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The Thrift Insurance Crisis

Since its founding in 1934, the Federal Savings and Loan Insurance Corporation (FSLIC) has helped to prevent depositor runs and panics at the thrift institutions it insures. Beginning in the early 1980s, however, the FSLIC has faced a growing threat to its ability to perform this function. Indeed, with the number of thrift failures and insolvencies at unheard-of levels, the FSLIC is now insolvent to the extent of about $90 billion, according to Treasury Department estimates. This *Letter* discusses why we are faced with a problem of this magnitude and how we might pay for its resolution.

Thrift failures

The large, unexpected rise in interest rates from late 1979 through 1981 was the catalyst for the crisis the thrift industry and the FSLIC now face (although the rise in interest rates through the entire latter half of the 1970s left the industry in a vulnerable position). During this period, the cost of many thrifts' deposits exceeded the yield on the long-term fixed-rate mortgages they held. This negative interest spread meant that the market value of these institutions' assets had fallen below that of their liabilities. Thus, except for the thrifts with large equity capital cushions, much of the rest of the industry was insolvent on a market-value basis in 1981, even though the book, or historical, values of assets and liabilities tended to camouflage the problem. Moreover, if the FSLIC had tried at this point to liquidate all the market-value insolvent thrifts, it would have been bankrupt as well.

These weak and insolvent thrifts faced enormous incentives to pursue high-risk strategies. With little or none of their own money at stake any longer, owners of these institutions faced a "heads-I-win, tails-you-lose" situation. If their high-risk, high-return investments panned out, they stood to profit handsomely. And if their investments fared poorly, the burden fell on the FSLIC. At the same time, the FSLIC itself was also market-value insolvent and lacked the resources to resolve the problems quickly. Thus, a policy of capital forbearance was pursued in the hope that interest rates would decline and the industry would be restored to solvency. This approach enabled weakened institutions to continue to operate and take even greater risks. Also, Congress relaxed restrictions on thrift activities, thereby providing new opportunities for risk-taking in activities that regulators were unaccustomed to monitoring. These factors all increased the risk exposure of the already weakened insurance fund.

To make matters worse, during this period the thrift industry also faced stiffer competition from banks and even nonbank financial firms that became major providers of home mortgages. This reduced thrifts' interest margins and profitability, which, in turn, further eroded thrifts' capital base, thus providing an additional incentive for risk taking.

This confluence of economic and regulatory events exposed a fatal flaw in the deposit insurance system. By charging insurance premiums unrelated to risk, deposit insurance provides an incentive for excessive risk taking. This incentive grows larger as institutions approach insolvency. Thus, once the FSLIC no longer had sufficient resources to close insolvent institutions, it was no surprise that weak and insolvent institutions created a large and growing problem.

How big is the problem?

Until recently, thrift industry spokesmen tended to play down the extent of the problem. But others argued that thrift losses were substantial. These divergent estimates tended to confuse policymakers and the public. Although Congress authorized a $10.8 billion increase in FSLIC borrowing in 1987 to resolve thrift insolvencies, that amount proved, in hindsight, woefully inadequate.

Currently, the estimates are converging at about $90 to $100 billion—staggering figures by any measure. Still, some economists argue the costs could be as high as $200 billion. The ultimate tally depends on the number of market-value insolvent thrifts and the extent to which they are insolvent. Although the number of book-value

insolvencies and book-value net worth are available, the FSLIC's cost when it liquidates or reorganizes a failed thrift is equal to the difference between the prices the institution's assets and liabilities can be sold for on the open market. Book accounting values have little relevance in a liquidation.

Through the end of 1988, the FSLIC had resolved over 200 savings and loan insolvencies, at an estimated total cost of approximately $40 billion. A small number of these resolutions entailed liquidations but the majority involved merger, reorganization, or purchase-of-asset and assumption-of-liability arrangements. In a liquidation, the FSLIC generally liquidates the thrift's assets and pays off the insured depositors, thereby incurring costs equal to the difference between the market values of the assets and liabilities. Alternatively, when the FSLIC reorganizes an ailing thrift or arranges for another institution to take control, it typically provides funds to bring the acquired thrift's market-value net worth close to zero as a necessary inducement to the acquirer. Also, the FSLIC may make guarantees to protect the acquirer against potential future losses, which can result in additional future costs to the FSLIC.

The Bush plan

In the plan recently presented by the Bush Administration, officials estimate that an additional $50 billion is needed to resolve the remaining involvencies. This figure brings the total cost to more than $90 billion. This amount is in line with several other estimates, including that of the FDIC, and is a reasonable benchmark measure of the current size of the FSLIC insolvency (that is, the aggregate negative net worth of insolvent institutions).

It is essential to distinguish between the current size of the insolvency and the stream of funds that might finance a solution to that problem over time. There are several ways this $90 billion could be financed. For example, the entire amount could be funded through the issuance of 30-year, 10 percent bonds. $9 billion per year would be needed to cover interest costs. If the $90 billion principal on these bonds were not amortized, it would be due in 30 years. One way to meet that obligation would be to purchase 30-year, zero-coupon bonds, as the Administration has proposed. In this case, an additional $5.2 billion would be needed to purchase the zero-coupon bonds, which, at an interest rate of 10 percent, would be worth $90 billion in 30 years.

Thrift industry resources

It is frequently argued that the savings and loan industry holds the primary responsibility for the current crisis and, therefore, should bear the burden of resolving the problem. Even if this is so, the industry's resources are inadequate.

As of mid-year 1988, thrifts that were solvent according to generally accepted accounting principles (GAAP) had a net worth of only $34 billion excluding goodwill. Taking this as an estimate of market-value net worth (even though regulatory incentives result in book net worth that generally overstates market-value net worth), the $34 billion would cover only a fraction of the estimated cost of the FSLIC bailout. Thus, even if all the net worth in the thrift industry could be taxed, the proceeds would be inadequate. And it is unreasonable to suppose such a draconian tax could be imposed while still preserving the industry.

A similar conclusion holds when one considers the thrift industry's ability to bear the financing costs. The Administration's plan to raise the insurance premium thrifts pay to 23 cents per $100 of total liabilities would yield about $2.9 billion per year, based on the industry's total liability base as of June 1988. Even if all this premium income could be used to service the bonds, $2.9 billion is a far cry from the $9 billion annual funding needed.

And even these premium figures are optimistic because they assume no loss of deposits at thrift institutions. Recent evidence is inconsistent with this assumption. In December 1988, there was an outflow of deposit liabilities at insured thrifts of about $8 billion. Similarly, in January and February, deposits fell by $10.7 billion and $8–9 billion, respectively. And this drawdown of deposits continues apace in March. Moreover, it will be extremely hard for thrifts to maintain their deposit base in the long run since banks would be paying a much lower premium of 15 cents per hundred, to say nothing of nondepository competitors that pay no insurance premium. In any event, it probably will not be possible to use all the premium income to service the interest cost of the bonds since some will be needed to

resolve future thrift failures. Also it would be prudent to set some aside to build a reserve fund, as the Bush plan proposes.

Some have proposed tapping the net worth of the Federal Home Loan Banks to raise additional funds. Since the Home Loan Banks are owned by the thrift industry, this would reduce the net worth of thrifts commensurately. Tapping the Home Loan Banks' net worth or retained earnings is a viable way to tax the thrifts' net worth, but the Banks are not an independent source of funds.

Who else might pay?
It is obvious that the thrift industry itself does not have sufficient resources to pay the total cost of resolving the FSLIC's insolvency. Some have argued that insurance premiums paid by commercial banks to their insuring agency, the Federal Deposit Insurance Corporation (FDIC), might be an appropriate source of funds. Domestic deposits of all FDIC-insured banks in the United States were approximately $2 trillion as of the middle of 1988. At the proposed premium of 15 cents per $100 of deposits, these deposits would produce about $3 billion in premium income each year.

Even if the banks' entire $3 billion premium income *could* be used for this purpose, the combined bank and thrift premium income still would not pay the $9 billion annual interest on the bonds used to resolve current thrift insolvencies. Moreover, the Bush plan calls for using the larger bank insurance premium only to increase the reserves of the FDIC. This is appropriate, considering that the number of bank failures is at a record high and the FDIC's reserves per deposit dollar are near an all-time low.

It might be conceivable to raise sufficient revenues for the FSLIC problem by subjecting the banking industry to further taxes. However, such taxes would impose a tremendous burden on the industry. Banks would face a large competitive disadvantage relative to money market funds and other financial firms that could offer bank-like services without the regulatory burden of the additional tax. Moreover, from equity considerations, there seems little reason to single out the banking industry now and in the future to pay for past thrift insolvencies.

In the final analysis, if the deposit insurance guarantees are to be honored, several billion dollars of additional funds per year must be obtained from another source, presumably general taxpayers. It is important to allocate sufficient funds to resolve current thrift insolvencies quickly. Delay will increase the ultimate cost since the longer insolvent and near-insolvent thrifts continue in operation, the greater will be their losses from excessive risk taking.

Never again
Equally important is the need to ensure that *future* thrift insolvencies will not require the use of general taxpayers' funds. The Administration proposal takes several important steps in this direction, mainly by imposing more stringent capital adequacy and regulatory standards on thrifts. Moreover, it proposes a detailed study of long-term deposit insurance reform.

The goal of such long-term reform should be to eliminate the incentives the bank and thrift insurance funds provide for excessive risk taking. Many approaches to reform are possible. The main issue is to ensure that if banks and thrifts choose to take risks, their owners' funds are on the line, and not the taxpayers'.

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Monetary Policy Objectives for 1989

Federal Reserve Chairman Alan Greenspan presented a report to the Congress on the Federal Reserve's monetary policy objectives for 1989 on February 21. The report includes a summary of the Federal Reserve's monetary policy plans along with a review of economic and financial developments in 1988 and the economic outlook in 1989. Single or multiple copies of the report can be obtained upon request from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120; phone (415) 974-2246.

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