
FRBSF WEEKLY LETTER

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Troubled Banks and Thrifts

Our financial system has had many difficulties in recent years. Banks and thrifts have failed in record high numbers since the Great Depression; the Federal Savings and Loan Insurance Corporation faces financial troubles; and troubled institutions still are operating.

"Troubled" (insolvent or near-insolvent) institutions appear to be most prevalent in the thrift industry, but the banking sector is far from free of similar institutions. There are about 1,600 banks on the Federal Deposit Insurance Corporation's problem bank list. Moreover, since many institutions' book values exceed their market values, current book value accounting practices most likely understate the number of institutions that are insolvent on a market value basis.

This *Letter* examines the consequences of allowing troubled institutions to continue in operation — a policy known as capital forbearance. It argues that the best policy would be to require such institutions to bolster their capital and, if they were unable to do so, to sell or close those institutions. However, should such a policy be politically unfeasible, the second-best policy would be to limit the damage such institutions can inflict on the economy.

Underpriced deposit insurance

In a world of fixed-rate deposit insurance, under which a bank's or thrift's cost of insured deposits is independent of its risk-taking, regulation is needed to limit the exposure of the insurance fund. The reason is that an insured institution would earn profits on successful investment outcomes while the insurance fund would absorb losses that exceeded the institution's capital on unsuccessful ones.

In a system of full insurance coverage, insured institutions could earn virtually unlimited profits by attracting funds at a risk-free rate and investing them in higher yielding risky projects. That is, without regulation and under our current deposit insurance system (which underprices risk), insured financial institutions would expand at the expense of their uninsured competitors.

Market value closure

One way to contain such risk-taking is to require or induce insured institutions to hold sufficient capital, depending on their asset risk (credit and interest rate risk) and the length of time between supervisory examinations. Sufficient capital ensures that the institutions' equityholders, and not the insurance fund, bear the full risk of any loss. This principle underlies the current proposals for risk-based capital that would require banks with riskier asset portfolios to hold more capital. For example, if an institution can be closed before the market value of its net worth falls below zero, that institution's equityholders would bear the full consequences of its risk-taking.

Moreover, if institutions know with certainty that they will be sold or closed with a positive (market value) net worth (say, one percent of assets), and thus lose their capital in the process, they would have an incentive voluntarily to hold sufficient capital relative to the asset risk of their portfolios to avoid such regulatory "bankruptcy" costs. Even if this closure policy could not be implemented in such a way that banks always were closed before their net worth fell below zero, requiring more capital would still reduce the incentive of insured institutions to increase asset risk.

Such a system might have been able to forestall the severe difficulties our financial system faces today. But now, after the kind of trauma our depository industry has experienced over the last 15 years, it may be politically impossible to implement. What, then, should be done, and, in particular, how should weak or insolvent institutions be handled? Is it possible to move toward a market value closure rule without closing large numbers of institutions?

Insolvent institutions

Those insured institutions that are insolvent on a market value basis but are still operating pose the greatest risk to the deposit insurance funds, to solvent banks and thrifts, and to the stability of the entire financial system. To see why, consider the incentives of the owners of such institutions.

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First, such institutions have very strong incentives to increase the riskiness of their asset portfolios. Since they stand to gain from profitable investments and loans but have no equity to lose if the investments and loans prove unprofitable, they will seek large payoffs that occur with low probabilities. Unfortunately, such "bet the bank" strategies are all too common. Moreover, such institutions will even undertake investments where the average return is less than the cost of their funds, as long as there is a chance of a payoff that exceeds the cost of their funds.

Second, such institutions have a strong incentive to expand assets funded with insured deposits. The reason is that a larger asset base increases their gain when investments are profitable. But, there is no countervailing loss when the investments are not profitable, as there would be for an uninsured institution. Moreover, insured institutions would be willing and able to pay above market rates for insured deposits in order to grow as rapidly as possible. This strategy of trying to "grow" out of past mistakes also is all too common.

The risks of these strategies for the deposit insurance funds are evident. Absent efforts to contain the risk-taking and expansionary behavior of insolvent institutions, only good luck will prevent the insurance funds themselves from facing ever-increasing losses.

Competing institutions

Less well-recognized are the implications of such behavior for solvent banks and thrifts competing with insolvent institutions. It is very difficult for solvent institutions that have positive capital to compete with insolvent ones that in effect are operating with no capital. Absent regulation, on the liability side, insolvent institutions will outbid solvent institutions to achieve rapid asset growth. Similarly, on the asset side, insolvent institutions will underbid solvent competitors by underpricing loans and other investments.

Since, under certain circumstances, insolvent institutions left unchecked would expand even when the expected return on their loans and investments is less than their cost of funds, solvent institutions themselves eventually may even be driven toward insolvency as they face market-determined asset returns that are too low to cover the cost of their liabilities.

As mentioned above, the best solution to these problems would be to sell or close insolvent institutions promptly. Doing so would not only contain the damage they can do to the financial system, but also provide a greater incentive for solvent institutions voluntarily to hold asset portfolios that are prudent in relation to their capital positions (to lessen the risk they would be sold or closed).

There is no economic benefit to protecting the owners of insolvent institutions. An institution is insolvent on a market value basis by definition only when its discounted expected cash payments (to depositors and other liability holders) exceed its expected discounted cash receipts (from loans and investments). Only an unexpected event will return such an institution to solvency.

As mentioned above, it may be politically impossible after-the-fact, to close a large number of institutions. The time for a strict closure policy is before institutions get into trouble, so that massive closures are not needed. Nevertheless, to contain the adverse effects such institutions can have, it is important that they be highly regulated.

Needed regulations

To keep troubled institutions from imposing even larger losses on the insurance funds and driving solvent competitors toward insolvency, they should not be permitted to grow or be allowed to increase the riskiness of their assets. One way to limit their potential harm would be to prohibit them from acquiring any new assets or issuing new insured liabilities. Although such a policy of "freezing" their assets and liabilities probably would force many of them to die a slow death as their loans matured, a slow death that contained losses is preferable to the potentially much larger losses that could occur absent asset growth and risk-taking restrictions.

Since the owners of such moribund institutions would have little incentive to run them efficiently, such stop-gap measures should be temporary while a buyer for the institution is sought. Although other policies, such as deposit rate ceilings for insured deposits (at the rate for comparable Treasury instruments, for example) and/or requiring additional capital for new growth, may be partly successful in containing the tendency of these institutions to grow, stringent asset portfolio risk restrictions still would be needed to contain the risk exposure of the deposit insurance system.

Troubled but still solvent

Although institutions that are insolvent on a market value basis pose the gravest threat to the insurance funds and the financial system, institutions near insolvency also pose a similar threat. For example, an institution with capital insufficient to protect the deposit insurance fund from losses in the event the institution's assets produce low returns has incentives similar to an insolvent institution. In fact, any institution that can shift potential losses onto the insurance agency (in excess of its deposit insurance premium) has incentives to grow and increase asset risk.

To reduce or eliminate these incentives for damaging behavior, weak institutions should be required to bolster their capital-to-asset ratios by an amount dependent on the riskiness of their asset portfolios.

Institutions could increase their capital ratios either by issuing new equity or perpetual subordinated debt, by selling assets and retiring insured deposits with the proceeds, or by retaining earnings (if available). From a regulatory perspective, an institution that refuses to bolster its capital or that cannot do so, should be treated just like an insolvent institution (i.e., ideally, it should be sold or closed; failing that, it should not be permitted to acquire any new assets).

It might be noted that increasing deposit insurance premium assessments of solvent institutions to bail out insolvent ones (for example, by raising the deposit insurance premium uniformly across all institutions) will not solve the basic problems discussed. Higher premiums unrelated to risk alone do nothing to contain the socially damaging risk-taking incentives of value-maximizing insolvent institutions. Moreover, higher premiums applied to only one sector of the industry, such as the current higher deposit insurance premium for thrifts, would cause that sector to shrink relative to sectors paying lower premiums, all other things equal.

Although solvent institutions should support policies such as those discussed above that limit destructive competition, weak or insolvent institutions may resist such policy actions because the actions reduce their shareholders' wealth. One way to lessen this resistance is to

compensate shareholders at least partially by offering to enhance the franchise values of the institutions involved. For example, an expanded range of powers — such as investment banking, insurance sales and underwriting, and real estate investment and brokerage — could be allowed for firms that complied with more stringent capital and closure requirements. In fact, the proposed repeal of Glass-Steagall seems to be a step in this direction, although expanded powers under the proposal do not appear to be tied to more stringent capital regulation or closure policy.

Summary and conclusions

Solving the financial problems of some of our insured depository institutions will not be easy. With the advantage of hindsight, it is easy to see that such policies as market value closure and risk-based capital requirements, if they had been in place a number of years ago would have reduced the severity of today's problems.

Nevertheless, there are still measures that can be taken with regard to troubled institutions to ensure that problems do not worsen in the future. For one, troubled institutions should be required to bolster their (market value) capital ratios in relation to the risk of their portfolios (both credit and interest rate risk). If this is not possible, they should ideally be sold or closed, or at the very least not permitted to acquire new assets or insured deposits.

Institutions still operating even though they are insolvent on a market value basis pose a grave threat both to the solvency of the deposit insurance funds and to the stability and competitiveness of the rest of the depository industry. If left unchecked, such institutions, will expand and increase asset risk, conceivably even driving solvent institutions toward insolvency. Without strict regulation and supervision, solvent institutions that are weak in capital pose a similar threat.

The steps proposed here would go a long way toward containing the losses already incurred, and would allow the industry to make the transition to a new structure better able to deal with risk.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from 12/31/86	
	Outstanding 12/30/87	from 12/23/87	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	207,821	- 169	- 6,416	- 2.9
Loans and Leases ^{1 6}	184,030	33	- 9,535	- 4.9
Commercial and Industrial	52,554	121	- 4,624	- 8.0
Real estate	72,538	- 123	4,621	6.8
Loans to Individuals	37,648	167	- 4,312	- 10.2
Leases	5,450	13	- 141	- 2.5
U.S. Treasury and Agency Securities ²	16,421	- 255	2,953	21.9
Other Securities ²	7,370	54	164	2.2
Total Deposits	209,812	1,484	- 14,081	- 6.2
Demand Deposits	55,242	1,629	- 12,968	- 19.0
Demand Deposits Adjusted ³	39,296	2,980	- 2,425	- 5.8
Other Transaction Balances ⁴	20,217	24	164	0.8
Total Non-Transaction Balances ⁶	134,353	- 169	- 1,277	- 0.9
Money Market Deposit Accounts—Total	43,898	16	- 3,204	- 6.8
Time Deposits in Amounts of \$100,000 or more	31,647	- 191	- 761	- 2.3
Other Liabilities for Borrowed Money ⁵	19,453	302	- 7,523	- 27.8
Two Week Averages of Daily Figures	Period ended 12/28/87	Period ended 12/14/87		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	37	114		
Borrowings	15	4		
Net free reserves (+)/Net borrowed(-)	22	110		

- 1 Includes loss reserves, unearned income, excludes interbank loans
- 2 Excludes trading account securities
- 3 Excludes U.S. government and depository institution deposits and cash items
- 4 ATS, NOW, Super NOW and savings accounts with telephone transfers
- 5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
- 6 Includes items not shown separately
- 7 Annualized percent change