. It is true that the situation is worst in these states, but it is, in fact, widespread.

The attached map (due to Gregory Gajewski of the Department of Agriculture) shows that thrift failures were experienced in most regions between 1983 and 1986. Bank failures, on the other hand, were more localized in the southwest and the midwest. Data in Table C-1 of the attached Appendix show that insolvencies existed in 42 states at the end of 1986.

Granted that things are worst in Texas and that regional economic problems are contributing to the severity of thrift losses, they cannot be given the lion's share of the blame, in my judgement. Thrift problems are nationwide, often predate the oil crisis, and also involve fraud, mismanagement, poor supervision and regulation, inappropriate laws and disastrously construed incentives.

THE WRONG INCENTIVES

It is difficult for a thrift to make a profit when its spreads are low and its liabilities exceed assets. The temptation is to grow fast and gamble to raise returns. Deposit insurance allowed thrifts earlier in the decade to take in additional money because depositors did not need to concern themselves about the risks their institutions were taking.

But many thrifts who had taken on risky assets in the past are now reaping large losses. They are making both operating and capital losses. Nonoperating losses largely reflect write-downs on assets that have already gone bad. They merely acknowledge economic losses that have already occurred and cannot be avoided by the thrift or FSLIC.

Operating losses are of greater concern to FSLIC, however, because some should be avoidable. Thrifts that are making operating losses need to attract new deposits just to pay their <u>current</u> bills. They are, in fact, running a Ponzi scheme with a government (deposit insurance) guarantee.

Operating losses among insolvent thrifts were $4.5 billion last year as compared to operating profits of $7.7 billion in the larger the solvent section. Net nonoperating losses were $5.9 billion and $0.8 billion among the insolvent and solvent, respectively.

The activities of the “zombies” harm their healthy competitors, particularly adjacent ones. The deadbeats initially bid up the cost of funds in order to grow. (Fast growth was permitted, indeed encouraged, by the Bank Board until 1985.) Later, as thrifts’ risky activities and FSLIC’s insolvency became known, weak thrifts had to bid to retain funds that would otherwise relocate to safer havens.

For example, data supplied by the Bank Board at the Committee’s request show that thrifts in the Dallas district offered the highest deposit rates in the nation last December -- a premium of 50 basis points on transactions accounts over thrifts in Indianapolis, 113 points over S&Ls in Seattle on money market deposit accounts, 108 b.p. over midwestern thrifts on 3 month consumer accounts, and 82 b.p. more than Chicago S&Ls on jumbo CDs.

It is also claimed, although I have not seen evidence to substantiate it, that rates are being bid up nationwide and for banks as well as thrifts.

Zombies also bid down the rates earned on loans. They are being called the “lenders of last resort” because, like the central bank, they will make loans when no one else will and they charge low rates.

THE CONSEQUENCES

The net result is to reduce industry-wide profit margins and capital levels. The industry as a whole is weakened. Thrift owners, uninsured depositors and unsecured creditors are adversely affected.

Moreover, the present environment, particularly in the southwest, is not a good one for many depositors (although others are happy with the high rates they are earning). The industry in general was losing funds prior to the stock market crash in October and runs were occurring sporadically. (See the attached book Appendix.) While thrifts have experienced an inrush of cash since the stock-market break, depositors are nervous. (When bad news is announced, they make calls to Senators' offices to ask if their money is safe!)

RUNS

The FHLBB is hard pressed even now to replace deposits being lost at severely troubled S&Ls. While deposits across the nation have risen recently, they continue to fall at some severely troubled associations.

Deposit withdrawals have been a problem at American Savings and Loan, Financial Corporation of America's thrift, at least since 1984. That year, the Federal Reserve Bank of San Francisco refused to make lender-of-last resort loans to American Savings despite its need for cash and the Federal Home Loan Bank of San Francisco did not meet all of American's needs either. Consequently, the Bank Board instructed the Federal Home Loan Mortgage Corporation (Freddie Mac) to lend to American via repurchase agreements.

Freddie Mac lent $1.5 billion to American in 1984 and $2.5 billion in 1986. These amounts constituted over 2 1/2 times Freddie Mac's capital in both of those years and, therefore, were risky for the agency. A commercial bank would, for example, not be allowed to lend anywhere near this much to one borrower. (The attachment discusses other nontraditional and undesirable responses adopted by the FHLB system to cope with the S&L funding crisis.

BANK BOARD RESOURCES

The Chairman of the Bank Board testified on May 26 that FSLIC will have enough resources to do its job. M. Danny Wall projected that $30.2 billion in resources would be available over the next 10 years to cover long-run expenses of $22.7 billion.

GAO had examined FSLIC's detailed cash flow projections and declared them to be based on very optimistic assumptions about:- interest rates, deposit growth rates, the continuation of the special assessment (the additional insurance premium that all FSLIC-insured thrifts are currently paying), an absence of new insolvencies, and the costs of resolving those that have already failed.

GAO concluded, that "while FSLIC has the resources to continue operating in the near future, ... the eventual costs of restoring the thrift industry's financial health are likely to exceed those FSLIC will have available."

Chairman Wall was pressed to release the Bank Board's detailed cash flow projections and did so at the hearing. The Committee was shocked to discover that the Bank Board's projection assumes that the special assessment (which brings thrift's cost of insurance to 20.8 basis points per dollar of deposits -- compared to the banks' 12.5 b.p.) will continue through 1995. In fact, the special assessment is FSLIC's largest projected source of income through 1995.

Under CEBA, the special assessment was to be phased out by 1991, unless the Bank Board declared its retention essential.

Continuing the special assessment at full strength for seven more years would encourage strong thrifts to leave FSLIC and apply for FDIC insurance. The Bank Board cannot afford to let that happen, so the Chairman asked for CEBA's one year prohibition on exit from the industry to be renewed through August 10, 1989. Such legislation passed the Senate on June 15 and the House on June 23.

The consensus at the Senate Banking Committee is that, absent some new disaster, the exit-moratorium extension will contain the S&L crisis until the start of the next administration. Then it will need to be dealt with promptly and courageously.

CONCLUSION

It seems almost certain that FSLIC will need additional money to resolve the S&L industry's problems. The Banking Committee staff is working on this assumption. A major issue is - where is this money to come from? A search is on to find the funds.

The Committee, for example, today held hearings on S. 2467, Senator D'Amato's bill to allow the preferred stock of the Federal Home Loan Mortgage Corporation to be sold to the general public. At present, it is owned only by thrifts that are members of the FHLB system. This and other restrictions severely constrain the price of the stock. One or two billion additional dollars might be added to thrifts' $47.4 billion of regulatory capital by allowing the public to own it.

While this any other ingenious schemes yet to be thought of will help reduce FSLIC's burden, no one here seems to believe they will be sufficient. FSLIC will still need funds from somewhere. In the words of Professor Greenbaum of Northwestern University, "There are three candidate oxen for goring: the thrifts, the banks, and Mr. and Mrs. America." The choice will have to be made.

But the Committee believes that an equally important issue is - how should the industry be restructured to prevent this mess from recurring? The staff will devote the next few months to studying the issues and assessing the remedies that are being suggested.

Memos on the causes of the S&L industry's current problems and the pros and cons of the several potential courses of action will follow.