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The Texas Thrift Situation:

Implications for the Texas Financial Industry

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Recent losses incurred by U.S. thrifts are sufficiently large to constitute a priority concern for U.S. policymakers. Last year the U.S. thrift industry recorded a net loss of $6.8 billion. The unprofitable segment of the industry lost $13.4 billion, and this was only partially offset by a $6.6 billion profit recorded by the profitable institutions. During the first quarter of this year, U.S. thrifts lost $3.7 billion, with the unprofitable S&Ls reporting losses of $5.1 billion. Much of the industry's problem is concentrated in the Southwest, and particularly in Texas.

The magnitude of the financial losses reported by Texas thrifts, together with the weakened financial condition of most of the state's banks, has impaired confidence in Texas financial institutions. This is reflected in the interest-rate premiums that are required to attract deposits to these institutions. Relative to the average cost of interest-bearing deposits at thrifts outside of Texas, the Texas thrifts paid about 74 basis points more for their interest-bearing deposits in the first quarter of 1988. At Texas banks, the average premium on their interest-bearing deposits was 31 basis points. This Texas premium is partly the result of the aggressive bidding practices for deposits by the state's most troubled financial institutions. The Texas premium also reflects uncertainty about the viability of many of the financial institutions in the state, due largely to questions about the value of the nonperforming assets that these institutions are holding.

This article provides an assessment of the financial condition of the Texas banks and thrifts. Analysis of interest-expense data indicates that the Texas financial institutions, banks and thrifts alike, are required to pay premiums on their deposits. These data also suggest that concerns about the financial viability of the state's most troubled financial institutions have impacted the stronger institutions in the state. This process not only weakens the financial condition of the solvent banks and thrifts, it also penalizes the stronger institutions because of the problems at the most troubled institutions.

Texas Thrift Situation: Assessment of the Problem

A large number of the banks and thrifts in Texas are experiencing serious financial difficulties. The key factors contributing to these difficulties are problems with asset quality and lowered interest margins. Regarding Texas thrifts, data included in Table 1 identify the asset-quality problems that have emerged during the last three years. At year-end 1987, Texas thrifts had just under $14 billion in loans that were delinquent for 60 days or more. Of this total, about $13 billion were in real estate loans of all categories. Texas thrifts also held over $9 billion in repossessed real estate assets, bringing total nonperforming loans plus repossessed assets to 23 percent of their assets.

The sharp rise in nonperforming assets at the Texas thrifts has seriously impaired the capital positions of these institutions. In December 1985, Texas thrifts, as a group, had $3.0 billion in positive capital. That position declined to −$1.0 billion by December 1986, and it fell further to −$11 billion by the first quarter of 1988. As shown in Table 2, by March 1988, 130 Texas thrifts were insolvent, but operating. In terms of numbers of institutions, these insolvent thrifts accounted for 47 percent of all Texas thrifts and, with $46.5 billion in assets, the insolvent thrifts held 48 percent of the thrift assets in the state. At the end of the first quarter of 1988, the capital position of the insolvent Texas

Table 1
Loans and Asset Quality at Texas Thrifts
(Billion $, End-of-Period)

	1985	1986	1987
Net Loans: [1]			
Real Estate [2]	53.5	52.6	44.5
Total	59.1	58.4	49.7
Delinquent Loans: [3]			
Real Estate	3.41	10.36	12.90
Total	3.75	11.28	13.98
Repossessed Assets	1.67	4.75	9.45
Delinquency Rate:			
Real Estate	6.4%	19.7%	29.0%
Total	6.3%	19.3%	28.1%
Troubled Assets/Total Assets[4]	5.9%	16.5%	23.4%

1. Mortgage-backed securities are excluded from net loans.
2. Real estate loans are defined as mortgage loans and contracts, which include residential and nonresidential construction loans and permanent mortgages.
3. Delinquent loans are loans overdue 60 days or more.
4. Troubled assets are defined as delinquent loans and repossessed assets.

SOURCE: Quarterly Trends, Federal Home Loan Bank of Dallas.

Table 2
Solvent Versus Insolvent Texas Thrifts
(March 1988)

	Solvent	Insolvent
Number of Institutions	148	130
Percent of Institutions	53%	47%
Thrift Assets	50.4	46.5
Percent of Thrift Assets	52%	48%
Capital (GAAP, billion $)	1.6	−12.8
Repossessed Assets (billion $)	2.2	7.7

SOURCE: Federal Home Loan Bank Board Thrift Financial Report.

Table 3
Management Differences:
Solvent versus Insolvent Texas Thrifts

	Solvent	Insolvent	Difference	
Average Asset Growth[1]				
1980-Q4 to 1984-Q4	23%	39%	16	**
1984-Q4 to 1988-Q1	13%	5%	−8	**
Average Loan Rate[2]	11.54%	12.30%	0.76	**
Average Deposit Rate[3]	10.60%	10.96%	0.36	**

1. Figures are the averages of the annualized growth in assets at individual institutions. Growth from mergers is included.
2. Figures are the averages of annualized rates earned on mortgage loans and contracts at individual institutions in the fourth quarter of 1984.
3. Figures are the averages of annualized rates paid on deposits at individual institutions in the fourth quarter of 1984.

** Denotes that the difference is significant at the 99% level of significance.

SOURCE: Federal Home Loan Bank Board Thrift Financial Report.

thrifts was −$12.8 billion, while the 148 solvent thrifts in the state had $1.6 billion in capital.

Analysis of differences in management decision-making at the solvent and insolvent Texas thrifts indicates that differences in risk decisions influenced the magnitude of financial losses at these institutions. The figures in Table 3 suggest that the thrifts that are now insolvent pursued more aggressive lending strategies than did the solvent thrifts. The insolvent thrifts also were more aggressive in bidding for deposits.

Table 3 figures indicate that during the period from the fourth quarter of 1980 through the fourth quarter of 1984, while the Texas economy was still relatively strong, the annualized growth in assets at the Texas thrifts that are now insolvent was significantly higher than the average asset growth at the Texas thrifts that are still solvent. Since 1984, the asset growth at the insolvent thrifts has slowed and is now lower than the asset growth at the group of solvent thrifts. Regarding loan and deposit rates, during the fourth quarter of 1984 the average loan rate at thrifts that are now insolvent was 76 basis points higher than the average loan rate at the solvent thrifts. Similarly, during the fourth quarter of 1984, the group of thrifts that are now insolvent paid 36 basis points more for their deposits, on average, than did the thrifts that are still solvent.

Additionally, Table 3 figures show that the difference between the average interest rates paid on deposits at the insolvent and solvent thrifts was less than the difference between their loan rates. This suggests that in 1984 thrifts that became insolvent were more aggressive in attempting to capture the implicit subsidy that is provided by insured deposits. These differences suggest that differences in risk decisions, not just economic conditions, had a significant impact on the magnitude of the financial losses incurred at individual Texas thrifts.

Southwest Plan

The Federal Home Loan Bank Board (FHLBB) developed the Southwest Plan to address the financial difficulties of the troubled Texas thrifts. The Plan is composed of two major programs. First, the FHLBB intends to consolidate the Texas thrift industry by merging a number of insolvent thrifts with stronger institutions. Unprofitable S&L branches also will be closed. The Plan for implementing the mergers divides the state into 14 regions. The FHLBB has stated that the size distribution of the Texas institutions will remain essentially unchanged and that competition and service will be adequate in each of the 14 regions. Thus far, five major mergers have been completed. The surviving institutions in those transactions are Coastal Savings, Southwest Savings, MeraBank, Sunbelt Savings, and American Federal Savings Bank, the last a *de novo* federal savings bank.

The FHLBB has indicated that the Southwest consolidation plan will provide a mechanism for reducing expenses and controlling losses from troubled thrift assets. The agency projects that expenses will be reduced through a reduction of overlapping and duplicate facilities. In addition, the FHLBB anticipates that losses from troubled assets will be controlled, as only the most capable thrift managers will be retained in the consolidation. The FHLBB emphasizes that in restructuring the industry the use of cash will be minimized, and the FSLIC will gain a share in the future profits of the assisted institutions. The FHLBB also expects the plan to attract a substantial inflow of private capital.

In addition to this consolidation plan, the agency is attempting to lower the cost of funds at Southwest thrifts by implementing a series of programs that lower the risk premiums on the deposits of the most troubled thrifts. The Federal Home Loan Bank of Dallas (FHLB-Dallas) has introduced three programs to accomplish this objective. The goal of these funding programs is to market FSLIC-insured CDs in the national money market to reduce the aggressive bidding practices of insolvent thrifts in local market areas.

The three funding programs that have been established thus far include the As-Agent CD program, the Letter of Credit-Enhanced CD program, and a third program that utilizes regional brokerage firms to promote the sale of thrift CDs.[1] The As-Agent CD program was introduced in March 1987. In that program, deposits for the most troubled S&Ls are purchased through other stronger thrifts and are then funneled back to the weaker thrifts. The Letter of Credit-Enhanced CD program was introduced in March 1988. That program attempts to lower the cost of thrift deposits by using letters of credit issued by the FHLB-Dallas to guarantee 10 percent of the principal of the CDs issued by the troubled Southwest thrifts. The 10-percent coverage is in addition to the normal FSLIC-insurance coverage on deposits up to $100,000. The guarantee from the FHLB-Dallas is offered to provide additional assurance to large CD holders that if a thrift institution fails, depositors will recover accrued interest earned on CDs in denominations of $100,000 or more.[2] Finally, in April 1988, a third program was introduced that utilizes regional brokerage firms to promote the sale of $90,000 CDs for designated troubled thrifts.[3] Thus far, however, these indirect funding programs have not attracted as much investor interest as had been hoped. And, although the cost of funds has declined in some local markets, the deposit premiums have not been eliminated.[4]

The immediate problem with the Southwest Plan is that insufficient resources have been allocated to the FHLBB to eliminate the capital deficiency at Texas thrifts without losses to depositors. As a result, the FHLB-Dallas is not able to address adequately the primary cause of the profitability shortfall at the Texas thrifts, namely the large and growing volume of nonperforming assets held by these institutions. Estimates of the cost reductions from thrift mergers cannot be made without additional information about the merger plans, but the FHLBB has indicated that the overall consolidation effort is expected to save Texas thrifts $650 million per year in operating costs.[5] That estimate is less than 10 percent of the losses reported by Texas thrifts in 1987.

Table 4
Loans and Asset Quality: Texas Versus Other U.S. Banks
(Billion $, End-of-Period)

	1985		1986		1987	
	Texas	Other	Texas	Other	Texas	Other
Net Loans:						
Real Estate	39.2	345.6	42.2	410.2	40.3	512.6
Total	125.4	1499.6	120.1	1627.4	108.0	1711.4
Problem Loans: [1]						
Real Estate	1.4	9.5	2.9	11.4	5.3	12.1
Total	4.6	41.2	6.9	44.0	9.6	56.3
Other Real Estate Owned	1.0	6.1	2.1	7.0	3.5	7.6
Problem Rate:						
Real Estate	3.5%	2.8%	6.8%	2.8%	13.0%	2.4%
Total	3.7%	2.7%	5.8%	2.7%	8.9%	3.3%
Troubled Assets/Total Assets[2]	2.7%	1.9%	4.4%	1.9%	6.9%	2.3%

1. Problem loans are defined as loans overdue 90 days or more, nonaccruing loans, and renegotiated loans.
2. Troubled assets are defined as problem loans and other real estate owned.

SOURCE: Report of Condition and Income.

Uncertainty about the market value of the nonperforming assets held by undercapitalized Texas thrifts will continue to generate doubts about the future profitability of these institutions. Moreover, the decision of thrift regulators to avoid placing further pressure on real estate values by assisting Texas thrifts to hold foreclosed real estate and nonperforming real estate loans on their books will contribute to this uncertainty. It is extremely difficult to evaluate the market value of real estate with too few market transactions. As a result, uncertainty about the market value of both real estate loans and ORE (other real estate owned) will continue to raise questions about the viability of Texas thrifts. This, together with the uncertainty about the impact of the FSLIC insolvency on the value of federal deposit guarantees, is likely to induce depositors to continue to demand risk premiums on the deposits of Texas financial institutions.[6]

Financial Condition of Texas Banks

The volume of nonperforming assets at Texas thrifts is larger than that reported by Texas banks, but the asset-quality problems at Texas banks are also unprecedented, at least for the post-Depression environment. The data in Table 4 identify the deterioration in asset quality that has occurred at Texas banks in relation to banks outside Texas during the last three years. Table 4 figures show that the level of problem loans at Texas banks increased to $9.6 billion by the fourth quarter of 1987, with problem real estate loans accounting for 55 percent of this total. Problem real estate loans increased from $1.4 billion in the fourth quarter of 1985 to $5.3 billion in the fourth quarter of 1987, while the amount of other real estate owned (ORE) increased from $1.0 billion to $3.5 billion during that same period. Excluding real estate, the level of problem loans continued to rise during the last three years, but at a slower pace. Problem loans, excluding problem real estate loans, moved from $3.2 billion in 1985 to $4.0 billion in 1986 and reached $4.3 billion at the end of 1987. Total problem loans plus other real estate owned at Texas banks reached $13.1 billion by last year's fourth quarter. That represents 6.9 percent of the state's banking assets.[7] In contrast, troubled assets as a percent of total assets at other U.S. banks was 2.3 percent.

The drag on earnings from these troubled assets was a key factor in the sharp rise in bank failures that has occurred in Texas during the last two years. In 1987, 50 FDIC-insured banks failed in Texas, representing 27 percent of all U.S. bank failures.[8] Through July 1988, 83 banks in Texas were closed due to failure, including 40 banks affiliated with First RepublicBank Corporation. In addition, in 1987, BancTexas received special assistance from the FDIC to avoid closure. And, through July 1988, First City Bancorporation and two other smaller Texas banking organizations— Texas Bancorp. and Oak Forest National Bank— also received special FDIC assistance. In addition, the FDIC has announced a plan to provide special assistance to facilitate the merger of two other large Texas bank holding companies—Texas American Bancshares and National Bancshares Corporation.[9]

Efforts to assist several of the state's largest banking organizations have alleviated concerns about the financial condition of the assisted banks. But continued uncertainty about the value of the nonperforming assets held by Texas financial institutions is likely to hinder the inflow of private capital to the state's financial institutions. This uncertainty is also likely to induce depositors to continue to demand risk premiums on the deposits of Texas financial institutions. These premiums, together with foregone earnings on nonperforming assets, will prevent the Texas institutions from earning a competitive rate of return.

Deposit Rate Premiums at Texas Banks and Thrifts

Interest-rate premiums on the deposits of Texas financial institutions are likely to persist unless more aggressive actions are taken to remove nonperforming assets from the portfolios of the troubled institutions. Data on interest expense from the first quarter of 1988 for Texas thrifts and banks highlight the higher funding costs that these institutions were required to pay. For analysis, the thrifts and banks were divided into four groups on the basis of their capital positions. Figures on the interest-rate premiums at the Texas thrifts are shown in Table 5, and those for the Texas banks are shown in Table 6.

Table 5 figures indicate that during the first quarter of 1988 Texas thrifts in all four capital groupings paid deposit premiums. The thrifts in Group 1 include the top quarter of Texas thrifts ranked according to their capital positions. The thrifts in Group 4 include the bottom quarter of Texas thrifts ranked according to their capital positions. Differences in capitalization provide a rough proxy for risk differences among these financial institutions. Given its limitations, this risk proxy was used to determine whether the lower-capitalized Texas financial institutions were required to pay higher risk premiums.

Risk differentials across the four thrift groupings are consistent with the risk differences reflected in their different capital ratios. For example, the Texas thrifts with the lowest capital ratios, having −$11.1 billion in (GAAP) capital, paid 132 basis points more for deposits than did thrifts outside the state, whereas the premium at Texas thrifts with the highest capital ratios was 33 basis points. If capitalization is a consistent proxy for degree of risk, the figures in Table 5 identify the impact on solvent institutions of allowing insolvent thrifts to continue operations. The data illustrate that the Texas thrifts in the first grouping, with an average capital ratio of 8.0 percent, reported average funding costs of 7.29 percent. That compares unfavorably to average funding costs of 6.96 percent at thrifts outside of Texas, which had an average capital ratio of only 3.7 percent.

The figures in Table 6 for Texas banks provide a consistent story. For banks, the availability of additional data enabled us to calculate their average cost of large CDs in addition to their average overall cost of interest-bearing deposits. The figures indicate that each group of Texas banks was required to pay substantially higher deposit rates than the average rates paid by banks outside of Texas.

Table 5
Cost of Deposits at Texas Thrifts
(1988-I)

	Total Capital (GAAP, Billion $)	Average Capital Ratio	Average Cost of Deposits	Premium
Texas Thrifts	−11.2	−11.2%	7.70%	0.74
Texas Thrifts by Capital Groupings[1]				
1	0.8	8.0%	7.29%	0.33 **
2	0.8	2.5%	7.50%	0.54 **
3	−1.7	−5.5%	7.73%	0.77 **
4	−11.1	−50.3%	8.28%	1.32 **
Other U.S. Thrifts	42.8	3.7%	6.96%	—

1. The Texas thrifts are divided into 4 groups on the basis of their individual capital (GAAP) ratios.

** The premium for each of the groups is significant at the 99% level of significance.

SOURCE: Federal Home Loan Bank Board Thrift Financial Report.

Table 6
Cost of Deposits at Texas Banks
Domestic Offices
(1988-I)

	Average Primary Capital Ratio	Average Cost: Large CDs	Average Cost: Interest-bearing Deposits
Texas Banks	8.6%	6.91%	6.47%
Texas Banks by Capital Groupings[1]			
1	13.3%	6.81% *	6.34% **
2	9.0%	6.85% **	6.44% **
3	7.3%	6.91% **	6.48% **
4	4.7%	7.07% **	6.63% **
Other U.S. Banks	9.7%	6.64%	6.16%

1. The Texas banks are divided into 4 groups on the basis of their individual primary capital ratios.

* Denotes that the difference between the figure and that for other U.S. banks is significant at the 95% level of significance.

** Denotes that the difference between the figure and that for other U.S. banks is significant at the 99% level of significance.

SOURCE: Report of Condition and Income.

Similar to the thrift data, the deposit premiums at the Texas banks also increased with the higher-risk profiles of the lower-rated banks.[10]

The evidence reported in Tables 5 and 6 suggests that concerns about the state's most troubled financial institutions have spilled over to the state's stronger institutions. The data also suggest that competitive pressures from the state's most troubled financial institutions required the stronger institutions to pay higher interest rates on their deposits to retain adequate funding. This process not only weakens the financial condition of the solvent banks and thrifts in Texas, it also penalizes the stronger institutions *because of* the problems of the most troubled institutions. Thus, the efforts of the FHLBB to assist insolvent institutions to continue operations have a negative impact on the current operations of the unassisted institutions in the state. Similarly, decisions by the FDIC to provide special assistance to several of the state's largest banking organizations, including the provision of 100-percent deposit guarantees to the depositors of First RepublicBank Corp. and First City Bancorp., penalize those banks that have not received the special assistance.[11]

Policy Implications: Assessment of the Issues

The characteristics of the Texas deposit market reflect a new form of crisis in confidence. Today's crisis is not characterized by panics and a generalized loss of confidence, nor by widespread deposit outflows from insolvent Texas thrifts to other weak but solvent institutions in Texas or to stronger institutions elsewhere in the country. To the contrary, in the current environment, depositors recognize that many of the operating Texas thrifts are insolvent. Depositors also recognize that the financial condition of many other banks and thrifts in the state is sufficiently weak to place these institutions at high risk of becoming insolvent in the near future. Large deposit outflows have not occurred at these weak financial institutions because depositors, regardless of deposit size, do not expect that they will incur financial loss.[12] But the policies that have removed incentives for depositors to reallocate their deposits from the most troubled institutions in the country have also removed a market process that contributes to the overall safety and soundness of the financial system.

The decision of the FDIC to provide full deposit guarantees on all of the deposits of First RepublicBank Corp. and First City Bancorp. was made to dampen incentives for depositors to withdraw their funds from these troubled institutions. But those actions also encouraged depositors to shift their funds from institutions that did not receive guarantees into the large troubled banking organizations that received the special guarantee. Such policies not only penalize the smaller institutions relative to the larger ones, they also penalize the more conservatively-managed institutions over the more aggressive ones.[13] Similarly, the funding programs implemented by the FHLB-Dallas encourage depositors to move their funds into the more troubled institutions. The Southwest Plan has this result as a *stated objective*.

Insolvent thrifts are able to continue to operate in Texas and elsewhere in the country not because their depositors view their problems to be temporary nor because their depositors have confidence in the financial strength of the FSLIC insurance fund, but, rather, because, in all likelihood, the public expects the U.S. Treasury to provide back-up coverage to the FSLIC insurance fund.[14] The public also anticipates that this back-up coverage would enable the appropriate regulatory agency either to recapitalize the ailing financial institutions or to close them without losses to depositors. At the same time, the investing public has questions about the manner in which the Treasury Department would provide this assistance. Specifically, questions persist about how the assistance would be implemented and how it would be financed.

These unknowns complicate assessments of the viability of the troubled financial institutions both in Texas and elsewhere throughout the country. Regarding the Texas institutions, depositors are requiring risk premiums at virtually all of them. These risk premiums are not likely to be eliminated until the uncertainty about the market value of the nonperforming assets held by the Texas financial institutions is removed. Similarly, capital investors are more reluctant to commit capital to the ailing Texas institutions presumably for two reasons: 1) because of questions about the longer-term viability of the institutions and, 2) because investors anticipate that larger subsidies will be available to acquire these institutions in the future if their financial condition should further deteriorate. The expectation that larger subsidies will be available in the future discourages private capital from flowing into the region at this time. This expectation also increases the probability that a larger problem will develop in the future.

Without adequate recapitalization, the troubled assets held by the Texas financial institutions will continue to generate a significant drag on earnings, and the risk premiums required on the deposits of these institutions will prevent them from competing effectively for profitable business with other financial institutions outside the state. At a minimum, the need to fund troubled assets with deposits issued at premium rates will prevent Texas institutions from earning a competitive rate of return. And, given the normal spreads in the industry, it could also prevent a large portion of the Texas institutions from earning a positive return. This, in turn, could impair the state's economic recovery.

Regional Focus: National Problem

Despite the regional focus on current difficulties in Texas, the more general problem of continued operations of insolvent thrifts extends beyond a regional issue. Insolvent thrifts are operating throughout the country. Similarly, the expectation that a growing portion of the nation's banks are "too big to fail" has important moral-hazard implications on decisions to incur risk at federally-insured financial institutions nationwide. These difficult issues, along with the more general question of how best to reform the overall U.S. financial structure, are receiving much attention from all relevant circles—financial market participants, policymakers, academicians, and politicians.

The numerous issues relevant to financial reform in general are too extensive to be addressed in this paper.[15] But given the far-reaching implications that these reforms will have on the operations of U.S. financial institutions, it is our view that the optimal approach to the problems of the Texas institutions is to address them as an integral part of a comprehensive reform of the U.S. financial system. Moreover, it is possible that the magnitude of current financial difficulties at Texas financial institutions offers a common focus that could facilitate the process of negotiating a comprehensive reform plan.

Much has been written on alternative approaches to financial reform in this country.[16] In this study we will not address the relative merits of these plans. It is our view, however, that the Texas problem is part of a broader problem with the underlying incentive structure that motivates federally-insured financial institutions throughout this country to incur excessive risk. In order to minimize the potential for significant financial problems to emerge elsewhere in the future, it is preferable to address the Texas problem in the context of these broader issues of moral hazard.

Conclusion

In conclusion, the recent record of U.S. financial problems suggests that piecemeal efforts of introducing financial reforms, coupled with policy efforts that focus on the symptoms of the financial problems rather than on their underlying causes, have contributed to, rather than diminished, unstable financial conditions in this country. In particular, legislative changes which have reduced constraints that were imposed to prevent federally-insured financial institutions from incurring excessive risk, without introducing changes to the nation's system of financial safety nets, have contributed to current financial difficulties.

Among other changes, the partial efforts to deregulate U.S. financial institutions that were included in the Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 broadened the financial powers of federally-insured financial institutions, and pending legislation will broaden them further. But, thus far, legislation has not been introduced that addresses the moral-hazard problems which result from 100-percent deposit guarantees and from federal assistance to recapitalize failed financial institutions.

The magnitude of current financial difficulties in Texas and elsewhere in the country may now be of sufficient concern to facilitate the introduction of a broad-based proposal to reform the U.S. financial structure. The purpose of this study is to examine the magnitude of the financial difficulties at Texas banks and thrifts. The issues examined in the study highlight our concerns about the long-term impact of forbearance policies used by the FHLBB to enable insolvent thrifts to continue operating. Similarly, decisions made by the FDIC to assist banks that are "too big to fail" also raise important policy issues. In particular, those policies raise serious questions about the long-term viability of a private financial system in this country. Efforts to understand these problems may assist the process of introducing a viable solution to our need for comprehensive financial reform. Finally, although we do not minimize the difficulties involved in implementing a comprehensive plan to reform the U.S. financial structure, it is possible that the Texas problem may be a catalyst for introducing such a plan.

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1. The FHLB-Dallas also is awaiting approval from the FHLBB of a fourth program called the "DalNote" program. The "DalNote" program is designed to have the FHLB-Dallas act as agent to raise funds for the more troubled Southwest thrifts. The plan calls for the FHLB-Dallas to issue a special series of secured notes that will be collateralized by FSLIC-insured CDs. The CDs will be purchased by the FHLB-Dallas from the more troubled thrifts in the Dallas District. The collateralized notes issued by the Dallas Bank are expected to be more attractive to investors than are FSLIC-insured CDs issued directly by the individual thrifts. The "DalNotes" will have maturities of six months to three years and they will be sold in minimum denominations of $50,000 and in $5,000 multiples thereafter. The FHLB-Dallas hopes to raise about $4 billion with this program.
2. The additional guarantee also reduces depositor concerns about potential "tie-up" costs that might accompany the closing of a troubled thrift given the reserve deficiency of the FSLIC fund. In essence, the FHLB-Dallas is providing back-up insurance coverage to thrift depositors. Drexel Burnham Lambert, Inc. agreed to market these letter of credit-enhanced CDs, but interest from other Wall Street brokerage firms has been limited.
3. For this program New Orleans-based Howard, Weil, Labouisse, Fredrichs has agreed to market FSLIC-insured CDs in denominations of $90,000 on behalf of 50 S&Ls in the FHLB's Dallas District.
4. Calculations of the average premium paid by Texas thrifts relative to thrifts outside of Texas indicate that the Texas thrift premium increased slightly from 67 basis points in 1987-IV to 74 basis points in 1988-I. In individual local market areas some declines in premiums were reported. These latter declines could reflect the impact of efforts to close insolvent thrifts. For example, FHLBB Chairman M. Danny Wall indicated that the interest rates paid by some of the competitors of Vernon Savings declined by as much as 100 basis points immediately following the Vernon closing. See "Regulator Recaps Benefits from Vernon Closing", by David LaGesse, *American Banker*, (April 7, 1988), p.3.
5. This estimate was cited in "Plan for Rescuing S&Ls Isn't Promising", by Robert E. Taylor, *Wall Street Journal*, (April 21, 1988), p.6.
6. Concerns about the insolvency of the FSLIC could also impact investor perceptions about the strength of the FDIC fund, particularly given the continued speculation that the two deposit insurance funds will be merged. For a more complete discussion of the condition of the FSLIC and the overall condition of the thrift industry, see the testimony of Bert Ely, Corporate Financial Consultant, Ely and Co., Inc., to the Senate Banking Committee on May 19, 1988.
7. The continued rise in nonperforming loans, other than real estate, remains a source of concern for Texas banks, but uncertainty about the quality of their real estate loan portfolios is the more critical problem at the present time. At the end of last year, Texas banks and thrifts had about $31 billion of troubled real estate assets, including $18 billion in problem real estate loans and about $13 billion in foreclosed properties. In addition, the Dallas liquidation office of the FDIC held another $4 billion in troubled assets from bank closings that occurred primarily in Texas and Oklahoma. Similarly, a large portion of the $5.2 billion in troubled real estate assets held by the Federal Asset Disposition Association (FADA) in June 1987 was from Texas thrifts.
8. In addition to the 50 insured banks, 2 private uninsured Texas banks failed in 1987.
9. Special assistance to the BancTexas Group impacted 11 banks affiliated with that bank holding company. The First City transaction involved 60 members of that major Texas bank holding company. Special

assistance to Texas Bancorp. involved 2 banks, while Oak Forest National was a single bank transaction. There are 24 banks affiliated with Texas American Bancshares, and 12 banks with National Bancshares Corporation.

10. A similar pattern was revealed by grouping the Texas banks according to their CAMEL ratings. The average cost of interest-bearing deposits at banks with 1 and 2 CAMEL ratings was 26 basis points more than the average cost of interest-bearing deposits at banks outside of Texas, whereas Texas banks with a 5 CAMEL rating paid 70 basis points more for their interest-bearing deposits.

11. The short-term negative impact of these decisions on the unassisted banks is in addition to the longer-term moral-hazard dilemma that results from special assistance, including 100-percent deposit guarantees. For a thorough review of the widely accepted arguments on the moral-hazard dilemma, see George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane, and George C. Kaufman, *Perspectives on Safe and Sound Banking: Past, Present, and Future, A Study Commissioned by the American Bankers Association* (Cambridge, Mass: The MIT Press, 1986). That study also includes an extensive bibliography on other related safety and soundness issues.

12. Substantial deposit outflows did occur at First RepublicBank Corp. earlier this year, but the concerns of depositors of First RepublicBank did not generate unmanageable spillover runs to other banks in Texas. The FDIC recently arranged the acquisition of First RepublicBank by North Carolina-based NCNB Corporation to form a new organization, NCNB Texas National Bank.

13. On this issue, see Eugenie D. Short, "FDIC Settlement Practices and the Size of Failed Banks", *Economic Review*, Federal Reserve Bank of Dallas, (March 1985), p. 12-20. Regarding the impact of these policies on risk decisions at small versus large banks, see Eugenie D. Short, "Bank Problems and Financial Safety Nets", *Economic Review*, Federal Reserve Bank of Dallas, (March 1987), p. 17-28.

14. This issue was recently complicated by the House Banking Committee's reluctance to affirm a federal guarantee to FSLIC notes. See Jim McTague, "FSLIC Hamstrung by Lack of Federal Guarantees for its Notes," *American Banker*, (August 16, 1988), p. 14.

15. For a thorough overview of these issues, see *Restructuring the Financial System*, proceedings of a Symposium sponsored by the Federal Reserve Bank of Kansas City, (August 1987).

16. Ibid. See also, "Financial Restructuring", *Challenge*, (November/December 1987).