U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

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RESPONSIBILITY AND REGULATION IN THE SAVINGS AND LOAN INDUSTRY

Address to
the U.S. League of Savings Institutions
Hyatt Regency Hotel
Washington, D.C.

June 26, 1989

Joseph A. Grundfest*
Commissioner

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*The views expressed herein are those of Commissioner Grundfest and do not necessarily represent those of the Commission, of other Commissioners, or of the Commission's staff.

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Usually, I begin a speech with certain pleasantries and a joke or two, or three. But not today. The situation in the S&L industry is simply too grave and the consequences for the U.S. taxpayer too severe to engage in Washington chit chat or banter. Instead, I will get right down to business.

To give you a quick idea of where I'm going in this talk, I'll begin by summarizing my basic observations. First, this is a very, very sick industry, and many S&Ls cannot and should not be saved. There is, however, a group of well-capitalized institutions that can play a constructive role in the U.S. financial services industry if they are subject to adequate capital requirements, appropriate accounting standards, and vigilant regulatory supervision.

Second, the credibility of this organization is poor. And that's a charitable assessment. For years, the U.S. League has lobbied aggressively to promote self-interest over

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public interest. The chickens are now coming home to roost. To rehabilitate the credibility of this organization you will have to start taking responsible public policy positions that show real concern for the taxpayers who provide you with the insurance without which you would not exist.

Third, the battle for adequate capital standards backed by real money, not accounting fluff, must be won. This industry must also adopt mark-to-market accounting, accept the principles of functional regulation, and drop the shibboleth that S&Ls are vital to housing formation in the U.S. The S&L industry was once vital to housing formation, but it is hardly essential today. Indeed, other financial institutions now provide the majority of mortgage lending, and the trend in the market is toward ever decreasing reliance on S&Ls for housing finance. To survive, S&Ls must evolve into a more diversified and modern industry that can take advantage of its remaining stable deposit base, its large branch network, and certain niche opportunities to provide valuable customer service.

The Good, the Bad and the Ugly: Three Types of S&Ls

The S&L industry is not a homogeneous industry, it is an industry composed of three distinct types of institutions.[1]

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[1] See, e.g., Brumbaugh, Carron & Litan, Cleaning Up the Depository Institution Mess, Brookings Paper on Economic Activities, at 3-4 (1989) (hereinafter "Cleaning Up"). Accord Group Toughens Stance on Weak Savings Units, N.Y. Times, Nov. 3, 1988, at D2 ("[t]he industry can be segmented into four parts, based on the institutions' net worth."); Time of Crisis for Savings League, N.Y. Times, Oct. 31, 1988, at D1.

At one extreme are solvent, adequately capitalized institutions. If a proper combination of regulatory supervision, sufficiently stringent net capital requirements, mark-to-market accounting, and risk sensitive deposit insurance are implemented, then these institutions will have a viable future in the financial services industry.[2]

At the other extreme are insolvent S&Ls that have no real or accounting capital at risk. These institutions must be shut down as quickly as possible.

In the middle we find the living dead. These institutions have little or no real capital at risk--because a large part of their capital exists in the form of accounting entries on a ledger sheet, entries that cannot be used to pay off depositors or for any purpose other than to procure regulatory forebearance.[3]

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[2]This approach is similar to the one proposed in Scott, Deposit Insurance and Bank Regulation: The Policy Choices, Stanford University Working Paper No. 46 (Aug. 1988). For discussion of the regulatory measures necessary to put the S&L industry on a sound footing, see generally Brumbaugh, Thrifts Under Siege (1988); American Enterprise Institute for Public Policy Research, Restructuring Banking & Financial Services in America (Haraf & Kushmeider, eds. 1988); Litan, What Should Banks Do? (1987); Cleaning Up, supra note 1; Barth & Bradley, The Ailing S&Ls: Causes and Cures, 32 Challenge 30 (Mar.-Apr. 1989); Brumbaugh & Litan, The S&L Crisis: How To Get Out and Stay Out, 7 Brookings Review 3 (Spring 1989); Haraf, Bank and Thrift Regulation, AEI Journal on Government and Society 50 (1988).

[3]Of the 2,949 thrifts remaining in operation as of year-end 1988, 364, or 12.3%, were estimated to be insolvent under generally accepted accounting principles ("GAAP"). Cleaning Up, supra note 1, at 3-4. These institutions controlled 8.4% of the industry's book value of assets, had an average ratio of tangible GAAP capital-to-assets of -14.0% and lost $14.8

The future of this industry, if it has one, lies with solvent, adequately capitalized institutions that have real money on the line as net capital. The future clearly does not lie with institutions that are already under water, and whose operations continue to generate losses that saddle innocent taxpayers with tens of billions of dollars of liabilities. The longer these institutions are allowed to survive, the larger the liability that taxpayers will be saddled with in the future, and the larger the millstone around the necks of the truly solvent survivors.

The future of this industry also does not lie with the living dead, who must rely on capital in the form of "goodwill," an accounting concept that exists only as an entry on a ledger sheet and that has no corresponding real value in any marketplace on this or on any other planet. Although these institutions have lobbied aggressively for the right to apply goodwill to their net capital requirement, the reality of the matter is that, even if they succeed in their efforts, they would remain insolvent in every economically rational sense of the term.

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billion in 1988. At the other extreme, 1,226 institutions reporting GAAP capital in excess of 6% (41.61% of the thrifts in operation) controlled 21% of the industry's book value of assets, had an average ratio of tangible GAAP capital-to-assets of 7.2% and reported net income of $2.0 billion. In the middle are 1,359 institutions (46.1% of the thrifts in operation) reporting GAAP capital between 0% and 6%. This latter group controlled 70.6% of the industry's book value of assets, had an average ratio of tangible GAAP capital-to-assets of 2.7%, and reported net income of $1.0 billion.

History demonstrates and economic logic compels the conclusion that economically insolvent institutions will, on average and over time, generate real economic losses that have to be absorbed by federal deposit insurance. Fortunately, the House of Representatives, by a vote of 326-94, resoundingly rejected this industry's efforts to weaken the tough capital standards proposed in President Bush's S&L bailout plan.[4]

I have, however, been around Washington long enough, and have seen enough of the U.S. League in action, to understand that the House vote is not necessarily the final word on the matter. The lobbying will go on in the conference committee,[5] and it remains quite important to emphasize the need that S&Ls backed by federal deposit insurance have real money at risk as capital in their own institutions.

If Congress allows economically insolvent institutions to remain in business, without raising hard cash to satisfy minimum capital adequacy standards, Congress will be guaranteeing that significant losses will recur as a new generation of S&Ls engaged in risky investments without

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[4]See 135 Cong. Rec. H2718 (June 15, 1989). The House's vote to reject the Hyde amendment, which would have allowed S&Ls to continue to include goodwill as a component of regulatory capital, has been described as a "stunning defeat" for the U.S. League. Bush Savings Plan Is Passed By House, N.Y. Times, June 16, 1989, at A1.

[5]See President Bush and Media Undo Best-Laid Plans of S&L Lobbyists, Am. Banker, June 19, 1989, at 10 ("[e]ven with House passage of the S&L bill, thrift lobbyists are hardly surrendering. . . . [Thus,] the fight to ease capital standards is not over yet.").

putting any of their real capital at risk. In other words, if, for whatever reason, Congress ultimately fails to require that S&L owners have real money at risk as capital in their institutions, and if it allows the continued use of accounting goodwill as a fictional substitute for hard cash, then the S&L crisis will not be over for the taxpayer--it will merely be magnified and prolonged.[6]

It is therefore in the best interest of the strong, well capitalized S&Ls, who want to see this problem solved and not protracted, to support adequate net capital standards that rely on real money, not on accounting fluff. This is particularly the case if S&Ls are, in the future, to expand their activity beyond the banking sector and into brokerage, underwriting, and other lines of business traditionally closed to S&L institutions. Indeed, if inadequately capitalized institutions are allowed to enter new lines of business, such as brokerage or underwriting, then it is only a matter of time till the problem spreads outside the banking sector, and the government eventually finds itself holding the bag for risk-

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[6]This argument regarding the need to eliminate goodwill from bank capital adequacy standards does not address the concern over fairness raised by certain S&Ls who claim they would not have engaged in acquisitions of troubled S&Ls but for the promise of federal regulators to allow them to amortize goodwill over an extended period. The resolution of these claims is logically separate from the need to eliminate goodwill as a component of capital adequacy. See, e.g., Dufilho, S&L 'Good Will': The Other Side, Wash. Post, June 26, 1989, at A11.

taking behavior in non-banking activities. Under no circumstances can we afford to let this happen.

As a regulator in the securities industry, I welcome responsible entry, on a level playing field, by adequately capitalized S&Ls. The securities industry does not, however, deserve to be tarred with the S&L industry's brush, as will inevitably happen if inadequately capitalized institutions--the living dead--are allowed to gamble with taxpayer dollars by engaging in securities activities. Real capital at risk, and true economic solvency, measured in hard cash rather than accounting fantasies, must therefore be a condition precedent to resolution of the S&L crisis and to entry by S&Ls into other sectors of the financial industry. Without these safeguards, government insurance will be extended beyond the banking sector, where its problems are already obvious, and into the securities industry, where its potential problems are at least as severe and where it has no rightful or logical place.

Talking Sense, Not Self-Interest

Capital adequacy is not, however, the only condition precedent to S&L entry into other segments of the financial services industry. In order to be taken seriously by regulators who are not in your hip pocket, this organization will have to start talking sense rather than self-interest.

The U.S. League and the entire S&L industry have a credibility problem. The activities of the U.S. League are frequently cited as a shining example of how a talented and well-financed trade organization, with a membership that is broadly dispersed across all Congressional districts, can influence the political process to promote its private interest at the expense of the public good.[7] It is widely understood that, partially as a consequence of the U.S. League's past lobbying success, the U.S. taxpayer will be required to pay many tens of billions of dollars to make good for this industry's excesses.[8] These payments will be in real dollars that could otherwise have been spent to reduce the deficit, shelter the homeless, care for the sick, or defend the Republic.

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[7] See, e.g., Kilpatrick, The S&L Mess: The Stench Gets Worse, Wash. Post, June 13, 1989, at A27 ("The [S&L] lobby is winning, and the people are losing."). See also Congress Has Been Cozy With The S&Ls But Now It Is Becoming Cautious, Nat'l J., Jan. 14, 1989, at 62; As S&L Crisis Grows, U.S. Savings League Loses Lobbying Clout, Wall St. J., Mar. 7, 1989, at A1 (hereinafter "As S&L Crisis Grows"). The chairman of one bankrupt institution recently declared that "[o]ne question among the many raised in recent weeks, has to do with whether my financial support in any way influenced several political figures to take up my cause. I want to say in the most forceful way I can: I certainly hope so." Senatorial Shills, Wall St. J., June 13, 1989, at 20 (quoting Charles H. Keating, Jr.). Recently, however, some members of Congress, recognizing the problems generated by S&L lobbying, have begun to back away from the industry. See id. (reporting that Senator McCain is now "embarrassed" about his activities on behalf of certain S&Ls).

For an academic analysis of the political factors that have led to poor regulation of bank and S&L risk-taking activities see Macey, The Political Science of Regulating Bank Risk, 49 Ohio St. L.J. 1277 (1989).

[8] See, e.g., S&Ls Seduce Congress--It's A Scandal, Wall St. J., June 30, 1987, at 32.

The perception that the U.S. League caters to the lowest common denominator in the S&L industry is growing. The League's efforts to weaken capital standards in President Bush's bailout bill fuel the view that this organization's priorities are set by its weakest and most dangerous institutions.[9]

In the view of many observers, myself included, the League's activities have not been designed to promote a structure that is in the best interests of the most solvent and responsible members of the industry. Warren Buffett's recent decision to withdraw his solvent, well-managed S&L from this organization illustrates the growing frustration with this "bottom of the barrel" approach. Mr. Buffett, in his letter of resignation, described the U.S. League's lobbying efforts as "so flawed, indeed disgraceful"[10] that he was no longer willing to continue being a member of the League. Even more pointed was his observation that "[i]t is not unfair to liken the situation now facing Congress to cancer and to liken the League to a significant carcinogenic agent. And, like cancer, our present troubles will recur if Congress lacks the

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[9]For example, the Wall Street Journal has described the industry's efforts to weaken capital standards as an "incredible" display of "amendment chutzpa." S&L Watch, Wall St. J., June 9, 1989, at A10.

[10]Letter from Charles T. Mungar, Chairman, Mutual Savings and Loan Association, to United States League of Savings Institutions, at 1 (May 30, 1989).

wisdom and courage to excise elements which helped cause the troubles."[11]

Sadly, the League's response to Mr. Buffett's letter was nonsubstantive. It rested in part on the observation that there have been more resignations from members who think the League is not pressing hard enough to weaken the Bush plan than from those offended by the League's efforts to weaken the plan.[12] Put another way, the League's defense to Mr. Buffett's criticism is, in part, to suggest that we should be grateful the situation is not even worse.

The credibility of the U.S. League in estimating the depth of the S&L industry's insolvency, in proposing responsible solutions to the S&L crisis, and in measuring the policy consequences of its own recommendations has also been seriously damaged. For example, in 1987 Congress passed legislation providing $10.8 billion to recapitalize the FSLIC, an amount substantially less than the $15 billion initially requested by the Administration. The U.S. League, however, insisted that only $5 billion was necessary.[13]

The $5 billion sought by the League was a pitiful amount measured against the industry's losses. The inadequacy of the

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[11]Id.

[12]Buffett S&L Pulls Out of U.S. League, Wash. Post, May 31, 1989, at F1.

[13]See, e.g., Veto Avoided, Banking Bill Nears Passage; U.S. League Acquiesces on Compromise Measure, Am. Banker, July 31, 1987, at 1; The Sick Get Sicker, Nat'l J., Apr. 11, 1987, at 874.

League's plan was obvious even as it was being considered,[14] and the estimate was so low that questions have been raised about the U.S. League's motives in recommending a $5 billion bill. In particular, the suggestion has been made that the League purposely kept its estimates low in order to allow the problem to grow to such a magnitude that a taxpayer bailout would become inevitable. That strategy, it was hoped, would allow the industry to save as much of its capital and profits as it could, while passing on the greatest possible losses to the federal taxpayer.[15]

These problems have been compounded by reports of widespread fraud and abuse in the industry. For example, a recent study by the Federal Deposit Insurance Corporation of more than 200 insolvent S&Ls, conducted at the request of President Bush, "found evidence of criminal fraud and abuse at almost half the institutions."[16]

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[14] See, e.g., Band-Aid Banking Law?, Nat'l J., Aug. 15, 1987, at 2082; Barth & Brumbaugh, A Sham Banking Bill, N.Y. Times, July 22, 1987, at A27.

[15] As S&L Crisis Grows, supra note 7, at A1; Anatomy of a Mess, Barron's, Feb. 27, 1989, at 14, 47 (hereinafter "Anatomy of a Mess") ("the U.S. League wanted just $5 billion in funding, not $15 billion. It was part of their policy of 'buying time'. . . . If funding were kept relatively low, the reasoning went, by 1989 there would be a new Administration that would find itself with a problem so bad that only a massive taxpayer bailout would solve it.").

[16] F.D.I.C. Found Fraud at Half of Savings Units It Studied, N.Y. Times, May 19, 1989, at D1. In addition, a federal grand jury recently indicted the president of Vernon Savings & Loan for conspiring to use Vernon's funds--which were, after all, taxpayer dollars, inasmuch as Vernon had no real net worth--to make more than $50,000 in political

Further exacerbating this problem is the perception that the U.S. League has mastered the art of agency capture.[17] There are few situations in the history of the United States in which a supposedly objective regulator has been subject to influence as great as that exercised by the U.S. League over the Federal Home Loan Bank Board.[18] Needless to say, the League's strong efforts to maintain a separate regulatory

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contributions to five members of Congress. Former S&L President Indicted; Illegal Campaign Donations Alleged, Wash. Post, June 2, 1989, at F3. In a separate proceeding, the FHLBB has secured an $86 million judgment against the former officers of a defunct S&L in order to recap losses that were caused by the officers' mismanagement and fraud. U.S. Awarded $86 Million in a Savings Unit Lawsuit, N.Y. Times, June 5, 1989, at D5.

[17]"[T]he current structure of bank regulation makes it unusually easy for banks to capture the administrative agencies and committees that are supposed to regulate them. This political capture translates into a series of banking policies that not only lead to, but also encourage, excessive risk-taking by federally insured depository institutions." Macey, The Political Science of Regulating Bank Risk, 49 Ohio St. L.J. 1277, 1298 (1989).

[18]See, e.g., Is Tangled System Part of S&L Woes? Regulatory Agreement Said to Invite Conflict, Wash. Post, Sept. 25, 1988, at H1 (quoting Paul Volcker as saying that, "[h]istorically, it's fair to say that the FHLBB has in its regulatory area . . . been . . . insufficiently independent of the industry it regulates"); Saving the S&Ls, Nat'l J., Jan. 14, 1989, at 60 (quoting Frederick Wolf, director of accounting and financial management at the General Accounting Office, as describing the FHLBB as "first as industry advocate, rather than a "regulator", and as saying that, "[i]f you wanted to construct a case study of how not to regulate an industry, this is it"); Anatomy of a Mess, supra note 15, at 14 ("[w]hen Ed Gray came to the Bank Board it was still an inconspicuous agency firmly under the thumb of the U.S. League. . . . As a matter of fact, the League until the 1940s had appointed the chairman of the Bank Board, and had helped draft its supervisory law in 1966, a law which actually impeded effective action against reckless management . . . .").

system for the thrift industry have been widely perceived as a last ditch attempt to preserve a regulator that can be regulated by the institutions it is supposed to regulate.[19] Similarly, the League's cozy, monied relationship with members of Congress has been the subject of extensive criticism, and has been blamed for Congress' unwillingness to confront the S&L crisis.[20]

The perception also exists that this organization is willing to engage in revisionist history whenever that suits its purposes.[21] The story you hear today will not necessarily

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[19]See, e.g., Seidman to the Rescue, Nat'l J., May 27, 1989, at 1288, 1289; Obstacle Seen on S&L Plan; Regulatory Change May Spur Showdown, Wash. Post, Feb. 15, 1989, at D1; S&L Plan Faces Heavy Sledding, Nat'l J., Feb. 11, 1989, at 348.

[20]See, e.g., St Germain's Back on the Hill--As S&L Industry Lobbyist, Wash. Post, June 15, 1989, at E1 (describing former House Banking Committee Chairman St Germain's acceptance of favors from the U.S. League and how he "often sided with the savings and loan industry when it requested expanded powers, and fought administration attempts to build up the federal deposit insurance fund"). See also Have We Gone Too Far?, Time, June 12, 1989, at 18; Money and Morals Inseparable in Congress, L.A. Times, June 4, 1989, pt. 4, at 1 ("Bobby Baker, an aide to Lyndon Johnson, wrote in his memoirs two decades ago of California savings and loan companies delivering paper bags of cash to senators. The only difference today is that with the sums involved it would be hard to get a paper bag big enough.").

[21]See, e.g., Capital People, Am. Banker, Aug. 1, 1988, at 12 ("Revisionist history? Maybe it's the ozone. The U.S. League of Savings Institutions has published a 210-page history of the S&L crisis that, in the words of the trade association's own wags, elevates Edwin Gray and trashes Richard Pratt. . . . [The book] portrays Mr. Pratt as overly liberal in providing thrifts with new powers and says that he inadvertently helped to set the stage for the asset problems that are at the heart of the industry's current woes. The book neglects to mention that Mr. Pratt was very popular with

be the story you hear tomorrow. You can also be sure that, despite past lobbying efforts, this organization does not easily accept responsibility for positions that may have been somewhat less than beneficial for the federal taxpayer. Thus, while Representative Gonzalez complains that "[e]verything the industry has wanted, Congress has rolled over and given it to them,"[22] the industry feigns ignorance and argues that the problem was foisted on them.[23]

The public outcry against the S&L debacle, and against the aggressive self-interested lobbying conducted by this organization, is growing rapidly. The New York Times,[24] Wall Street Journal,[25] Washington Post,[26] and several other media

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the industry at the time he was lifting the regulatory barriers. There's no record of the U.S. League having accused the former golden boy of jamming power down the throats of their membership."). See also Saving the S&Ls, Nat'l J., Jan. 14, 1989, at 60, 61 ("A number of S&L leaders, . . . after years of pushing for a relaxation of federal regulation, now blame the federal government for the crisis, contending that it failed to heed their call for tougher oversight.").

[22] As S&L Crisis Grows, supra note 15, at A18.

[23] See, e.g., Fight Seen on Savings Insurance; At Industry Parley, Top Executives Balk at Added Premiums, N.Y. Times, Nov. 1, 1988, at D1 (quoting the chairman of the U.S. League as stating that "[i]t is Congress and the regulators who bear the ultimate responsibility" for the crisis in the S&L industry).

[24] See, e.g., Same Old Shameless S&L Game, N.Y. Times, June 2, 1989, at A30; Strong Medicine for Weak S&Ls, N.Y. Times, May 1, 1989, at A16; Fix the Thrifts, or Pay and Pay, N.Y. Times, Mar. 4, 1989, at 26.

[25] See, e.g., S&L Watch, Wall St. J., June 9, 1989, at A10; Congressional Crack, Wall St. J., May 17, 1989, at A18.

organizations[27] have editorialized aggressively against positions espoused by the U.S. League. Investigative journalists are tooling up massive exposés of the industry's excess.[28] Cartoonists are beginning to warm to the acerbic potential of the industry's conduct,[29] radio and television talk shows are picking up the subject,[30] and columnists are starting to sharpen their pens as the outrage grows.[31]

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[26] See, e.g., A Strong S&L Bill, Wash. Post, June 19, 1989, at A8; Safe and Solid S&Ls, Wash. Post, June 12, 1989, at A14; Mopping Up After the S&Ls, Wash. Post, Jan. 17, 1989, at A22; Dealing with the S&Ls, Wash. Post, Nov. 11, 1988, at A22.

[27] See, e.g., Are S&Ls Wriggling Free?, L.A. Times, June 14, 1989, pt. 2, at 6; The S&L Bailout--and S&L Shame, Christian Science Monitor, June 12, 1989, at 20; Don't Gut the S&L Bailout Bill, Chicago Tribune, June 12, 1989, at 14; Leaks in the S&L Bailout Plan, L.A. Times, May 29, 1989, pt. 2, at 4; Insure Depositors, Not Bad Risks, Bus. Wk., May 8, 1989, at 164; The Great S&L Giveaway, Bus. Wk., Jan. 16, 1989, at 112.

[28] See, e.g., The $150 Billion Calamity (Seven-Part Series--Part I), Wash. Post, June 11, 1989, at A1.

[29] See, e.g., Wash. Post, Apr. 1, 1989, at A23; Nat'l J., Feb. 11, 1989, at 348; Wash. Post, Feb. 11, 1989, at A25; Chicago Tribune, Feb. 4, 1989, § 1, at 9; Wash. Post, Feb. 1, 1989, at A25.

[30] Soaring Bailout Cost Puts S&L Crisis in Public Eye, Wash. Post, June 4, 1989, at H1, H4 ("Lawmakers have grown familiar with crisis for retribution from the public during radio and TV shows from California to Florida.").

[31] See, e.g., Knight, "Goodwill Junkies" Have Much at Stake in the Final Word on S&L Capital Requirements, Wash. Post., June 13, 1989, at D3; Kilpatrick, supra note 7, at A27 ("[T]he House is poised to give the powerful S&L lobby all that it wants in the way of sweetheart capital requirements. For the past 10 years, the industry has exuded an aroma of something rotten in the icebox. Now the stench gets overpowering.").

Where Do We Go From Here?

This is, however, all water over the dam: A lot of expensive water over a very large dam, to be sure. We certainly should learn from our mistakes but we must also look forward in a constructive manner to discern the future for this troubled industry. In that vein, I would like to lay out a bare bones sketch of measures that are absolutely necessary if we are to restore solvency and sanity to the S&L industry. The success of these measures is also rationally related to this industry's ability to expand into other sectors of the financial services industry out of fear that S&Ls may lower standards in their market and cause Congress to impose tougher regulatory standards on all market participants, or hold the financial services industry liable for losses incurred by S&Ls.

To put the matter bluntly, until the S&L industry is cleaned up on a forward-looking basis, S&Ls will be perceived as a class of financial lepers that are properly subject to stringent scrutiny in order to assure their solvency and integrity, if and when they expand into other lines of business. No responsible industry in America wants to have happen to it what has happened to the S&Ls. The financial services industry is therefore understandably skeptical of sharing a market with S&Ls.

Further complicating the problem is the fact that there is excess capacity in the banking system, which includes the

S&Ls.[32] In the long run, the only institutions that will be left alive in the S&L sector will be those firms that are better capitalized and that provide real value added to borrowers and depositors. The sooner the S&L industry recognizes that fact, the less money will be wasted in the process of cleaning up this industry.

It is therefore quite important that the larger, better capitalized, and more responsible institutions in the industry begin to respond aggressively to the lobbying campaign of their weaker colleagues. Some evidence is emerging that the healthy institutions will no longer carry water for their financially troubled colleagues--but much more needs to be done.[33]

If the larger, more solvent institutions are smart, they will advocate a responsible regulatory regime for the S&L industry--a regime that is not susceptible to industry capture. Only if the healthy institutions help shut down the weak will there be any long run hope for this industry. Only if the stronger S&Ls prove their willingness to live by credible regulatory standards, and hold firm against weaker

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[32]According to Carl E. Reichardt, Chairman of Wells Fargo & Co., "[w]e have an enormous oversupply of undermanaged, undercapitalized financial institutions backed by an underfunded insurance system." Saving the S&Ls, supra note 18, at 66.

[33]See, e.g., Rift Runs Deep in Savings Bill Battle, N.Y. Times, Apr. 17, 1989, at D1.

S&Ls' efforts to degrade the regulatory process, will there be any future in being an S&L of any sort.

Capital, Firewalls, and Expansion into Securities Activities

The debate about regulation of the banking or S&L industry often proceeds as though capital requirements, firewalls, and expansion into non-banking activities are three separate topics of discussion. They are not. They are closely related in a manner that must be clearly understood if we are to allow S&Ls to expand beyond banking activities. In a nutshell, the higher a bank's real economic capital relative to the risk of its banking activities, the lower the necessary firewalls between bank and non-bank activities, and the broader the scope of the activity in which the bank can reasonably be permitted to engage.

If S&Ls are allowed to expand into non-banking activities without adequate capital and without appropriate firewalls, then we will be expanding the scope of potential losses to be assumed by the innocent taxpayer. We may also be creating a competitively unfair situation in which underpriced deposit insurance can be used to subsidize S&Ls in competition with non-banking financial service firms. This situation potentially adds insult to injury because non-banking firms can later be asked to pay taxes to bail out the losses incurred by their subsidized competitors. In the meantime, no one would subsidize them for any losses they might incur.

The need for adequate minimum real capital--consisting of hard dollars at risk--is easily explained, especially if the topic is expansion into non-banking areas. Once an institution exhausts its cold cash capital, it has no economic reason to behave as a rational risk-averse lending institution. At that point, its only real asset is the guarantee of the federal savings deposit insurance and the institution can invest with impugnity, knowing that it can keep any gains it may be lucky enough to earn while passing on to the taxpayer all of its losses.[34]

Accounting measures of capital, such as goodwill, are useless safeguards against S&Ls willing to bet on a "heads-I-win-tails-you-lose" proposition because the accounting measures do not reflect the owner's real money at risk. Thus, the owner has nothing but his "accounting net worth" to lose, and that net worth is worth nothing, except to a regulatory accountant. Goodwill is therefore not acceptable as a substitute for real dollars at risk.

A simple example of the danger that results when the federal government lets inadequately capitalized banks gamble with taxpayer dollars can be found in the story of Seapointe Savings and Loan Association. When Seapointe was founded, its owners put up $2 million in capital, which the bank proceeded to lose. With nothing left at risk, the bank decided to

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[34] See Congressional Crack, supra note 25, at A18 ("Deposit Insurance is another way of saying Government-Subsidized Risk Taking by Bankers.").

speculate in the futures market by contracting to sell 10,370 U.S. Treasury bond futures options contracts. These options gave Seapointe control over U.S. Government bonds with a face amount of $10.37 billion. Seapointe would have made money on this gamble had interest rates declined, but instead they jumped. This "heads-I-win-tails-you-lose" proposition ultimately cost Seapointe $15.9 million, money that eventually had to come out of the taxpayer's pocket.[35]

Notice that a large cushion of accounting goodwill would not have changed Seapointe's economic incentives at all: accounting goodwill won't buy you a cup of coffee anywhere in America. Thus, accounting goodwill is good for nothing except for providing a fictional base from which to impose risk on the U.S. taxpayer. Indeed, as one Congressman recently explained, if capital standards aren't properly set, Congress will "be here in another few years spending another $100 billion."[36]

Mark-to-Market Accounting

Even if we succeed in imposing adequate net capital standards in the S&L industry, the taxpayer will not be protected against unreasonable losses unless industry accounting practices are changed. Solvency cannot be achieved

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[35] At Least Four S&L Failures Laid to High-Risk Trading, Wash. Post, June 3, 1989, at A1.

[36] White House Pushes $157 Billion Bill on Thrifts as House Takes Up Measure, Wall St. J., June 15, 1989, at A3 (quoting Representative Charles Schumer).

and maintained as long as this industry relies on accounting practices that reflect wishful thinking more than economic reality. Much more needs to be done in this area.

Instead of relying on historical cost accounting, the industry must move to market value accounting that measures the net worth of an institution based on the current market value of its assets and liabilities.[37] The need to move to market-value based accounting is not yet adequately understood in this industry or by Congress. The traditional cost-based measure of accounting that underlies much of Generally Accepted Accounting Procedure ("GAAP") and Regulatory Accounting Principles ("RAP") are wholly unsuited for the regulation of banking institutions whose activities are insured by the federal government. It is all too easy for an institution to be solvent on a cost accounting basis but totally worthless on a market value basis.

A simple example suffices to illustrate this point. Suppose an institution's assets are composed totally of 30-

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[37] For a discussion of mark-to-market accounting as applied to the S&L industry, see, e.g., Brumbaugh & Litan, The S&L Crisis: How To Get Out and Stay Out, 7 Brookings Review 3, 8 (Spring 1989); J. Arnold, ed., Proceedings of the October 8, 1987 Roundtable Discussion on GAAP and RAP (Univ. S. Calif. 1988); White, Market Value Accounting: An Important Part of the Reform of the Deposit Insurance System (J.L. Kellogg Grad. Sch. Mgmt., Dec. 14, 1988); Glenn & King, Market Value Accounting: A Practical Perspective, 5 Secondary Mortgage Markets 16 (1988); Johnson & Peterson, Current Value Accounting for S&Ls: A Needed Reform?, 157 J. Accounting 80 (1984); White, Mark to Market Accounting is Vital to FSLIC and Valuable to Thrifts, 4 Outlook of the Fed. Home Loan Bank System 20 (1988).

year mortgage obligations paying 10.5 percent, and the institution has six percent net capital at prevailing interest rates. Interest rates then increase sharply and the market value of these fixed term mortgages declines by ten percent. At that point, the institution is under water and no longer has any real economic capital at risk. Put another way, no rational buyer would pay a plugged nickel for this bank regardless of what its GAAP and RAP balance sheet says, and regardless of the bank's intention to hold its portfolio to maturity. That bank is bust, and it has all the incentive to engage in the same plunging behavior that characterizes banks with inadequate capital calculated according to traditional cost accounting measures.

The federal government is therefore able to assure the solvency of its own insurance fund only if it measures the solvency of its insured institutions on a mark-to-market basis. Market based valuations must be used for all assets regardless of whether those assets are long-term or short-term, or whether they are held for trading or investment purposes.

Opponents of mark-to-market accounting often claim that it is infeasible because market values are hard to determine with any accuracy. This argument fails, however, for at least two distinct reasons. First, for a very large class of assets it is relatively easy to arrive at quite reasonable estimates of market value. These valuations are easily derived regardless of whether the underlying assets are short-term or long-term, and regardless of whether a bank intends to hold those assets to maturity. Second, even in situations where estimates of market value are not easily derived, these estimates can be more realistic than a continuous and unthinking adherence to historic costs that are clearly irrelevant. Consider, for example, the value of a real estate project acquired three years ago. Although it is easy to calculate the cost of that acquisition with great precision, that number is precisely meaningless because there is absolutely no reason to believe that the project can be sold for the same price at which it was bought.

Regulators insuring S&Ls therefore need reasonable estimates of the current market value of an insured institution's assets, even if those estimates are imprecise. Historical values are useless unless we feel comfortable assuming that history will never change, and we know that is not true.

Some small steps have already been taken in this direction. For example, the Federal Home Loan Bank Board recently announced a statement of policy requiring thrifts to account for securities investments in accordance with GAAP.[38] Under this policy statement, securities held by a thrift must

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[38] 54 Fed. Reg. 23,457 (June 1, 1989). See also Bank Board Issues Final Rule Governing Securities, Investment, 52 BNA Banking Report 1197 (May 29, 1989); Bank Board Acts to Tighten S&L Accounting, Am. Banker, May 23, 1989, at 1.

be placed in one of three categories: (1) securities being held for investment;[39] (2) securities being held for sale; and (3) securities being held for trading. Securities in the first category must be amortized over the life of the instrument, while securities in the second category must be accounted for at the lesser of cost or market. Securities in the final category must be marked to market. While these measures are to be applauded, they hardly go far enough because they still leave a major portion of an S&L's balance sheet--namely, those securities that the S&L intends to hold to maturity--free to reflect unrealistic valuations based on

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[39]To fall within this category, the FHLBB stated that the thrift must have both the intent and the ability to hold the securities to maturity.

> This does not imply that an institution may never sell securities from the investment portfolio. Significant events that were not reasonably foreseen when a security was acquired or originated may affect the institution's intent and/or ability to hold that security until maturity, although such instances should be extremely rare. A positive intent to hold a security until maturity is presumed to exist only if management's strategies, as supported by its actions, proscribe the sale of securities due to changes in external factors that are reasonably foreseen.
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> Amortized cost is appropriate only when all future events that can be foreseen, and that will lead to a sale, are not considered to be more than remotely possible. If an event in the future has a reasonable possibility of occurring, and that event may lead to a sale, then the institution must use either market accounting or the lower of cost or market accounting.

54 Fed. Reg. 23,457 (June 1, 1989).

historical costs that may no longer reflect true market realities or the insurance fund's exposure.

Functional Regulation and the Level Playing Field

To survive and compete in the financial services industry of the future, the S&L industry must come to grips with the concept of functional regulation. Like President Bush,[40] I believe that functional regulation is the most appropriate strategy for addressing the issues raised by expansion into non-banking activity. Functional regulation means that S&Ls entering into the brokerage or underwriting businesses, for example, would be regulated by the same agencies that regulate brokers, underwriters, and other securities market participants.

Functional regulation thus establishes a level playing field among all participants in a particular market. Differential regulation, on the other hand, inherently gives one set of market participants an advantage over others, and thus prevents the market from doing what it is supposed to do--rewarding efficient participants and penalizing inefficient ones.

What does the drive toward functional regulation mean for the S&L industry? Basically, S&Ls should not expect to be allowed to engage in the securities business, or in the insurance underwriting business, unless they are willing to be

[40] Blueprint For Reform: Bush Task Group Report on Regulation of Financial Services (1984).

treated like any other securities firm or insurance underwriter. If S&Ls and other banking organizations truly desire to engage in securities brokerage in competition with broker-dealers, for example, they should, I believe, be prepared to surrender their exemption from registration under the federal securities laws[41] and to accept SEC regulation, just like any other broker-dealer.

Furthermore, even if the regulatory playing field is levelled, S&Ls will have a potential competitive advantage over non-S&L competitors because of their access to federal deposit insurance. Put simply, S&Ls can borrow money (in the form of deposits) more cheaply than can non-banking organizations, because a loan to an S&L carries with it the best guarantee available--that of the United States government.[42] If S&Ls use lower cost of capital to subsidize competition with non-banking firms, then deposit insurance can be used to the detriment of non-insured institutions and for purposes for which it was never intended.[43] If there is truly to be a

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[41]See, e.g., 15 U.S.C. §§ 78c(a)(4), 78c(a)(5) (exempting "banks" from the definition of the terms "broker" and "dealer"); 15 U.S.C. § 78c(a)(6) (defining the term "bank").

[42]The rate of return on U.S. government securities is generally deemed to be the risk-free rate of return. See, e.g., R. Brealey & S. Myers, Principles of Corporate Finance 137 n.16 & 474 n.5 (3d ed. 1988).

[43]Certain economists argue that such inefficient cross-subsidization is unlikely to continue in the long run, because non-banking competitors have an incentive to establish or acquire deposit-taking subsidiaries in order to take advantage of the lower cost of capital available thereby. See Federal Deposit Insurance Corporation, Mandate for Change: Restructuring the Banking Industry 79 (1987).

level playing field between depository and non-depository institutions, then it is crucial that S&Ls, as well as other banking organizations, not transfer this lower cost of capital to their non-depository lines of business.

The S&L industry must also recognize that functional regulation means that S&Ls will have to adjust to unfamiliar regulatory schemes based on different statutory objectives and priorities. For example, under the National Housing Act, the FHLBB and the FSLIC are charged, first and foremost, with safeguarding the integrity of FSLIC's deposit insurance fund. Under the federal securities laws, however, the protection of investors is the paramount objective. It makes no more sense for S&Ls to ask that the FHLBB regulate their securities activities to protect the interests of investors than it would for the SEC to regulate their deposit-taking activities to protect the integrity of the FSLIC insurance fund.

Unfortunately, this industry appears to be opposed to the notion of a level playing field if levelling the field requires that the industry might have to operate under more stringent standards. In contrast, if a level field makes life easier for S&Ls, then the League is all for it. The industry cannot have its cake and eat it too. A level playing field cannot be tilted towards S&Ls whenever it suits S&L interests and yet be kept level in all other instances.

S&Ls, Housing Formation, and Diversification Outside the Mortgage Business

Finally, and perhaps most important, the time has come to question the role and purpose of the S&L sector. This industry has, for decades, wrapped itself in the flag and claimed that it is essential to housing formation in the United States. That argument may once have been true, but it is no longer accurate today.[44]

S&Ls in 1986 originated only 30 percent of home mortgages, down from 43 percent in 1979, and there is every reason to believe that this percentage will continue to decline.[45] The advent of a liquid secondary market for mortgage backed obligations renders inefficient the traditional "buy and hold" approach to mortgage lending, in

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[44]In an editorial, the Washington Post put it bluntly: "There is no longer any need for a separate S&L industry. Those S&Ls that can qualify as banks will survive, and the others, unfortunately but necessarily, will not." Mopping Up After the S&Ls, supra note 26, at A22. The Post has also suggested that "[t]he time has come to abolish the S&L industry." The End of the S&Ls, Wash. Post, Oct. 11, 1988, at A18. This sentiment has been echoed by Mark Riedy, president of the National Council of Savings Institutions, who declared that "[w]e don't think that by either legislation or regulatory fiat, there is a need for a separately legislated, narrow, specialized housing finance industry." Saving the S&Ls, supra note 18, at 60, 61. See also Only the Strong Will Survive the Thrift Rescue, Bus. Wk., May 8, 1989, at 122 ("in a few years, half of the nation's 3,000 thrifts could disappear"); Dinosaur Industry: Bush's New Solution For Problems of S&Ls Could Kill Them Off, Wall St. J., Feb. 7, 1989, at A1.

[45]Weicher, The Future of the Housing Finance System, in W. Haraf & R. Kushmeider, Restructuring Banking and Financial Services in America 296, 308 (1989).

which an institution holds in its portfolio the loans that it makes in its local community. S&Ls, as a group, do not have a comparative advantage in bearing or judging either the interest rate or credit risk associated with holding diversified pools of mortgages. S&Ls also have no comparative advantage in structuring appropriately diversified pools of mortgage obligations. It is far easier and cheaper to acquire a diversified pool of mortgage assets by purchasing a portfolio of mortgage backed securities than it is to build that portfolio from scratch by attempting to make a diversified series of home loans. Moreover, because of questions about the pricing of the option component of traditional fixed-term mortgages (i.e. the option the borrower has to pay off the mortgage if interest rates decline and to refinance at a lower rate), serious reservations exist about the long-term profitability of home mortgage financing as currently practiced by S&Ls.[46]

S&Ls may have a comparative advantage in acting as originators of and servicing agents for mortgage loans that can be repackaged and sold into the secondary market. This market niche may well constitute a reasonable profit opportunity for appropriately situated institutions. But here too the S&L sector is guaranteed to face increased competition

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[46] See, e.g., Carron & Brumbaugh, The Future of Thrifts in the Mortgage Market, Presentation at the 25th Annual Conference in Bank Structure and Competition, Fed. Res. Bank of Chicago (May 1989) ("Investment in mortgages has been unprofitable for thrifts for most of the last seven years.").

from banks, mortgage bankers, and other intermediaries. Indeed, some of these institutions may be able to perform the S&L's traditional origination and servicing functions better than the S&Ls themselves.

The future of the S&L industry is thus far from clear. If the S&Ls are to remain viable and financially responsible insured institutions, it seems clear that their activities will have to expand far beyond their traditional housing finance function.[47] Strict prohibitions on participation in certain lines of business, such as the House's proposed prohibition on junk bond investments, are thus likely to be counterproductive.[48] A set of capital requirements, accounting standards, and supervisory practices designed to guarantee that S&L participation in these new lines of business is conducted responsibly, and without inordinate risk to the federal taxpayer, is a far more sensible approach.

Conclusion

S&Ls have a future, but it is a future far different from the industry's past. S&Ls must, as a group, decide whether they want to evolve into modern, responsible participants in

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[47] See also Weicher, id. at 308-309; Hanc, Is There a Future for Thrifts?, 4 Bottomline (Mar. 1987).

[48] Under the bill approved by the House on June 15, 1989, S&Ls and their subsidiaries would not be permitted to "acquire or retain any junk bond." 135 Cong. Rec. H2759, H2765-66 (June 15, 1989). In contrast, the Senate bill would simply require state-chartered S&Ls to limit their investments in junk bonds to the same extent as federally chartered S&Ls. See S. 774, § 223(d), 101st Cong., 1st Sess. (1989).

the financial services industry, or whether they want to cling to past practices and traditions that doom the industry to becoming a ward of the state. To a large extent, you hold your future in your own hands. By your actions you will determine whether your future is real or whether you will be remembered as the largest corporate welfare case in America's history.