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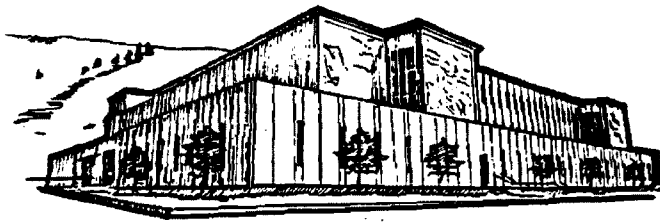
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University of
Montana

The Savings-and-Loan Crisis,
Causes and Remedies

Dalton Leonard Anderson

B. Commerce, University of Saskatchewan, Saskatoon 1986

Presented in partial fulfillment of the requirements
for the degree of

Master of Accountancy

University of Montana

1990

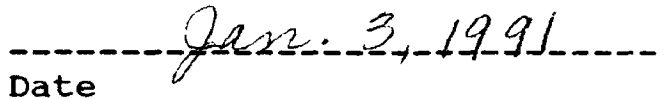
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Summary

The thrift crisis is a crisis because of the volume of taxpayer liability arising from Federal Government guarantees of thrift losses.

The crisis arose because the government extended a 100% guarantee on most thrift deposits without taking commensurate measures to prevent unsound banking practices likely to lead to losses.

Further losses can best be prevented by cutting back on insurance coverage which would give savers incentive not to provide funding for poorly run thrifts.

Additionally, the government can help deter unsound banking practices by requiring higher levels of owner capital.

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What Exactly is the Current
Savings-and-Loan Problem?

When financial commentators refer to the savings-and-loan crisis they are referring to the growing contingent liabilities of the Federal Government arising from savings-and-loan losses. These contingent liabilities arise because the Federal Government insures nearly all deposits in savings-and-loan banks, often referred to as S&L or thrifts. In the 1980s S&Ls gathered unprecedented amounts of savings-account funds from the public. Most of the S&Ls have had enough earnings to be able to repay depositors without outside help. However some savings banks have invested savings funds so unsuccessfully that they do not have that ability. Federally guaranteed deposit insurance makes the government liable for almost any shortfall.

Why is the S&L Problem a Crisis?

The word crisis is defined by most dictionaries as a critical time when the course of future events is determined. The word crisis is therefore largely synonymous with the word impasse. A crisis occurs when one reaches a point at which it becomes an impossibility for events to continue on an unaltered course. The S&L problem may be accurately described as a crisis because the contingent government debt arising from S&L losses is now so big, and the rate of its growth so great, that the government no longer has any choice but to try to deal with the matter.

Any further dilatory measures by the new Bush administration would have so eroded the confidence of the financial community as to give the new administration untenable credibility problems with the business community, probably the single most important constituency of the Republican Party.

Although the S&L problem has many aspects, there are essentially two broad areas requiring policy decision. First, the government must decide where to find the necessary funds to cover its present debt to depositors. Second, the government must implement sufficient regulation and supervision to prevent a recurrence of such large-scale S&L losses. The federal legislation passed in August 1989 dealt with both of these areas of concern. However even the most partisan supporters of the bill anticipate that in a bill of such great size and complexity there are likely to be some errors and oversights. For this reason the S&L crisis cannot be assumed to have ended with the passage of this bill. Ongoing monitoring of the industry will be necessary if there is to be prompt detection of problems and timely amendment of the bill.

How Serious is the Current
Savings-and-Loan Problem?

The savings-and-loan problem is a grave development from many points of view. Widespread reports about irresponsible and dishonest behavior among politicians and

S&L executives, combined with similar reports of dishonesty in connection with the insider-trading scandals, give ample cause for worry that business ethics in this country may be deteriorating to the point that monitoring and security measures may unfortunately become necessary on a widespread basis at a great cost to the national economy. These considerations alone make the thrift crisis a serious and troubling development. Aside from that, however, the savings-and-loan crisis must be considered an extremely significant development simply because the volume of loss is so huge. How to pay for these costs--and how to prevent their recurrence--will be a daunting challenge.

The Wall Street Journal (often abbreviated WSJ) quotes an unnamed budget official as saying "This isn't just a huge problem; we've got huge problems all around. This one is the problem." (WSJ, Nov 23 '88, A14) Paulette Thomas, a Wall Street Journal reporter specializing in the thrift crisis, calls the crisis "the biggest financial disaster in U.S. history." (WSJ, Nov 21 '89, A20) Frederick Wolf of the General Accounting Office describes the S&L crisis as a problem "that goes far beyond anything that the government has ever had to deal with." (WSJ, Oct 25 '88, A24) According to L. William Seidman, chief regulator of commercial banks in the United States, "you're talking about a problem that is many, many times greater than anything that has been faced before." (New York Times--often

abbreviated NYT--March 13 '89, p25) Thomas Moore, writing in the Jan. 23 '89 U.S. News and World Report calls the crisis George Bush's biggest problem and says that "politicians, government officials, and banking officials will not talk about it openly....but in private they worry mightily about a wildfire bank run." Maggie Mahar, chief thrift commentator at Barron's, conjectures that the S&L crisis might even prove to be George Bush's downfall:

"As Washington wisdom has it, Bush told the architects of the S&L bill 'bury this problem for eight years.' For whatever reason, they failed to carry out that command. And now the president will almost certainly have to go back to Congress and ask for more money. The timing could be dreadful. According to one seasoned spectator of the financial and political scene: 'It will probably happen in 1991---just when Bush is coming up for re-election'. The S&L's could be George Bush's hostages." (Barron's, Sept 11 '89, p32)

Nathaniel C. Nash, chief thrift writer for the New York Times, estimated, in an April story, that the ultimate cost of the crisis would be some \$157 billion, which he points out is "far larger than the bailouts of Chrysler, Lockheed, Continental Illinois and New York City combined". (NYT, April 20 '89, p25) But even this figure is now considered by some to be insufficient for on June 20, 1989 an editorial in the Wall Street Journal (page A16) branded the problem as "mind-boggling" and estimated that the ultimate costs could eventually be "well over \$300 billion" and on June 24 the New York Times concurred (page 14) stating that "the official estimate is \$150 billion and that could double."

In April 1990 Comptroller General Bowsher warned that the long-term cost could eventually rise as high as \$500 billion.

To put these figures into perspective it is helpful to consider the opportunity cost of the crisis as expressed by various authorities. Economist Benjamin J. Stein points out that his S&L loss estimate of \$100 billion "is more than the total wage of all the public school teachers in America..land isl about the total income of all the active-duty soldiers, sailors and airmen in the U.S. armed forces." (Barron's, Feb 20 '89, p20) David E. Rosenbaum, writing when the cost estimate had been updated to \$200 billion, informs us that this amount "is much more than the Government will spend on such critical social problems as preschool education, drug control and aid to the homeless. It is more than will be spent on highways, air traffic control, and pollution abatement. It amounts to more than \$1,300 for every American taxpayer, and it will not enhance national security, promote economic growth or improve public welfare one bit." (NYT, March 18 '90, Sec 4 p1)

These figures do however have two basic flaws. First of all, they do not take into consideration the time value of money. Robert M. Garsson writing in American Banker (Aug14 '89, p9) points out that the largest estimates include interest rate costs over the thirty years. Garsson points out that "the federal government operates at a

deficit. At the margin it borrows for everything it buys...interest must also be financed as must interest on that interest... you can make the total almost anything you want it to be." If the problem were completely taken care of with a one-time surtax then according to some expert opinion the amount needed might not much exceed \$180 billion.

The second basic flaw of the cost estimates is that they are based on subjective estimates of the market value of the nonperforming loans and seized assets. As Maggie Mahar points out, "...until the FDIC actually checks the assets at individual institutions, Washington's estimates of the cost--and the length of time it will consume--are nothing more than shots in the dark." (Barron's, Sept 11 '89, p20)

As uncertain as the actual numbers may be there is no doubt in the minds of the experts that this is truly a disaster. Even if the more moderate figure of \$180 billion is accepted as the best estimate, we still must raise \$750 for every man, woman and child in the country. It would be unrealistic to hope that the United States can be burdened with a per capita cost of such dimensions and not suffer some disadvantage when competing with other nations.

One authority who advocates calculating costs using the more conservative present value approach is Bert Ely of Washington, D.C., who, according to Maggie Mahar, "...may

well be the world's leading expert on federal deposit insurance." (Barron's, Sept 11 '89, p9) Ely is often quoted in both the New York Times, and the Wall Street Journal and has also been interviewed on the National Public Radio network. Although Ely accepts the lower cost estimate, he still feels that the problem is gravely serious and in an article in the Wall Street Journal on Nov. 23 '88 (page A14) Ely is quoted as saying, "We now realize we are in the financial equivalent of a nuclear meltdown."

As emphatic as many of the experts' statements may sound, it is possible to argue that the severity of the crisis has been exaggerated. The chief factor said to mitigate the crisis is the fact that much of the \$180 billion will be raised by domestic debt. Some economists are of the opinion that domestic debt is not actually a burden at all in that it is only "money that we owe ourselves." Funding will come mainly from two sources : increased deposit-insurance premiums and bond sales. Nearly all of the former will be domestically raised and also a large part of the latter.

In a special report appearing on the front page of the New York Times Louis Uchitelle maintains that there is a consensus among economists that "...the public will not feel the one-time loss...because money the government borrows from the public to repay lost deposits goes right back to the public in the form of restored deposits." (NYT, Aug 13

'89, p1) Of course, the argument can be raised that although S&L-bailout funds are domestically raised, there is nevertheless going to be an increase in foreign debt as a result of such borrowing since domestic money used for S&L bonds (and increased insurance premiums) is then unavailable for other government borrowing, which, of course, means that there must then be more reliance on foreign capital markets. If this is true, then the marginal composition of federal borrowing should be considered the significant indicator, and at the margin government borrowing is dominated by foreign lending, acknowledged by all to be a real burden.

Even the domestic portion of the marginal borrowing may not be entirely innocuous. Many economists would argue that "debt is debt" and regardless of who the creditors may be it still must be repaid by future taxpayers. With this in mind Representatives Joseph P. Kennedy 2nd (D-MA) and John J. Lafalce (D-NY), apparently with some sympathy from their colleagues, advocated immediate taxation, however heavy, to immediately and completely pay for the S&L problem. (NYT, May 3 '89, C2) In March Rep. Sam Gibbons (D-FL) said "we created the mess. We shouldn't pass it along to my children or my grandchildren." (WSJ, March 16 '89, B5)

It may seem difficult to reconcile Kennedy's and Lafalce's concerns with the apparent logic of Uchitelle's position. Macroeconomically speaking it can indeed be argued that the crisis will have few economic effects

because the money needed to take care of the problems after being taken from the public will be given right back to the public. Uchitelle is certainly wrong, however, in his assertion that the public will not feel the effects of the crisis, for the S&L impasse has without consensus or discussion brought into being a redistribution of wealth in the form of windfall profits achieved by sellers of overpriced real estate and other overpriced assets. These uneconomically high prices could only be demanded because overly optimistic purchasers had access to large amounts of S&L deposit money which never would have been available in a market in which the government played no part, but which was available because underpriced federal deposit insurance served as an effective magnet for attracting funds from savers. However unfair these windfall profits may seem, there is usually no way, in the absence of proven fraud, that a completed sale can be reversed. Very often, when these assets are overpriced, the purchaser finds that the income (or capital gain) is insufficient to permit repayment of the loan. Then the bank will usually seize the assets and sell them for whatever they will bring, which often has not been enough to cover the amount outstanding on the mortgage. When this happens, if the bank is not financially strong enough to absorb the loss it becomes the responsibility of federal deposit insurance, i.e. the taxpayer, to cover the shortfall. Thus the redistribution

alluded to is from taxpayers to the fortunate sellers of overpriced assets. The same redistributive dynamics apply in favor of contractors who overcharge or else who erect buildings which cannot pay for themselves, such as unrented office and apartment buildings, and the same overall result will occur regardless of whether the S&L supplies funds to borrowers for such uses or builds or buys such uneconomic properties for its own direct ownership.

Although the main cost to citizens will be increased taxes to cover S&L losses, for a long time there will be additional burdens on citizens in that the tremendous volume of bailout bonds will use up available investment funds making credit harder to obtain, and because of this shortage of available credit interest rates will be somewhat higher, the difference likely being about 10 or 15 basis points.

(NYT, June 6 '90, A1)

A less publicized redistributive influence caused by the crisis is the artificial transfer of wealth to the South-West, especially Texas. Because of overly optimistic borrowing and construction in that region there has been a vast increase in vacant houses, apartments and office space, particularly in Dallas and Houston. This surplus has made residential and commercial rents in those two cities so cheap, and house prices so reasonable, that there is now an artificially induced incentive for large companies to move to those two cities. In the last year both Exxon and J.C.

Penney have moved their headquarters from New York to Texas. Thus not only do the citizens of New York have to pay higher taxes for the bailout, and endure higher interest rates, but they also must tolerate an outflow of jobs from their community to Texas. Hilary Stout writes, "The government's thrift-industry bailout amounts to an enormous transfer of wealth to a few states that have the bulk of the U.S.'s sick savings-and-loans, a fact that is beginning to provoke resentment in states left to foot the bill....'I think there's starting to be a lot of anger,' said Keith Laughlin, staff director of the Northeast-Midwest Coalition, a bipartisan group of House members." (WSJ, June 25 '90, A2) Edward Hill, an economist from Cleveland State University, has made a special study of the inter-regional effects of the crisis and concluded that for each citizen of Texas there will be an influx of \$4,000 of unearned wealth paid by citizens of the rest of the country. (ibid)

Thus an approach such as Uchitelle's which only takes into consideration the overall effects of the crisis errs badly since it does not take into account important concerns of fairness. Uchitelle's assertions, however, at least have the merit of being macroeconomically sound. A far emptier argument that the crisis is benign is presented by William Baldwin in the February 20 '89 edition of Forbes (pp. 38-9). Baldwin contends that "'Solving' the crisis will not save much money now. It will merely help account for the loss

that has already occurred.....even the dumbest S&L operators aren't putting out new money to finance new condo projects in Houston." At the time those words were written, however, many loans of this nature were still being made, often by desperate S&L managements trying to gamble their way back to solvency. It is astonishing that Baldwin should be so unaware of these occurrences despite the fact that they were widely reported at the time he wrote his article. Baldwin correctly asserts that a thrift solution would have to provide an accurate accounting of past losses and a satisfactory plan for paying off these losses but he erred badly in implying that an S&L solution would not have to concern itself with terminating ongoing abuses. The fact of the matter is, putting a stop to unsound practices is the element most necessary of all to the successful solution of the thrift crisis, and what is more, it will likely prove to be the most elusive feature of thrift reform since the new regulations and enforcement policies must at the same time be strict enough to prevent further large-scale losses, and yet not so strict that they stifle initiative and useful service to the community. Despite the efforts of writers such as Uchitelle and Baldwin to downplay the crisis, layman and expert alike, generally speaking, remain unconvinced, and like Kennedy and Gibbons consider the problem to be urgent.

Why Was the Public So Slow to Realize
The Gravity of the Crisis?

The main reason for the slowness of the public to react to the crisis probably was the long-entrenched public image of conservativeness and soundness which thrived until very recently enjoyed in the public mind. For many years this widely held opinion was to a considerable extent warranted, for prior to the 1980s S&Ls seldom had financial problems largely because they were not permitted to engage in any speculative or unusual activities. S&L investments were very conservative and usually well collateralized, mortgages backed by owner-occupied housing being the main investment vehicle. There used to be a standard joke among bankers that anyone at all could successfully manage an S&L by simply following the 3-6-3 rule : borrow at three per cent, lend at six, and be on the golf course by three! The general perception of S&Ls as being dull and staid was so deeply ingrained that the public persisted in holding these views even in the face of repeated S&L bankruptcies and scandals. It was not until 1988 and 1989 that people became concerned enough to demand political action, and it is questionable whether there was much awareness of the problem in 1988, in view of the fact that S&L reform was not a campaign issue in the 1988 presidential election.

The great delay in public response would at first glance seem to suggest either a lack of open government or

else a failure on the part of the news media to carry out their responsibility to alert the public to important developments in public affairs.

Politicians certainly must bear some of the blame, for there was scarcely any mention of proposed S&L reform in the Congressional or Presidential campaigns of 1984, 1986 or 1988. The shortcomings of today's shallow politics are decried by David E. Rosenbaum who observes that "the savings crisis was too complicated for a catchy slogan or a television sound bite." (NYT, June 6 '90, A1)

Although the lack of discussion by politicians was very regrettable, an even greater cause for concern was the failure of the national news industry to convey to the public the seriousness of the S&L situation. Professor Edward Kane, of Ohio State University, suggests that the media were overly cautious about reporting S&L problems because "sticking one's neck out can hurt career prospects if an accuser fails to uncover a 'smoking gun'." ("How Incentive-incompatible Deposit Insurance Funds Fail", p16) This explanation is not entirely satisfying, however, for there have several occasions when failure to locate a "smoking gun" has done little to inhibit bold exposés. In fact, the most notorious political scandal of the last fifty years, Watergate, only came to light because of the tenacity of two Washington Post reporters who held no "smoking gun" but knew they were onto something and would not quit

hounding the Nixon Administration until finally the truth came out. Why then, in a country with this kind of a journalistic tradition, was more coverage not given to the S&L calamity? The failure of the media to make the public aware of the thrift crisis gives one cause to examine the nature of modern news reporting. According to Ellen Hume, renowned critic of the press, the failure of the press to arouse timely public interest in the thrift crisis was "a scandal in itself..[warranting]..embarrassment and soul-searching at the highest levels of journalism." (See Martz, Newsweek, June 25 '90, p42.)

Larry Martz blames a similar neglect on the part of news broadcasters on the fact that "the story wasn't right for television, since it had no vivid images. It was boring, since it turned on obscure regulations and difficult financial concepts rather than clashing personalities." (ibid)

Although failure to communicate the gravity of the S&L crisis can indeed be taken as prima facie evidence that the news media are not fulfilling their obligations to the public, such a charge can be refuted to some extent, however, for the truth of the matter is that although the problem no doubt was underrepresented, nevertheless, for those who took the trouble to look, there were at least a few thorough and accurate reports on the S&L problem right from the start. *situations?*

In fairness to the news media, it must be conceded that until the recent scandal the average American really did not care much about banks and banking problems and could not easily have been motivated to take an interest in any banks, and especially S&Ls. As Larry Martz points out in the Newsweek article cited above, "The press can lead the horse to water. The horse has to decide whether to drink." Responsibility for the inappropriate slowness of the public's response to the crisis, therefore, must be apportioned among politicians, the media, and the public itself.

Causes of the Savings-and-Loan Crisis

The comment "there's plenty of blame to go around" has been repeated so often by President Bush and others that it has become the main S&L cliché. Although this remark is usually made in reference to individuals, it could be applied equally well to causes of the crisis.

The S&L crisis had about nine or ten major causes, any one of which would have been sufficient to cause major problems, and there were also many less important but still troublesome contributing factors.

The major causes are the present system of deposit insurance, overly lenient legislation allowing thrifts to engage in unfamiliar activities, overly lenient regulation and supervision (including the granting of regulatory goodwill, certificates of regulatory net worth, forbearances

and delay privileges), inadequate agency funding (needed for adequate supervision and timely closures), the failure of generally accepted accounting principles (usually abbreviated GAAP) and more especially regulatory accounting principles (RAP) to portray the true financial condition of S&Ls, excessive interest-rate fluctuations, weak capital requirements, unreliable property appraisals and excessive growth in many thrifts, which often created problems for managers many of whom had insufficient experience to competently manage such large amounts of money.

Many of these problem areas are interrelated to a greater or lesser degree, and at least five of them are particularly closely related in that they are direct results of thrift deregulation. Deregulation was the trend in the 1980s of granting greater freedom not just to financial institutions but to business in general. The five major causes of the thrift crisis which may be grouped together under the heading "deregulation" include permission to engage in unfamiliar activities, overly lenient regulation and supervision, inadequate agency funding, weak capital requirements, and overly lenient accounting. Excessive industry growth, while not strictly speaking an essential component of deregulation, was nevertheless an immediate consequence in that it was the result of weakened capital standards and newly expanded investment activities. Although the list of factors which contributed to the crisis

could be shortened by subsuming these five or six under the designation "deregulation", it is probably more useful to look at each of them separately since it would be entirely possible to adopt any one of them without adopting any of the others.

The Problem With Federal Deposit Insurance

Although one occasionally hears deregulation named as the main cause of the crisis, expert opinion tends not to consider any facet of deregulation, nor even deregulation in the aggregate, to be the main cause, but instead the chief blame is usually placed on federal deposit insurance in its present form. The deciding factor that causes federal deposit insurance to bear the brunt of the blame is the fact that without it the unprofitable S&Ls would not have been able to raise the money which they eventually lost. This desirable termination of funding, which would have saved the country billions and which would have occurred under normal market conditions, did not occur because the public has strong faith that in the event of a bank failure the Federal Government will immediately make good any insured losses. Because the depositor is convinced, probably rightfully so, that he cannot lose any money under any circumstances, he is usually more or less unconcerned about the soundness or unsoundness of a bank's lending and investment practices. Unless the service or location is especially bad, many depositors, particularly those with large accounts, will

base their choice of bank strictly on where their savings will draw the highest interest. To be sure, there are some S&L customers who, for personal reasons based on location, habit or personnel, tend to remain loyal to one particular bank, but even these core depositors can often be induced to switch banks if the interest they are earning falls too far below what they can get somewhere else.

Because a very large segment of the saving public has little or no interest in a bank's financial condition, but is mainly interested in finding the one that pays the highest interest, it is easy for unprofitable banks to attract new deposits simply by raising the interest rate paid on savings deposits. In the absence of appropriate intervention, this easy availability of funds sets into motion a vicious circle which works as follows : when losses occur and a bank starts to run out of cash, it will raise rates paid on savings, and new deposits will soon come in. The bank will now be faced with higher interest costs, however, and to meet these higher costs it must accordingly demand higher interest rates from its borrowers. In fact when there is an increase in rates paid on savings accounts there must be a considerably greater increase in loan rates demanded since the increased loan interest rates can only be charged on new loans, whereas the increases in rates paid to depositors must be granted right away to most depositors, and in a short time to the rest as their time deposits come

up for renewal. Thus if a bank needs cash very badly it can readily obtain it merely by raising interest rates on savings accounts, but if it does so it must raise loan rates even more. Unfortunately for the bank, the most reliable borrowers cannot be charged these above-market rates, since their good credit rating enables them to obtain credit elsewhere. This means that if the bank wants to raise its interest income it has no choice but to accept a greater number of lower-quality loans, despite their greater risk. As the general loan quality deteriorates there are greater and greater loan losses. Before long the bank will once again find itself short of cash, so once again it will have to raise rates offered on savings accounts, and in this way the cycle is started all over again.

In a booklet describing thrift problems Jonathan Gray, an analyst at Sanford C. Bernstein & Co., cited a remarkable example of such a loss cycle with its ever-increasing bad loans and ever-increasing deposits :

"American Diversified Savings, a California S&L,...had been a mere \$11 million in size at June 30, 1983, and had grown to \$800 million in the next 18 months. At liquidation its \$1.3 billion in assets were worth less than 40 cents on the dollar or \$509 million, with a total cost to FSLIC of \$800 million.

"This anecdote is tantamount to a news report that a drunken motorist has wiped out the entire city of Pittsburgh.

"A company with \$11 million in assets lost \$800. With perhaps \$500,000 in equity, it destroyed \$800 million of insured deposits, a kill ratio of 1,600 to 1. In terms of sheer destructive power, only the black hole in astrophysics would appear to be in the same

league." (Jonathan Gray, cited by David O. Beim in "Beyond the Savings-and-Loan Crisis", The Public Interest, Spring '89, pp96-7)

How Deregulation Worked in Concert With
Federal Deposit Insurance to Cause the Crisis

Although deposit insurance provided ready funding, the thrift crisis still could have been averted if legislators and regulators had maintained sufficiently strict controls. Indeed, although insurance has existed in virtually its present form for over fifty years, serious loss cycles seldom if ever had a chance to get started prior to deregulation, for prior to the 1980s S&L activities were so stringently controlled by law that in many respects S&Ls almost seemed to be straitjacketed. For example, it was once required that a loan for a single-family home (usually about the safest loan) could not be made if the house was more than fifty miles away from the S&L. Under such rigid rules profits were generally very modest, but major losses hardly ever occurred.

When the monetary policy of the 1979-82 period resulted in unprecedentedly high interest rates, S&Ls found it difficult to pay the 12% or so interest which was then expected by depositors since the bulk of their earnings came from long-term noncancelable mortgages only earning about 7%.

The proponents of thrift deregulation correctly realized that the thrifts were in an impossible position,

and their solution was to grant far greater freedom to the thrifts by greatly loosening traditional use-of-funds restrictions so that hopefully S&Ls could find more profitable lending and investment opportunities.

Deregulation also weakened inspection and supervision activities by making provision for various exemptions and delays, and more indirectly by reducing the funding for inspection and supervision activities. Owner-capital requirements were also weakened and thrift accounting standards were weakened to make it easier for money-losing thrifts to conceal their losses. Although the proponents of deregulation knew that these various protective devices were now substantially weaker than before, they nevertheless felt that these safeguards still had enough strength to prevent the types of unsound lending and investing likely to cause the type of loss cycles described earlier. Unfortunately this did not prove to be the case, for these overly liberalized mechanisms responded neither quickly enough nor firmly enough when problems began to emerge and by the early '80s the loss cycles described earlier were endemic in the industry. By the late '80s industry losses had reached unprecedented levels and it would have been in the public interest to close down hundreds of the most unprofitable S&Ls. Since deposit insurance was not structured to prevent S&L losses, industry soundness depended on the various regulatory safeguards' continuing to prevent (or at least

contain) losses as they had successfully done in the past. Although badly structured deposit insurance is considered the chief cause of the crisis, the malfunctioning safeguards, which had been undermined by deregulation, were almost equally to blame, and should it prove politically impossible to change deposit insurance, then the main hope for improving industry safety will lie in amending these areas.

Of the five problem areas of deregulation alluded to earlier, one, the newly legislated permission to engage in unfamiliar activities, was a problem in that it permitted money-losing activities to occur in the first place. Another, weak capital standards, was a problem in that it removed a powerful deterrent to such activities, in that owners were no longer required to have large amounts of their own money at stake. These two mechanisms, therefore, are similar in that when working properly they both deal with prevention of money-losing activities, the one directly through express rules, and the other indirectly through fear of owner loss. The other three problem areas, however, did not involve lack of prevention of money-losing activities, but instead were problems of overly slow response to the ensuing S&L insolvencies, i.e. overly delayed shutdown of insolvent S&Ls. These three problem areas that caused these delays were underfunding of enforcement activities, lenient accounting, and permissive regulation and supervision, which

included excessive availability to S&Ls of various delay mechanisms as well as excessive regulatory discretion to bend rules for favored S&Ls. Even if one or two of these mechanisms had been functioning properly there would have been far less overall loss.

Lenient accounting posed a particular problem in that it made it legally impossible for the federal enforcement agency to shut down a thrift when it first became economically insolvent. Although the accounting profession likes to think that its activities are insulated from passing ideological movements such as deregulation, nevertheless S&L accounting was indisputably affected by the mood of the times as shown by the adoption of RAP, now discontinued, an extremely permissive accounting system which allowed S&Ls to unduly postpone loss recognition while at the same time oftentimes fully recognizing profits which had not yet been confirmed by bona fide arm's-length receipts. According to law, a thrift was not in a negative-net-worth situation, and therefore subject to closure, until it was deemed to be so by RAP standards. However, by the time this occurred, true economic losses had invariably reached unmanageable levels. Because RAP gave full recognition to such empty assets as regulatory goodwill and regulatory-net-worth certificates, many thrifts which in real terms were worthless could argue that according to federal law they really had substantial financial strength.

Of course by the time they had zero net worth even by the lenient RAP standards they were no longer even close to having enough assets to pay off insured depositors, and to make matters worse, even at that point thrift managements still had at their disposal several ways to postpone closure.

To begin with there was the ninety-day grace period which an errant thrift was normally allowed for the preparation of a reasonable business plan. After this delay, a further eighteen-months delay was possible in that this was the length of time required for regulators to withdraw deposit insurance from an unsoundly run bank. Needless to say, these long delays gave poorly run and desperate thrifts ample time to lose vast additional amounts of money. A few aggressively managed thrifts obtained even further delays by means of lawsuits or threats thereof. Although not known as such, these lawsuits were de facto appeals against regulatory closure orders, for generally speaking their chief object was not so much the winning of large monetary damages as the reestablishment of the right to remain in business.

The most notorious example of this strategy was the case of the gravely insolvent Lincoln S&L of Irvine, California whose manager, the charismatic and very domineering Charles Keating Jr., threatened to take the federal agency to court. S&L authorities in Washington felt

that such a lawsuit had some chance of success so closure actions were held off until the enforcement agency felt it had a stronger case. When Lincoln finally was closed it had amassed losses of \$2 billion.

The third aspect of deregulation that prevented timely closure of insolvent S&Ls was the excessive amount of agency discretion to deal leniently with favored S&Ls. Reference has already been made to such accounting fictions as regulatory goodwill and certificates of net worth. The blame for perpetrating these deceptions must be shared by RAP accounting which allowed the recognition of these assets, and the regulators themselves who arbitrarily granted permission to favored thrifts to include them among their assets. Regulators also had the authority to exempt favored S&Ls from specific regulations. Although these exemptions, known as forbearances, were technically discretionary, in reality the enforcement agency had little choice but to grant them because of the third aspect of deregulation which contributed to the closure problem : underfunding.

It is extremely expensive to close a thrift. All insured depositors must be immediately paid in cash, and it can take a long time to sell off the assets and partially recover the funds expended. The federal agency did not have enough money to close all the insolvent thrifts and the Federal Government did not provide it. Even as late in the

crisis as 1986 Congress only authorized a small fraction of the necessary closure funds. This left the enforcement agency with two choices : either reneging on the insurance guarantees, or else granting the various privileges described above, allowing the errant thrifts to stay open, while hoping for a turnaround in profitability. Neither option was very appealing, but it would have been the height of irresponsibility to choose the former since this would be sure to start a terrible financial panic, and would permanently undermine the public's confidence not only in banks, but also in the government. Really, then, the agency had no choice but to try to buy time by granting whatever discretionary favors it had at its disposal.

Although most experts agree that many of these forbearances were probably necessary under the circumstances, nevertheless they consider it very unfortunate that somehow it was not possible to find some other strategy, for forbearances, on general principle, are held in very low repute by most banking authorities since they generally only make a bank's situation worse by giving unsuccessful managements extra time to draw in more insured deposits which are usually lost as quickly as were the earlier deposits.

Although the main problem arising from underfunding was that it prevented timely thrift closures, inadequate funding also prevented the hiring of enough examiners to curb

unsound banking practices. Because of cutbacks in examination staff, bank inspections were not always as thorough as they had been in earlier days and in many cases by the time a particular problem was discovered serious losses had already occurred.

It has been aptly pointed out that with the greater freedom allowed thrifts by deregulation it would have been more logical to increase the staff of examiners rather than reduce it, as was done, but the policy of staff reduction was deemed to be more consistent with the general aims of deregulation. Mortimer B. Zuckerman, editor-in-chief of U.S. News and World Report, reveals in a June 18, 1990 editorial (p92) that from 1981 to 1985 the number of regulators in Texas, the state with by far the greatest number of S&L problems, was slashed from 54 to 14.

Of course the advocates of deregulation never would have recommended liberalizing the various regulatory mechanisms to such an extent had they realized that by doing so they were making it impossible to shut down unprofitable thrifts in the early stages of insolvency, for even the most avid proponents of deregulation would agree that it is nearly always in the public interest to close down an insolvent thrift as expeditiously as possible so that losses may be minimized. It is true that from time to time there is a successful turnaround situation, and under very special circumstances it might make good business sense to allow a

thrift extra time to get back on its feet, but in the great majority of cases any delay in taking action only results in more loss.

News stories about improprieties at such S&Ls as Lincoln, Silverado, Centrust and Vernon reveal that in some cases failure to close insolvent thrifts was due to improper influence and/or careless examiners. It would be a mistake, however, to assume that most of the delays in closure were due to such lapses as these. Most of the delays were caused neither by dishonesty nor by negligence but by the S&Ls' lawful availing themselves of the various privileges newly created by deregulation.

Why Deposit Insurance Even More Than

Deregulation Was the Cause of S&L Troubles

Deposit insurance may confidently be named as the main cause for the crisis, for no matter how ineffective all the other regulations were, even the simplest changes in deposit insurance would have kept the public from entrusting its savings to unsound S&Ls. The most drastic solution would be a complete repeal of deposit insurance. This would not be politically feasible. There should be little or no problem, however, in slightly reducing the current 100% coverage. Even if coverage were kept as high as 95% the risk of losing fifty dollars out of every thousand would make depositors far more interested in the soundness of a bank's practices. Small investors might not be sophisticated enough to know

how to avoid an unsound bank, but many of the larger investors are, particularly the handlers of brokered deposits, and these larger investors would certainly provide adequate monitoring of the soundness of individual thrifts. A slight reduction in deposit insurance, perhaps to 95% would have been extremely easy to introduce. There are no complicating factors that would have prevented it, and measures similar to those just outlined would have been sufficient to prevent the crisis. In no other way could the crisis have been so easily prevented. That is why federal deposit insurance must rightly be considered the main cause of the crisis. It must be acknowledged, however, that this policy would also have allowed a large number of S&Ls to go bankrupt since without full insurance coverage many depositors would have hesitated to leave their savings in institutions having large holdings of low-earning mortgage assets. Such savers would have realized that thrifts only earning six to nine per cent on their assets really were in no position to compete for savings dollars at a time when 12% savings rates were the norm. Recognizing the inherent unsoundness of the situation such savers would have withdrawn their money, relieved even to get ninety-five cents on the dollar, and of course with the possibility of a 5% loss new depositors would not be as easily found as they are now. Selling off their mortgage assets at lowered market prices many thrifts, perhaps as many as half, would

not have had enough money to pay off depositors and would have shut down, with the government ultimately making sure all depositors received their 95%. Although such widespread shutdowns would involve considerable outlays, it would have been far less costly to the government, for the same half of the industry which would have been shut down by such a measure ended up being shut down anyway but at far greater public cost. Furthermore, S&Ls as an industry would have been taught a valuable lesson : that they must insure themselves against interest-rate risk, mainly by making better use of adjustable-rate mortgages (ARMs). For years authorities had warned that thrifts were sitting on an interest-rate time bomb in that they were borrowing short and lending long. Removing the deposit-insurance prop would have forced the industry to make long-overdue and salubrious changes to cope with interest-rate swings.

It has been suggested that instead of cutting back on insurance coverage S&L problems could have been solved by having the premiums banks pay for deposit insurance adjusted according to the level of risk associated with an S&L's activities. However, if this change were made without cutbacks in coverage, unlimited funding from an unconcerned public would still be available, so unfortunately a desperate thrift would still get caught up in loss cycles, the only difference being that with higher insurance premiums to pay as riskier loans were made the S&L would

have to raise savings rates even faster than otherwise in order to raise the additional cash needed, and this would only accelerate the move to still riskier loans, since loan-interest income would have to rise sufficiently not only to pay the higher savings-account rates but also to pay the higher deposit-insurance premiums. In other words, if risk-related premiums had been introduced without any accompanying measures, not only would they not have prevented the loss cycles which occurred, they would, in fact, have made them worse. In the context of overall change, risk-related insurance is generally considered a good idea. Had it been brought in by itself it would have proven to be a disaster.

The second cause for the crisis was the newly legislated permission to engage in unfamiliar thrift activities such as direct investments in raw land, and building-and-development loans to contractors. FIRREA wisely curtailed those activities, but it would be a mistake to blame the crisis on this one problem area. The speculative ventures such as investments in raw land and unneeded office towers resulted in very fast losses. But had the other unfortunate problem areas been left alone, and this one area changed, large amounts of money still would have been lost, although, to be sure, it would have been lost more slowly since traditional house mortgages are less likely to undergo drastic deterioration in value. In spite

of this, it must not be imagined that all residential mortgage loans are sound. It is possible to debase these instruments to a low speculative grade by lending to persons with doubtful credit histories and also to lend too much money in proportion to the true market value of the residential property. As long as weak capital standards existed and lenient accounting methods were allowed it still would be possible for a negative-net-worth S&L to stay in business with deposit insurance providing funding for ongoing loss cycles. As in all loss cycles there would have been the same need to make loans earning a higher and higher rate of interest, which means tolerating more and more risk. It is not hard to imagine a very desperate thrift lending \$100,000 for the purchase of a property only worth \$80,000 if the borrower seemed sincere, despite his unfortunate past, and promised to pay five per cent above the going rate. Of course a bank can lose money faster on speculative investments such as raw land and badly located shopping malls than can be lost on even the most imprudently granted house mortgages. Because reform of this particular problem area, even without any other reform, would at the very least have resulted in far less loss, it may be considered an especially significant cause of the crisis, possessing, as it does, considerable autonomy from the rest of the causal factors.

This autonomy is completely lacking, however, in the third causal factor, overly lenient regulation and supervision. Underfunding made it impossible to conduct optimal inspections, and weak capital requirements combined with unrealistic accounting methods made it illegal for regulators to shut down thrifts in the early stages of insolvency. By the time S&Ls could be legally shut down the immediate cash costs of doing so were so great that again, because of underfunding, there was a de facto paralysis of enforcement which was disguised only very thinly by the various exemptions and forbearances which prevented the situation from coming to a head. On the surface it might seem that the various appeal privileges could have been limited somewhat, but if the means to take control of an S&L was lacking due to underfunding then any lessening of appeal privileges would have been largely meaningless since without closure funding shutdowns were seldom a serious worry to risk-prone S&Ls. All in all, the lenient regulation and supervision which occurred was closely tied to weaknesses in many other areas, and being lacking in autonomy, the lenient regulation and supervision situation was not amenable to easy correction. It would be a mistake to consider the crisis to be prima facie evidence of lack of dedication or vigilance on the part of regulators. Preventing a recurrence of the crisis will not be so simple a matter as merely hiring examiners who are more alert. Although there

have been a few reports of examiner negligence, on the whole the problem of lax regulators and examiners was more a symptom of the crisis than a cause.

The fourth cause of the crisis, inadequate agency funding, is likewise beset with autonomy problems, in this case of a political nature. Given the lack of appreciation of the seriousness of the crisis the American public never would have tolerated the huge expenditures needed to expeditiously close down all the distressed thrifts. Both politicians and the media are at least partly to blame for the public's indifference, but it is hard to imagine how any informational campaign could have made the public realize the depth of the problem in time to demand action while an industry cleanup could still be done cheaply. Given the former rigid public attitude toward thrifts, and refusal to believe that there really was a crisis, there certainly would have been great taxpayer protest to the expenditure of the few billion dollars which at that time would have been sufficient. Although the funding shortfall was a cause for the crisis, it was one which would have been difficult to avoid, and perhaps it could not have been avoided at all. It is not clear that even now the public is really ready to lend its approval to the funding needed to solve this crisis. It may well be that this lack of public enthusiasm has influenced the decision to finance most of the bailout off budget. It is only to be expected that most lower-

income taxpayers, having little or no savings of their own, would be resentful of having their tax dollars go toward the protection of the assets of the wealthy, especially since many of these well-off savers will refuse, in the voting booth, to return the favor by supporting programs designed to benefit the poor taxpayer, such as child care, higher minimum wage, etc. Although the public now realizes that the cleanup will require tremendous outlays, most taxpayers probably will once again be resentful of lavish agency funding once industry normalcy is restored, so it is probably not wise to rely to any great extent on perpetually generous federal funding as the main means of preventing future thrift problems.

Although the most serious result of the low funding has been the problem of not having enough cash to close insolvent thrifts, underfunding also creates a situation of understaffing. The hiring of a greater number of examiners would almost certainly have been cost effective, even if only a few irregularities had been caught, and would require far less money than the amount needed for bank closures, since even the closure of a mildly insolvent bank is administratively extremely expensive and requires a great amount of immediate working capital pending the sale of assets. Without accompanying reforms to provide a disincentive to risk-taking as fast as one thrift was shut down by the hypothetically better funding another thrift

would also amass staggering losses requiring expensive shutdown, and in terms of public cost the industry would be a bottomless pit. Although improved funding could not by itself prevent a recurrence of thrift problems, it is a good idea since larger examination and inspection staffs could undoubtedly pay for themselves by catching more errors and preventing a greater number of unsound loans and investments.

The fifth cause of the crisis, inadequate financial reporting, provides a promising area of attack. If GAAP and/or RAP really had given an accurate picture of S&L earnings and net worth on a fair-market-value basis then the hands of agency enforcement officials would not have been tied by bankrupt thrifts' spurious but legal claims of having acceptable levels of positive net worth. If GAAP and/or RAP had immediately identified the thrifts which were either at or approaching market insolvency then shutdowns could have been enforced while there were still enough assets left to pay off depositors, or at least come close to doing so, and the cost to the government of such expeditious shutdowns would generally have been comparatively modest.

There is considerable autonomy in this area of reform, and indeed FIRREA has largely moved in that direction. There are, however, some complications which make this reform less straightforward than would be a reduction in deposit-insurance coverage. For one thing, it might be

resented by the accountants and the FASB as an interference in their profession. Lively and cogent arguments could be raised that if each industry in the land were free to adopt its own variation of GAAP there would be no meaningful way to compare inter-industry financial statements. Although there were no reports of militant accountant opposition to or sabotage of RAP, striking an independent accounting course must be considered at least slightly antagonistic to FASB and the accounting profession. An additional problem is that any departure from GAAP could entail extra work for GAAP-trained bookkeepers and accountants, and this would mean higher preparation and auditing fees. Furthermore, the use of a specialized accounting system would add to the time needed for the preparation and auditing of financial statements. The problem with this is that it is likely to result in further delay in closing down or otherwise reining in a risk-prone S&L, and this additional delay would only give such an institution more time in which to run up additional losses. Accounting reform in the direction of market-value accounting will also encounter opposition from within the thrift industry. According to Robert Litan of the left-leaning Brookings Institute, "bankers aren't worried about market-value accounting; they're freaked out about it." (WSJ, Aug 30 '89, A16) Reliable appraisals and estimates both of real assets and loan assets are nearly impossible to obtain, and very expensive. Michael Allen

reports that an official from a large Houston thrift recently complained to a group of real-estate executives that one of thrift's properties had been valued by one appraiser at \$6.4 million, and by another at \$2.2 million. "'So what am I supposed to do, split the difference?' he asked, frustrated." (WSJ, Jan 24 '90, A1) Equally disturbing, a hotel was valued at exactly \$1.7 million in four separate appraisals after which it was sold for \$3.6 million. (ibid) According to Michael Allen, one-fifth of the appraisals in Texas have a valuation spread of at least 30%. Thus it can be seen that establishing a reliable value, even at a given point in time is difficult, and the task of recording up-to-date values is complicated by the need to estimate the impact of intervening economic events and trends on these appraised values. Thus recording month-to-month or even quarter-to-quarter fluctuations in asset values would undeniably be a considerable diversion of managements' and auditors' time and energy, and managers would have more inducement than at present to manage their assets from the short-term perspective of traders rather than the long-term perspective of investors. American business is widely criticized for focusing too much on short-term profits rather than long-term planning. By permanently holding assets at acquisition cost the manager is freed from the distraction of value fluctuations. As long as the difference between book value and market value

was fairly small, whether or not to switch to market-value accounting was not a major issue. In the past ten years, however, with the advent of higher interest rates, the difference between book value and market value has become too great to be tolerated, and it is plain that some movement toward more realistic asset values will have to occur. The main stumbling block to such a reform is the fact that many asset values, especially those of real estate, are so subjective and, as shown above, so varying from one appraiser to another as to have little value. Because of all of these complications, it is impractical to rely entirely on accounting reform to prevent future S&L mistakes.

The sixth cause of the S&L crisis was the extreme interest-rate rise which occurred in the late '70s and early '80s and for which the S&L industry was unprepared. The 20% rates which occurred were deliberately created by Paul Volcker of the Federal Reserve Bank as a means of combating the high inflation of the late '70s. It is hard to imagine how any thrift reform could impose itself upon the Federal Reserve System, and even were such influence possible there is every year a greater and greater international influence on interest rates, not subject to our control, so it probably most realistic to consider future interest-rate fluctuations as an unavoidable parameter.

This being so, there are two possible accommodations. First, the Federal Government could provide some sort of insurance to tide S&Ls over during periods of higher-than-expected interest rates. Politically this would be very complicated. S&Ls are not the only businesses adversely affected by high interest rates. When the cost of money is 20% all businesses suffer, and if the government gives high-interest subsidies to S&Ls it would have to do the same for all the other businesses hurt by high rates. This would be impossible, of course, so if the government granted this favor to S&Ls it would have to explain why that industry was more deserving than the rest--a complicated task. The other possible reform to protect against high interest rates would be to require S&Ls to hold a larger number of interest-resistant assets, most notably ARMs. Although such a policy, adopted many years ago, would have been helpful, it would not have prevented the crisis, for losses caused by rises in interest rates, although very severe, pale in comparison with losses that were caused by bad credit decisions. A brief example will show why this is so. Suppose that an S&L owns a reliable \$100,000 mortgage and interest rates soar. The value might fall to \$60,000 or \$70,000 but it will not disappear entirely. If an S&L makes a bad loan, however, and ends up seizing the property, and finds out that it is unsaleable it may end up only salvaging \$10,000 or \$20,000, with property taxes to be paid all the

while until a buyer is found. This extreme difference in potential magnitude of loss between credit problems and interest-rate problems makes it far more important to have in place reforms which will prevent S&Ls from assuming too much credit risk.

The seventh cause of the crisis, weak capital requirements, is the mainstay of FIRREA. The requirement that all thrifts have 3% tangible real owner investment is expected to give managers strong incentive to lend money more carefully, since the first losses come out of the owners' pockets. There is no question that this will be a beneficial effects on the problem of excessive S&L risk taking. The problem in using capital standards as a tool for controlling risk is that it is very tricky to strike the right balance, for although the required level of owner capital must be set high enough to provide a risk disincentive, the required owner capital must not be set so high that it becomes impossible for investors to earn an acceptable rate of return.

Home mortgage lending is not extremely profitable. The government is presently finding that there is not a great deal of interest on the part of investors in purchasing even the most attractive S&Ls which it has for sale. The only way to make an S&L a desirable investment is to allow considerable leverage. And yet if the government lowers the required owner capital to the point that a satisfactory

return is possible, any slight market or interest-rate fluctuation could reduce owner capital to razor-thin levels and then there would no longer be any effective disincentive to risk taking. The stricter owner-capital requirement of FIRREA is a good idea in that this measure will definitely inhibit risk taking, but it is important to realize that there are severe practical limitations to this remedy in that investors cannot be forced to invest in thrifts at leverage levels they deem unsatisfactory. As high a level of owner capital as possible should be striven for, but since it is highly uncertain what levels can be realistically be demanded it is preferable that this remedy, potent as it is, be brought in together with deposit-insurance reform.

The eighth cause of the crisis, unreliable property appraisals, has already been alluded to in the paragraphs describing the need for accounting reform. Had all appraisals been accurate much of the industry loss would have been prevented, for even a recklessly run thrift would not knowingly lend double the real value of a property. American Banker reports (July 19 '89, p1) that "until now appraisers have been virtually unregulated....agencies such as Fannie Mae, however, set high standards of their own." The article just cited mentions that FIRREA requires that all appraisers working for S&Ls will have to meet certain standards and be licensed by 1991. While the goals of these

strengthened requirements are entirely commendable, no act of legislation can instantly cause appraisals to become accurate. In particular, there will always be valuation problems with building-and-development schemes such as unfinished shopping centers in yet-to-be-opened urban subdivisions. The shopping center may remain uncompleted forever, or, given favorable developments, it may be finished off in a few weeks and prove to be a gold mine. There is no way of securing an immediate correction of the problem of uncertain appraisals, although, to be sure, requiring that appraisers be better qualified is likely to result in far greater accuracy, and is a long-overdue measure.

This leaves only one cause for discussion : excessive growth. It takes not only great skill to manage a large portfolio of assets, but also great restraint. Because of explosive growth in the thrift industry many managers found themselves in control of more money than ever before, and it is not to be wondered at that many of them were taken in by various schemes and promotions. There is no talk now of future excessive growth. In fact, the thrift industry is expected to become much smaller in the '90s, so one may consider this particular problem to be already corrected. If appropriate checks and balances can be kept in place, there would not need to be any great worry even if another expansionary period did occur, since with proper safeguards

overly risky lending would be strongly discouraged, making it probable that excess funds would end up in T-bills and other ultra-safe investments rather than in speculative schemes.

At this point it is well to take an inventory of the nine causes discussed, and decide which are most likely to yield beneficial results if corrected.

One of the causes, excess growth, has already been cured. Two of the causes, interest-rate fluctuations and unreliable property appraisals are not amenable to correction by any S&L reform bill, and must be tolerated as parameters.

This leaves insurance reform and the five causes related to deregulation, which are permission to engage in unfamiliar activities, lenient regulation and supervision, inadequate funding, inadequate reporting, and tougher capital requirements. One possible approach would be to consider whether any combination from these five would be more cost-effective than a reform of deposit insurance.

Any effective prohibition of S&L involvement in unfamiliar activities must depend upon effective enforcement which in turn must depend upon adequate supervisory funding. Assuming that such funding were no problem, and assuming that there were no major loopholes in the list of prohibited activities, these three reforms in concert, even without strengthened capital requirements and/or better financial

reporting, would bring the industry under control as effectively as could ever be hoped for. The only disadvantage that this approach has, when compared to deposit-insurance reform is its very great cost. Reduction of deposit-insurance coverage, on the other hand, would cost the government nothing, and very likely the discipline of the marketplace would provide equal protection. Thus reliance on deregulatory reform is automatically defeated if such reform includes expensive supervisory upgrading. Since the first three deregulatory aspects just named are impossible to enforce without such heavy supervisory spending, the only remaining possibility of deregulation-related reform being more cost effective than insurance reform lies in the other two.

It is unreasonable to expect that better accounting, all by itself, could have prevented the crisis. Although it would more realistically describe the losses, it would not prevent the losses, as long as managers were allowed to make risky investments and pull in any amount of insured deposits, and escape shutdown because regulators lacked the funds to pay off depositors. However if better accounting were combined with the remaining deregulatory factor, tougher capital standards, there would be a combination that would offer strong potential benefits, in that tougher capital standards would enable regulators to shut down money-losing thrifts while they still had positive net-market value, which would

solve the problem of thrifts having to be allowed to stay in business simply because regulators did not have enough money to pay off depositors. Thus these two aspects of deregulation offer an equally effective and less costly alternative to the first three. As already pointed out, it is very difficult to strike a happy medium in the matter of capital requirements. If set too high additional investment ceases. If set too low, then, when the first increase in general interest rates lowers the value of thrift assets, the thrift will be reduced to a zero or negative net-worth position so quickly that it may not be possible for regulators to shut it down soon enough to salvage any real-market value. Then, assuming that adequate closure funding is a problem, there would have to be the same capital and accounting forbearances as before, and the loss cycles would be a problem once again. Other S&Ls could demand the same forbearances, claiming to be innocent victims of "temporary" economic downturns, and of course, that would put an end to all semblance of regulatory discipline.

The main object of requiring higher real capital standards is to control S&L behavior by making sure that owners have a real financial stake in the decisions that they make. But the same result can be obtained without the complicated accounting and interest-rate complications simply by requiring depositors to have a greater financial interest in the actions of the S&L. Small savers cannot be

expected to have sufficient sophistication to judge the soundness of a bank, but the purveyors of brokered deposits are capable of being effective monitors. No doubt, in response to the new insurance conditions regularly published reports would soon appear giving the safety ratings of individual S&Ls.

Reform of deposit insurance is the area that promises the greatest improvement with the least cost and disruption, and it should receive the main emphasis in future reform. Although capital requirements should not be increased to the point at which they stifle further investment, nevertheless they should be increased to whatever level the market will bear. A complete overhaul of S&L accounting would prove extremely expensive and troublesome, and would not likely be cost effective, but where it is fairly simple to make changes in the direction of fair-market-value reporting, this should be done, and in fact is already being done by FIRREA which, for example, now requires low-grade ("junk") bonds to be recorded at lower of cost or market instead of at cost. Any other asset for which there is an established secondary market could with equal ease be reported under this more stringent method. Appraisal problems make it very unlikely that in the foreseeable future there will be a total switchover to market-value reporting, but this should not discourage the government from requiring whatever partial move in that direction might be practicable, since

even a partial switchover to fair-value accounting will increase the reliability of financial statements. Of course risk reduction implies requiring that thrifts avoid unfamiliar activities and in the future there will have to be sufficient examination staff to enforce the rules, but if depositors and owners have more to lose as a result of insurance and capital-standard reforms, then there ought to be much less propensity to take risks, making industry safety less reliant on express prohibition of risky activities. Similarly, if the above suggested reforms are adopted there should be far less need for heavy closure funding in the future, once the currently insolvent thrifts are disposed of. Since much of the leniency of the past was due to a lack of closure funding, the problem of excessive leniency will probably be self-correcting once the mismatch between closure funds needed and closure funds available is resolved.

In summary then, a consideration of the workings and interworkings of all the mechanisms which were relied upon in the past to prevent thrift losses leads to the surprising conclusion that deposit insurance--a venerable American institution which seemed to work well for years and years--is the well-intentioned cause of the crisis, and the industry adjunct most in need of reform. Though each expert has his own approach to analyzing the crisis, nearly all

experts come to the same conclusion and likewise place the main blame on a faulty system of deposit insurance.

Although deposit-insurance reform alone could probably restore the industry to its former useful role, there is no reason why other modifications should not also be made, if they are not unduly disruptive. There are two in particular which are likely to prove worthwhile : a movement toward fair-market-value accounting and a requirement that there be as high a level of real owner capital as is compatible with the needs of the industry to attract new investment. Enforcement of real-value capital standards is impossible without fair-market asset valuations, so capital-standards reform must imply accounting reform. Both the capital-standards reform and the insurance reform are predicated on the axiom that fear of actual financial loss (by depositors or by owners) serves as the most effective deterrent to risky S&L behavior. If either one of these deterrents is in place, or preferably both, then the public can expect to see great improvement in how thrifts are managed. Other proposed reforms have their individual merits and should be adopted when cost effective, but reduced deposit insurance is far and away the most promising area of reform, with strengthened real-value capital standards also a highly worthwhile reform.

How Certain Is It That Deposit Insurance
Really Is to Blame for the Crisis?

There is a surprising level of agreement among the experts that the present system of deposit insurance must be changed. Very few commentators overlook this problem. Some commentators want to abolish deposit insurance altogether. The rest want to modify it---usually drastically. Nearly all of them consider deposit insurance to be the main culprit in the thrift crisis.

Failure to blame the crisis on deposit insurance is uncommon but must not be taken as proof of incompetence. Philip B. Chenok blames thrift problems on interest-rate fluctuations, weak oil and farm prices, and deregulation and does not mention deposit insurance at all. (NYT, Jan 16 '90, A16) Mr. Chenok could not have risen to the presidency of the AICPA without great intelligence and exceptional business sense, so his omission of this problem area shows that the majority position is not absolutely de rigueur. Nevertheless such an omission is highly unorthodox.

R. Dan Brumbaugh, Jr. and Andrew S. Carron flatly state, "The cause of the current thrift problems is the moral hazard inherent in the deposit insurance system." (Brookings Papers on Economic Activity, 2:1987, p359) In an editorial entitled "Who is to Blame for the Thrift Crisis?" Fortune guardedly states only that "much [not most] of the problem is rooted in the present system of deposit

insurance," (March 13 '89) and yet two-thirds of the editorial discusses deposit insurance and no other causes are named, so the writer must consider this to be far and away the main cause. The main thrust of this editorial is that the current system "generates an avalanche of perverse incentives."

Moral hazard and perverse incentives refer to the same problem : by providing 100% coverage the insurance removes any fear of loss which would otherwise cause the depositor to more closely monitor the operations of savings institutions. Commentators also use the terms in connection with owners, and those who act under their direction, i.e. managers. In this case the perverse incentive, or moral hazard, refers to the fact that when real owner capital is low, as has often been the case, it is in the owners' best interests to take spectacular gambles since in that situation owners have little or nothing left to lose and everything to gain by adopting such a strategy. The perversity of the situation arises from the unintended and unnatural separation of risk and return. The owners bear little or no risk, since it is the insurer that is responsible for any loss, and yet they are allowed to reap the full benefits of any gambles which prove to be lucky. Deposit insurance is justly condemned as the underlying cause for this bad situation since it provides the funding for these ventures.

According to W. Lee Hoskins, president of the Federal Reserve Bank of Cleveland, "The major flaw in the system is not the lack of regulatory powers or the regulatory structure, but is rather the system of deposit-insurance pricing and coverage, which creates an incentive for bank management to take--and private suppliers of bank funds to be unconcerned about--excessive risks." (American Banker, July 18 '89, p4)

Lowell Bryan, of McKinsey & Co., writing in the Harvard Business Review, Jan-Feb '87, notes that "...federal deposit insurance enables weak participants to take on credit risk disproportionate to their management skills and their capital. The result is an unhealthy concentration of credit risk in our weakest institutions that creates instability and puts stress on the entire system."

William Niskanen, past president of the conservative-leaning Cato Institute, and Catherine England write in the May 19 '89 edition of National Review (p39), "A number of commentators have concluded, quite incorrectly, that the current crisis among savings banks is due to deregulation....As long as insolvent banks are allowed to remain open and offer federally insured accounts, deposits will flow from low-risk to high-risk banks.."

In 1933 President Roosevelt foresaw the dangers of deposit insurance : "the minute the government starts to do that...the government runs into a probable loss...We do not

wish to make the United States government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future." (WSJ, May 8 '89, A1) According to the article just cited, it was only the simultaneous adoption of ultra-strict regulations (which prevailed until the Garn-St.Germain Act of 1982) that allayed FDR's fears.

Because the issue of deposit insurance is politically sensitive, and would be subject to long public and Congressional debate, and because immediate industry improvement was needed, FIRREA relied on tougher capital standards and somewhat more market-value-oriented accounting requirements to accomplish an immediate improvement of thrift discipline, but Section 1001 of FIRREA does establish a committee to study deposit insurance and report to Congress in April, 1991. In a sense the present FIRREA may be considered a laudable stop-gap measure which has indeed resulted in quick improvement, but which cannot even pretend to be the final answer in that it leaves deposit insurance basically unaltered.

What Should Deposit Insurance Try to Accomplish?

There is a general perception that deposit insurance exists for the purpose of helping unfortunate persons who might otherwise lose their savings. Perhaps this ought to be the purpose for such insurance, but the existence of such altruism is not consistent with the lack of altruism shown

by society in other even more essential aspects of life. Health is far more important than money, and yet there are millions who have no health insurance, and society does not guarantee these people free health insurance, nor even emergency treatment. If such an uncovered person breaks his arm, he is at the mercy of private charity to obtain treatment. Similarly, it is well known that there are millions of homeless Americans. There is no constitutional guarantee of shelter, and those without a roof over their head must also often resort to private charity, when it is too cold to sleep out of doors. If there is so little societal and public concern for the individual in these areas of living, which are far more necessary to the individual than having a bank account, then it is probably unrealistic to believe that altruism and love of the individual are the moving forces behind deposit insurance.

Timothy W. Koch, states in Bank Management, a widely used finance textbook, that all future reforms must take into account "the true insurance purpose--to strengthen public confidence in the safety of financial institution deposits." (1988 edition, p177) The need to maintain this macroeconomic function is indisputable. If savers quit using banks, then, of course, borrowers would have no access to funds needed for important uses such as capital expansions. To a large extent, this is what triggered the painful contraction of the early thirties, and therefore it

is imperative, when considering any proposed reform, to take into account the extent to which the changes considered could trigger excessive disintermediation and subsequent dearth of credit. A further problem is that without the use of banks, check writing would no longer be an available mechanism for making payments, and this obstruction in the actual and anticipated flow of payments would also seriously inhibit economic activity.

The Most Drastic Solution--

Get Rid of Deposit Insurance Altogether

In spite of the grave danger that abolition of deposit insurance might drive away depositors, two extremely prominent authorities, R. Dan Brumbaugh, Jr. and Lowell Bryan, have recommended this extreme measure. When one considers that on April 6, 1990 Comptroller General Bowsher estimated that the final forty-year cost could easily be \$500 billion, it is easy to be driven to an abolition viewpoint out of sheer exasperation. If there were no deposit insurance, there would be no government liability, and therefore no crisis. At least, not the same crisis.

It is interesting to imagine what would have happened in the '80s had there been no deposit insurance. The collapse of land, oil and farm product prices, and the concomitant interest-rate problems were widely known and without the protection of deposit insurance these problems certainly would have led to numerous bank runs and

widespread bank failures. These occurrences, of course, have always been anathema to the smooth flow of business, and have always triggered intense business contraction. When this occurs, there is a fall in personal and business income levels as money becomes more and more tightly held and the depression mentality takes hold. The \$500 billion expenditure we may now face is, of course, a painful and unprecedented expense and enough to make us wish that the country had never adopted deposit insurance. But if the choice had to be made between having a decade of economic stability at a cost of \$500 billion or having a decade of instability, we may well be money ahead in terms of overall salaries and profits to have had the admittedly expensive deposit insurance in place. S&L losses over the last ten years have been staggering, but we must acknowledge that taken as a whole the decade has been one of prosperity. Personal and business income levels and tax collections have all been very strong, and for that reason it is only prudent to be very cautious about tampering with any aspect of the economic infrastructure as essential as deposit insurance. The record shows that until bank insurance was adopted in the '30s panic disintermediation and resultant depression were a constant threat to national prosperity. David Glassner, author of Free Banking and Monetary Reform, is opposed to deposit insurance, but concedes that it has been supported by highly reputable authorities :

"The addiction to deposit insurance stems from the trauma of the bank runs that marked the Great Depression, when 40% of U.S. banks failed. The idea that without deposit insurance the economy might be vulnerable to another collapse was reinforced by the work of Milton Friedman and Anna Schwartz, who argued that it was bank failures that transformed a serious but not abnormal downturn into America's worst economic calamity.

"Thus, the rationale for federal deposit insurance is not that it protects individual depositors but that it ensures macroeconomic stability. Mr. Friedman himself supported this notion by stressing that deposit insurance has made the modern economy 'depression proof'" (WSJ, May 5 '89, A14)

If Milton Friedman is correct that deposit insurance has made the United States depression proof, then no commentator could reasonably ask the nation to give it up without first persuading society that its continued economic safety can be just as well preserved without it. In other words, if banking authorities wish to abolish deposit insurance, the burden of proof is on them to convincingly demonstrate that such action would definitely not result in renewed bank runs and depression and in that way do more harm than good.

Lowell Bryan in Breaking Up the Bank (1989), and Brumbaugh in Thrifths Under Siege (1988), suggest that any deposits collected for the purpose of making housing and/or commercial loans should be completely uninsured. Bryan suggests also offering an alternate type of account for those who have no tolerance for risk. Such fully guaranteed lower-earning deposits would not be loaned out but would

only be placed in ultra-safe government securities, which would serve as direct collateral, obviating the need for government insurance. Brumbaugh, in Thriffs Under Siege (p178), also makes this suggestion, although much less emphatically.

Having thrifts offer two types of deposit accounts so vastly different is an experiment society cannot afford to take. The Lincoln fiasco clearly demonstrated that depositors do not always know the difference between the two types of placement. Even if emphatic warnings, similar to those found on cigarette packages, were required every time an uninsured (i.e. uncollateralized) deposit were received, a bank eager to obtain uninsured cash available for lending could well be tempted to soft-pedal the risks by telling depositors words to the effect that "this deposit, technically speaking, isn't insured, but it pays a fantastic return, and don't worry--there isn't a chance in the world that you'll lose a cent." There is too much risk that if two types of accounts--insured (i.e. collateralized) and uninsured--are offered on the same premises--perhaps at the very same wicket--there will be confusion and disillusionment as there was in the case of the Lincoln customers who bought uninsured subordinated debentures apparently in the belief that it was only another form of an insured CD. Since this already has actually occurred the government cannot without guilt sanction any similar double

offering. Thus Mr. Bryan's desire to mitigate the radicality of his suggestion by providing an ultra-safe option is not feasible, and the no-insurance proposal must be considered entirely on a stand-alone basis.

Mr. Lowell contends that insurance can be dispensed with if thrifts will reduce their credit risk and interest-rate risk by selling their mortgage assets instead of holding them. Being divided into marketable shares such bundles of mortgages would go off the balance sheets of thrifts and this disengagement from risk-prone long-term assets, combined with the greater market discipline which abandonment of insurance would impose, would give sufficient protection to the ordinary saver.

R. Dan Brumbaugh is less committed to the abandonment of traditional institution-held mortgages. He does however favor greater investment freedom for thrifts and banks. He believes that the public is capable of establishing reliable information agencies which would provide accurate risk assessments and ratings of individual S&Ls, and hopefully this free-market approach would put a quick end to unsound management practices. This increased soundness of management would hopefully make bank runs unlikely. Brumbaugh also advocates market-value accounting with provision for quick seizure of ailing thrifts. Any unsound thrift would be shut down, hopefully before it actually sank to a negative fair-value net worth. In that way whatever

funds were available could be equitably distributed on a pro rata basis to the various claimholders, including depositors, whose claims, of course, would have priority over those of other creditors. If a soundly managed, positive-net-worth thrift experienced withdrawal problems the Federal Reserve Bank would lend it any amount of money needed pending an orderly sale of assets to cover the withdrawal outlays.

Since confidence in the system is the real goal of deposit insurance, and since, whatever its failings, deposit insurance does inspire this confidence, it would be foolhardy for the public to tolerate the abandonment of deposit insurance unless strong prior assurances could be credibly given that despite this change public confidence in banks would not be undermined by the occasional uninsured bank failure which inevitably would occur, especially in the event of fraud, even with the strictest controls. The main result, and also a major cause, of such lack of confidence is the occurrence of widespread bank runs.

Edward Kane astutely points out that there is nothing reprehensible about a rational bank run. ("How Incentive-Incompatible Deposit-Insurance Funds Fail", pp9-10) If a bank really is broke, and depositors line up to recover what they can, then it cannot be said that the behavior of these customers is not in and of itself destructive. The bank failure has already occurred. The depositors are only

reacting to it. Allowing rational bank runs to occur does not in any way undermine the aggregate value and smooth workings of the banking industry.

If a bank failure could be no more emotional or problematical than a furniture store closure, then it would probably be acceptable policy to allow rational bank runs, rather than preventing them from occurring by means of deposit insurance. Other businesses go bankrupt all the time, and as painful as bankruptcies are, sometimes they are blessings in disguise since they force people to redirect careers and resources to more productive uses. Rational bank runs are not in and of themselves any more of a societal problem than similar collection efforts by creditors in other bankruptcies. Unfortunately, however, bank insolvencies are beset with unique complications. If Jones Furniture Store goes broke, creditors and suppliers of Smith Furniture Store might become a bit more nervous than they were before, but it would not be usual for Smith to have all further credit cut off merely because Jones had gone under. In banking, however, there has always been a unique tendency for trouble at one bank to cause unmerited problems at other banks. It might be all right to follow Lowell Bryan's suggestions and allow bank runs to occur if these bank runs could be confined to rational bank runs. However, as Professor Kane has pointed out, the danger in allowing rational bank runs is that they usually cause

rumors and hysteria to take over and cause irrational runs on sound, solvent banks, which are quickly forced into insolvency by the emergency sale of assets at distress prices precipitated by the wildfire withdrawals. Without the inhibiting safeguard of deposit insurance to prevent bank runs, any negative rumor about a bank that sounds at all plausible will be a self-fulfilling prophecy in that it will trigger stampede withdrawals which will cause the insolvency assertions to become true, and thus what started out as an irrational run could end up being a rational run.

A brilliant thumb-nail sketch of these interdynamics is provided by R. Dan Brumbaugh :

"It is important to emphasize why the U.S. government has been so concerned about bank and thrift-institution runs and why the regulatory system's vulnerabilities are disquieting. The Federal Reserve, the FDIC, and the FSLIC were not created to prevent runs per se. Were they intended to prevent each and every bank run, they would merely protect individual depository institutions against failure. There is no more justification for protecting individual banks and thrifts from failure than there is for protecting any other retailer of goods and services. Instead, the Federal Reserve, FDIC and FSLIC were created to protect against the externalities, or larger social costs, caused by widespread runs.

"Social costs from widespread, as distinct from individual, bank runs result from a breakdown in the intermediation function and (what has traditionally been viewed as more important) a disruption of the payments system. The costs can arise in the following chain reaction. Depositors withdraw funds from both solvent and insolvent institutions. Withdrawals force solvent institutions to liquidate assets precipitously in order to satisfy depositors. The hasty sale of assets can result in prices below those that orderly sales can produce, thus driving solvent banks into insolvency. If the chain reaction

continues long enough the intermediation process and payments mechanism can falter." (Thriffs Under Siege, p34)

It is not hard to see that without the use of banks the fluidity of payments would indeed be hindered. Individuals and businesses do not like to be unsure whether they will collect their receivables. Delayed reward dampens motivation, and undermines the work ethic. A man painting a fence who knows he will be paid in full right after the last brush-stroke will make a far more reliable worker than one who knows he has no hope of being paid for at least six months. Any element of delay or uncertainty in the flow of payments undermines the effectiveness that payments normally have to provide positive reinforcement to conscientious effort. By keeping payments flowing smoothly banks help to stimulate commercial activity, so Brumbaugh is correct in stressing this extremely important function.

Brumbaugh contends that the protection from irrational runs and payment logjams now provided by deposit insurance could just as effectively be provided by emergency backup by the Federal Reserve Bank. He suggests that accounting be market-value based and that solvency be strictly defined so that in the event of a run the Federal Reserve would know right away whether the beleaguered thrift was qualified to receive the backing. Those falling short of the required net worth would instead face immediate shutdown with

equitable distribution of net worth to the various claimholders.

Brumbaugh is a highly esteemed, exceptionally well informed thrift commentator whose suggestions must be considered with respect. Even if the nation is not yet ready to go as far as he suggests in insurance phase-out, his immense faith in the power of the Federal Reserve Bank makes one wonder if this institution could not perhaps play a greater role in future thrift affairs. Indeed, it may well be true that emergency lending by the Federal Reserve could contain a small-scale rash of unfounded bank runs. However, to accept as fact Brumbaugh's untested assertion that the central bank could contain a nation-wide bank run requires a leap of faith the nation cannot afford to take. If a crisis occurred and the central bank were not able to cope, the Treasury would be forced to choose between two very bad alternatives. The first choice would be to print whatever amount of money were needed to cover deposits. This would trigger hyperinflation and create a permanent distrust of United States paper currency, and, as a result, the dollar would be impaired as a unit of exchange, creating not only payments problems, but also credit problems, since prudent lenders would no longer be willing to grant dollar-denominated loans. The second unpleasant choice available to the government in the event of a sudden nation-wide liquidity crisis would be immediate distress borrowing from

foreign sources at exorbitant rates. The main complication to this alternative is the probability that any nation-wide bank run here would be part of a world-wide financial panic, in which case funds from abroad would not be readily available. It goes without saying that in an emergency the Federal Reserve would have to relax its stringent collateral rules which currently require collateral far greater in value than the amount loaned, since no besieged thrift could afford to provide this level of collateral.

As improbable as a nation-wide bank run might seem, it is not impossible that one could occur at some time in the future : perhaps in the next year or two, perhaps not until fifty or sixty years hence. However the fact is that judging by the historical record a banking industry without deposit insurance inevitably does have a problem with bank runs, and should one occur, the financial community should brace itself for the worst, for in an era of instant communication and advanced technology bank runs are certain to be far swifter and deadlier than they were sixty years ago.

In the crash of November 1987 the financial community witnessed the awful power of destruction which can be unleashed when modern technology is turned loose onto an institution which has not yet adapted itself to the new technology. Just as electronically programmed sell orders run amok threatened to paralyze the world's largest stock

market, so a frantic use of electronic funds transfers and electronically programmable account withdrawals, perhaps triggered by negative movements in thrift share prices, could wreak havoc in the thrift industry. When one thinks of a bank run one visualizes long, slow-moving lines of people closing their accounts in turn. In olden days there were no automated tellers or withdrawals by telephone, not to mention electronic funds transfers. It has to be a cause for worry when one considers that all the withdrawals made over two or three hours by a long line of people could now be made electronically in a second or two. Those who suggest completely abolishing deposit insurance do so in the name of stamping out risk, and yet the untried and unproven extreme remedy which they propose is the riskiest measure imaginable. Once one recognizes this inherent inconsistency one realizes that the nation cannot acquiesce to Brumbaugh's and Bryan's proposal, as admirable as their writing may be in terms of thorough scholarship and well-constructed arguments. Nothing is so likely to produce a banking environment characterized by panic and hasty actions as a complete withdrawal of insurance, for although most people can cope with taking a small investment loss, there are few who can "keep their cool" when confronted with the specter of total ruin. In short, total abolition of coverage would create a financial tinderbox. A great many people would quit using banks altogether, keeping their money at home,

resulting in a severe underavailability of credit, and inconvenience in making payments. Perhaps in the distant future, after a cautious step-by-step phase-out, coverage can be safely brought down to 0%, but in the meantime neither this nor any other precipitous action should be taken since so much is at stake.

What Less Radical Measures Are Available?

If total abolition offered the only hope, it would have to be adopted in spite of the risks. If, however, the moral-hazard problem could be largely brought under control with less drastic a change, this would offer a more prudent course of action. Perhaps there is some level of coverage between 0% and 100% which would at the same time leave open enough possibility of loss to reduce the moral-hazard problem and yet which would be reassuring enough to depositors to offer society continued protection from bank runs. As was pointed out above, fear of total loss would cause many people to quit using banks altogether and start keeping their money at home, but if the potential loss were only very slight then the vast majority of people would continue to use banks, since it would be well worth the slight risk of a minor loss to have one's money earning interest and protected from theft. As long as the penalty is kept small, there should not be much, if any, additional danger of bank runs. A saver who stands to lose at worst only a small portion of his savings is not likely to be

provoked by highly uncertain rumors into dropping whatever else he is doing at the moment and running to close his account. The challenge, then, is to strike the right balance. The penalty must be small enough not to provoke runs, but large enough to encourage at least some depositor monitoring of thrift activities.

A good first step in insurance phase-down would be to cease the present practice of fully paying out uninsured depositors when bank failures occur. This practice, of course, is de facto insurance, and is especially costly to the nation in that such coverage is not assessed premiums. Paul Duke, Jr. reports that "many [bankers] support proposals to give depositors a 'haircut'--a 10% or 15% loss on deposits above the \$100,000 level--when a bank fails. Two of banking's biggest guns, Citicorp Chairman John Reed and Chase Manhattan President Thomas Lebreque, support variations of this proposal." (WSJ, Aug 3 '89, A16) William Seidman has spoken favorably of penalizing uninsured deposits with a 10% loss in case of bank failure. (NYT, Feb 22 '90, C1) Such a shift in policy should not encounter insuperable opposition since it falls far short of enforcing the insurance limitations which legally already exist.

Since the Continental Illinois bankruptcy the federal banking and S&L authorities have adopted a too-big-to-fail policy. The policy is closely related to the unwritten policy of rescuing any faltering American corporation if it

is large enough. The most notable cases so far have been Continental Illinois and Chrysler. Had Chrysler been allowed to fail, so the justification goes, then so many thousands of people would have been put out of work that there would have been a harmful ripple effect which would have been costlier, in the end, than saving the company. Similarly, when Continental Illinois became insolvent it was argued that confidence in U.S. banking was at peril, and it was deemed prudent to pay off all deposits in full, even those not insured, so as to preserve faith in the system.

This new policy was probably a justifiable experiment at the time. Certainly the rescue of Chrysler has proven to be a thrilling success story, and had the rescue of Continental Illinois been a one-time expense, as it then was probably expected to be, then it probably was the sensible thing to do, given the importance of maintaining confidence in American banks.

Unfortunately, the event proved to be a precedent for numerous other bank failures. Ever since the uninsured depositors were paid off in that case, it has been assumed that the government will never allow any very large bank or S&L to default on any deposits, insured or not, and in order to maintain faith in U.S. banking it is generally understood that the government will also fully cover foreign deposits, repurchase agreements, advances from the Federal Reserve Bank and letters of credit, none of which are insured.

In the beginning this de facto extension of coverage only applied to the banks and S&Ls which were large enough to have a wide financial influence. According to Koch (p193) only the eleven largest banks were originally covered, hence the designation "too-big-to-fail". The government however was rightfully criticized for this policy on the grounds that it put smaller banks at a competitive disadvantage, so, to correct this inequity the government has for several years made it a general policy to pay off all depositors in both large and small failed banks. The too-big-to-fail policy may not be entirely a thing of the past, however. Up to quite recently the government has allowed some depositor losses to occur, most notably in connection with some smaller banks seized in the Southwest Plan, a foreclosure and resale campaign which preceded FIRREA. While the payment of uninsured deposits at small banks is done purely on a discretionary case-by-case basis, the tendency has been more and more to do so.

William Isaac, the regulator who made the original decision to rescue Continental Illinois, now admits that he wonders whether his decision was for the best, in view of the weakening of depositor monitoring that has since occurred. One thing is certain : anyone who has coverage should expect to pay premiums. If present policies are to be continued then actual payout practices should be made explicit and appropriate premiums collected. If, for

example, it were decided that accounts not qualifying for the basic \$100,000 full protection were henceforth to be paid ninety-five cents on the dollar, then they should accordingly pay 95%-prorated premiums, or something very close to it, and not continue to receive free coverage. Concern that some are not paying their fair share led the Independent Bankers' Association of America at its March 1989 convention to pass a resolution recommending that foreign deposits be assessed premiums for their de facto insurance. (WSJ, March 1 '89, C19)

Since insurance premiums are a mere pittance compared to the true value of deposit insurance, it is probably not a major issue whether uninsured deposits should be assessed premiums or not. A far more important question is whether these uninsured accounts should continue being paid out in full.

Since there is general concurrence that there ought to be a move in the direction of insurance phase-down, and since these accounts are legally uninsured, and therefore legally not entitled to anything, it is clearly the logical place to begin any overall phase-down. There would not have to be legislative approval, nor would there be serious complications of any kind. For the sake of being fair to all concerned, clear statements of intent should be made. It would probably be a good idea to require that all uninsured account-holders be given several months' notice in

writing of the policy change. Since the chief goal of such a change would be the encouragement of better monitoring by large, sophisticated investors, and since such investors are very sensitive to rate changes, there would only have to be a slight reduction in payouts to provide the necessary incentive. Even a 5% penalty might be sufficient. On February 21, 1990 William Seidman advocated phasing out the too-big-to-fail policy but emphasized that great care should be taken not to make any changes radical enough to disrupt financial markets. (NYT, Feb 22 '90, C1) For this reason, it is important for regulators to maintain great flexibility in this matter. There is no absolutely certain way of predicting how markets will react. The imposition of a small 5% penalty sounds safe, but even a 5% penalty might be sufficient provocation for irrational runs by some uninsured depositors, and, as previously noted, any run on a bank can wreak so much havoc that what starts out as an irrational run can end up as a rational run, so the large, sophisticated investors who would never start an irrational run might find themselves caught up in one as a bank's weakening condition made it in their best interests to withdraw their funds while there was still some money left.

With a view to encouraging monitoring and at the same time preventing irrational runs, it is hard to suggest what the exact penalty ought to be. In order to keep the greatest flexibility, such partially uninsured depositors

should only be assessed premiums for 90%-or-so coverage even though actual payouts are higher. That way the depositor would only have a legal claim to ninety cents on the dollar, and could not interfere with or hold up any upward or downward adjustments in the 90% to 100% range.

After the uncomplicated first measure of slightly reducing the generosity of uninsured payouts, the next phase-down step would be to limit the coverage of \$100,000 to each citizen rather than to each account. This is the major recommendation of Paul Pilser's soon-to-be-released book Other People's Money. Under this sort of a scheme, joint accounts would be prorated and each person's share should count against his \$100,000 total allotment.

The present system makes a mockery of the nominal \$100,000 limitation in that a wealthy individual can obtain any amount of coverage he wants merely by opening numerous accounts--usually, but not necessarily, at different banks.

The Congressional approval required for this change should be fairly easy to obtain, since most voters, and perhaps some members of Congress, believe that deposit insurance exists for the protect of the individual, and would consider \$100,000 coverage to be ample to satisfy this need. Indeed, this microeconomic social role, though subservient to the macroeconomic function, is not entirely without expert support. Karen Shaw, of the Washington, D.C.-based Institute for Strategy Development says, "I like the

concept of government protecting only those who cannot protect themselves." (NYT, Nov 27 '88, Sec 3 p1) W. Lee Hoskins, president of the Federal Reserve Bank of Cleveland, said in a recent speech, "The justification for deposit insurance is based on the premise that society should protect people who are not able to protect themselves. It would appear that the present federal insurance system, which insures each deposit account up to \$100,000, offers much more insurance than is necessary to protect those who are unable to protect themselves." (American Banker, July 18 '89, p4)

It has been pointed out that in order to limit each person's total coverage it would be necessary to keep track of all the thrift, bank, and credit union accounts throughout the country. The information would probably be filed under each person's social security number. Many other facts and statistics are recorded in huge computer files, so on the face of it, the suggestion sounds easy to implement. In fact it would be a formidable task.

If an individual has \$100,000 in each of two thrifts and one fails, which of the two accounts shall be considered the one that is covered? If the policy is one of proration, then each would be 50% protected, but the saver's file would have to be constantly updated, to facilitate the proration, every time any transaction occurred affecting any of his balances. If, on the other hand, there were a last-in-

first-out approach to the problem, there would be an additional complication in that not only would it be necessary to keep track of all balances, but it would also be necessary to know the exact times of all past transactions so that it could at any time be determined which funds were the longest held. Without these complicated records dishonest claims would be made. For example, suppose the saver has \$100,000 on deposit at Bank A, his older account, and also has a similar deposit at Bank B. Bank B fails. As soon as the failure occurs the saver closes his account at A and swears that at the time of the failure of B, the deposit at B was his older deposit, and therefore qualifies for coverage. To defeat such false claims the government would have to have a record not only of the account at A but also the exact time of the closing of the account. Thus the precedence approach to insurance limitation would require that the central insurer maintain a listing of all of the person's accounts complete with exact times for all transactions so that at all times it would be possible to make a sequential listing of which exact monies were in fact the oldest. This fracturing of the various monies into intermeshing layers of various ages would occur whenever there was intended or unintended rotation of deposits and withdrawals among two or more banks.

It is complications such as those just outlined that cause many authorities to decry the feasibility of

restricting the limitation to individuals rather than accounts. This, however, need not be an insurmountable obstacle.

If it is true that government-provided deposit insurance is a privilege, not a right---and the fact that such insurance could legally be abrogated leads us to conclude that it is a privilege---then the individual should not think that it is something to which he, as an American citizen, is automatically entitled. Instead he should recognize it as a favor received from the rest of society. Since it is a favor, he should not complain if asked to fill out certain forms and conduct his banking affairs around the parameters of the program.

One workable scheme would be to have each individual designate one bank as the one he intends to use for insurance purposes, and accounts at all other banks would be uninsured. If no designation were made there would be no coverage. After making the designation, it would then be the individual's own responsibility to keep his deposits at the designated institution as close as possible to the full insurable amount, if he wished to fully avail himself of the insurance privilege. Any individual who wished to have insurance at more than one bank could designate more than one bank, allocating the \$100,000 coverage any way he wished among the chosen banks.

The slight inconvenience of making a designation and remembering to keep one's savings at that particular bank is not an onerous burden. For the sake of comparison, it is interesting to consider the annual income-tax obligation. Those lacking the time, ability, or inclination to personally handle this procedure are expected to obtain outside help. Often for income-tax purposes an individual or business may be required to make an election regarding how he wishes to handle a certain matter. Such elections are binding, and once declared are usually irreversible. It is the individual's responsibility to remember and adhere to whatever arrangement he has agreed to. Seldom is this practice of income-tax elections impugned as onerous or oppressive. Similarly, wealthy multi-account holders could just as reasonably be expected to decide which bank they intend to use for insurance purposes, to make the required designation, and to keep their balance at that bank as close as possible to the insurable limit. Procedures could easily be set up for allowing a depositor to cancel an old designation in favor of a new one, should he find it more convenient to switch most of his business to a new bank.

The great advantage to a plan along these lines is the reduced invasion of privacy such a plan would permit. There would not have to be any centrally kept record of an individual's transactions or balances, only of the name of his designated bank.

There is good cause for concern that too much information about individuals is already being kept in central computers with inadequate safeguards against unauthorized access. The establishment of a central file capable of revealing to a corrupt government each citizen's bank balances and daily transactions would be a repugnant Orwellian assault on individual dignity, and must never be allowed to happen. A system based on individual designations would have no such privacy ramifications, however, since no balances would be centrally recorded, only the list of designations.

The greatest obstacle to the perfect implementation of this plan will be getting rid of the double counting which arises from pension-plan pass-through. This refers to the privilege which is granted to pension funds of allowing \$100,000 coverage for each individual covered by the pension plan. Because it is backed by banks, labor unions and the influential House Education and Labor Committee, this particular problem is likely not amenable to immediate correction. Even Congressman Schumer (D-NY), the most influential member of the House in thrift matters, has found his colleagues intractable on this point. (See Cranford, Congressional Quarterly, June 17 '89, p1451.) Although a designation system, with no pass-through double counting allowed would be the ideal, it is not going to happen now. However, even with this pension double counting, the

designation system would be a vast improvement over what has existed up to now.

Since pension-fund administrators are highly sophisticated investors capable of especially effective thrift monitoring, it would be particularly beneficial to make these pension deposits subject to the same penalty assessed against uninsured deposits. With no such deterrent the vast and ever-growing pension monies will continue to gravitate to the thrifts paying the highest rates, regardless of risk. It is unfortunate that the current Congress is so adamant that no penalty shall ever be assessed against pension monies. Perhaps in two or three years the matter can be raised again with better results.

Some thrift commentators have suggested lowering the coverage limit. As long as the limit applies per account rather than per depositor such reductions would be meaningless, since any level of coverage desired could easily be obtained simply by opening more accounts. James K. Glassman suggests allowing each individual full coverage up to \$50,000 with 50% coverage provided on the next \$150,000. (The New Republic, March 20 '89, p29)

Unfortunately, in the wake of recent thrift losses there is so much nervousness about safety of deposits that Mr. Glassman's suggestion could not possibly receive a dispassionate consideration at this time. Peter T. Kilborn reports "one [option] that was abandoned early was lowering

the \$100,000 limit....In the face of the ensuing outcry from Congress, the Treasury immediately rejected the suggestion..." (NYT, Feb 9 '89, p1) Such a reduction could be achieved, however, simply by never raising the \$100,000 limit and allowing a number of years of inflation to gradually bring coverage in real value down to a more moderate level.

Should the Basic Payouts

Also Be Assessed a Slight Penalty?

It would be a sobering influence on investment decisions to confine all deposit insurance to 95%. A desire to protect less affluent savers might be satisfied by allowing the first \$25,000 or so to continue to be fully covered. The next \$75,000 would be not quite fully covered--95% coverage being a possibility. If no arrangement is made to have formal insurance arrangements with appropriate premium charges for amounts beyond \$100,000 and continued payouts are deemed prudent, then these uninsured payouts should be at a lower rate than that paid on any insured holdings, otherwise there would be no point in carrying insurance.

The question has been raised whether there would really be any point in penalizing ordinary savers who have \$100,000 or less. As a group, they lack the sophistication to judge for themselves whether a thrift is properly run and therefore would have to rely on printed reports, which could

be based on information three or four months old. William Seidman, the head of FDIC and the Resolution Trust Corporation (RTC) has commented that it is hard enough for the regulators to judge the soundness of a bank, so to ask an untrained depositor to do so is unreasonable. Even if savers are not quite as hapless as Mr. Seidman fears, he may be largely correct in doubting the efficacy of relying on small savers for market discipline. Whatever one's opinion of small savers may be, of one thing there can be no doubt--the large account-holders are far more sophisticated and better able to judge--and influence--management practices. Therefore if society wishes to move in the direction of greater depositor discipline but only wants to take one step at a time, it is certainly wiser, as well as politically easier, to begin by imposing a slight penalty on the uninsured deposits before touching the \$100,000 allotted to each ordinary saver. It was not the ordinary saver who caused numerous now-defunct thrifts to increase in size by 1,000%, but rather the sophisticated Wall Street professional purveying brokered deposits.

Even though one may doubt the wisdom of inflicting any severe penalty on insured depositors, it is nevertheless somewhat tempting to throw some inconveniences in their path to deter them from again investing in a poorly run bank. The only slight inconvenience which is currently in force is the loss of expected interest. Following a thrift takeover

the holder of a CD is only guaranteed the former rate of interest for two weeks. The holder, does, however, have the privilege of being paid out in cash if there is any change in interest rates, so depositors all in all are not badly treated at the time of a default. Possible actions of a more severe nature could include the imposition of long delays in making deposit payouts, perhaps with complete cessation of further interest earnings during these long delays, and the requirement that all depositors fill out complicated application forms, perhaps requiring notarization, before they receive their money.

If Mr. Seidman is right about the smaller insured depositors lacking the ability to judge thrifts, then such measures would not likely achieve very much. However, even if there were something to be gained by taking such measures, or else by lowering payouts to ordinary savers, there are some marketing and ethical implications which ought to be considered before taking any negative measures against thrift customers.

One of the most valuable lessons taught by modern marketing is that all successful businesses must be demand-driven, i.e. customer oriented. This is the ethos behind the old adage "the customer is always right." S&L account-holders do not have to do their banking at thrifts. For that matter, they do not even have to keep their savings in the United States. To talk of thrift reform is pointless,

unless there is going to be a thrift industry, and there will be no thrift industry if vast droves of depositors are permanently driven away by negative actions. To give customers the VIP treatment is not an only an appropriate recognition of their past patronage, it also makes good business sense. If customers have caused problems by indiscriminately pursuing high rates, that is only because the government allowed them to. The last thing a reformed thrift industry needs is depositor disenchantment. Since the good achievable by inflicting inconvenience and slight payout penalties is probably small, and the potential loss of good will is very great, such tactics are not to be recommended. In fact such a strategy could backfire right away if payout delays spawned negative rumors leading to bank runs.

Whether one considers depositors to be customers, or, more accurately, crucial suppliers of lendable money, they cannot with impunity be antagonized. It is bad enough to have to reduce payouts on uninsured deposits, but this step is probably necessary. A firm line should be drawn, however, on the matter of reducing payouts to, or otherwise inconveniencing, the 99% of thrift customers who as ordinary savers are the mainstay of the industry. Their continued loyalty is more important now than ever.

In summary, then, the only deposit insurance phase-down measures that may be confidently recommended at this time

are 1) the effective limitation of deposit insurance to \$100,000 per citizen, possibly with reluctant toleration of additional pension pass-through coverage and 2) the imposition of a slight penalty, perhaps 4 or 5% in the case of payoffs of uninsured deposits.

The Role of Risk-Based Premiums

The problem with risk-based premiums is that it is exceedingly difficult to rate the risk of bank-held assets. Benjamin Graham got to the nub of the matter many years ago when he pointed out that a warrant or option might be of the finest investment calibre while a bond could be no better than a rank speculation. Generally speaking, a loan for an owner-occupied single-family dwelling is considered the safest possible real-estate loan, so, this being the case, a thrift having 100% of its loans in that category should be an ultra-safe thrift and therefore qualify for very low insurance premiums. If, however, the loan officer had little understanding of real estate and no understanding of local markets, and to make matters worse, if the loan officer were a poor judge of character, and little aware of the proper methods of conducting a credit check, then the true risk level of that thrift's portfolio would be extremely high. Similarly, one can depict a knowledgeable loan officer prudently approving loans for astute bargain purchases of raw land--normally an extremely risky asset. In a risk-based system such a thrift would, of course, pay

far higher premiums than the other thrift although in reality its loan portfolio would be of far higher quality.

Professor Frederick E. Balderston of the University of California, Berkeley, has pointed out that

"..to enact statutory changes that would enable risk-related premiums to function would require statutory specification, in exquisite detail, of the different elements of risk and the consequent sizes of premiums for risk categories, and the counterattacks from the financial industry lobbies would be intense. The political practicality of a risk-related premium system for deposit insurance is in grave doubt." (Thifts in Crisis, 1985, p172)

Niskanen and England contend that risk-based premiums "would require more information than is realistically available to federal authorities." (National Review, May 19 '89, p39)

Professor George J. Benston, of the University of Rochester, explains how complicated a reliable risk-rated system would be :

"As long as deposit insurance is underpriced with respect to the risk imposed on the FSLIC, SLA managers and owners have incentives to take more risks than they would take were the insurance correctly priced. Unfortunately, determining a risk-adjusted insurance rate is difficult, in large part because of the difficulty of measuring the effect of specific assets, liabilities, and activities on the probability that the FSLIC will have to expend funds. Such holdings and activities include fraud and self-dealing, the holding of duration-unbalanced portfolios, growth without a well-managed and monitored investment program, and insufficient economic net worth to absorb losses. The variance of returns on and the costs of individual assets and liabilities is not a sufficient measure of risk; rather, the totality of the variance and the extent to which negative total returns may be incurred should be

considered. In any event, the FHLBB should not simply assert that a particular activity is 'risky'---it first should conduct adequate research." (An Analysis of the Causes of Savings and Loan Association Failures, 1986, p174)

One wonders whether the attainment of such a level of refinement could ever be cost effective, although this could depend upon the learning curves applying to the various auditing chores and the amenability of such audits to being organized into repeatable routines which could be used on numerous occasions.

Although most authorities are discouraged by the difficulties inherent in risk-based premiums, there are others who downplay these difficulties. Professor Allan Meltzer, of the Carnegie Mellon Institute, believes that such sliding premiums would be one of the most effective means possible to impose discipline on the industry (NYT, Aug 17 '89, A18) and David G. Hoffman of Young & Associates, in an editorial entitled "Why the Fuss over Risk-Based Premiums?" points out that most providers of insurance gauge the price of coverage to the risk of loss, and asks why federal bank insurance agencies should not be able to do the same. (American Banker, April 19 '89, p4)

In all probability there will be, and perhaps ought to be, some premium surcharge for risky assets held in the 30% of the portfolio which FIRREA allows to be non-housing-related. Even though crude criteria and measurement techniques will inevitably result in numerous large

individual errors, if the overall influence is likely to be beneficial then in today's crisis situation it is probably a good idea, from a practical viewpoint, to adopt such a scheme, with a view to later refinement and improvement.

Another factor that makes the adoption of risk-related premiums desirable from a practical point of view is the present existence of risk-related capital standards. A schedule already exists for rating the supposed risk attached to various assets commonly held by banks and thrifts. All banks and thrifts must attain owner capital amounting to 8% of the risk-adjusted asset levels. It would be a logical extension of this present practice to require similar risk-related adjustment to insurance premiums, and since there has not been much opposition to risk-related capital standards, there probably would also not be much resistance to risk-related premiums. If such a plan did not prevent excess risk altogether, at least it would make the risk-takers pay a fairer price for the insurance they are receiving.

Related to, but not the same thing as, the risk-related premium issue is the question of continued government subsidization of deposit insurance. Even at the newly raised levels, deposit-insurance premiums are far below what a private insurer would charge. Savers demand between 1.75% and 2% additional interest on uninsured money-market accounts. If this differential may be legitimately taken as

the imputed market value of deposit insurance, then deposit insurance, even at the new rate of .23%, is a remarkably underpriced good.

Arguments against this subsidization focus on the fact that thrifts and banks are privately owned businesses which exist for the profit of their owners. By giving insurance coverage at such cheap rates the government is enhancing the private profits of the owners, and this can be argued to be an abuse just as much as would be the provision of any other underpriced supplies to any other private business.

While this is a strong argument, an even stronger one can be raised for continuing the subsidization of deposit insurance. The universal provision of well structured deposit insurance is conducive to nationwide financial stability, which is a public good. Once the flaws in the insurance are removed, it is virtually certain that it will prove to be of great benefit to the United States and for that reason it is not unreasonable to expect the United States to contribute to its cost. Just as the government contributes to the transportation infrastructure of roads and bridges, because their construction and maintenance are for the good of the nation, so subsidized deposit insurance can be regarded as a necessary aspect of the financial infrastructure, and equally deserving of public support.

Other Suggested Insurance Reforms

Discussion of insurance reform has brought forth a number of unusual ideas which have no hope of adoption, and perhaps are not really practical, but which nevertheless are thought-provoking. John V. Lyons of Phoenix suggests that if a thrift pays more than 75% of the prime rate then any insured payouts, in case of failure, should be limited to 50% of deposits. If the thrift paid over 125% of prime, no insurance would be in force. (WSJ, Nov 23 '88, A13) One wonders whether a low rate on savings accounts is an infallible guide to the soundness of a thrift's activities, as seems to be implied by the suggested plan, which is reminiscent of the long-expired Regulation Q, which in former days restricted the interest rates that thrifts were allowed to pay.

A suggestion which, for a while, received much consideration was the merger of thrift and bank insurance monies, a plan supported by Representative Gerald Kleczka (D-WI). This suggestion was naturally enough strongly opposed by bankers who correctly anticipated that such a merger would wipe out their fund. Comptroller of the Currency Robert L. Clarke no doubt made his audience very uncomfortable when he also advocated this measure in a speech given at the annual convention of the American Bankers' Association in Honolulu on October 10, 1988. He

very imaginatively drew a comparison between the thrift crisis and the occurrence of a house fire :

"When your neighbor's house is on fire, the fire fighters responding to the alarm won't ration water to make sure there is enough for you should your house go up in flames, too. They will pump until the fire at hand is out. And they will tap your private well to finish the job." (Vital Speeches of the Day, Jan 15 '89, p205)

This suggestion had enough support that the nonthrift banking industry heaved a collective sigh of relief when FIRREA did not make FDIC money available to cover thrift losses. Probably this had less to do with sympathy for bankers than realization that FDIC funds were so inadequate for the job as to be not worth expropriating.

Yet another reform suggestion that was not acted upon was the suggestion by the director of the Federal Home Loan Bank Board (FHLBB), M. Danny Wall, that a super-insurer be established to receive premiums from and rescue, when necessary, FSLIC, FDIC, and the credit-union insurance fund. (NYT, Dec 20 '88, p34) Tremendously huge insurance companies, which only insure other smaller insurance companies against catastrophic runs on claims, do indeed exist, many of them being based in Switzerland. However, Mr. Wall's suggestion would in this case only create more unnecessary bureaucracy in that there is already a de facto super-insurer of the three funds, namely the Federal Government, i.e. the taxpayer.

Although these last-cited suggestions offer little promise at this time they should not be completely forgotten. It is always possible that at some time in the future they may prove valuable.

To What Extent Was the S&L Crisis
Caused by Inadequate Accounting?

There is general agreement that GAAP has been an unsatisfactory source of information for thrift regulators and investors, and that regulatory accounting principles (RAP) proved to be even more unsatisfactory. According to Hendriksen and most accounting theorists, the main goal of accounting is the provision of financial information which is timely, accurate, and complete and which can effectively aid managers, regulators, creditors, investors, suppliers, customers and all other interested parties in making appropriate decisions thereby serving society by expediting a more productive allocation of resources.

Edward Kane compares the regulators who must keep ahead of risk-prone managers to a car driver trying to win a race despite being handicapped by a muddy windshield. ("No Room for Weak Links in the Chain of Deposit-Insurance Reform", Journal of Financial Services Research, 1 : 1987, p94)

According to Professor Kane, the unavailability of necessary steering information which is caused by a muddy windshield may be compared to the unavailability to regulators of

essential financial information which exists because of weaknesses in GAAP and RAP.

Proponents of the efficient-market hypothesis have demonstrated that despite the shortcomings of GAAP, enough surrogate information is usually available to permit interested parties to correctly assess the value and solvency of any organization. Unfortunately, it is not the realistic investor view of net worth and/or solvency that affects the legality of regulatory takeovers, but rather the outdated figures embedded in GAAP statements. Many thrifts that are millions "in the hole" are shielded from regulatory takeover by having the required minimum GAAP net worth. This unfortunate situation gives money-losing thrifts extra time in which to take desperate gambles which occasionally pay off, but which usually only increase their losses. Typically, by the time such an institution becomes GAAP-insolvent its losses have reached staggering levels. Thus, far from being a useful tool, GAAP and RAP actually get in the way of corrective action.

This failure on the part of GAAP to reflect declines in S&L net values that often occur after interest-rate rises and/or real-estate declines is in sharp contrast with the tendency of GAAP in other businesses to nearly always underrepresent net worth. This underrepresentation occurs because inflation as a rule gradually raises the potential sale price of buildings, land and other major assets above the acquisition cost embedded in the GAAP statements.

Although there may be a few items having exit value (i.e. net realizable value) lower than acquisition cost, in most businesses the value of these untypical declining assets is vastly outweighed by the value of assets increasing in exit value.

When applied to banks, however, GAAP does not have this built-in conservative bias, for banks have a smaller proportion of their wealth in fixed productive assets subject to inflationary gain, and to make matters worse, they usually have a large number of assets which in times of high interest rates are subject to strong market decline, but which are allowed by GAAP to be carried at face value.

One occasionally hears GAAP condemned because after the collapse of a real-estate boom it supposedly permits direct investments in land and buildings and seized collateral to be carried on the books at the old unrealistically high levels. This, however, is not the fault of GAAP, for GAAP does indeed require the immediate write-down of any asset which has undergone a permanent impairment in value. When these real-estate declines are not recognized, it is the fault of the management, who are, of course, the issuers of financial statements, and the auditors, for not disputing the unadjusted values.

Similarly one occasionally hears criticisms directed against traditional accounting methods in connection with failure to establish sufficient reserves for bad loans, or failure to write off bad loans. Neither of these abuses has

ever been sanctioned by GAAP or RAP. The fault for their occurrence lies not with any particular method of accounting but with unconscientious managements, careless auditors and overworked and thinly spread examiners.

Two practices which offend the accounting principle of conservatism have been permitted by GAAP, however. The first, and less important of these, has been the failure of GAAP to forbid the practice of recognizing as interest income monies not externally generated but taken out of the loaned amount. (NYT, Dec 28 '89, C1) This, of course, is a patently preposterous misrepresentation. If a man hands his friend money and the friend gives it right back, it is hardly an arm's-length transaction. These so-called interest earnings are really only a return of part of the loaned money, and these receipts should be recorded as adjustments to the principal outstanding. Not being externally generated, it would be misleading even to call them payments on the principal, since this would suggest that the borrower is at least starting out as a reliable debt payer when the fact of the matter is, he is only giving back money which the bank gave him and which never left his hands. Any bank that books this type of interest income and then boasts about its great earnings is as ridiculous as the unloved landlady who gave all her tenants the money they needed to buy her a Christmas present, and then afterward bragged to all the other landladies that she was so popular

with her tenants that each of them bought her a Christmas present. It is surprising that the normally conservative GAAP should be so permissive in this one aspect of income recognition.

Of more serious financial consequence has been the failure of GAAP to require that long-term financial instruments such as bonds and mortgages be carried at current market value. This failure to acknowledge changes in the value of these assets which dominate the portfolios of virtually all thrifts has caused a much greater magnitude of net-value misrepresentation than any other accounting abuse, simply because mortgage assets loom so large in the affairs of S&Ls.

In addition to these two abuses, several others were sanctioned by regulators in the now discredited RAP. Koch (pp194-5) cites several of these. First of all there was the recording at face value of net-worth certificates issued to ailing thrifts by the FHLBB. Although technically promissory notes, these spurious assets should not have been recorded since there was legitimate doubt that FSLIC, itself insolvent, had the means to pay these notes. The second RAP abuse cited by Koch is the asset known as appraised equity capital. This was the difference between book value of land and buildings and estimated market value. Although it sounds reasonable to give recognition to demonstrable increases in asset values, to apply these value updates only

to assets that have increased in value while ignoring the market declines affecting other holdings certainly offends the principle of consistency, and exacerbates the overvaluation bias. The third RAP abuse cited by Koch was the unconventional creation of goodwill, known as regulatory goodwill, which often accompanied thrift mergers. Yet another RAP-sanctioned abuse, which had both balance-sheet and income-statement ramifications was the proration of realized mortgage-sale losses over the remaining term of the mortgage.

Edwin Gray, former chairman of the FHLBB, conceded that these RAP-sanctioned practices enabled the thrift industry to report an aggregate net worth of \$32 billion at the end of 1983, instead of the \$4 billion net worth which it had according to GAAP. (Koch, p195) No doubt, with market write-downs of mortgages, the true aggregate net value of the industry would have been deeply in deficit. Already saddled with the valuation biases inherent in GAAP, the thrift industry only made problems worse by adopting RAP. According to Edward Kane, "arguably the agency's single greatest mistake was to adopt irregular and misleading regulatory accounting principles (RAP) that served to create important new opportunities through which insolvent and unprofitable thrifts could legally conceal their ongoing weakness." ("The High Cost of Incompletely Funding the FSLIC Shortage of Explicit Capital", unpublished paper written in

1989 by Professor Edward Kane of the University of Ohio, Columbus)

Brumbaugh (1988, pp132-3) makes similar observations about the bad results of both historical accounting and RAP. He urges that contrary to GAAP interest-sensitive assets such as mortgages and mortgage-backed securities be continually marked to market. If one makes the reasonable assumption that unearned "front-end" interest and fee revenues are relatively small, perhaps almost immaterial, then we can conclude from the calculations in Table 2-7 of Brumbaugh's study that failure to mark mortgages to market-- although permitted by GAAP--is a far greater cause of net-value overstatement than all the RAP-sanctioned ornaments combined, and conceding that his calculations are probably correct, this GAAP-sanctioned practice must be considered far and away the greatest cause of unreliable thrift balance sheets.

Brumbaugh dismisses possible objections that interest-caused problems, being self-correcting, should be ignored. Brumbaugh would not agree that Newton's famous maxim "what goes up must come down" applies to interest rates. He argues that the market has a better idea than the regulators about future interest movements, and that the various probabilities are already impounded into the interest rate in force at any given time. While Brumbaugh does not prove that this is true, the mere fact that this possibility can

be plausibly raised leads one to suspect that it may indeed be risky to provide any kind of forbearance or subsidization to thrifts hit with interest-rate misfortunes. If it were a certainty that every time interest rates rose they would eventually return to former levels then it would make good sense to keep interest-induced fluctuations off the books on the grounds that such changes were of a purely temporary nature. If, however, this is an unjustifiable assumption, as Brumbaugh suggests it is, then failure to mark to market cannot be defended on these pragmatic grounds. Indeed, to ignore the fluctuations only guarantees that if and when there is a secular move in interest rates there will be many years of severely misstated thrift net values pending the gradual retirement of all the old mortgages recorded on the books at the old values.

Marking mortgages to market would create certain complications, however. For one thing, it would have to be decided whether to mark to market even if values rise above acquisition cost, or instead to use the more commonly accepted lower-of-cost-or-market valuation. The problem with the latter is that it could result in secret reserves if interest rates fell and thrifts were forbidden to raise the carrying value of mortgages higher than original value. A shareholder has a right to know the full value of any thrift lest he sell his shares at too low a price, so, in order to give a shareholder a conservative estimate of what

ought to be a satisfactory selling price, mortgages should be marked to market with no upward limit if interest rates fall. Of course, the same arguments could be made that marketable securities should be marked to market rather than lower of market or cost, and they probably should be, but since they constitute a much smaller portion of a thrift's assets, they pose much less of a threat in terms of creating secret reserves.

Another problem with recognizing market changes in mortgage values is that mixed in with operating income it would disguise management performance, and destroy the validity of financial ratios. Changes in market value caused by interest-rate movements do not meet the criteria of extraordinary income or loss, so they must be included in current income, even though these changes are dictated by something beyond the control of management. The value of the income statement as a communicative and motivating document lies in its being a reflection of good decisions, skilful management and dedication on the part of workers. This is the main reason for keeping extraordinary gains and losses out of the main body of the income statement. If a lazy manager and a group of unmotivated employees lose a million dollars in the course of a given year, but an extraordinary gain of \$10 million that they had nothing to do with comes along, and is incorrectly mixed in with operating income then shareholders would be misled into

thinking that all is well, and the staff would not learn the lesson they should from their poor results. With similar concerns in mind, gains and losses arising only from the extrinsic factor of interest-rate movements should be separated out. Since interest-induced profits or losses on bond holdings are classified, when realized, as investment income, it would seem natural to treat analagous changes in mortgage values as investment income as well, but perhaps both of these ought to be given a category of their own since unlike most other investment income such profits and losses are of extrinsic origin and do not reflect the good or bad judgment of management, assuming, of course, that Brumbaugh is correct that interest-rate movements are not subject to rational prediction. Probably the best solution would be to report such interest-induced income on the income statement after investment income but before extraordinary income.

Although it might seem irrelevant to thrift regulators to worry about secret reserves and the effectiveness of income statements as communicators of earning ability, both do in fact have an impact on thrift regulation. If interest rates crash then, even making ample allowance for mortgage prepayments, the mortgage portfolio become more valuable, and if market value sufficiently exceeds acquisition value it might not be necessary for regulators to shut down a thrift which according to GAAP does not have the minimum net

worth. Since such mark-ups represent real economic changes providing owners and insurers with a real source of wealth there can be no economic justification for treating this particular type of increase in capital any differently than any other infusion of capital.

Clearly distinguishing mortgage gains from operating and investment income would reveal both to regulators and the public which managements need close supervision. Of course, regulators know that anyway, without such an income statement refinement, but if they were required to defend any particular action to politicians or to the public, they would have something in black and white that they could produce to defend their actions. Since Charles Keating and other thrift operators have accused regulators of conducting witch-hunts and vendettas, it would be a good idea to provide future regulators with impartial management-descriptive income statements shorn of interest-rate-induced profits for potential use as a public-relations tool. Of course, such a tool can be of use to managers, as well. If operating profits have been very strong but a spike in interest rates has brought net market value below the required level, it is only fair to provide competent but unfortunate managements with the same black-and-white documentation that would enable them to argue that seizure would be poor public policy.

A slight problem with GAAP not likely to receive immediate attention is the inducement which it often provides to take uneconomic decisions for the purpose of producing more favorable financial statements. In particular, there can be pressure to time one's actions according to the dates of financial statements. The same deleterious pressure can arise from observing budget deadlines. For example, Robert E. Taylor once reported that "Bank Board Chairman M. Danny Wall has said he is eager to complete as many deals as possible by Friday so that they don't count against his agency's spending in the fiscal year that starts Saturday." (WSJ, Sept 26 '88, p4) It goes without saying that when a seller wants to complete deals before a certain date there is a shift of bargaining power from the seller to the buyer and in this way there are arbitrary economic effects which would not exist if the deals struck after the deadline date could be backdated to be included in the previous period. Such a negative shift in bargaining power must be considered economically unjustified in that it has not in any way been earned by the those who gain by it, but only occurs because of arbitrary rules which the disadvantaged side has inflicted upon itself. A similar uneconomic action was carried out by Columbia S&L, which, wishing to comply with certain limitations on "junk-bond" holdings, once sold the bulk of its "junk-bond" holdings to Drexel Burnham Lambert very

close to its year-end, with the tacit understanding that it would buy the bonds back as soon as it had completed its balance sheet, which, of course, in GAAP only describes the holdings existing on one day. (NYT, June 12 '89, C1) It could be argued that GAAP is highly dysfunctional and ought to be scrapped since in instances such as this it is itself the cause of actions having no economic justification, and a good accounting system should only give a fair report of economic events, not itself be the cause of them. However, a rebuttal could be furnished that the admittedly foolish situation just described, and others like it, are the fault not of GAAP, but of regulators and legislators for not requiring a standard of compliance based on weighted-average continuous holdings. GAAP was never intended to be used as an ongoing asset monitor. It is meant to describe economic activity, not to prescribe it. Nor should Columbia be excoriated for availing itself of a loophole. Virtually all businesses avail themselves of loopholes if they are able to find them. If regulations are better written and compliance better monitored there should be less problem in the future of thrifts indulging in uneconomic accounting-driven behavior.

Although it is generally true that it is not GAAP but the abuse of GAAP that causes the type of problem just mentioned, in one pervasive problem area GAAP is itself an unwholesome influence: in hold-or-sell decisions. Because

GAAP does not require continuous marking to market of readily saleable securities, and allows gains or losses to be recognized only when realized, i.e. when a sale has occurred, managers have considerable opportunity to indulge in income manipulation. An asset which ought to be kept will be "cashed in" so that the gain may be counted in income, and an asset which ought to be sold, perhaps certain mortgages, will be kept in order to avoid booking the loss. According to G. Christian Hill and Paulette Thomas this is currently a problem with many capital-short thrifts. (WSJ, Aug 7 '89, A1) If assets were continuously marked to market then the losses and gains would be recorded whether or not the assets were sold, so accounting would not influence the hold-sell decision.

Since the overly lenient RAP has already been abolished, the only remaining problem areas are all aspects of GAAP. In particular, two changes are to be recommended :

- 1) Mark mortgages to market.
- 2) Disallow front-end fees and early interest payments from being recognized as income if such monies have come out of the loan and were not externally generated.

Less urgent, but still worth considering, would be the recommendation that capital requirements, portfolio requirements and the like not be couched in terms referring only to GAAP financial statements, if doing so leaves room

for evasions or provides incentive for uneconomic actions. In many situations GAAP would have to be supplemented with or replaced by other written regulations better designed to unmistakably prescribe desired economic behavior.

To What Extent Did Weak Auditing
Standards Contribute to the Crisis?

Weak auditing standards cannot be considered one of the major causes of the crisis, but they did contribute a certain amount to the problem. Auditors who followed current standards of testing on some occasions did not discover problems which would have been uncovered had more rigorous standards been in force.

Auditing is an expensive process, and in this branch of applied statistics there is an especially pronounced problem of diminishing returns. Extremely rigorous standards would make audits vastly more expensive and probably not correct enough additional problems to make the added expense worthwhile.

At present, the auditing standards that apply to banks are the same as those that apply to other businesses. In the wake of the current S&L crisis, it would seem wise to tighten up these standards somewhat, despite the additional cost of doing so. In a special report issued on April 6, 1990, "the GAO said it is considering recommendations of extraordinary auditing requirements, particularly for large banks. Those would include more frequent on-site

examinations by banking regulators as well as double teams of outside auditors." (WSJ, April 9 '90, A16)

Before one condemns present auditing standards, it would be well to remember that they already do require a high level of sampling and testing, as well as conservative provisions for loan losses and write-offs. The function of auditing is not to prevent the granting of bad loans, but only to verify that the financial statements accurately and fairly represent the financial affairs of the auditee. Since the necessity of submitting financial statements to auditors abiding by present standards did little to deter the more risk-prone managements, it is hard to believe that the existence of somewhat tighter auditing standards would have been much more successful in holding back these risk-prone managers. For that reason, the strengthening of present auditing standards should be considered only a minor remedy for the crisis. This does not mean, however, that the standards should not be tightened as recommended by the GAO, for that agency would not have recommended these changes unless it had determined that such changes would be cost effective.

To What Extent Did Negligent
Auditors Contribute to the Crisis?

Although current auditing standards are already very high, these standards have not always been lived up to by auditors. There have been numerous reports of auditors

accepting all management statements at face value, and accepting suspicious real-estate valuations without so much as a superficial on-site inspection. Careless, overly-influenced auditors have in many cases failed to meet the requirements for impartiality; adequate testing, sampling and inspections; and conservatively computed provisions for losses as well as timely write-offs.

Nearly all of the Big Six firms are being sued by RTC for purportedly negligent audits conducted by one or more member firms. Allowing undue dominance by clients, and taking unprofessional shortcuts are only two of the problems that occurred time and time again.

In spite of these embarrassing charges, it still holds true that the great majority of thrift losses arose from bad credit decisions, pure and simple. A good auditor will make sure that loss provisions and loan write-offs are adequate but he cannot prevent bad loans from being made. For this reason, it is unreasonable to consider careless auditing to be a major cause of the crisis. There is, however, a reasonable charge that had some of the auditors done a more thorough job, then some of the more reckless managers would have been replaced earlier and losses would have been curtailed. Since it is only a small minority of the auditors that is being accused of carelessness, and since it is debatable how much additional money was lost because of them, or how much sooner miscreant managers might have been

replaced, unprofessional audits must be considered a significant but not overwhelming negative influence in the crisis.

It is well to remember that much of the impugment of auditors arises from audits of fraudulent firms. It is unfortunately true that a criminal element was present in many failed thrifts. According U.S. News and World Report, "One New York mobster turned up in deals in 130 thrifts, of which 125 failed." (See Zuckerman, June 18 '90, p92.) An auditing team does not pretend to be a fraud squad. That is a different type of task requiring a different type of skills. It is so difficult and expensive to detect fraud when there is skilful collusion that detection of fraud is an unreasonable expectation of a normal team of CPAs. Edward Kane has warned us against assuming that since fraud was involved in over half of the thrift failures that this means that half of the thrift losses were caused by fraud. ("The Unending Deposit-Insurance Mess", unpublished manuscript to be published in Science, p4) According to Professor Kane, in most of the failures where fraud was involved it was only a few deals that were tainted with this crime. Professor Kane estimates that losses due to fraud do not exceed 20% of industry losses, and may be as low as 10%. Thus even if auditors had been so spectacularly successful as to expose half of this fraud in time to recover the money (no mean feat even for crack law enforcement officers!) at

least 90% of thrift losses would have remained unaffected. Bert Ely estimates that losses attributable to fraud are about 5%. (See Mahar, Barron's, Sept 11 '89, p24.) Although at this point there is insufficient evidence to reject the belief of Professor Kane and Bert Ely that fraud has been one of the lesser causes of the crisis, nevertheless it is important to keep an open mind on this point, especially since William Seidman contends that it was the main problem in 30% of the shutdowns that have occurred so far. (NYT, June 6 '90, A1) On June 22, 1990 Representative Schumer (D-NY) stated that losses due to fraud would total about \$20 billion, an estimate that concurs with the lower figures of Kane and Ely.

Robert Elliott of Peat Marwick, a nationally known auditing expert, maintains that CPAs are being "used as a scapegoat for bad laws, poor regulation and incompetent management...Congress deregulated the left side of the balance sheet....now legislators are blaming accountants for creating this mess." (WSJ, Feb 6 '89, B3)

Perhaps the greatest favor that could ever be done for CPAs to rid them of management pressures would be to institute some hiring system in which auditors would not work for management and in that way be subject to tacit threats of dismissal. Like any other business, an accounting firm cannot afford to lose a big client. If a situation comes up in which it is professionally defensible

to take two positions the natural temptation will be to take the position more favorable to the client. This would be innocuous if it only happened in one or two small matters in an entire audit, but when it occurs numerous times it can result in an overall bias which does indeed compromise the validity of the audit, though individually each of the discretionary actions could be successfully defended.

Since the taxpayer is deeply involved with the thrift industry, and since undue influence has been a problem, perhaps the Office of Thrift Supervision (OTS) might consider appointing itself the employer for all thrift audits. Individual thrifts would be assessed an annual fee to cover costs but all hiring and dismissal authority would reside in the Office of Thrift Supervision. This is an extremely radical suggestion, and since poor audits are only a secondary or tertiary cause of the thrift crisis, it might not be a good idea to bring in such a plan right away, there being so many other areas of concern requiring more immediate attention. In the meantime, however, regulators and legislators should give long and careful thought to possible measures along these lines if there appears to be a chronic problem of managements intentionally or unintentionally undermining the independence of auditors.

Perhaps lawsuits against accounting firms, although sometimes merited, are also in large measure motivated by the desire to pursue deep pockets. All too often there is

little point in pursuing fraudulent managers. They usually have dissipated their ill-gotten gains, making civil remedy futile, although their lack of honesty makes one wonder if some of these corrupt former managers might not have hidden much of their booty for later recovery.

Criminal charges have been brought against a number of allegedly fraudulent managers. Convictions, however, are extremely difficult to obtain, given the complexity of these white-collar crimes and the need to prove criminal intent. William Seidman has wryly noted that a theft of \$500 out in a public street is usually severely punished while a multi-million-dollar-theft perpetrated by a polite, well-dressed thrift manager is often dealt with sympathetically, especially by a jury.

The Special Problem of What
To Include in Owner Capital

Everyone agrees that undistributed profits, i.e. retained earnings, and contributed capital, i.e. cash originally invested, are true owner capital, in substance as well as in form. However, controversy arises as soon as a suggestion is made to recognize anything else as owner capital.

Because GAAP statements are not directed at any one group of interested parties but aim to provide reliable financial information for use by all, it is understandable that GAAP is conceived in extremely general terms and

occasionally must be modified to meet the specific needs of a particular user group.

No better example of this can be found than the varying ways owner capital must be computed to suit the various groups. An uninsured depositor will be mainly concerned with the safety of his deposits. For his purposes, owner capital can be very broadly defined since all that concerns him is the priority of claims in case of bankruptcy, and for that reason bonds, preferred shares, deferred taxes, contingency reserves and common equity all may be grouped together under the general designation capital, since all of them have a claim subordinate to his own. Of course, this improvised change in the definition of capital results in a misnomer, capable of creating communication snags, but the needs of this particular user are better served when the account called capital is, for him, computed in this way. This broad definition of capital is in sharp contrast to the narrow one which would best serve the investor in search of leverage. This individual would only want to count that portion of equity having claim to residual earnings. Preferred shares are certainly capital, legally speaking, for they do not confer upon their owners the power to force bankruptcy, and yet (assuming they are of the usual nonparticipating variety) such shares have the same effect on leverage as bonds, since they only have a fixed claim on profits. For this reason the computation of capital that

would best serve a leverage seeker would only include the value of common shares fully diluted, and would even exclude preferred shares.

These two examples serve to demonstrate that GAAP is not an end unto itself, but only a tool to be used by decision makers, who will usually not hesitate to make whatever modifications are dictated by the specific application at hand.

Since the imposition of higher capital standards has been widely proposed as a measure to help prevent future thrift insurance losses, an important question is : what definition of capital is the most relevant to the financial interests of the insurer?

There are two quite distinct ways in which high capital standards can protect the interests of the insurer, and each requires a slightly different strategy to be made fully effective. The first and by far best known function of high capital standards is the cushion it provides against insurance liability. If the main point of imposing higher capital standards is to put in place a financial buffer, then it would make sense to include any monies which would be available to depositors before insurance money had to be resorted to. This would include bonds, debentures, preferred shares, common equity, loan-loss reserves and other contingency funds, and deferred taxes (which, of course, in a bankruptcy are permanently deferred, i.e.

cancelled, with the value of the account reverting to the thrift owners). These are the credit accounts that have claims subordinate to the claims of depositors and hence may be included in capital if the cash-cushion approach is to be used.

Certain adjustments, however, must be made for the values of the intangible assets which as a group tend either to be unmarketable or else of very uncertain value. Obviously, goodwill is meaningless in a normal bankruptcy, unless a buyer intends to keep the thrift operating as before, in which case the franchise value, or marketing value of the thrift might have ongoing value. Even in this case it seems improbable that the recorded value of the goodwill would be accurate. By definition goodwill represents the ability of a business to earn excess profits over and above what is normal considering the value of its other assets. If a thrift is bankrupt, it, by definition, has had negative earnings, and if there are negative earnings how can there be excess earnings? Although unusual conditions can occasionally reconcile the coexistence of goodwill with negative net worth, a far likelier explanation is that the goodwill recorded on the company's books, which may at one time have really existed, has been dissipated regardless of the number of years remaining in its amortization. This is why lenders generally draw a line through the goodwill account and immediately make a

deduction from owner equity. It is an evanescent asset. It can go on for years pulling in superior earnings, or it can disappear in a flash. The lenders who draw a line through the goodwill account are not saying that the goodwill is not real at the time, or that it does not have commercial value. All they are saying is that its value as collateral is zero because if a loan becomes nonperforming then it is highly probable that the superior performance embodied in the goodwill account has vanished, and, by definition, the goodwill along with it.

This is why FIRREA is requiring that goodwill be deducted from capital. In a distress situation requiring insurance payouts any goodwill recorded on the books is highly unlikely to be real, and this fact will be reflected in the prices bid for the troubled thrift. On occasion bankruptcy is caused by extreme mismanagement or fraud, and the unfortunate thrift really does have goodwill, i.e. strong franchise value, which will induce a bidder to offer more than he normally would in such distress circumstances. Usually, however, when there is a bankruptcy, goodwill as a real asset is long gone, and its precautionary advance deduction from capital is entirely logical.

Another asset that presents problems is mortgage-servicing rights. These rights are not as liquid as most financial instruments and their net realizable value is hard to estimate. Because the exit value of servicing rights is

very indefinite they cannot be relied upon as contributing to a cash buffer and accordingly should normally be deducted from the capital account. If, however, the market value of these servicing rights has been established through an arm's-length transaction, then there is no reason for them not to be accepted as a valid asset. Eric Hemel, an analyst with First Boston Corporation, believes that it is acceptable to give mortgage-servicing rights the same recognition as any other asset, provided they are fairly priced, which he concedes is not always the case. (American Banker, July 31 '89, p12) FIRREA only allows the inclusion of these rights if they have been purchased, and therefore have a demonstrable value.

Although deductions for these two accounts are not likely to arouse much controversy, a rather surprising objection to the inclusion of deferred loan losses, a credit account, has been raised by William Seidman. (NYT, May 25 '89, p1) Since there is no GAAP requirement to maintain such an account, Mr. Seidman's position, on theoretical grounds would seem to be untenable, in that at any time this type of account may be closed out into owner equity. However it seems likely, given Mr. Seidman's attitude on this issue, that in his many years as a bank regulator he has seen this type of account abused. The most likely abuse would be to use the existence of this account to justify not having a sufficiently large contra-asset adjustment account

to the receivables account. It is likely that in many cases the credit account "deferred losses" should be closed out to the account "allowance for bad debts", also a credit account, but structured as a contra-asset account, or, if it is deemed appropriate to take care of the matter in such a way that loan losses are deducted from current income then the account could be closed out to equity after which there could be an entry debiting loss expense and crediting allowance for loan losses which would put the account where it belongs, give current-income recognition to loan write-off expense, and get the account removed from the owner's equity section of the balance sheet where it is likely to be claimed, in many cases wrongfully, as an available cash cushion.

In summary, then, if the sole purpose of requiring strong capital standards were to have access to a strong cash buffer then all bond and debenture debt, all equity, deferred taxes and perhaps some reserves could be included with deductions being made for goodwill and any asset having unusually uncertain sales values, most notably mortgage-servicing rights.

There is much merit in wanting to see a built-in cash cushion to protect the insurer in case of insolvency, and this is deemed by Brumbaugh to be the main reason for imposing higher capital standards. However there does exist a second, perhaps equally important, reason for requiring

higher capital standards: reduction of moral hazard. When owners and managers have more of their own money at stake they tend to operate the thrift in a more responsible manner. Experience has shown that when risk-prone managers are operating at their worst, there can be such a precipitous rate of decline in thrift net value that even a 10% cash buffer--very high by modern investment standards--can be quickly wiped out. While FIRREA has endeavored to reduce the opportunities for excess risk taking by means of greater regulation, the thrift crisis has furnished so many examples of managers able to get around regulations that it would be extremely optimistic to hope that the new lending requirements in FIRREA all by themselves can end imprudent management behavior. As praiseworthy as FIRREA may be, just in case it turns out not to be quite strong enough medicine to cure the risk problem, the thrift industry should also avail itself of whatever additional risk-deterrence can be arrived at by limiting the number of items that may be counted in owner capital.

If reduction of moral hazard is to be the main focus of capital-standards reform then what matters most is that capital be defined in such a way as to discourage excessive common-shareholder leverage. When those persons who have a vote in the running of the thrift have relatively little of their own money to lose, and yet are positioned to reap all the residual benefits of any gains, they have an incentive

to take risks. If such items as subordinated debt and preferred shares are allowed to be counted as capital then the perverse situation will frequently arise in which a thrift will have a positive market net value and yet the financial interest of the decision makers will be virtually zero. Of course, this situation creates the same nothing-to-lose incentive to gamble that has been the main cause of the crisis.

A further problem is that of adverse selection. If thrift capital is too inclusively defined then the type of common-stock investor that is needed will be deterred while the type of investors most dangerous to the thrift will be attracted, hence the expression adverse selection. As a thrift begins to lose value the common stock will be the first thrift securities to undergo a deterioration in market value. This increases the leverage, while debasing the quality of the shares to a low speculative grade. Even though the thrift may still have a positive market net value, the residual value, i.e. the market value of the common shares, will be very low. At this point what is needed is prudent management to stem the losses. But this is not the type of management the thrift is likely to get in these circumstances. Because the shares are of a highly leveraged speculative grade the only investors who will continue to hold such shares or willingly buy them will be persons of a strong gambling temperament. More prudent

investors--the kind sorely needed--will shun these low-grade shares. And in this way control will pass to those least likely to exercise it wisely.

If the purpose of capital-standards reform is behavioral change on the part of managers, then the only owner capital that matters is that possessed by those who control the managers, i.e. holders of common shares. The existence of large numbers of preferred shares and/or subordinated debentures is irrelevant to the interests of common shareholders, and therefore potential losses by such senior claimholders cannot be reasonably be expected to worry common shareholders who control management any more than potential losses by the insurer have worried them in the past. To avoid this moral hazard, and to avoid the problem of adverse selection, thrift capital should be very narrowly defined to include only common stock plus whatever residual accounts would revert to the common shareholders in case of breakup, such as deferred taxes and perhaps certain discretionary reserves. A case can be made even for excluding nonvoting common stock from capital in that such holdings do not represent wealth that is subject to loss by those in control. They do however dilute the potential payoff of any gambles so they do in this way deter risk-taking, and reduce the problem of excess leverage which is the main cause of adverse selection and much of the cause of moral hazard. Because gains and losses by nonvoting share-

holders cannot occur without corresponding gains and losses by the voting shareholders, owner-managers will not be as unconcerned about protecting the financial interests of these security holders as they might be about protecting the financial interests of preferred shareholders or bondholders. This being the case, a heavy weighting of such shares in a firm's capital structure, with less reliance on bonds and preferred shares, will affect in a positive manner the behavior of the owner-managers. Because nonvoting common equity does in this way help to reduce the moral hazard problem, it would probably not be any great mistake to allow it to be included in owner capital, although it might be wise to only allow it to be counted on a partial basis--perhaps 50%--the reason for this being that although it dilutes the potential payoff of imprudent gambling by management, it also dilutes the potential downside to voting share-holders, making risk-taking less dangerous.

Whether one takes the moral-hazard approach to capital or the cash-cushion approach, the reasoning behind the deductions for uncertain assets such as goodwill remains the same, and the same deductions are appropriate in either case.

Auditors and regulators will not always find it easy to keep ahead of imaginative thrift operators who can sometimes come up with surprising ways to comply with capital

requirements. When the now-defunct Silverado Savings and Loan of Denver wanted to bolster its weak capital levels it loaned certain developers with whom it had close relations money with the stipulation either that all or part of the money be used to buy Silverado stock. (WSJ, Dec 12 '88, C6) Of course this practice makes a mockery of capital standards. Using this approach to capital compliance anybody at all could open a new bank without investing a cent and yet be in full compliance simply by lending himself or a close relative or friend enough of the insured deposits to buy whatever amount of stock was required to meet capital requirements. The unfortunate incident at Silverado highlights the need for extreme examiner vigilance if non-arm's-length transactions and relationships are to be exposed and hopefully prevented.

How Much Capital Ought to Be Required?

The amount of owner capital needed to effectively inhibit excessive risk taking is quite low. Furthermore, the amount of capital that can be demanded of investors is also low since housing loans are not sufficiently profitable to make investment in thrifts financially attractive without the benefit of fairly strong leverage. Paul DeRosa, of Eastbridge Capital, has pointed out that only 246 of the 910 S&Ls that were solvent in 1988 earned the 12% return on equity that he maintains is generally considered the minimal

acceptable level for commercial banks. (American Banker, July 21 '89, p4)

According to Ned Eichler, president of the investment firm of the same name, 3% real market capital contribution is about the going rate for an S&L that has no particular problems. (NYT, Dec 18 '88, Sec 3 p2) William Seidman also advocates a standard of 3%. (NYT, May 25 '89, p1)

An amazingly stringent proposed standard was forwarded by Shadow Financial Regulatory Committee, a group of banking scholars. Their spokesman, Professor Edwards of Columbia University, proposed bringing in a 10% requirement with government takeover mandated should the capital fall below 3%. (WSJ, Feb 14 '89, C23) Although according to Koch (p188) 20% owner capital was common at the turn of the century, nowadays even this 10% proposal must be considered an outlier.

Perhaps the best answer to the question of how much tangible capital ought to be required is furnished by Koch. Koch (pp197-9) refuses to give a number, but only states that the greater the riskiness of a firm's operations and/or assets the higher the required level of capital should be. Since Koch refuses to commit himself to any particular number, it is probably safe to assume that the level of tangible capital which ought to be required is whatever level can be extracted from thrift investors. If the going rate for return on equity makes 3% unacceptable to

investors, then regulators might have to be satisfied with 1.5 or 2%. Because it has been conceded by investment authorities that 3% tangible capital is about the going rate for healthy thrifts, this level would probably be a good point of departure. At present only 1.5% is in effect with phased-in increases to 3% planned.

Allowing such a period of adjustment is not unreasonable, considering the enormity of recent problems. Even the comparatively mild 1.5% tangible capital requirement should go a long way towards solving the moral-hazard problem since it will guarantee that owners and managers will at least have some real capital to lose whereas in the past they often had not a cent at stake. 1.5% of assets is not a strong cash cushion, but it is far better than what has existed up to now, and hopefully if it is enforced as a threshold figure for swift and certain shutdowns then any liquidations will either cost the insurer nothing at all or else very little.

If money cannot be found to raise thrift equity levels to more desirable levels, and if the current transitional 1.5% tangible-capital requirement, combined with other FIRREA reforms, is proven by experience to be adequate deterrence to risk taking, then the ultimate goal of 3% capitalization might have to be reconsidered. GNMA and FNMA have much safer portfolios, having 100% in home mortgages instead of the 70% required of thrifts by FIRREA, but

required tangible capital in these agencies is only 1%. Because thrifts, even after FIRREA, do have more leeway for risk-taking and often retain some credit risk for mortgages sold for securitization, it is only fair that they should be more conservatively capitalized than FNMA and GNMA, but requiring three times as much equity seems somewhat on the high side. Fortunately the requirements in FIRREA are not carved in stone and if 3% proves to be somewhat excessive it can easily be moderated by legislative amendment.

What Are the Pros and Cons of Risk-Related
Capital Standards and Insurance Premiums?

The increased flow of capital across international borders has increased the pressure on bank regulators in the major western nations to harmonize their regulatory standards so that holders of wealth cannot play one nation off against another in their investment decisions thereby undermining world-wide banking standards. A recent meeting in Basel of the central bank regulators of the major western countries resulted in the adoption of risk-related capital standards to be enforced by all the signatory nations. All thrifts and banks covered by this agreement must by 1993 have equity amounting to 8% of risk-adjusted assets. Because the object of this calculation is to obtain more equity when there is greater risk, assets deemed to be of above-average risk are given a higher value. There are numerous multiples to reflect extra degrees of risk. For

example, if a house loan is made for more than 80% of market value then this particular mortgage asset would be carried at a higher risk-adjusted value. Interest-rate risk is recognized as well. The effect on net value of a two-point rise or fall in interest rates is calculated and the greater the potential fluctuation in net value, the greater the required percentage of owner capital. (WSJ, Nov 29 '88, A4)

There are essentially two objections to risk-related capital standards (and by extension risk-related insurance premiums). First of all, risk is devilishly difficult to compute, as Professor Benston points out in the passage quoted on pages 86 and 87 of this paper. Secondly, adoption of risk-related capital standards, according to some, confers upon government regulators illegitimately gained powers to influence how credit shall be allocated. The internationally set standards are only a minimum. Once the general policy is adopted there is nothing to prevent regulators from arbitrarily increasing the capital required for certain types of loans and in this way inhibiting certain economic activities.

Since successful crisis prevention will depend mainly on risk-prevention, and since risk-based capital standards, despite certain imperfections, overall will nearly certainly be a deterrence to risk-taking, it is just as well that the United States has signed the recent international agreement to adopt risk-related capital standards.

It is true that this expansion of regulatory control may give regulators and legislators inordinate economic power. Perhaps from time to time a hidden social or ideological agenda may influence how assets are rated instead of the ratings being based purely on honestly perceived expected losses. Because this potential problem has been raised there must be close scrutiny and periodic re-evaluation of any program of this nature in order to expose any abuses which may arise, and perhaps to debate whether with proper controls such influences might not be legitimate, perhaps along the line of tax laws which often are constructed not merely to raise revenue but also to affect behavior.

Taking into account these public-policy complications as well as the admitted difficulties of accurate risk appraisal, it must be admitted that risk-related capital standards are certain to be somewhat controversial, especially at first, but the severity of the current financial crisis is ample justification for having adopted this policy even though the problems have not all been entirely worked out.

In a sense risk-related capital standards have already existed for some time in that GNMA and FNMA are only required to have a 1% rate of capitalization which is in sharp contrast with the higher rates applying to thrifts. On the surface, this disparity seems very surprising since

these agencies and thrifts are all in the business of providing mortgage funding. The only reasonable explanation for this difference is that the two types of institutions have differing levels of risk. If this is true then these disparate rates are manifestations of de facto risk-related capital standards.

Although risk-related capital standards involve certain practical difficulties, the involvement of the insurer in potential losses makes it reasonable to want more of a cash buffer when additional risks are taken on. Virtually all insurers respond to increased risk by requiring a higher deductible (i.e. the cash buffer made available by the owners' equity) and/or higher premiums. Risk-related insurance premiums and capital standards viewed in the context of general insurance practices is not at all a radical suggestion.

Is There Any Legitimate Place
For Capital Forbearance?

No matter how low the standards are set, whether in absolute terms, or risk-adjusted terms, there will be some deserving thrifts unable to comply, and in many of these cases it was the regulator that got them into trouble. Charles McCoy mentions a certain thrift in Chicago (Talman S&L) which was created in 1982 at the behest of regulators. This thrift has a negative net worth when regulatory goodwill is disallowed. According to McCoy this particular

thrift is exceptionally well run and is improving its position every year. In spite of this, however, at the present rate of earnings it will be a number of years before it is in compliance with required tangible capital. McCoy relates that regulators have unofficially told him that because of its steady improvement they intend to go easy on this particular thrift, granting it exemptions to tide it over. (WSJ, Dec 7 '89, A1) This case brings to the fore the question of forbearance, and in particular the ethical dilemma of whether the Government has the responsibility to continue honoring regulatory goodwill when it was granted as an inducement to persuade a thrift to take over a negative-net-worth thrift without the amount of the negative net worth being made up in cash, as would be done in most private arm's-length transactions.

It does not seem like good-faith business or regulatory practice to shut down a thrift when the only reason the thrift got into trouble was that it previously took actions that were urged upon it by the regulators themselves. Using this argument Representative Hyde (R-IL) garnered considerable support from his colleagues in his efforts to protect these thrifts from losing this goodwill and being forced out of business because of capital noncompliance. The day the unsuccessful vote was taken many of these Congressmen wore badges reading "A Deal is a Deal", and it is hard to refute the logic of their position.

Legally, however, the thrifts that made these uneconomic acquisitions at the suggestion of the government have little ground to stand on. Richard B. Schmitt writes :

"...Law professors...[say]...that normal contract-law principles apply most rigorously in the procurement area, but that when it comes to policy matters, including the levying of taxes, the government has considerably more discretion. 'We all benefit from loopholes that at any moment may be withdrawn,' said W.F. Young, a law professor and contract-law expert at Columbia University School of Law in New York.

"A century ago, he said, the U.S. Supreme Court backed the State of Michigan, which had granted a tax exemption to entrepreneurs to build railroads in the state and then decided to tax the railroads after they were built. The court held that 'it was an inducement [sic], and that although the investors had relied on it, they could not expect the courts to hold the government to maintain a tax advantage over a period of time,' according to Mr. Young, who said the case is still good law." (WSJ, April 4 '89, A12)

The words just quoted explain what the situation is, and has been for the last century. The ability of the state to abrogate agreements that between private parties would be binding should have been drawn to the attention of the complaining thrifts by their lawyers. Like the privilege of eminent domain, this unusual power to abrogate agreements is, according to the Supreme Court, conferred upon the Federal Government by the Constitution so that the public good may always receive the first consideration. Thus, in a narrow legal sense, the unfortunate thrifts that are losing their regulatory goodwill and as a result face a capital-noncompliance shutdown have no right to complain. They

should have known right from the start that in the event of an overall thrift clampdown they could lose this goodwill.

Because the current situation is an emergency, first consideration must be given to the tasks at hand : reforming the industry and cutting losses. One must feel sorry for the unfortunate thrifts who believed that the Federal Government would honor its word. Extending forbearance to these thrifts, who provided help in the past, would under the circumstances seem the ethical thing to do.

Unfortunately, moral probity for its own sake has no more place in thrift reform than it would have in extinguishing a house fire. In this present emergency the only possible justification for being charitable--i.e. granting capital forbearance--is that such a policy would pay in the long run.

If the only reason that a thrift folds is that it trusted the Government, then the Government will be seriously disadvantaged in any future negotiations with investors, since they will be able to point to these repudiations and demand a hefty premium as compensation for the risk of abrogation. In other words, even though the Government can get away with doing this, it may not be in its best interests to do so.

However, if leniency is granted to institutions such as Talman, which are in trouble mainly because they cooperated with regulators, there is a danger that leniency may also be

shown to less worthy institutions setting the stage for large-scale losses. This is why Edward Kane opposes any forbearances whatever. ("The Unending Deposit-Insurance Mess", unpublished paper to be published in Science, p18) It may, however, be excessively rigorous to completely ban any and all forbearance.

The importance of maintaining the reputation of bank regulatory agencies as good-faith bargainers suggests that the thrifts encumbered with large amounts of regulatory goodwill should be shown some extra consideration. Provided there is strict monitoring, and provided these capital forbearances are few and far between, it might not be incompatible with the public interest to hold certain closure actions in abeyance as long as there are positive real earnings. Nor is it asking too much to expect such favored thrifts to agree to certain "belt-tightening" measures until compliance has been achieved. One's sympathy for Talman's plight is sorely tried by reports that it has continued right along to pay dividends. (NYT, Dec 6 '89, C1)

Perhaps what is called for in these cases is a set of clearly outlined criteria stating under what exact circumstances extra time to achieve compliance may be granted, and what exact operational restrictions shall apply during the probationary period. Such restrictions would typically include limits on growth, tightened rules governing new lending, and limitations on salaries

(including excessively generous severance agreements, often known as "golden parachutes"), as well as limitations on dividends and subordinated-debt payouts (interest or principal). If there were clearcut rules governing eligibility for forbearance then it would not be a discretionary favor that would give a capital-deficient thrift the right to remain open, but clearcut regulation. Kane feels that industry discipline is compromised if regulatory intervention is not certain and predictable. These objections could be largely overcome by making capital forbearance automatically available to any thrift meeting certain stringent criteria, and definitely unavailable to any thrift not meeting them. Hopefully any such codification would be so strict that only the very most deserving would receive this favorable treatment--perhaps only a dozen or two out of the several hundred insolvent S&Ls.

What Role Has Interest-Rate Risk
Played in the Crisis?

S&Ls have traditionally had dangerously high exposure to interest-rate risk. For years they were warned of the dangers of lending long and borrowing short. In fairness to the thrift industry, it should be pointed out that the chief hedge against interest-rate risk, ARMs, were not legalized until the '80s, so Congress must bear some of the blame for excessive exposure to interest-rate risk which affected the

industry. Thrifts did not lobby very hard to have ARMs legalized, however, and the industry's former influence was so great that it is probable that had thrifts strongly demanded the right the issue ARMs this would have been granted, so, to a large measure, it was the industry's own complacency that left the excessive interest-rate risk in place for so many years.

It is nearly always the case, in borrowing, that long-term rates are higher than short-term rates. Although it may occasionally happen that the 90-day rate in force at a given time may exceed the rate being earned on some of the older long-term mortgages held in a thrift's portfolio, overall the portfolio of long-term mortgages nearly always earns enough interest income to adequately cover the interest payments that must be made to short-term depositors. This, combined with the former long-lasting interest-rate stability enabled thrifts to get away with the dangerous funding mismatches that had always worried the most conservative authorities.

In the late '70s, however, this long streak of luck ran out and the long-predicted interest-rate squeeze finally did occur. Had deposit insurance been more prudently designed, or else, had capital standards been stricter, then there would have been no public crisis, for the weaker S&Ls would have been swiftly put out of business by 1982 and the extreme costs to the public which ensued would have been

avoided. Thus, it was not interest-rate risk that caused the present crisis, but the failure of ineffective safety mechanisms to shut down the thrifts whose unpreparedness for interest-rate problems rendered them insolvent. Needless to say, even though other reforms are more urgent, there is much to be gained in terms of greater industry stability if in the future thrifts are required to be better prepared for wide interest-rate swings.

What Can Thrifts Do to Protect
Themselves From Interest-Rate Risk?

If one assumes that thrifts will continue by and large to hold mortgage assets, rather than selling them, then far and away the main hope for reducing exposure to interest-rate risk will be to issue as many ARMs as possible, rather than long-term mortgages, which typically have fixed rates for thirty years. In an ARM the interest rate is adjusted at predetermined intervals, usually once a year. The borrower has the protection of a binding formula which anchors future rates to some publicly quoted rate, often the rate paid on 90-day Treasury Bills or the more slowly changing cost of funds based on deposit rates demanded in a well defined market, e.g. the State of California. Further protection is usually provided by a cap higher than which the rates may never be raised. Sometimes there is also a maximum payment which will never be exceeded no matter how high the rates go. It is possible, if rates rose high

enough, that the payment would not cover all the interest and the debt would actually increase each month, although this would hopefully be only a temporary situation resolvable either by lower rates or voluntarily raised payments. Normally the interest-rate cap would prevent this from happening. ARMs have been fairly well accepted and according to American Banker (Aug 10 '89, 5A) now account for one-third of new mortgages. According to this publication this swingover to ARMs has enabled thrifts to cut their interest-rate risk, as measured by the funding gap, to half of what it was in 1984. (The funding gap is computed by dividing the difference between current liabilities and current assets by the value of the total assets.)

If every 30-year mortgage could be matched dollar for dollar by a 30-year CD then long-term mortgages would present no interest-rate risk, since interest paid and interest charged could be matched. Since very few savers are willing to have their money tied up for so long, the only way to arrive at a closer funding match is to issue as many ARMs as possible. Unfortunately, this is easier said than done. The public is very attached to the traditional fixed-rate 30-year mortgages. S&Ls usually must offer borrowers strong incentives to get them to switch to ARMs. The main incentive is usually a substantially lower rate of interest on ARMs. Currently the difference is about 1.75%

(Consumer advisers generally consider 2% to be about the minimum difference in rates required to make ARMs the recommended choice.) Another common inducement is to make such mortgages available with very low handling fees. Unfortunately, S&Ls have been so eager to persuade borrowers to take out ARMs that they have occasionally gone overboard in offering incentives, most notably in charging below-market rates for the first year. Losses resulting from these giveaway policies do not in any way negatively reflect upon the intrinsic merits of ARMs. In an article entitled "Lenders Bid Farewell to Bargain Arms" William Celis III describes the problems lenders have had in striking a happy medium. (WSJ, June 1 '89, B1)

Although 30-year mortgages are considered risky, they have a further flaw in that the risk is lopsided. Because there is no way to abrogate the contract as long as the borrower makes his payments as agreed, when rates rise the only way for the bank to get rid of the money-losing mortgage is to sell it on the secondary markets, usually at a great discount. If, however, rates fall, and the mortgage becomes a desirable source of high interest earnings the borrower is permitted to pay it off at any time, usually with no more than a slight penalty of three months' interest or so. To remove this inequity it perhaps would be reasonable to greatly stiffen the prepayment penalty--perhaps requiring six or nine months' interest instead--and

hopefully, in addition to dividing the risk more fairly, a stringent payout requirement of this nature might provide additional incentive for borrowers to switch to ARMs. FIRREA strongly encourages the switchover to ARMs in that the newly adopted risk-related capital standards require that long-term mortgages must be backed up with a higher percentage of owner capital.

In addition to ARMs there are numerous other possible hedging practices, but none of these is likely to become widely accepted. For one thing, FIRREA only allows 30% of a thrift's assets to be non-housing related, which leaves less scope than before for hedging activities. Balderston (p161) refers, with approval, to the suggestion of Professor Paul M. Horvitz of the University of Houston that exposure to interest-rate risk be calculated and overcome by the issuance of subordinated debentures specially designed to counteract the interest-rate risk and sold only to certain sophisticated investors willing to participate in such a hedging arrangement. More publicity has been given to hedging techniques involving such types of innovative securities as the interest-rate-futures contracts sold mainly in the Chicago Futures Market. Barbara Donnelly reports that "while there are sophisticated futures and options strategies that can hedge a thrift's interest-rate exposure, the cost of using them can be prohibitive." (WSJ, Jan 27 '89, C1) Indeed hedging, which one would expect to

be praised, since it is a risk-reducer, is often, with the exception of ARMs, criticized as being outside the legitimate scope of lending institutions whose purpose is to promote home ownership. In a lengthy editorial entitled "Financial Vietnam" a certain strongly hedged thrift, Franklin S&L of Ottawa, Kansas, is condemned by the Wall Street Journal which flatly states "...there's no reason for taxpayers to subsidize a hedging operation." (WSJ, April 2 '90, A14) On April 17 '90 the Journal published a letter from Professor Pyle of the University of California, Berkely, who likewise condemns the hedging practices at Franklin, and further points out that such sophisticated schemes are a drain on regulatory manpower in that it takes considerable study for a regulator to fully grasp all the fine points of such schemes.

Since a large-scale switchover to ARMs would probably provide adequate protection against interest-rate risk, it will not likely be necessary for thrifts to use the other, more controversial hedging devices.

How Good Is President Bush's Rescue Plan?

When one considers the importance and complication of the various S&L reforms already mentioned, one can see that an effective thrift-rescue bill is a massive undertaking. Mention has been made so far of the various reforms which are deemed likeliest to prevent future problems, but prevention of future troubles is only part of the task at

hand. A good thrift bill must also set up funding and stipulate exact procedures for shutting down the hundreds of thrifts which currently are insolvent, many of them hopelessly so, and additionally must deal with the problem of how to dispose of the assets--many of them problem assets--which fall into the hands of the Government in connection with thrift bankruptcies.

With regard to future crisis prevention, experts agree that there need to be 1) adequate real-market-value capital standards and 2) reduced insurance coverage. These are the two all-important changes that are emphasized by virtually all experts. The imposition and strict enforcement of reasonable real-market-value capital standards (even at a level of 1.5 or 2%) would prevent a recurrence of heavy taxpayer loss since strict enforcement of such standards would ensure that foundering S&Ls would be shut down while still possessing enough net worth to pay off depositors. Insurance phase-down would also prevent a recurrence of trouble since it would make it impossible for unsound thrifts to raise money. This remedy has the further advantage of being less expensive to implement and monitor. All the government would need to do would be to announce the new coverage rules and savers and investors would do the rest. There would, however, have to be ongoing monitoring of the effectiveness of the terms in force, in response to changing market conditions, particularly with a view to

preventing irrational bank runs. Since these two recommendations do not clash with each other, and have been so emphatically stressed by commentators, any plan which includes both of these remedies should be considered likely to succeed. The Bush Plan is incomplete at present in that it does not adopt insurance reform. It does, however, make provision for bringing in such reform very soon, pending the April 1991 report of a committee especially set up to study bank insurance. This being the state of affairs, FIRREA may be described as a very good first step. Although it may prove difficult to raise the required tangible capital to a level higher than 3%, stronger real-equity levels can probably be attained by making further accounting changes in future revisions of the Act, the likeliest change being a requirement that mortgages be carried at market. FIRREA does unquestionably have many shortcomings, but in spite of this it is a vast improvement over the previous state of affairs. What is important is that at long last thrift owners will be required to have some of their own money at stake, with no more accounting gimmickry being available as a means to evade this requirement. Hopefully insurance reform will be promptly adopted as well. Thus FIRREA, even in its present flawed state, goes a long way toward preventing any repeat of the unsound practices which led to the crisis.

Professor Edward Kane, in the article "The Unending Deposit-Insurance Mess" (pp18-20), decries the continuing danger of forbearances and political interference. Banking authority George Kaufman concurs regarding forbearance. He suggests that well before insolvency is reached regulators be absolutely required to forbid further dividend payments and additional loans. (NYT, Aug 17 '89, A18) An even more sensitive issue is that of political interference in thrift affairs. There has been much public indignation at the efforts of a certain group of senators known as the Keating Five and House Speaker Jim Wright to obtain forbearance for certain insolvent S&Ls. Professor Kane recommends requiring all politicians who intercede with regulators on behalf of any S&L to report their actions to the ethics and banking committees so that from time to time determination can be made whether any of these actions were unethical in any way, the likeliest impropriety being the acceptance of personal gifts or excessively generous campaign funding from the favored S&L. The mood of voters is particularly restive on S&L matters. Representative St. Germain was voted out of office for alleged S&L improprieties, and Senator Cranston (D-CA), who interceded for the notorious Charles Keating, is considered certain to lose his seat in the next election. The other four members of the Keating Five, Senators McCain (R-AZ), DeConcini (D-AZ), Riegle (D-MI) and Glenn (D-OH), did not receive anywhere near as much campaign funding from

Keating and are not blamed as much as Cranston for getting regulatory favors for Keating. Although they are not politically crippled by the affair to the same extent as Cranston, the incident is a profound embarrassment to all of them. The RTC considers continuing political interference to be enough of a threat that it is considering keeping a log of all enquiries made by politicians about the regulatory treatment of any particular S&L, with special reference to sale of assets--which was a common problem in the HUD scandals. (WSJ, Nov 6 '89, A18)

Despite certain ongoing weaknesses, such as those raised by Professor Kane, FIRREA is generally considered a promising beginning as regards prevention of future problems. Where FIRREA has been much less successful is in meeting the more immediate challenge of shutting down the insolvent thrifts and efficiently disposing of the seized assets. The two main problem areas needing amendment are 1) an unwieldy structure of authority for thrift liquidation and asset disposal and 2) inadequate funding. On May 23, 1990 Treasury Secretary Brady advised Congress that only with a vast increase in funding can the problem thrifts be dealt with. This new governmental frankness about the cost of the crisis offers hope that inadequate funding may not long remain a problem.

The structural problem that has most slowed down the first year of cleanup operations has been the existence of

an overly powerful oversight board consisting of representatives of the Treasury, HUD, and the Federal Reserve Bank. Such a division of power invites turf battles. The Resolution Trust Corporation (RTC), which is responsible for thrift liquidations and asset dispositions is managed by FDIC but must also report to the Oversight Board, which has the power to veto directives issued by FDIC. According to William Isaac, former chairman of FDIC, "The existence of the Oversight Board diffuses responsibility. There is no one to blame because it is a committee. It allows the Treasury to blame the FDIC and the FDIC to blame the Treasury, the Fed to duck responsibility and all of them to blame the Congress." (NYT, Feb 10 '90, p1) In a similar vein Paulette Thomas complains that those who designed the bailout "sprinkled responsibility across the government, giving half a dozen top officials a role, but giving no one the final word. The bailout lacks one 'czar' to direct the charge, set the pace and resolve conflicts. The zeal to have prudent supervision has instead meant that the buck stops everywhere." (WSJ, Oct 11 '89, A20) In early February 1990 the president of the Oversight Board, Daniel P. Kearney, resigned complaining that he found the constant interference from the Treasury to be intolerable. Subsequent reports indicate that the Treasury, sensitive to this criticism, has lessened its involvement in RTC affairs, but since no changes were made in the basic

structure of command the potential for power struggles still exists. Although the Treasury Department was criticized as the main source of trouble in the controversy just described, there is no reason why HUD and the Federal Reserve could not just as easily find themselves at cross purposes with the RTC, given the right developments. These problems were deemed important enough to merit front-page coverage by the New York Times. (March 13 '90) The Office of Thrift Supervision (OTS) is the normal regulator of thrifts. Like its banking counterpart, the Comptroller of the Currency, it is answerable to the Treasury. So far this arrangement seems to have gone smoothly enough. The RTC is operated by FDIC which also administers the Savings Association Insurance Fund (SAIF), and there are no reports of administrative tangles among OTS, SAIF, FDIC or RTC. RTC has the privilege of regulatory override over OTS if it perceives a safety-and-soundness concern likely to result in losses to SAIF. Because it has this override, one would have thought RTC-OTS turf wars to be the likeliest source of trouble, but so far the two agencies have been models of cooperation. Despite the frustrating ambiguities inherent in such a labyrinthine arrangement, most of the inter-agency relationships seem to be quite good.

Occasionally one encounters the opinion that FDIC is being spread too thin. The \$2.3 trillion banking industry has problems of its own--in fact FDIC is itself bankrupt or

nearly bankrupt--and taking care of thrift liquidations and asset dispositions is considered by some to be a dangerous distraction from the agency's primary responsibility of monitoring the banking industry. This concern, though valid, has not been very widely expressed, and it appears that so far, at least, FDIC has been able to take on its new thrift duties without compromising its effectiveness in carrying out bank responsibilities.

Although not as grave a worry as inadequate funding or poor interagency structures, there has been a problem of excess red tape with regard to real-estate dispositions. The rigid rules regarding real-estate pricing and bidding procedures are probably the direct result of HUD scandals. There has also been some understandable worry about depressing certain markets by suddenly dumping large amounts of real estate. These concerns resulted in a rule that no real estate could be sold for less than 95% of the appraised value. It is evident from the slow pace of sales, however, that most of the appraisals are unrealistically high. Furthermore, it is estimated that holding a property for one year costs the government about 15% of the market value of the property. The high holding costs and the low pace of sales have resulted in an about-face on the 95% rule, and sales will now be made in many cases at much lower prices. (WSJ, April 26 '90, B11)

In an article entitled "RTC Should Turn Its Fire Sale Over to Pros" (WSJ, Feb 27 '90, A24) Ronald Utt, vice president of the National Chamber Foundation, expresses doubt that RTC has the selling skills needed to complete advantageous deals. He in particular decries the piece-meal sale of individual assets which is extremely inefficient in terms of transaction costs both to seller and buyer, and points out that costs could be minimized by selling properties in homogeneous bundles, e.g. motels in Texas, apartment houses in Arizona, etc. Martin Mayer (WSJ, Nov 17 '89, A14) likewise emphasizes the need to bundle similar properties together for efficient sale.

Another suggested change in sales policy would be a slight softening of the ethics guidelines that prohibit awarding any contracts to any real-estate companies that have in the past been involved in any transactions resulting in a loss to the Government of \$50,000 or more. (WSJ, Feb 5 '90, A16) The unavailability of real-estate agents and developers with perfectly clean records is particularly severe in certain cities. For example, RTC holds, or soon will hold, over 40% of the property in Colorado Springs. Virtually every major developer in that city has been involved in at least one questionable S&L deal. (NYT, Jan 16 '90, C1) Although justice, and the need to set an example, demand that the most egregious offenders continue to be blacklisted, in a situation such as the one in Colorado

Springs practicality will necessitate overlooking past offences which were comparatively minor. Suggestion has been made that only those individuals or agencies whose actions, were fraudulent should continue to be blacklisted. (WSJ, Feb 5 '90, A16)

In view of the large number of problem areas connected with sales of assets it must be admitted that FIRREA has overall been unsuccessful as a plan for shutting down thrifts and disposing of assets. However these problems are being corrected. Its current lack of funding is soon to be remedied. Complaints about excessive red tape are resulting in some streamlining of sales procedures. Unfortunately the problem of excessive decentralization of authority does not so far show any sign of being corrected. As a preventer of future losses FIRREA may be deemed a greater success, particularly since it is anticipated that a revision in 1991 will bring in deposit-insurance reform. FIRREA already has resulted in far greater industry discipline since it brings into force fairly demanding market-value capital standards. Many further reforms are possible, and desirable, but since these two are far and away the most important FIRREA is successful as a preventer of future unsound practices. Considering all of these points, it is probably safe to say that FIRREA is a success, but a very flawed success. The political will to have a really strong and effective bailout bill exists now as never before, so the prospects are quite

good that within a year there will an amended FIRREA which hopefully will iron out most of the problems existing in the present bill.

The On-Budget-Off-Budget Debate

The United States has a dangerously high deficit which has expanded to the point that the United States is now a net debtor nation and Americans are therefore gradually becoming economically answerable to the wealth-holders of other nations. To reduce this problem Congress passed the Gramm-Rudman-Hollings (GRH) Bill which stipulates that the budget deficit must attain certain targets year by year and by 1993 the budget must be completely balanced. When the targets are not met the Bill requires that there be pro rata across-the-board spending cuts. Because the thrift crisis is hopefully a one-time event, argument is made that bailout spending should be kept off the budget altogether, or else, if that is not possible, such spending should be specifically exempted from GRH calculations.

In an eleventh-hour compromise, \$30 billion of the \$50 billion approved in August 1989 was kept off budget by stipulating that the money would be raised by special bailout bonds issued by a newly set up corporation, the Resolution Finance Corporation (Refcorp). The annual interest on these bonds will be paid by the Federal Government and will be included in the annual budgets as regular spending. The "on-budget" faction points out that

Federal debt is cheaper than agency debt such as the bonds issued by Refcorp. (For example, in early July 1990 Treasury Bills were only yielding 8.54% while Refcorp bonds were yielding 8.93%.) Opponents of agency financing calculate that over the next thirty years between four and five billion dollars will needlessly be paid out in interest because of the use of Refcorp. The "off-budget" faction disputes that the cost difference will really be that great and insists that even if true it would be well worth the cost to maintain GRH discipline. The same debate applies to the raising of working capital for the RTC. Because any funds advanced for working capital would be quickly repaid pending the sale of seized thrift assets, there is not likely to be much objection to keeping such funding either off-budget or else exempted from GRH.

According to some authorities the "on-budget" advocates err in not acknowledging that a swelling of Federal Bonds outstanding would drive up interest rates on these instruments and perhaps this slight bailout-induced push, when applied to the vast Federal debt to be issued and rolled over, would result in increased interest expense that would go a long way toward wiping out the savings achievable by using Treasury debt instead of Refcorp debt. According to Nathaniel C. Nash, "One Treasury official calculated that if the Ways and Means [i.e. on-budget] proposal caused interest rates on new Treasury issues to rise one-hundredth

of one percent, or one basis point, the Government's borrowing costs would rise more than \$280 million annually, more than canceling any taxpayer savings." (NYT, May 10 '89, C2) Professor Robert Haney Scott of California State University concurs that all new Treasury debt would likely have to pay one extra basis point wiping out any interest savings applying to the thrift bonds. (NYT, April 15 '89, p14) Not all experts hold this view, however. Both Bert Ely and Professor Kane, for example, maintain that Refcorp financing really does result in greater overall interest expense. Since there is no proof either way, the truth likely lies somewhere between the two extremes.

However debatable the claims of the "on-budget" advocates may be regarding interest savings, they are certainly correct when they point out that the on-budget treatment gives a more realistic portrayal of economic reality. The Federal Government really does owe all the bailout money borrowed from the public, and there is no use pretending it does not. The de facto deficit is going to be the same no matter how the debt is disguised.

Perhaps this is merely a case of de gustibus non est disputandum. What has been so unfortunate about this emotional debate is the fact that it has been, and continues to be, a terrible legislative distraction and was largely responsible for the unconscionable six-months' delay in passing President Bush's February 6, 1989 initiative.

It does not much matter how the money is raised. An on-budget approach has the advantage of being more candid. If the bailout were for certain an event of a one-time nature, then there could be some justification for exempting S&L spending from GRH calculations, but this is not really the case for although the thrift crisis is probably a one-time crisis, there have always been and always will be numerous one-time crises which must be dealt with by the Federal Government. Now it is the thrift crisis that demands funding. In a year or two it could be nuclear-waste cleanup or some other equally expensive problem. However one may try to disguise the facts, debt is still debt, so strictly speaking it is hard even to justify the proposed GRH exemptions.

It could well be that a bailout income-tax surcharge spread over a number of years would be the best solution, if the surtax could be imposed without causing a recession.

Whatever financing decision is made, the essential thing is that funding not be held up. This is the perfect example of the old management adage that sometimes the wrong decision made promptly and decisively is better than the right decision made slowly and uncertainly.

Is It Appropriate For the Thrift Bailout
To Concern Itself With Housing for the Poor?

There can be little doubt that there should be at least some consideration shown for providing housing for the poor

in the bailout effort. For the sake of efficiency it is always a good idea to "kill two birds with one stone" whenever possible. It makes little sense for the government to sell RTC-managed apartment houses for pennies on the dollar and then turn around and build low-income housing at exorbitant cost. Nor does it make economic sense for the government to hold on to vast surpluses of housing properties, at an annual carrying cost of about 15%, if the surplus could be relieved by selling the properties at fair but attractive prices to the working poor. It has always been government policy to relieve the problem of agricultural surpluses by giving surplus food to the less affluent, or at the very least selling it to them very cheaply. In private business as well one occasionally hears of donations of surplus goods to charity. So long as the cheap sale of surplus housing to the poor does not inflict materially greater cost on the bailout such activity is consistent with general business and government practice, and the OTS has already authorized the donation of certain hard-to-sell properties to charities and local governments for social purposes such as day-care centers and shelters for the homeless.

However, if concern for the poor were to divert too much RTC attention away from S&Ls, or result in cheap sales of properties that could bring good prices, then such activity would be inconsistent with general business and

government practice and ought to be avoided since FIRREA is a thrift-bailout bill and not a welfare bill. FIRREA will stand a far better chance of success if it concentrates on thrift problems instead of trying to address a host of other social and consumer issues. Furthermore, it is not fair to these other issues to only address them "on the coattails" of other programs and legislation. If social and consumer issues have any real importance then they deserve their own legislation and administrative programs.

Virtually all of the experts largely agree with this point of view. A typical comment may be found in an editorial in the New York Times, a publication normally sympathetic to social causes : "Low-cost housing is a worthy purpose, but adding it to this bill distracts from the problem at hand." (NYT, May 1 '89, A14)

One social abuse likely to be closely monitored henceforth is red-lining, i.e. the practice of drawing a red line, on a map, around slum and near-slum neighborhoods, as an indication that no loans are to be approved for properties within the ostracized neighborhoods. On Feb. 16, 1989, Jack Kemp, the Secretary of HUD, decried the practice and insisted that any bailout legislation should stipulate that this practice be ended. (NYT, Feb 17 '89, p29)

Mr. Kemp's permanent seat on the Oversight Board gives him sufficient influence to enforce this view. Politician Jesse Jackson has also spoken out against red-lining. (NYT, Feb 8

'89, p30) Loan managers, of course, know all the neighborhoods in their communities, even without consulting any maps, and, unfortunately, there will likely continue to be some discrimination based on irrelevant social and racial differences rather than legitimate credit factors, although hopefully the publicity given to the abuse of red-lining will reduce the incidence of this unfortunate practice.

In summary, then, it may be stated that the enormity of the thrift clean-up task precludes diverting too much attention to related social issues. Red-lining, because of negative publicity, will now be less flagrant. In communities where there are numerous RTC holdings, non-thrift-related agencies will likely be set up to purchase bundles of housing properties for the purpose of reselling these to qualifying low-income citizens. Occasionally there will be gifts of problem properties for such purposes as day-care centers and homeless. It will be to the advantage of the bailout effort to make such nonprofit sales and gifts since such actions will result in lower carrying costs and are consistent with common business and government practices regarding social and charitable disposition of surplus inventory. It has been suggested that low-income borrowers be granted lower mortgage rates. There is virtually no expert support for such subsidization programs which do not in any way benefit the bailout process and therefore are extraneous to any thrift cleanup efforts. Many

Many commentators, including Brumbaugh, Bryan, Kane and Ely, do not mention social issues at all.

Who Have Been the Main Players

In the Thrift Crisis?

The main player, and chief casualty of the crisis was M. Danny Wall, the last director of FSLIC and the first director of OTS. Demands for his resignation were centered on three main criticisms. First of all, he approved a number of deals in December 1988 which were widely and somewhat unfairly criticized as being overly generous. Second, he caved in to pressure from Charles Keating and removed the San Francisco examiners from the Lincoln examination, putting that S&L under direct Washington, D.C. supervision. This criticism also may be somewhat unfair in that FHLBB counsel Rosemary Stewart had advised Wall that Keating was in a strong legal position to fight orders given by the San Francisco office. In a Dec. 5, 1989 letter to the Wall Street Journal (page A23) Mr. Wall pointed out that "there were insufficient legal grounds back in May 1987 to put Lincoln in conservatorship, despite the recommendation for such action from the San Francisco examiners. My predecessor did not act, and by the time I became chairman, the information based on the 1986 exam was stale." The third criticism of Mr. Wall was that he consistently underestimated the cost of the crisis--possibly to help Republicans in an election year. For this deception--or,

equally bad, ignorance--there can be no excuse, and Robert Litan of the Brookings Institute probably speaks for the majority of informed observers when he condemns this as Mr. Wall's worst failing : "I think the Lincoln affair is a relatively minor matter. The much greater sin, the much greater cost, was underestimating the size of the problem." (NYT, Dec 5 '89, A1)

In March 1988 Mr. Wall estimated that the crisis could be resolved for \$17 billion. In April he raised his estimate to \$23 billion and in July he raised it to \$31 billion. Until the election in November, Mr. Wall maintained that the thrift industry could pay for the bailout without outside help, mainly by means of higher insurance premiums. (WSJ, March 22 '89, A2) On Dec. 16, 1988, after the election, he began an about-face on the issue of a public bailout by making a far more limited claim, only that no taxpayer help would be needed in fiscal 1990. (NYT, Dec 17 '88, p17) Compared to contemporary estimates made by all outside experts, all of these estimates were ridiculously low. Kathleen Day writes scathingly of Wall in an article entitled "When Hell Sleazes Over (Judgment Day for S&L Slimeballs)". Despite its vivacious writing style this article is mainly only a review of what others have said all along. She lambasts Wall, strongly implying deliberate deception : "Why would Danny Wall downplay the crisis to the extent of undermining his

own credibility? Here's a hint : he quit doing it shortly after the presidential election; suddenly, with George Bush's victory secure, Wall's S&L cleanup estimates miraculously matched the Treasury's much more alarming figures." (New Republic, March 20 '89, p26)

Mr. Wall offers an extremely weak defense of this behavior : "We did not cry fire in a crowded theater, of that we're guilty. They gave us a Band-Aid and said take care of it until 1989. That's what we did." (WSJ, May 1 '89, A16)

The question may be put "what other choice did Mr. Wall have if his political superiors were pressuring him to downplay the crisis?" The answer, of course, is he could have resigned. He ended up having to resign anyway, and had he done so on a matter of principle, there would have been far less damage to his reputation and probably his career.

M. Danny Wall took charge of the FHLBB at an impossible time. No one could have succeeded. But to make the best of a bad situation he should have made a protest resignation rather than cooperating with a "don't-make-waves" policy that he should have known was sure to backfire.

If the S&L crisis was the undoing of Mr. Wall, it brought considerable praise and honor to Mr. Wall's nemesis, Texas Representative Henry Gonzalez, a Democrat. Mr. Gonzalez' impressive performance as head of the House Banking Committee proved to be something of a surprise

since, according to the New York Times (Nov 11 '88, p29) he had formerly been a "less-than-engaged member of the [banking] committee...not versed on the intricacies of banking law." The Wall Street Journal's description of Mr. Gonzalez as a "touchy eccentric" (July 19 '89, A16) makes his success even more to be wondered at. Although he was disappointed on one issue long dear to his heart, major subsidization of housing for the poor, he was successful in fending off thrift lobbyists who wanted to weaken many of the requirements of FIRREA. A fitting testimonial was given by Representative Jim Leach (R-IA) : "You have enormous antagonism towards Gonzalez, but my own view is that for all his faults, public policy is well served by his persistence." (NYT, Nov 12 '89, Sec 3 p4)

Another individual who received much favorable publicity because of the crisis is William Seidman, head of FDIC and chairman of SAIF. Mr. Seidman has also received considerable criticism by some who regard him as a publicity-seeker and not a good team player. Although President Bush does not have the authority to ask for Mr. Seidman's resignation, he has clearly shown that he would like to receive it by publicly announcing who Mr. Seidman's successor will be. Because the septuagenarian Mr. Seidman has a long, excellent record as a bank regulator, he enjoys great favor and influence with Congress, which by no means shares Mr. Bush's cool sentiments towards Mr. Seidman. In

fact twenty-three members of the House Banking Committee effectively chastised Mr. Bush in the Seidman affair by sending Mr. Bush a letter warning him not to pressure Mr. Seidman into resigning. The general opinion of Congress was well expressed in the remarks of Henry Gonzalez who said, "The Administration will be foolish to let the services of Bill Seidman slip away just because his straight talk ruffles some political feathers. Seidman has great credibility with members of Congress and the American public. The Administration will be in dire need of all the credibility it can muster in coming months as the costs mount for taxpayers." (NYT, May 2 '90, A1) Influential House member, Charles Schumer (D-NY), recently wrote in the New York Times, "I recommend to Mr. Bush that he make a very humble phone call to..L. William Seidman..and beg him to remain in his job....Mr. Bush ought to realize--fast--that he cannot afford to lose him." (NYT, July 24 '90, A15) Mr. Seidman's great influence with Congress was used during the shaping of FIRREA to ensure that the bill would expedite sound banking, and according to some, also to ensure that Mr. Seidman would have as much authority as possible. According to Bert Ely, "What Seidman has been doing is trying to grab as much power as he can. It's a story of bureaucratic aggrandizement." (See Mahar, Barron's, Sept 11 '89, p22.) According to American Banker, "People are just fed up with what they regard not as legitimate policy

differences but as an ego trip." (July 10 '89, p1) Although comments such as these are negative, they in no way suggest incompetence or ethical impropriety. Furthermore, it must be acknowledged that many of the most talented people, if not exactly eccentric, at least may be considered "characters". Perhaps Mr. Seidman is one of these. In any case, it is hard to sympathize with the administration's coolness to Mr. Seidman when one reads that "Through months of frustration and provocation, Seidman has never lost his political cool--even when he couldn't get an audience with the President. Several months ago he apparently asked to meet with President Bush to warn him that the problem was ballooning. His request was turned down, according to the National Journal, a Washington-based publication." (See Mahar, Barron's, April 30 '90, p11) No matter how busy the President may be, it is deeply disappointing that he would not meet with the person most central to the cleanup of the greatest financial crisis of the last half-century, the very crisis upon which he is blaming his volte-face on the no-new-taxes pledge. In summary, then, it may be said that it appears that William Seidman has some personality characteristics which make him appear egotistical to some, but according to many observers he is, with his long successful record, by far the best qualified person in the nation to manage the bailout. Hopefully he will receive

full support until he himself decides to retire---which may not be for another year and a half.

Not yet fully deserving inclusion on this list is Neil Bush, youngest son of President Bush. Apparently Neil Bush's conflict-of-interest improprieties at Silverado were fairly minor, and owing more to naiveté than dishonesty. Nevertheless, because he is the President's son he is susceptible to being negatively exploited in thirty-second "sound-bite" political ads. The Democrats are still smarting from what they regard as the unethical use of such negative ads in the campaign against Dukakis, in particular the "Willie Horton" ad which suggested that Dukakis was soft on crime. Depending on what the Democrats are able to come up with regarding Neil Bush, they may be able to launch a negative "thirty-second-spot" ad campaign of their own. Mr. Seidman has still not decided whether SAIF will bring a civil lawsuit against Neil Bush. Even if this were to occur, by no stretch of the imagination can Neil Bush be considered one of the major players in the crisis, but in spite of this, he may become one of the best known.

If the S&L crisis has a villain it is Charles H. Keating, Jr. Lincoln is only one of hundreds of insolvent S&Ls, and it is very unfair to try to make Keating a scapegoat for the whole crisis. Although the Lincoln failure is expected to be the costliest at \$2 billion, there are several others that rival it, most notably Sunbelt of

Dallas, and Centrust of Miami, at about \$2 billion and \$1.7 billion respectively. Like Lincoln, both of these thrifts have been brought to ruin by unethical managers. The President of Sunbelt, Edwin T. McBirney III, has been indicted on seventeen counts of bank fraud. The president of Centrust, a certain David Paul, is no less a person of notorious reputation, having lived a sybaritic existence complete with a painting by Rubens provided for his personal delectation by Centrust. However, neither Mr. McBirney, nor the pampered Mr. Paul can begin to arouse public ire as Charles Keating can. Keating has been so flagrant, so brazen, so materialistic, and so hypocritical that he has come to symbolize all the S&L evils. Keating's excessive materialism unmistakably reveals itself in the Phoenician Inn, a hotel erected by Keating in suburban Phoenix which is lavish almost to the point of vulgarity. He used insured deposits to pay his 26-year-old son a salary of nearly a million dollars a year. (See Zuckerman, U.S. News and World Report, June 18 '90, p92.) He is an avid and outspoken religious fundamentalist and yet he has a long history of deception and shady dealings. (See Stein, "What Investors Never Knew--Ugly Facts About Charles Keating Were Not Disclosed", Barron's, April 16 '90, p6.) Constantly suing regulators and threatening to sue them, he cowed all but the most stalwart. Not only was he a master of intimidation tactics, he also knew how to use the power of the purse,

donating millions to politicians at all levels of government (See Borger, "The Man Who Tried to Buy Washington", U.S. News and World Report, Nov 27 '89.) Mike Patriarca, the San Francisco regulator who was removed by Mr. Wall from the Lincoln audit has said, concerning the efforts of the Keating Five, "I can tell you for a fact there aren't any of the largest banks in the country who can get two senators in a room together to argue with its regulator about the examination. I think that this meeting is an example of some extraordinary political influence, the likes of which I've never seen in my career." (NYT, Nov 4 '89, p1) When asked once whether he thought his money affected the actions of politicians Keating replied, "I certainly hope so." When former FHLBB chairman Edwin Gray started to be an inconvenience, Keating unsuccessfully tried to get rid of him as a regulator by hiring him for \$300,000 a year. (NYT, Nov 9 '89, A1) Keating continues to give interviews, even with national publications such as Time (with Margaret Carlson, April 9 '90) and the Wall Street Journal and in an affable and disarming style, which no doubt dupes many of the uninformed, he portrays himself as the innocent victim of vindictive regulators.

There is no disputing the fact that operators such as Keating are unlikable, ruthless and difficult individuals, but it misses the point to blame the crisis on these fast operators. That type of person is always going to exist in

society, and perhaps these people really cannot help being the way they are. If this is true, there is no use blaming them--the fault is society's for negligently allowing conditions to arise in which these people can so freely pursue their predatory impulses. Fraud and embezzlement must be punished if social order is to be maintained, but the search for industry improvement must be based on improved structure and regulation rather than hoped-for changes in human nature.

If Charles Keating is the main thrift villain, the main thrift hero--and martyr--has been former FHLBB chairman Edwin Gray. In sharp contrast to Danny Wall, who cooperated with Keating, Gray fought him fiercely. Mr. Gray's few detractors point out that he made his share of mistakes in his years as chairman, but his host of admirers paint a portrait of an extremely concerned and sincere individual whose inconvenient penchant for telling the truth earned him nothing but scorn and animosity. Mr. Gray a number of years ago gave realistic estimates of the size of the crisis. According to his friends, the burgeoning crisis became a personal obsession and he would talk about it on the 'phone late at night for hours on end. He became more and more frustrated as the political cooperation necessary for a clampdown was persistently withheld. According to Nathaniel C. Nash, "Mr. Gray, an advocate of strong regulation, was pressed by the White House chief of staff, Donald T. Regan,

during the Reagan Administration to resign, but he did not. When his term expired in June 1987, he was not renominated." (NYT, Nov 8 '89, A1) Whatever mistakes Mr. Gray may have made in his career, of one thing there can be no doubt : he is a man of exceptional character. The normal reaction to such a lack of appreciation would be to say, "To heck with them! I tried to tell them but they wouldn't listen! Let them find out the hard way!" And when one considers that at the very time there was this frustrating lack of appreciation, Charles Keating was waiting with open arms and an offer of \$300,000, it becomes plain that Mr. Gray-- regardless of his technical skills as a banking regulator-- is clearly a man of the highest principles. Studying the S&L crisis can leave one with a deeply pessimistic impression of human nature. It is certainly refreshing to learn about someone like Ed Gray. Some feel Mr. Gray's virtues have been somewhat exaggerated, but none will deny that this public servant, unappreciated and unpopular as he was, has long since been vindicated.

The same favorable comments cannot be made about the United States League of Savings Institutions, which has come out of the crisis as one of the most detested organizations in American business. The hatred now felt for the League is so intense it sometimes verges on paranoia. An editorial in New Republic entitled "S&L Hell Revisited" declares that lobbyists from the League "should be treated literally as

untouchables; any member of Congress who so much as has lunch with one of them should be publicly flogged.." (June 26 '89, p7) Eric Hemel, of First Boston Corporation, says, "After it stops breathing I'd wait 10 minutes before I declared the league dead." (WSJ, March 7 '89, A1) All S&Ls under the control of RTC are forbidden to belong to the League. (NYT, July 4 '89, p29) Because until the recent past nearly all thrifts have been members of the League, and because S&Ls have been prominent and influential businesses in nearly every community, the League has in the past enjoyed great influence with politicians, and this influence has been strengthened by the efforts of well financed thrift lobbyists, the most notorious of whom was a certain Mr. J. Freeman, better known as "Snake" Freeman. The League until very recently was so influential that for all intents and purposes it wrote its own regulatory legislation and named its own regulators, which resulted in an unhealthy close "revolving-door" situation reminiscent of similar problems which occurred a few years ago in the procurement department at the Department of Defense. Because the same people shuffled back and forth from executive positions in the League to executive positions in the FHLBB and state agencies, strict, disinterested enforcement was compromised. Former Comptroller of the Currency John G. Heimann has said that "the regulators [of the thrift industry] were closer to

the regulated than in any other industry in America." (NYT, June 6 '90, A1)

Because the League campaigned for, and received, many lenient regulations it has now been held to account as one of the major contributors to the thrift crisis. When the chairman of the League attempted to make a suggestion at bailout hearings he was bluntly told by one senator, "You have no credibility here today." (NYT, March 8 '89, p29) Occasionally a commentator describes the League as "still-mighty", "still-powerful" or "not to be underestimated"; the fact of the matter is that it is now thoroughly discredited and its influence is greatly on the wane. To the amazement of many long-time observers the League was not able to exert much influence on FIRREA. Robert M. Garsson describes the rescue as "historic not only in the size of the problem it addressed but in the way it brushed aside the lobbying efforts of the once-powerful thrift industry." (American Banker, July 31 '89, p12) Hopefully the League will be able to rehabilitate itself and earn the respect of the financial and general community, so that it can in the future play a more positive liaison role between the industry and both the government and the general public.

The thrift crisis is so dispersed and so vast that it cannot be fairly represented by these few individuals along with this one organization. However the individuals and organization just described have to a great degree captured

the imagination of the public and symbolically at least may be considered the principal players in the crisis.

Should the Government Renounce the

"Give-away" Deals Made in 1988?

Although some of the sales of government-held thrifts in December 1988 were unduly favorable to the buyers, and aroused a furor in Congress, few commentators recommend abrogating these sales. Most observers feel that to do so would be counter-productive since future thrift buyers would not trust the government and would therefore not be willing to deal with it. With fewer interested buyers sales would have to be made at extremely low prices and this would cost the government more than it could gain by renegotiating the December 1988 deals. With this in mind Comptroller General Bowsher suggested that when possible unfavorable terms should be renegotiated and yet "stopped short of advising Congress to cancel the contracts, saying that would set a dangerous precedent." (NYT, March 13 '89, p25) Nathaniel C. Nash writes, "Few in and outside Government actually believe Congress or the President will abrogate the contracts signed in 1988 with investors. They warn that such an action would set a very bad precedent, severely disrupting confidence in the validity of Government contracts." (NYT, Feb 11 '89, p18)

Even if abrogation were a viable alternative, however, it is doubtful whether a cancellation of these sales would

put the government in much better a position with regard to S&L dispositions. Those who condemn Mr. Wall and his staff for the supposedly bad deals which they struck forget the terrible conditions under which the Bank Board labored. The FHLBB had virtually no money and the thrifts that needed to be sold had a negative net worth, i.e. money had to be spent on them before any rational buyer would consider purchasing them even for a price of one dollar. Since the FHLB did not have the cash to bring the seized S&Ls up to a saleable condition, the only way they could dispose of these thrifts was to make whatever concessions they could to compensate the purchasers for whatever expenditures would be necessary to bring up to zero the net market value of the purchased institution. Far and away the strongest selling point available to the FHLBB was the 100% transferability to the purchaser of the past taxable income losses of the purchased thrift. The tax code only allowed this lucrative tax break until December 31, 1988, so it is not surprising that there was a flurry of sales late in 1988.

Although these sales were condemned as give-aways, once this tax break expired very few additional purchasers came forward. Therefore actual market experience has shown that generally speaking the terms of those sales were no more favorable than what was necessary to make the sales. There was, however, one deal that was exceptionally unfavorable---

the sale of First Texas Gibraltar S&L to Ronald Perelman.
According to William E. Sheeline :

"Perelman invested \$315 million, \$155 million of it borrowed. Less than a week after closing the deal, he sold \$2 billion of the thrift's assets for a loss, mainly mortgage-backed securities. One investment banker familiar with the transaction estimates that this generated about \$200 million of losses for tax purposes. The red ink saved Perelman \$135 million of tax he otherwise would have had to pay. That's an 84% return on his equity capital in the first ninety days of the deal. Does he face any risks on the transaction? Says an expert: 'The only one is that he can't run an S&L on a 250-basis-point spread, which is unlikely since even the mediocre guys can make a buck on a 100-point spread.'" ("The Screwiest S&L Bailout Ever", Fortune, June 19 '89, p122)

There can be no excuse for careless deal-making such as this. Fortunately it appears to be the only really scandalously bad large-scale deal, so there probably would be little economic justification for a blanket renunciation of the December 1988 agreements.

One exception, however, may be the sale of Bluebonnet S&L of Dallas to James M. Fail of Phoenix for \$97 million less than the highest bid. Senator Metzenbaum (D-OH) has made this particular sale a cause celebre. The FHLBB apparently was so busy in December 1988 that it did not adequately check Mr. Fail's background, which includes a 1976 admission of fraud on the part of a company owned by Mr. Fail, admitted by Mr. Fail, and in the same year a personal indictment of fraud, later dropped, but not mentioned by Mr. Fail in his application. Since Mr. Fail

was a staunch financial supporter of the Republican party there is at least some appearance of impropriety in his having obtained the thrift despite the existence of a much better bid. Bluebonnet has been highly profitable and has already received a \$250 million installment of bargained-for federal aid. Although the loss to the taxpayer will be far less than in the Perelman deal, the ethics problem, particularly the concealment of past fraud, makes the Bluebonnet deal a likely candidate for reversal, and such action would probably be well accepted as fair by the business community, and therefore would not undermine the Federal Government's reputation as a bona fide bargainer.

Considerable controversy has also been expressed concerning many of the guarantees and concessions granted in the late-1988 deals. These include indemnification of any clean-up expenses in the event that any of the S&L properties are found to be contaminated with toxic waste (WSJ, Jan 13 '89, A1); a 10-year guarantee of a minimum stream of profits on designated thrift properties (NYT, March 11 '89, p7); permission to open a new thrift to which nonperforming assets could be transferred--the idea being that the new thrift would soon fold and become the responsibility of the government, leaving the original thrift with its selected assets unaffected by the losses at the newly created thrift (WSJ, Jan 23 '90, A18); guarantees against losses in performing assets caused by adverse

movements in interest rates (See Stein, Barron's, Feb 20 '89, p7); the issuance of high-yielding promissory notes, usually of a ten-year duration, to purchasers to cover the negative net worth of the thrift being sold.

Although the slow pace of sales in the past year and a half suggests that these controversial bonuses may have been necessary to attract buyers, there is no ethical reason why the thrift agency, now much better funded, should not improve its position as much as it can. Congressman Schumer has pointed out that if the Federal Government were to explicitly back only certain notes (presumably those paying less interest) then all the other notes would plunge in market value enabling the Government to retire them through open-market purchase. (WSJ, Feb 15 '89, A3) Such unusual guarantees as indemnification against toxic-waste cleanup are unlikely to result in inordinately great expense for the Government and perhaps are acceptable public policy if they expedite sales. Nor are the pocket charters which were granted likely to create much difficulty. The stiffer tangible-capital requirements imposed by FIRREA make it most unlikely that such charters will ever be exercised for the purpose of establishing dumping-grounds for bad assets. As Stuart Root, the former director of FSLIC, has pointed out, the negotiators of the 1988 deals had the foresight to make provision for optional advance payouts of the ten-year notes

as well as optional repurchase of guaranteed assets. (WSJ, March 13 '89, A16)

The Oversight Board has addressed the issue of guaranteed profits on assets by stipulating that purchasers will be given only six months to decide whether to return a given asset. The 1988 deals generally guaranteed a stream of profits for ten years. Because many properties cannot be accurately appraised buyers do of necessity assume considerable risk and justly demand compensation for this risk-assumption in terms of an adjusted purchase price. The Government finds it advantageous to relieve the buyer of this risk-assumption, and this is achieved by the stream-of-payments guarantees and/or return-of-assets privilege. While ten years seems an unnecessarily long period for such guarantees, six months is certainly too short, since many real-estate projects (some in need of completion) are based on zoning and/or development plans which may depend upon government or business decisions requiring two or three years for finalization---common delays being litigation, public hearings and the need to obtain confirmation from other levels of government. Because of these complications it would be fairer to allow a purchaser two or three years to exercise the return option. William Seidman has suggested that the six-months policy be changed. (WSJ, Feb 1 '90, A14) The tax breaks still existing in 1988--now expired--while questionable public policy were the result of

provisions in the tax code and not subject to alteration by banking authorities.

In summary, it may be stated that with the exception of the Perelman sale, the controversial deals struck late in 1988 were probably not outlandishly generous, for once the sales conditions were made less favorable further sales ceased. Outright abrogation, even of the Perelman deal, is not to be recommended in that it would undermine the Government's future bargaining credibility. If Senator Metzenbaum's ethics case against the deal with James M. Fail is as strong as it now appears to be, then the public good would probably be best served by making an exception in this one case and reversing the sale. Since the agency is now better funded, and since provision was made right at the outset for advance payout and repurchase options, these should be exercised whenever this would be financially advantageous to the Government.

Is There Any Advantage to Maintaining
A Separate Thrift Industry?

On this point there is virtually unanimous agreement among experts that the time has come to merge S&Ls into the banking industry. The advocates of this position point out that home-mortgage loans are now quite freely offered at a variety of financial institutions, so there is no longer any justification for maintaining a separate banking system devoted to making mortgage loans. Merging thrifts and banks

would cut down on administrative expense, since only one insurer and one regulatory agency would need to be maintained where now there are two. The only dissenter among the experts is Paul Volcker who has said, "I think there is a future for the industry...the institutions that have concentrated on home lending have done quite well...they should have a future." (NYT, Feb 8 '89, p30) Far more typical is the view of Robert Litan, who said, "Danny's [i.e. Danny Wall's] successor should realize that it is his place to phase out this industry and this agency." (NYT, Dec 10 '89, Sec 4, p1) On February 17, 1990 the New York Times, normally sympathetic to consumer causes, stated editorially that the thrift industry "has outlived its original function." (p16) The Wall Street Journal editorially agreed on April 2, 1990, stating that "in the current financial environment there is no public-policy justification whatever for a separate and distinct Savings and Loan industry. The good thrifts should become banks, or perhaps in some cases financial firms without deposit insurance. The rest should be put out of their misery with the least damage to anyone else." (page A14) Lowell Bryan, writing in the Washington Post, noted:

"Many outside observers have come to believe that there remains no useful distinction between the savings-and-loan and commercial-bank industries. Commercial banks have become very committed to the housing and real-estate industries; indeed real-estate loans now exceed commercial and industrial loans as the largest category of loans on commercial-bank balance

sheets. Meanwhile, savings and loans have used their expanded powers to look more and more like banks. And the securitization of mortgages has dramatically expanded the role of non-depository institutions (e.g. pension funds, insurance companies, individuals, etc.) in the finance of residential mortgages.

"Moreover, many feel that the nation suffers by having two overlapping sets of deposit-insurance regulation. Essentially we have two sets of players both of whom are funded by federally insured deposits, which play by different sets of rules...This makes no sense." ("Rx for S&Ls : Mercy-Kill the Sickest", November 20, 1988, page D1)

In a similar vein, David O. Beim states, "Thrifts helped house America, but times have changed. Rather than cling to the failed patterns of the past, we must move ahead. The destiny of healthy thrifts is to become banks; the destiny of insolvent thrifts is to be liquidated." ("Beyond the Savings-and-Loan Crisis", The Public Interest, Spring 1989, p88)

When virtually all the top experts seem to speak with one voice, it is not likely that they can be far wrong.

Would It Be Possible to Disband The Thrift Industry at This Time?

In terms of political influence, thrifts, for the first time in history, are bankrupt. The reaction of Congress and the public to the crisis has been so negative that the disbanding of the industry would be favorably viewed by many as the one sure guarantee that there will never again be a multi-billion-dollar thrift crisis. As late as 1988 this

statement could not have been made, but over the last two years, as the losses have been tallied, public sentiments toward this industry have soured.

Why It Might Be Advantageous to Temporarily Postpone Shutting Down the Thrift Industry

Because there is currently such a strong emotional backlash against thrifts it might be wise, simply on general principle, to postpone taking any irreversible actions until the danger has passed that irrational emotions may have compromised the decision-making process. In other words, although it seems very likely, in the light of expert opinion, that the S&L industry and the banking industry ought to be merged, it might be prudent to allow a cooling-off period before making the final decision, just in case thrifts, despite their current low reputation, still have something distinct to offer society.

Home ownership is still the American dream. There seems to be little dispute that generally speaking home ownership is conducive to psychological contentment, lower crime rates, and a better sense of belonging to the community. The Government of the United States must consider home ownership to be a worthwhile social good, or else it would not encourage home ownership by allowing mortgage interest to be fully deducted from income for tax purposes. If the Government is willing to forego vast tax revenues to promote home ownership then it cannot be

considered inconsistent or unreasonable to maintain a separate housing-related banking industry if this also promotes home ownership.

One factor that suggests that thrifts may become less necessary in the future is the upward shift in the average age of the American population. Most of the "baby boomers" have reached or passed the age when they are likeliest to be in the market for a home. The "baby busters" are going to find that in most parts of the country residential real estate will be a buyer's market. After discounting for inflation, the real price of residential property is expected to steadily decline for the foreseeable future. For this reason it will be less and less urgent that a separate industry be maintained to provide financing for housing.

Furthermore, risk-related capital standards are expected to help assure that adequate housing financing will continue to be available, since the more loans for owner-occupied homes there are at a given bank, the less owner capital will be required.

When one considers these two factors, the one demographic and the other financial, it would certainly appear that in the future there will be less need for thrifts than there has been in the past.

The problem with projections such as these is that they are at this time only expectations. The amount of caution

the government shows in demanding an adequate cooling-off period before taking final action should be commensurate with the importance society attaches to personal home ownership. Because FIRREA does require that 70% of thrift loans be housing related, a surviving thrift industry will give stronger assurance of continued mortgage funding than can be provided by the housing incentives built into the newly adopted risk-related capital standards which only encourage home lending, but do not stipulate that any required percentage of loans be for housing. And furthermore, if there is any kind of debt that in terms of volume can justify its being the object of a specialized industry, it is mortgage debt. According to Jonathan E. Gray of Sanford E. Bernstein & Company :

"By comparison, no other sector of the market comes close. Mortgage debt is five times the size of bank loans (\$600 billion), four times the size of consumer credit (\$700 billion), and four times the size of the corporate bond market (\$760 billion). Whether mortgage investment is done through a separate industry called the thrift industry or through the banking system, the thrift function will persist as the largest and most important sector of the financial system." (NYT, Jan 1 '89, p1)

John R. Cranford, writing in Congressional Quarterly, raises doubts that the huge thrift industry could be shut down without reducing the supply of mortgage funding. Mr. Cranford notes that "thrifts still generate 49% of all mortgages, a task that could not be transferred overnight to banks, mortgage companies, and other financial institutions

without shrinking the supply of mortgages and driving up their costs to borrowers." (Aug 12 '89, p2114) If Mr. Cranford is correct on this point then society has all the more reason to demand a fairly long period of study before disbanding the industry.

Because there is considerable doubt that thrifts should even be allowed to continue playing their traditional mortgage role, it may seem out of the question to propose expanding their lending role, but if it is deemed good public policy to maintain a double banking system, the one purely for profit, the other mainly to cater to loans for socially desirable expenditures, then argument can be raised that not only housing should be catered to by this second set of banks--which would be S&Ls by that or some other name--but other socially desirable loans could also be made at these banks--perhaps even loans for education and durables of a non-frill nature. While it might seem logical to include these other socially desirable loans with housing loans it is not likely in the aftermath of the thrift crisis that S&Ls will soon receive any extra privileges. They will be lucky if they are allowed to stay in business at all, and it would be unrealistic to hope for any expanded powers within the next ten years or so, although in the distant future it is possible that the suggestion made above might advantageously be adopted, assuming a separate S&L industry still exists.

A very good reason for maintaining a second set of banks is that there is really no way of knowing for sure that at some time in the future there may not be an extreme shortage of capital. If this occurs rational lenders will pursue the highest interest earnings and will not concern themselves with promoting social goods. The result could be that the only people able to afford to borrow money would be those who intend to use the funds to earn money (i.e. commercial loans) or those borrowing small amounts for consumer purchases--the small size of the loan guaranteeing that the interest charges, even at near-usurious rates, could still be easily paid out of the borrower's monthly paycheck. If there is an extreme shortage of lendable capital home buyers may not find affordable mortgages available since a lender would be far better off making high-earning loans such as credit-card loans to compulsive spenders unaware of and unconcerned about the usurious rates they are paying. If the government feels that the purchases made with these high-interest loans, such as business projects of a venture nature, or consumer goods purchased on revolving charge accounts, are of less social benefit to the nation than good housing it may consider it good public policy to intervene in some way in favor of housing. Such intervention, whatever its form, will be easier to implement and probably more effective if it can be directed across the board to a separate and intact housing-related banking

industry instead of being parcelled out only to some departments within a commercial bank and not to others. Such intervention, of course, need not be outright subsidization, but can as easily consist of the granting of various competitive advantages. For example, recent advantages enjoyed by thrifts have included permission to make direct investments in real estate (as opposed to being limited to acquiring real estate only through seizure of collateral), permission to own, or be owned by, real-estate or securities firms, and permission to directly market on their premises products of related corporations. If interest rates were to sky-rocket as a result of a shortage of lendable capital then more radical actions could be taken, such as allowing interest income earned on deposits at thrifts to be tax free; this would permit thrifts to pay below-market rates to savers, and charge below-market rates on house mortgages. If there were no separate thrift industry then the government would no longer have available the segregated banking structure which would so greatly facilitate the implementation of any such promotional activities.

In spite of these precautionary remarks, it would be irresponsible to propose propping up the thrift industry forever, no matter how unnecessary thrifts prove to be. The key to the proper resolution of this question is to maintain an open mind. If, as the critics suggest, there will be

ample mortgage funds available from other sources, and the government, because of this ample availability of housing credit, does not need to grant the industry any particular favors,, then assuming the critics are right that thrifts are redundant, thrifts will one by one shut down due to lack of business, since, if they are redundant, then by definition they will not be the low-cost providers of housing finance.

The advocates of forced thrift-industry shutdown claim to favor reliance on free market forces for the provision of housing financing. Therefore, by this very reasoning, if thrifts really are redundant then there should be no need for the government to formally shut down this industry since the marketplace itself will do so. The experts contend that it is costly to maintain an extra regulatory structure, but this cost is not prohibitively high if there is any lingering question that such an expenditure might now or in the future expedite a worthy social goal. If there is any danger that in the future there might be a shortage of lendable capital, then it might be prudent to leave in place, especially now that the losses have been largely stemmed, a structure that specializes in and promotes home lending. Of course the experts are very likely correct. There probably is really no need for a separate thrift industry and time will likely bear this out. But just in case, due to unforeseen developments, there is, it might be wise to err on the side of caution and not allow any

disbanding of the industry to be the result merely of government fiat, but instead only allow the decision to be made by the American public itself, as it expresses itself in a free marketplace.

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