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THE S&L DEBACLE

LAWRENCE J. WHITE*

THE savings-and-loan (“S&L”) debacle is in many ways an awful story—awful in both senses of that word. But it is a story that has not been well reported in the press or media, because the media focus is on anecdotes and personalities. All you have to do is look at the front page of the *Wall Street Journal* to get yet another version of the personalities and the anecdotes and to see the media focus on the ephemeral rather than the fundamentals. What I want to do here is to tell the story of what happened, why it happened, how it happened, and what must be done so that it never happens again.

The story is one of government failing, of *our* government failing. It is a story of greed, and of neglect; it is a story of corruption in high places; it is a story of the end of a number of political careers. I am not, however, going to address any of that. You can get that from the *Wall Street Journal*. I am going to examine something for the moment that is much more important, and, to me, considerably more exciting—accounting. Now, I say the word accounting and people start looking at their watches. Please, stay with me. I hope I can convince you that an understanding of some very simple accounting concepts can provide a great deal of insight into what happened, why it happened, and how it happened. I begin with a simple illustration.

<u>Assets</u>	<u>Liabilities</u>
\$100 (loans)	\$92 (insured deposits)
	<hr/>
	\$8 (net worth)

Figure 1. Balance Sheet of a Healthy Thrift as of December 31, 198X.

I start out in Figure 1 with a very simple balance sheet for a S&L (a “thrift”), but it would apply equally forcefully to any commercial bank

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This speech was given by Professor White as part of the annual Financial Institutions and Regulation Symposium at the Fordham University School of Law.

in the land. The assets of that thrift or bank are the loans that it makes. That may be somewhat counter-intuitive, but from the perspective of the bank or the thrift, the loans that it makes are investments, and thus assets.

The primary liabilities of a bank or a thrift are its deposits. Again, that may seem counter-intuitive, but it owes that money to the depositors. I am going to assume that all of those deposits are insured. For the S&L industry that is in fact a very good assumption. For commercial banking it is at least a reasonable assumption. If we subtract the liabilities from the assets, and the liabilities are less than the assets, there is something left over. That something left over is called capital in the banking world. The rest of the business world calls it net worth. It is just a simple subtraction of the value of the liabilities from the value of the assets. In essence, it is the owners' stake in this enterprise. You could think of it as the liquidation value of the enterprise: net worth is just the simple residual of the owners' stake. Notice that I have made an important assumption that these numbers represent true market values. That is an extremely important assumption, one to which we shall return later.

If these are true market values, the net worth of eight dollars is the true market value net worth. The media has done a dreadful job in reporting this net worth or capital figure. They refer to it as cash, or cash on hand, or cash capital, but it is nothing of the sort. It is simply an arithmetic residual of the difference between the value of the assets and the value of the liabilities.

<u>Assets</u>	<u>Liabilities</u>
\$92 (loans)	\$92 (insured deposits)
	\$0 (net worth)

Figure 2. Balance Sheet of a Marginal Thrift as of
December 31, 198Y.

Figure 2 represents a thrift in which the value of the assets has declined from one hundred to ninety-two dollars because some of the borrowers cannot pay their loans back or can only pay them back on extended terms at lower interest rates. The value of those loans has gone down.

<u>Assets</u>	<u>Liabilities</u>
\$60 (loans)	\$92 (insured deposits)
	-\$32 (net worth)

Figure 3. Balance Sheet of a Marginal Thrift as of
December 31, 198Z.

Figure 3 represents the S&L that I saw all too often and that we continue to see all too often, one that has assets worth only sixty dollars, but

where deposit liabilities equal ninety-two dollars. By a simple arithmetic process we have negative thirty-two dollars of net worth.

Even this modest amount of accounting offers some important insights. First, banks and S&Ls, even healthy ones, are very thinly capitalized. Stated another way, they are very highly leveraged.

There are two ways of measuring capitalization or leverage. One is to relate the debt of an institution, essentially the deposits for a bank, to its net worth. For example, a typical manufacturing company in this country has a debt to net worth ratio of one to one or two to one. In a leveraged buyout, we are typically talking about a ratio of five to one or six to one. Here, however, we have a healthy bank or S&L with a ratio of 11.5 to one.

In terms of net worth to assets, the manufacturing company in the above example would have a fifty percent net worth to assets ratio, whereas this healthy bank or thrift has only an eight percent net worth to assets ratio. If you own an enterprise like this, the attractiveness of leverage is that a small positive percentage change in the value of the assets leads to a large positive percentage change in the value of the net worth. For example, in Figure 1, a four percent gain in assets—from \$100 to \$104—would lead to an increase in net worth to twelve dollars. Thus, a four percent change in assets leads to a fifty percent change in the owners' stake in the enterprise.

We must also remember that we operate in a legal economic environment of limited liability. The owners' liability for the costs of this enterprise is limited to their stake in it. Except for exceptional circumstances like criminal activity or failure to meet fiduciary obligations, the owners' liability ends once their initial investment is gone. If there are inadequate assets to cover the obligations to the depositors, that becomes somebody else's problem. Thus, the owners' incentives are rather different than if they were completely liable for all of the shortfalls. In this limited liability world, owners want to take more risks. They get all of the upside of taking risks, but are exposed to only a limited amount of the downside. That limited amount is their initial contribution.

In addition, the owners of a bank or thrift would like to operate with as little net worth as possible because the less net worth they have invested, the less they have at risk and the more they can say, "heads I win, tails it is somebody else's problem."

The rest of the economic world came to understand this basic paradigm long ago. The debt holders in a manufacturing company understand these problems. If they hold the bonds of such a company, they typically put covenants in their bond indentures that limit the activities of the owners or of the managers of the company operating on the owners' behalf. If a bank makes a loan to a corporation, it puts restrictions in its lending agreement to ensure that nothing will happen that could put it at risk. Thus, the rest of the world understands risk analysis. And, to a limited extent, the bank regulators do too. Many of the safety and

soundness regulations in the banking area can be seen as the equivalent of the bond holders' covenant.

The bank regulator has several tools available to restrain action. The tools can be divided into two primary categories: (1) direct restrictions on an activity that the bank or thrift takes; and (2) the requirement that a bank or thrift maintain a minimum level of net worth. Net worth represents a direct form of protection for the regulator or the insurer. The larger the net worth, the more the value of bank assets can decline before a shortfall is created that will require the bank's insurer to cover the bank's deposit liabilities. Consequently, the insurer and regulator will desire that a bank have a large net worth because it provides direct protection.

Net worth also provides indirect protection because the larger the amount of net worth, the larger the owners' stake in the enterprise and thus the more they have to lose if things go sour. Therefore, owners will be less likely to undertake risk and more likely to exercise care in the operation of the company.

From the insurer's point of view, net worth is similar to a deductible in a home owner's or car owner's policy. The larger the deductible, the larger the direct protection for the insurer, because the loss on the home or car has to be greater before the insurer's obligation begins. With a larger deductible, the home owner or car owner is also likely to be more careful because he or she is going to be responsible for more of the initial costs.

Because net worth is so important, one would presume that the regulator or insurer would want to measure it as accurately as possible. Unfortunately, this presumption is incorrect. The standard accounting system used today is not a market-value oriented system. Today's system calculates a backward-looking cost, based on an historical accounting system. It is used for all enterprises in our economy except for investment banking firms and pension funds, which operate on a market-value basis. Everybody else, including the bank and thrift world, operates on Generally Accepted Accounting Principles ("GAAP"), which is a backward-looking, historical system that is slow to recognize market value. Needless to say, I am not an enthusiast of GAAP.

Once a bank or S&L has a shortfall in the value of its assets as compared to the value of its insured liabilities, unless the federal government is prepared to tell the depositors in insured banks and S&Ls, "No, we lied to you, you're not going to get back your full money, you're not going to get back a hundred cents on a dollar," unless we're prepared to do that, this shortfall, the thirty-two dollars from our example, must be reimbursed to depositors.

In the S&L cleanup that is constantly in the newspapers, the cost of which runs into the hundreds of billions of dollars, what we are talking about is an accumulation of the scenario depicted in Figure 3. Notice that I have not used the word "bailout," because in this context that

word is a complete misnomer. It implies that bad guys are getting a windfall. In reality, however, the money is going to pay off insured deposits, a direct payout of ninety-two dollars to the depositors. The sixty dollars in assets are liquidated. We hope and pray that we get the full sixty dollars back; but even then, we're out thirty-two dollars.

The money may also be used to pay an acquirer, perhaps the bank across the street or perhaps somebody who has never been in the banking business before. In the latter case, this person comes along and the federal government asks, "Are you interested in taking this enterprise over?" The acquirer says, "Yes I am, I'll be happy to take it over and operate. But on day one you've given me an operation that has ninety-two dollars in liabilities and only given me sixty dollars in assets. You're going to have to give me something to balance out the liabilities with assets. I will need roughly thirty-two dollars in assets—cash, real estate, promises, something so that I've got ninety-two dollars in assets to balance the ninety-two dollars in liabilities."

Consequently, the thirty-two dollar payment will either directly satisfy the obligations of depositors, or indirectly satisfy these obligations by finding somebody else to take on the obligations of the depositors. But the shortfall in assets must be rectified, or nobody is going to take on the obligation.

I keep asking anybody who uses the "B" word, "Where is the bailout?" Depositors have an insurance contract with the Federal Government. The Federal Government promised that their money was insured up to \$100,000. If your house burns down and the insurance company comes around the next day and gives you a check to pay for your losses, has the insurance company bailed you out? No. It has made good on its insurance contract with you. Approximately one to two percent of the deposits in an insolvent S&L are above \$100,000. Sometimes these depositors are left unprotected and told, "Your money was uninsured, you have to line up with anybody else who's a creditor and maybe you'll get thirty, forty, sixty cents on the dollar." Sometimes they are made whole because it is the easiest, lowest cost arrangement to transfer all of the depositors into the hands of an acquirer. In any event, there are only a few such uninsured depositors.

Who else might be the beneficiary of something called a bailout? The previous owners are out of the picture the minute the S&L is either liquidated or turned over to an acquirer. They do not see a cent. In fact, a recent *Fortune Magazine* story points out that they are being indicted and sued wherever there seems to be either criminal or civil liability.

Now it is clear, as we will see from the story, that the owners were allowed to operate those S&Ls for far too long. Many of them enjoyed a high style of living for far too long, and once again we wish we could go back into history and undo that. But when it comes time to dispose of these insolvent S&Ls, not a cent is going in their direction; it is virtually

all going to insured depositors either directly or indirectly. That is why I do not use the "B" word.

Now let me tell you the horrible story. The S&L industry was put back on its feet in the 1930s as part of the general reform of the financial system following the debacle of the 1929 to 1933 period. For the first time we had federal deposit insurance, in 1933 for commercial banks and a year later for S&Ls. For the first time we had federal regulation and federal chartering of the S&Ls under the Federal Home Loan Bank Board, which also provided the deposit insurance in these S&Ls through the Federal Savings and Loan Insurance Corporation ("FSLIC"). S&Ls were seen to be a crucial part of the residential finance system because they were to be the major providers of home mortgages. And during the 1940s, 1950s and 1960s, as the American economy and its residential sectors grew and prospered, home values generally grew and with that, S&Ls prospered. The industry was composed largely of small town S&Ls based on mutual ownership rather than stock ownership. Many of their operators acted as if they had a calling because they were promoting thrift and encouraging home ownership. How could there be a higher purpose in life? Many of them thought of themselves in just the same way that Jimmy Stewart portrayed George Bailey in the 1946 Frank Capra film *It's A Wonderful Life*.

The S&L industry was secure because home mortgages were basically a safe investment. Almost everyone paid back their mortgages. Even if they did default, in a era of rising property values, the S&L could sell the property and still avoid a loss. Consequently, the S&Ls were solid institutions because they had safe assets and because a safety and soundness regulatory system was in place.

There was a serious flaw in this system, however. These financial institutions were borrowing short and lending long. Their deposits were short-term deposits. They were basically pass-book deposits from which depositors could withdraw on very short notice. Their loans were long-term, typically thirty years at a fixed rate of interest.

As long as interest rates remained stable, declined, or only increased gradually, the system worked. During the 1950s and 1960s, this was frequently described as the industry of three-six-three. They were taking in deposits at three percent, they were lending the money out at six percent, and they, executives of the local S&Ls, could be expected to be seen on the golf course by three in the afternoon. If interest rates went up sharply, however, these institutions would be in deep financial difficulty.

The S&Ls' income potential declined because they made long-term mortgages at the fixed interest rates that were now relatively low because interest rates had just risen. To keep the deposits in the institution, S&Ls were going to have to raise the rates that they paid to their depositors. This would result in a cost squeeze. They would run losses because their income from these fixed rate loans of earlier years would be inadequate to cover the current interest costs to keep the depositors in the institution.

This problem first arose in 1965 and 1966 when the United States significantly increased its involvement in the Vietnam War. Prices and inflation started rising and interest rates increased sharply. When the S&L industry went to Congress for help, Congress responded. Legislation was passed that extended to S&Ls interest-rate ceilings on the rates of interest that could be paid on deposits in S&Ls. These "Regulation Q" ceilings had previously applied only to commercial banks.

The ceilings worked for a little more than ten years because depositors had very few good alternatives. Basically the only place that a depositor could go to in the late 1960s and the early 1970s to get another reasonably safe, reasonably liquid instrument was to another S&L or commercial bank. And all of them were subject to the same Regulation Q ceilings.

In 1970, to trap depositors into keeping their money in S&Ls, the United States Treasury raised the minimum denomination of a Treasury bill from one thousand dollars to ten thousand dollars. In that year the average deposit in a S&L was \$3,045. Thus, one thousand dollars was well within the means of the average depositor. But ten thousand dollars was not.

During the 1970s, however, a number of academic and Congressional studies predicted that the current system eventually would fail if no changes were made. Calling for deregulation, these studies stated that a narrow focus on residential mortgages was not the correct long-term solution for these institutions. They suggested that the government allow them to diversify their portfolios and make other kinds of loans. The studies also suggested that the S&Ls get away from fixed-rate mortgages and make adjustable-rate mortgages.

Study after study concluded that the Regulation Q ceilings were ill-conceived. They hurt depositors and led to non-price competition. Anybody reading the *New York Times* a decade ago remembers that there were pages of advertisements by the local commercial banks and local S&Ls offering potential customers prizes if they deposited one thousand dollars, five thousand dollars, or ten thousand dollars into their banks. They offered potential customers tennis rackets, toasters, trees planted in their name in Israel, anything to bring in their money. Because of Regulation Q, they could not pay them a market rate of interest, so they gave them a toaster instead.

While study after study concluded that changes had to be made, nothing happened. Neither the Congress nor the presidents were interested in making any changes during those years.

There is a little-known story that in 1973 and again in 1975 and 1976, my predecessors at the Federal Home Loan Bank Board started developing regulations that would have allowed federally chartered S&Ls to make adjustable-rate mortgages. This would have served as an important example for the rest of the country. At that time only a few states, such as California and Wisconsin, allowed their state-chartered S&Ls to

make adjustable-rate mortgages. The rest of the state-chartered institutions, and all of those federally-chartered, could not make adjustable-rate mortgages. They could only make fixed rate mortgages.

Each time the Congress, and especially the Congressional banking committees, said "don't you dare," and my predecessors at the Federal Home Loan Bank Board backed down. The Congress viewed it as a consumer issue. Many consumer advocates were afraid that S&Ls and banks would act arbitrarily and summarily raise the interest rates on adjustable-rate mortgages. They did not believe that there could be adequate regulation. Consequently, the S&L industry went into the late 1970s locked into a narrow portfolio of long-term, fixed-rate mortgages and short-term deposits.

In the late 1970s and early 1980s interest rates went up again; inflation increased and interest rates shot skyward into double digits. This time Regulation Q was not the solution for the S&Ls' problems because a new investment alternative appeared on the financial horizon: money market mutual funds. Money-market mutual funds began in 1972 and grew slowly during the mid 1970s. Between 1978 and 1982, however, money market mutual funds grew from less than ten billion dollars to over \$200 billion.

Money market mutual funds were a real alternative for depositors because they offered them a relatively liquid and safe instrument. They were investing the collected monies given to them by depositors either in short-term Treasury bills, short-term large denomination bank certificates of deposit, high-quality commercial paper, or other very safe instruments.

Now the S&Ls were back in the original dilemma, and Regulation Q was not available to help them. They were hemorrhaging money. It started in late 1979, and by 1981 and 1982 the S&L industry had massive losses. They went back to Congress and again asked for help. Congress agreed and looked toward deregulation.

In early 1980, Congress passed a major deregulation bill called the Depository Institution Deregulation Monetary Control Act ("DIDMCA"), which President Carter signed. Toward the end of 1982, Congress passed another major deregulation bill, the Garn-St Germain Act, which President Reagan signed.

The deregulation that passed was what an economist would call economic deregulation. First, it at last allowed the S&Ls to make adjustable-rate mortgages. It also allowed them to diversify their portfolios by making other kinds of consumer loans. They could now make car loans, boat loans, credit card loans and other kinds of real estate loans, such as commercial real estate loans. The deregulation allowed the S&Ls to make commercial loans that did not have any mortgage collateral as well as out-and-out commercial loans, the way commercial banks made commercial loans. At the federal level, it even allowed thrifts to take direct ownership positions in small quantities in enterprises and undertakings.

At the state level, states such as Florida, California, Texas, Arizona, Louisiana, Arkansas and Colorado were even more liberal in the deregulation on the asset side of their state-chartered but federally insured S&Ls. For example, California had an "anything-goes" policy permitting investment in just about anything.

Deregulation also removed the Regulation Q interest rate ceilings. Consequently, both the S&Ls and the commercial banks were no longer limited in the interest rates that they could pay to their depositors. (The only place where the Regulation Q ceilings remain is on commercial checking accounts.) Another effect of the deregulation scheme was the raising of the amount of federal insurance on an individual deposit from forty thousand dollars to \$100,000.

The intent and effect of deregulation was basically to deregulate on the asset side, deregulate on the liability side, and increase the amount of insurance on deposits. These were basically sensible measures to take, ones that many studies and commissions had been recommending for the previous decade.

While these changes may have been the correct steps to take, they came too late. I must emphasize that these changes should have been accompanied by a drastically stepped-up effort in safety-and-soundness regulation. To see why, I will take you back to the accounting framework. Remember that in this limited liability world the owners and operators of the S&Ls always have a tendency to take risks. The deregulation gave them new opportunities to take risks. They were no longer limited to the narrow, safe world of the home mortgage. They could now invest new kinds of assets. If they had done it prudently, it would have given them the opportunity to diversify their portfolio, which was the sensible thing to do. But because it was done imprudently, it gave them the opportunity to play roulette with other people's money.

Second, deregulation increased the capability for funding the increased opportunities because S&Ls could now pay market rates of interest. Thus, any small S&L could put an advertisement in the *Wall Street Journal* reading, "I am the XYZ Savings and Loan of Waco, Texas. You have never heard of me, but I pay market rates of interest. Send your deposits to me, they are federally insured."

That same thrift could also ask a deposit broker, many of them first quality Wall Street investment houses, to gather up the deposits for it and send them to Waco. Because the insured deposit amount had been increased from forty thousand dollars to one hundred thousand dollars, all of these transactions could now be done in larger chunks. To use an economist's term, the "transaction costs" of gathering up these deposits had decreased. Thus, by allowing thrifts to pay market rates of interest and by increasing the insured amount, the capability for funding the increased opportunities for risk-taking had also increased.

Finally, the most important aspect of deregulation was that the incentives for risk-taking had gone up. Because all the thrifts had been run-

ning losses during 1980, 1981 and 1982, their net worths were effectively gone. With the owners' stake gone, there was no incentive for them to avoid risks. That is why we desperately needed a stepped-up safety-and-soundness system at the time.

In retrospect, it is a miracle that of the over three thousand S&Ls at the time, only several hundred abused their opportunities. It is a miracle that the rest of the industry did not do it as well.

Although we needed a stepped-up safety and soundness system, we got exactly the opposite. During the early 1980s, the safety-and-soundness system was weakened. First, in response to a clear signal from Congress, the Federal Home Loan Bank Board lowered the net worth requirement in 1980 and again in 1982. Thus, at the same time that the risk opportunities went up, the deductibles decreased.

Second, again partially in response to a clear directive from Congress, the already inadequate accounting system was altered. The only way to describe it is that S&Ls were allowed to create false assets, ones that had no real value. The only purpose of this plan was to allow S&Ls to show increased assets and increased net worths.

Third, the whole safety-and-soundness structure was weakened by a reduction in the number of field-force examiners and supervisors between 1981 and 1984. These men and women were supposed to be looking over the shoulders of the S&Ls, doing audits and ensuring that S&Ls operated in a safe and sound manner. This was the era of deregulation in Washington, and there were too many people there who did not understand the distinction between economic deregulation, which was mostly (if not entirely) sensible, and safety-and-soundness regulation, which needed to be stepped up.

They appeared to understand it in the airline area. They understood that we could have economic deregulation by getting rid of the Civil Aviation Board, but that we needed to keep safety regulation in place, thus keeping the Federal Aviation Administration intact. But when it came to banking, and S&Ls, that same connection was not made.

Consequently, several hundred S&Ls took advantage of the lax supervision. They had the incentives, and they grew very rapidly. Most of their growth was in non-mortgage, non-residential mortgage assets. What was clearly going to be a problem was exacerbated by new guys coming into the industry. It was no longer Jimmy Stewart running the local S&L. All too often the president of the local S&L looked like Warren Beatty in *Bonnie and Clyde*. New guys had new ways of doing things.

There were also two external things making it a whole lot worse. One was the pattern of the price of oil. In the spring of 1981, oil hit a peak of around thirty-four or thirty-five dollars a barrel. There were a lot of people in Texas, and even people outside of Texas, who felt that there would be future oil shortages and oil would go to forty, fifty, eighty or maybe even one hundred dollars a barrel. Consequently, many real es-

tate deals took place in Texas and in the energy areas on the expectation that oil would reach forty and fifty or even eighty dollars a barrel. S&Ls were either the lenders or investors in these real estate transactions.

The price of oil did not go to fifty or eighty dollars a barrel. It started slipping in the early 1980s, and then plummeted in 1986. Rather than going to eighty dollars a barrel, it briefly hit eight dollars a barrel, before settling at around eighteen dollars a barrel.

At eighteen dollars a barrel for oil, many of those real estate projects were no longer attractive at all and, in fact, became big money losers. This meant that the S&Ls that had invested in, or lent to, these projects were going to lose money on those transactions.

The second change involved taxes. The Economic Recovery Tax Act of 1981 made real estate a very tax-favored investment. Depreciation periods were shortened so that one could get a lot of cash out of a real estate investment without paying any taxes on it.

Congress changed course with the 1986 Tax Act, however. For our purposes, the 1986 Tax Act did two things. First, it lengthened those depreciation periods. Second, it limited the ability of investors to shelter income earned in non-real estate investments with the paper losses that they might have incurred on real estate projects. Not only did they limit that sheltering capability, but they also applied the provision retroactively to existing real estate projects. Once again, this completely changed the economics of many investment projects, many of which failed. And again the S&L lenders took heavy losses.

My predecessors at the Federal Home Loan Bank Board started realizing that something was going wrong in 1984. Over the next three years they tightened up the regulatory system. They put limits on growth, raised the net worth standards, improved the accounting system, limited direct investments, and more than doubled the number of examiners and supervisors out in the field.

These changes were all vitally necessary to ensure that more damage was not done. But unfortunately these changes were three years too late. Between early 1983 and the middle of 1986, virtually all of the damage that we now read about was done. That was when the bad loans were made. That was when the bad investments were made. That was when those assets were put on the books. They were initially valued at one hundred dollars but today are worth only sixty dollars. The damage could not be undone at that point because the loans and investments were already made. We simply did not know at that time how bad they were.

Part of the fault lies with the accountants, who were slow to examine those transactions closely. Additionally, the real estate markets of the Southwest were only starting to crumble in 1985. They have continued to crumble since then, and as recently as the first or second quarter of 1990, those prices were still declining. Since early 1989, the real estate decline has spread to other parts of the country as well. Any time there

is a decline in the price of real estate, the values of assets held by the S&Ls go down. And that means that the shortfall between the assets and liabilities increases.

We are only now fully realizing the extent of the damage done between 1983 and 1986. During the period between 1986 and the end of 1988, my predecessors at the Bank Board, and then I, disposed of well over three hundred of these insolvent S&Ls. We liquidated some of them but found acquirers for most of them. In each instance we had to come up with the equivalent of negative thirty-two dollars either directly in the payouts to the depositors or indirectly when we found the acquirers. Those transactions generated a great deal of controversy because they have been misunderstood, and also because the acquirers were some rather controversial figures: for example, William Simon, Ronald Pearlman and Robert Bass. In each case, an individual took over an insolvent S&L that did not have enough assets to cover the liabilities, and the deposit insurer, the government, had to come up with the shortfall. Sometimes the payment was made in a single payment. Sometimes the payments were stretched out over ten years, but the shortfall had been made good.

Legislation was subsequently introduced that included a complete change in the bureaucratic landscape. My agency was abolished and the Federal Deposit Insurance Corporation ("FDIC") took over our operations. Fifty billion dollars in funding to handle the "negative thirty-twos" was to be found partly through Treasury bonds and partly through off-budget borrowing arrangements. S&Ls were expected to meet higher net worth standards, and there were some other regulatory reforms in the package. We now know that fifty billion dollars is not enough and that the next Congress is going to have to re-address the question not only of funding but also of deposit-insurance reform.

Before I leave you with what I think are the important reforms, I would like to address two questions that come up over and over again. The first question is where the money went. Most people who ask the question think it must be in a safe deposit box somewhere in Zurich. If only we could find the key, Secretary of the Treasury Brady could take the next plane to Zurich, open the box and find all the shortfall money.

Unfortunately, the money is not in a safe deposit box in Zurich. It is gone. Suppose that you had taken your ninety-two dollars to a friend, instead of to a S&L. That friend promised that he had a great investment opportunity for you in a shopping center across the river in New Jersey. You invest in this "sure thing" and the shopping center is built. Because it turns out to be the wrong location, the shops do not do very well. Instead of being worth ninety-two or a hundred or a hundred and ten dollars, that shopping center today is worth only sixty dollars. Where did the money go? It went to the brick layers who laid the bricks, to the John Mansville Company that provided the drywall, to the electrical workers, to the roofers, to the air conditioning company. That is where the money went.

In essence, that is where the money in these S&Ls went. They were bad investments made at a value of one hundred dollars but are worth only sixty dollars today. The money has been dissipated in bad investments. There may be small amounts scattered around. To that extent the charlatans, the frauds and those who violated their fiduciary obligations can and should be sued—we should try to get every cent we possibly can. But we are not going to get back an appreciable amount—it is simply not there.

The second question is why the taxpayers should pick up all of this shortfall. The answer is that it is our Government that made the insurance promise to depositors and then fell asleep at the switch. Besides, there is no one else. There is only one place that money can come from: that is our Government and, ultimately, the taxpayers. I cannot imagine a worse recipe for financial disaster than to tell depositors that their Federal Government lied to them about deposit insurance. There is truly no choice but to come up with the money and honor these insurance obligations.

The sooner we can dispose of these insolvent S&Ls, the smaller the cost is going to be. But we also need to think about fundamental reform of our entire deposit-insurance system. The United States Treasury is supposed to report on this topic either in December 1990 or January 1991. It will be hotly debated in Congress.

I think there are six important aspects of that reform. First, and most important, we must change our accounting system to market-value accounting. Imagine running a deposit-insurance system without knowing the market value of the assets and liabilities of the institutions you were insuring. All you receive are historical reports that tell you what this loan was worth four years ago when it was made rather than what it is worth today. You would not want to run a system like that. Nobody in Washington should want to do so.

Second, we need better net-worth standards. They must be risk-oriented so that somebody that has larger risks in his portfolio must come up with more net worth, a bigger deductible that will result in greater protection for the insurer. And the net worth requirement must be based on a market-value calculation of net worth.

Third, we need to have risk-oriented premiums. We currently have a system of flat-rate premiums that are paid by banks and S&Ls. Whether the safest bank or the riskiest bank is involved, they pay the same premium. No private insurer would charge flat-rate premiums to its insureds. It knows it has to charge higher premiums for the riskier ones and lower premiums to the safer ones. The same is true for our deposit-insurance system. If nothing else we should charge lower premiums to the banks or thrifts that choose to operate with higher net-worth levels because higher net-worth levels provide more protection for the insurer. Remember, net worth is like a deductible. Every automobile insurance company in the land will lower your auto insurance if you choose a

larger deductible. The same should be true of our deposit-insurance system.

Fourth, we need to give the bank and S&L regulators stronger powers so they can intervene early. They should not have to wait for a S&L virtually to collapse before being able to put that S&L under very tight restrictions or take it over.

Fifth, we must understand that if we are going to have the Government run the deposit-insurance system, we have to have the Treasury as an automatic backup for the deposit-insurance company. Depositors should never have to worry about whether the Government is going to make good on their deposit-insurance policy. There should be an automatic Treasury backup.

This doesn't mean that the Congress should not exercise extensive oversight and supervision of how those clean-up monies are spent and how the transactions occur. That is absolutely the business of Congress. But, depositors should never have to worry about whether that deposit insurance guaranty is going to be there. This means we need to have something akin to automatic authorization: The Treasury shall make these payments. That is not true right now for deposit insurance.

Last, we must go through a period of substantial consolidation of our financial system. Currently, there are 12,500 commercial banks, 2,500 thrift institutions, and 14,000 credit unions in this country. These are incredibly large numbers. No other country has nearly that number of financial institutions. Substantial consolidation means breaking down the barriers to interstate and intrastate ownership and branching establishment of branches and offices.

This process must be handled very carefully. If it is handled in a reckless manner, these institutions will probably fail because they are too thinly capitalized.

There it is. That is the story. It is a horrible story, and one that we should stand in awe of. I hope and pray that we can all learn from it and prevent yet more awful losses from occurring in the future.