

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## The Cost of Buying Time: Lessons from the Thrift Debacle

by James B. Thomson

The collapse of the Federal Savings and Loan Insurance Corporation's (FSLIC) deposit insurance fund, coupled with the subsequent appropriation of taxpayers' money to underwrite the cleanup of the thrift industry, ranks as one of the greatest financial disasters of our time. When all is said and done, around \$200 billion (in 1990 dollars) will have been spent to honor the claims of depositors in closed thrifts and to dispose of failed-thrift assets. To put this number into perspective, the combined loan guarantees for Lockheed, New York City, and Chrysler Corporation in the 1970s were only about \$9 billion in equivalent dollars.

As researchers continue to sift through the rubble of the FSLIC meltdown, they have unearthed the following facts: First, the economic insolvency of the FSLIC occurred early in the 1980s.<sup>2</sup> Economist Edward Kane of Boston College estimates that the cost of cleaning up the giant red-ink spill on the FSLIC's balance sheet reached \$100 billion as early as 1982, a figure that was validated by former Federal Home Loan Bank Board (FHLBB) Chairman Richard Pratt in his 1990 testimony before Congress.<sup>3</sup>

Second, official recognition of the FSLIC's financial problems did not begin until 1987, when Congress authorized \$10.8 billion in new funding through the Competitive Equality Banking Act. Official recognition of the FSLIC's irremediable insolvency did not occur, however, until August

1989, when Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).<sup>4</sup>

Between the onset of the FSLIC's insolvency and the signing of FIRREA, the chosen regulatory option for dealing with undercapitalized and insolvent thrifts was capital forbearance. Rather than confronting the emerging problems of the industry early and vigorously by enforcing existing capital standards, regulators and policymakers instead poured their energy into papering over losses to cover up both the insolvency of a large number of thrifts and the deteriorating condition of the FSLIC. In buying time, they hoped that lower interest rates would restore the industry's health and reduce the ultimate cost of resolving the deficit in the FSLIC's insurance fund. This interest-rate bet was not symmetric, however, since the prepayment option held by mortgagors would make interest-rate declines less profitable for thrifts than increases would be costly.<sup>5</sup>

Forbearance may have seemed like a reasonable strategy to policymakers at the time, because the underlying source of the thrift industry's problems was the historically high interest rates of the early 1980s. Indeed, interest rates did decline after 1982, and a number of insolvent institutions used the extra time afforded them to regain their health. But the majority of troubled thrifts did not recover and were closed by the end of 1992, or are due to be closed this year. What's more, forbearance increased the

*Forbearance is urged by those who think we can avoid paying a bill for what we have already spent. It is urged by those who believe that we can operationalize an industrial policy for banks that will somehow save money by propping up the sick and poorly managed. It is urged by those who wish to further postpone the costs so that they will be incurred on someone else's watch. Regardless of why forbearance is urged, its outcome will be the same: more costs for the taxpayer and more inefficiency for the economy.*

**Thomas Woodward**  
Chief Economist, Republican Staff  
House Budget Committee<sup>1</sup>

ultimate cost of closing these institutions, as well as the total cost of resolving the thrift debacle.

Despite the unprecedented size of the taxpayer bailout of the thrift deposit insurance fund and the attendant political fallout, some current and former regulators, as well as a number of academics and industry analysts, still advocate capital forbearance programs. Former Federal Deposit Insurance Corporation Chairman William Taylor's "hospital plan" for troubled banks is but one example of this.<sup>6</sup> The most recent case is OTS Chairman Timothy Ryan Jr.'s call for more lenient treatment of distressed real estate assets on the books of the nation's depository institutions.<sup>7</sup>

This *Economic Commentary* takes a critical look at capital forbearance as a policy for dealing with troubled financial institutions. A review of the mounting evidence on the cost of thrift forbearance leads to the inexorable conclusion that it was indeed a losing proposition for taxpayers.

### ■ Capital Forbearance and Moral Hazard

The problems of the thrift industry in the 1980s can be traced to a combination of record-high interest rates in the early years of the decade and the structure of thrift institution asset and liability portfolios. Traditional thrift portfolios, which consist of long-term fixed-rate loans (principally mortgages) financed with short-term liabilities (principally deposits), are extremely vulnerable to sudden, unexpected increases in interest rates. The three-month Treasury bill rate, which stood at 6.49 percent in January 1980, rose to a peak of 16.30 percent in May 1981 before returning to single digits in August 1982. By 1982, unrealized capital losses on thrift balance sheets exceeded not only book-value tangible equity at a large number of institutions, but also surpassed the explicit resources of the FSLIC's deposit insurance fund.<sup>8</sup>

## THE EVOLUTION OF CAPITAL FORBEARANCE

Capital forbearance in the 1980s had two components. First, regulators systematically lowered the actual requirement from 5 percent to 3 percent of assets:

- **November 1980:** The FHLBB reduced thrifts' explicit capital requirement from approximately 5 percent to about 4 percent and provided for a "qualifying balance deduction" that effectively lowered the requirement even more.
- **January 1982:** The capital requirement was further reduced to 3 percent.
- **After 1987:** Regulators largely ignored capital standards.

Second, policymakers adopted regulatory accounting practices that represented a departure from generally accepted accounting principles (GAAP):

- **November 1981:** The FHLBB accepted net-worth certificates from thrifts with less than 3 percent net worth as capital in exchange for FSLIC promissory notes, with face value guaranteed by the FSLIC.
- **July 1982:** Thrift regulators permitted goodwill to be amortized over a 40-year period while allowing income from unbooked gains to be realized in as little as five years.
- **November 1982:** The FHLBB began to include "appraised equity capital" in its calculations of regulatory net worth.

The initial policy response to the S&L insolvency was capital forbearance.<sup>9</sup> Both the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Gam-St Germain Act of 1982 aimed at providing relief for the industry. DIDMCA, the first in a series of actions taken by legislators and regulators to grant thrifts new investment powers, authorized federally chartered institutions to invest up to 20 percent of their assets in corporate bonds and consumer loans and extended their authority to make construction or acquisition loans. The portfolio investment limits for commercial and consumer loans were raised further by the Gam-St Germain Act. More significantly, DIDMCA increased the deposit insurance ceiling from \$40,000 to \$100,000, an unprecedented 250 percent rise.

These two pieces of legislation, combined with regulatory efforts, resulted in both a dramatic reduction in thrift capital requirements and the introduction of regulatory accounting principles

aimed at masking the industry's insolvency. The box above briefly outlines the evolution of capital forbearance in the 1980s.<sup>10</sup>

Armed with these new asset powers, little or no capital, essentially 100 percent government guarantees of their deposits, and with the encouragement of thrift regulators, FSLIC-insured institutions saw their assets expand 18.6 percent and 19.9 percent in 1983 and 1984, respectively. Thrifts in the Sunbelt states grew at rates nearly twice the national average. And as a group, those institutions that failed later in the decade more than doubled their assets between 1982 and 1985.<sup>11</sup> The dramatic expansion in credit extension surely contributed to the sharp increase in the supply of real estate, which has depressed prices over the past several years.<sup>12</sup>

Unfortunately, the combination of little or no private capital and the underwriting of thrift losses through FSLIC insurance provided thrift managers and owners with a perverse set of incentives to dramatically increase the risk of their portfolios. This is the classic moral hazard problem. Thrift operators, in a desperate gamble to regain solvency, booked increasingly speculative investments that often had little chance of paying off.<sup>13</sup>

Consequently, while historically high interest rates were responsible for the industry's problems in the early 1980s, losses in the latter half of the decade stemmed primarily from the poor asset quality of troubled institutions' portfolios.<sup>14</sup> By 1987, the deteriorating quality of thrift assets, particularly real estate investments in the Southwest, accounted for virtually all of the industry's remaining problems. Ironically, fraudulent activity in closed thrifts has received the bulk of the media's attention, but its contribution to the overall cost of resolving insolvent thrifts was only about 10 percent of the total resolution costs.<sup>15</sup>

#### ■ Thrift Capital Forbearance: A Losing Proposition

Although the price tag for resolving the insolvency of the FSLIC insurance fund is staggering, it does not necessarily mean that forbearance was a losing proposition. A recent study by economists George Benston and Mike Carhill suggests that forbearance was not particularly costly.<sup>16</sup> Most other analyses, however, support the conclusion that forbearance was at best a misguided policy that increased the ultimate cost of resolving the thrift mess.<sup>17</sup>

Economist Philip Bartholomew looks at all thrifts closed between 1980 and the end of 1990, as well as at those that were slated for closure in 1991.<sup>18</sup> For the 1,130 institutions in his sample, he finds that the present-value cost of delayed closure was \$66 billion (in 1990 dollars). This conclusion is consistent with the results of an earlier paper, which showed that the most significant determinant of the cost of closing troubled thrifts was the number of months they were insolvent.<sup>19</sup>

Another study examined the 996 thrifts that did not meet book capital standards at the end of 1979.<sup>20</sup> The final sample of "forbearance thrifts" consisted of the 952 institutions that were neither merged nor closed in 1980. Tracing these thrifts into the future, the authors collected the estimated resolution costs for the 362 firms closed between January 1981 and July 1992.<sup>21</sup> The present-value cost of the delayed closing of these thrifts beyond 1980 was more than twice the projected cost of resolving all 952 forbearance thrifts in that year.

All of the above studies examine only the direct costs of forbearance. That is, they look at differences in the cost of closing thrifts at one point in time versus a future point in time. But the indirect costs of forbearance, which unfortunately are difficult to quantify, are also potentially large and economically significant.

#### ■ Indirect Costs of Capital Forbearance

Capital forbearance as practiced in the 1980s had important unintended, or secondary, effects. These resulted from the changes in economic incentives that forbearance entailed (specifically, from the increase in risk-taking incentives for insured depositories). Moreover, as Kane notes, the profitability of the healthy segment of the depository industry was reduced as insolvent thrifts, in a last-ditch attempt to regain their solvency, bid down lending rates and bid up deposit rates to unsustainable levels.<sup>22</sup>

The most notable example was the Texas deposit premium in 1987. Because the state was home to a disproportionate number of troubled depositories, solvent thrifts had to pay 50 basis points more for deposits than did thrifts in other parts of the country.<sup>23</sup> Thus, capital forbearance impacted negatively on industry stability as the erosion of profit margins pushed a number of marginally capitalized institutions over the edge into insolvency.<sup>24</sup>

Although the degree to which forbearance contributed to the record-high post-World War II level of bank and thrift failures in the 1980s has yet to be quantified, three studies have identified significant economic costs. The first argues that thrift forbearance was a major factor in the 1980s' real estate construction boom and subsequent collapse, with the authors estimating that deadweight losses in this market ranged from \$124 billion to \$150 billion.<sup>25</sup>

The second study, conducted by the Congressional Budget Office, calculates that between 1981 and 1990, the misallocation of resources associated with the thrift insurance collapse produced a deadweight loss of \$200 billion (in 1990 dollars) in forgone gross national product (GNP), and that the total loss in potential GNP by the year 2000 will reach nearly \$500 billion.<sup>26</sup>

The final study links the record-high real interest rates to "zombie" thrift behavior in deposit markets.<sup>27</sup> Federally insured certificates of deposit and Treasury bills are close substitutes (made even closer by forbearance). As zombie thrifts bid up the rates offered on quasi-government debt, they also drove up the required rate of return on official U.S. Treasury debt. The authors project that this increased the Treasury's borrowing costs by as much as \$100 billion (in 1990 dollars) per year by the end of the 1980s.

## ■ Conclusion and Policy Implications

Capital forbearance for thrifts in the 1980s was at best a misguided policy whose costs will have long-term consequences for the health of both the nation's depositories and the overall economy. A review of the thrift insurance debacle shows that despite the dramatic decline in interest rates over the 1980s, few troubled institutions recovered, and the losses on those that have been forced to close their doors significantly eclipsed the cost of prompt closure in the early years of the decade. Furthermore, there is growing evidence of massive secondary costs associated with thrift forbearance that may exceed the increase in direct resolution costs. These include overinvestment in real estate at the expense of capital formation and public infrastructure, and increased borrowing costs for the U.S. Treasury for the foreseeable future — all at a time when interest on the national debt has become one of the largest nondiscretionary expenditure items in the federal budget.

Unfortunately, it appears that policymakers have turned a jaundiced eye toward the lessons of the thrift insurance disaster applicable to the dangers of forbearance. Even as Congress grapples with the need to appropriate more funds to complete the cleanup of the industry, forbearance remains an attractive option for regulators.<sup>28</sup> The prompt corrective action provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which became effective last December 19, are an important first step in changing regulators' incentives to forbear, making them directly accountable for their actions and limiting their discretion when dealing with undercapitalized depositories.<sup>29</sup>

## ■ Footnotes

1. See Woodward (1992).
  2. Insolvency occurs when the market value of a firm's assets is less than the market value of its liabilities. In the case of the FSLIC, the unrealized losses of insolvent savings and loans (S&Ls) exceeded the market value of the assets held by the insurance fund.
  3. See Kane (1985), chapter 4, and Pratt (1990).
  4. FIRREA provided \$50 billion in new money to close insolvent thrifts and created an entirely new federal regulatory structure for the industry. The FSLIC was replaced by the Savings Association Insurance Fund, a subsidiary of the Federal Deposit Insurance Corporation, and the FHLBB was replaced by the Office of Thrift Supervision (OTS), which operates under the U.S. Treasury. Furthermore, FIRREA created the Resolution Trust Corporation (RTC) to oversee thrift resolutions from January 1, 1989 through the end of fiscal year 1993 (September 30, 1993). For a discussion of FIRREA and the RTC, see Pike and Thomson (1991).
  5. Mortgagors have the option of paying off their loans before the contract date. As interest rates decline, they can take out a new mortgage at the current lower rates and use the proceeds to retire the old loan. On a typical mortgage, it becomes profitable to refinance or to exercise the prepayment option whenever prevailing mortgage rates are 200 basis points below the rate on the old contract.
  6. For an accounting of recent proposed forbearance schemes, see Woodward (1992).
  7. See Ryan (1992).
  8. See U.S. General Accounting Office (1987).
  9. Kane (1989) argues that bank and thrift regulatory agencies are self-maximizing bureaucracies whose primary task may be seen as acting as the taxpayers' agent (the government's principal) in order to ensure a safe and sound banking system and to minimize taxpayers' exposure to loss. Regulators also must cater to a political clientele who are intermediate or competing principals and who are likewise motivated by their own self-interest, which may not coincide with the interests of taxpayers. These political pressures and self-interest considerations create socially perverse incentives that make forbearance an appealing alternative to dealing with emerging problems in the industry early and forcefully. In sum, Kane's analysis suggests that forbearance might be an attractive bet for bureaucratic-minded managers of financial service regulatory agencies and their political constituencies, even if it is not a fair bet for taxpayers.
- A second reason forbearance appealed to policymakers is that the FSLIC did not have the explicit resources to deal with losses. Given the unwillingness of the President to request and the Congress to allocate funds to recapitalize the FSLIC in the early 1980s, thrift regulators could not have moved decisively against a large number of insolvent S&Ls, even if it had been in their best interest to do so.
10. For a more complete accounting of forbearances, see Barth and Bradley (1989), Kane (1989), and White (1991).
  11. See White (1991), chapters 5 and 6.
  12. See Hendershott and Kane (1991).
  13. Evidence of moral hazard behavior can be found in Barth, Bartholomew, and Labich (1989), Barth, Bartholomew, and Whidbee (1989), Brewer and Mondschean (1992), and Cole, McKenzie, and White (1991).
  14. See Kane (1989), chapters 2 and 3, White (1991), chapter 8, and DeGennaro, Lang, and Thomson (1991).
  15. See Barth, Bartholomew, and Labich (1989).
  16. See Benston and Carhill (1992).

17. For example, studies of thrifts that were either GAAP insolvent or undercapitalized in the early 1980s reveal that despite the dramatic decrease in interest rates after 1982, the majority of institutions receiving capital forbearance failed to recover later in the decade. See U.S. General Accounting Office (1987), Rudolph (1989), DeGennaro, Lang, and Thomson (1991), and DeGennaro and Thomson (1992).

18. See Bartholomew (1991).

19. See Barth, Bartholomew, and Bradley (1990).

20. See DeGennaro and Thomson (1992).

21. Resolution costs are the estimated costs of resolution by the FSLIC (before August 1989) and the RTC (after August 1989) at the time of closing. Blalock, Curry, and Elmer (1991) suggest that the FSLIC estimates understated actual resolution costs by an average of 26 percent between 1984 and 1987. For thrifts resolved through liquidation, FSLIC estimates were even worse, undershooting actual costs by 35.3 percent on average.

22. See Kane (1989), pp. 4-5.

23. See White (1991), chapter 8.

24. Kane (1989), pp. 4-5, draws a clever parallel between these insolvent but open thrifts and horror-movie zombies. In essence, insolvent thrifts are the living dead, kept alive by government guarantees and forbearances. As they gamble to recover, they suck the profitability out of healthy institutions, thereby creating new zombies.

25. Deadweight losses are the difference between the cost of building excess commercial and industrial structures and the current value of those structures. These losses are not recoverable. See Hendershott and Kane (1991).

26. See Congressional Budget Office (1992).

27. See Shoven, Smart, and Waldfoegel (1992).

28. See Cobos (1989), Ryan (1992), and Woodward (1992).

29. See Carnell (1992), Jones and King (1992), and Pike and Thomson (1992).

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James B. Thomson is an assistant vice president and economist at the Federal Reserve Bank of Cleveland. The author thanks William P. Osterberg, Christopher J. Pike, and Walker F. Todd for helpful comments and suggestions.

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**Federal Reserve Bank of Cleveland  
Research Department  
P.O. Box 6387  
Cleveland, OH 44101**

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