ISSN 1045-6333

AFTER THE FIRREA: AN ANALYSIS OF THE SAVINGS AND LOAN INDUSTRY AFTER THE FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT OF 1989

Larry G. Locke*

Discussion Paper No. 71

5/90

Program in Law and Economics
Harvard Law School
Cambridge, MA 02138

The Program in Law and Economics is supported by a grant from the John M. Olin Foundation.

*John M. Olin Fellow in Law and Economics and student at Harvard Law School.

ABSTRACT

The traditional savings and loan industry operated under a simple economic model, (interest on mortgages minus cost of funds, divided by regulatory capital, equalled profitability). The industry also operated in a regulatorily protected oligopoly. Profitability was limited, but assured.

The strategic outcome of this industry structure was that savings and loans operated as an integrated provider of a bundle of products. They had one cost pool, one capital pool, and focussed their resources and attention exclusively on maintaining their net interest margin. In so doing they missed the fact that their customer base included substantial cross subsidies and that their assets and liabilities were mismatched on the yield curve.

The drastic rise in interest rates in the late 1970's and early 1980's hurt the industry dramatically. Not only did they suffer from a negative interest spread, their oligopoly and resulting subsidies were also destroyed as capital markets and mutual funds disintermediated borrowers and depositors respectively. S&L's were forced to compete with the money markets.

The regulatory response was to broaden the powers of S&L's to allow them to search for profitability outside their traditional business. The result was more losses. The losses due to interest rate mismatch were followed by losses due to poor investments in misunderstood businesses and credits.

The losses became so great that the insurer failed and the Congress was forced to intervene. Their intervention was the Financial Institution Reform, Recovery, and Enforcement Act of 1989. The FIRREA is a self proclaimed bailout bill which claims saving the industry as its purpose.

The FIRREA, in fact, will further weaken the industry through raising operating costs, reducing revenues, and increasing capital requirements. The FIRREA also raises significant barriers to exit which will heighten rivalry in the industry and further hasten its demise. The result may be that a bill claiming to bail out the industry, though substantively bailing out the insurer, may lead to the failure of both.

AFTER THE FIRREA

An Analysis of the Savings and Loan Industry After the Financial Institutions Reform, Recovery and Enforcement Act of 1989

Larry G. Locke

Introduction

This paper is about the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the impacts that legislation will have on the savings and loan industry.[1] One historically distinctive element of the S&L industry has been the aura of public policy that surrounds it. The statute which created the federal S&L industry asserted that S&L's served a vital public function. S&L's protected the savings of the working people of America and provided housing credit for a nation of homeowners.[2]

With the FIRREA, the congress continued this rhetorical posturing and stated in the legislative history that one of the purposes of the FIRREA was to bail out and reestablish a necessary industry.[3] The FIRREA has popularly been referred to as the S&L

---

[1]. Hereafter the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub.L. 101-73, 103 Stat. 183, will be referred to as the "FIRREA". Hereafter the Savings and Loan industry will be referred to by various names including "S&L's", "thrifts", and the term applied in the FIRREA, "SA's", for "Savings Associations".

[2]. "In order to provide thrift institutions for the deposit or investment of funds and for the extension of credit for homes and other goods and services, the [Federal Home Loan Bank] Board is authorized, ... to provide for the organization,... of associations to be known as Federal savings and loan associations.... The lending and investment authorities are conferred by this section to provide such institutions the flexibility necessary to maintain their role of providing credit for housing." 12 U.S.C. { 1464 as amended (1987).

[3]. "By placing the federal deposit insurance funds on sound financial footing the FIRRE Act seeks to restore public confidence in the savings and loan industry in order to insure a safe, stable, and viable system of affordable housing finance." FIRREA, { 101.

bailout or S&L rescue bill.[4] The purpose of this paper is to critically evaluate the FIRREA according to this self proclaimed purpose. We shall examine the FIRREA substantively and attempt to determine whether its effects on S&L's will satisfy its express purpose.

To ascertain the impact of the FIRREA we shall employ two simple models. The first model is the fundamental equation for traditional intermediary lenders; interest revenue minus cost of funds produced net income which, when divided by regulatory capital, determined profitability. Non-interest expenses and non-interest revenues were usually of marginal importance. The (Interest Revenue - Cost of Funds) / Regulatory Capital = Profitability model will be used to explore the impacts of the FIRREA on industry profitability by examining its impacts on the components of profitability.

The second model is equally intuitive. The regulatory regimes for U.S. intermediary lenders were dominated by government deposit insurance. Each regime was defined by statutes, regulations and agencies; a set for implementing the insurance regime itself, a set for controlling the risk put on the insurer by the industry, and a set designed to manage those institutions which fail and require

---

4. <u>See e.g.</u>, 135 Cong. Rec. S10403-02 (August 15, 1989) (Comments of Sen. Wirth) ("The rescue of the thrift industry is the largest Government bailout in our history.").

action by the insurer.[5] This trifurcated model of the regulatory regime centered upon deposit insurance will provide the model for approaching the FIRREA. This paper will examine the FIRREA's alterations to each of these subsystems in turn.

The paper will first discuss the economic model and then explore the causes of its breakdown which precipitated the S&L crisis of the 1980's. The paper will then take a statistical look at the industry which the FIRREA purports to bail out; an industry which, we shall see, was clearly in need of support. The paper will then turn to the legislature's solution to the crisis and analyze pertinent segments of the FIRREA. This section will utilize the simple regulatory framework to categorize portions of the FIRREA according to their purpose or function. The next section will combine these two analytical models to determine the impact of the statute on the industry. The final section will present some conclusions regarding whether and how the statute will actually bail out the industry.

One of the major elements of the FIRREA was the large sums it provides to recapitalize the failing FSLIC and to deal with S&L's which were either insolvent or approaching insolvency. This paper is not about that element. The attention of our analysis will be focussed on the currently "living" portion of the industry and the FIRREA's effects upon its competitive position and potential for

---

5. Although the structure produced by the statutes, regulations and agencies varied between the commercial banking and thrift regimes, they were functionally equivalent.

survival and profitability. However, since the structure and the financing of the bailout shall prove to have an impact on the surviving segment of the industry, portions of the bailout will be referenced.

I. THE TRADITIONAL ECONOMICS OF THE THRIFT INDUSTRY AND THEIR BREAKDOWN

The Traditional Model

During the 1950's, 1960's and into the late 1970's the thrift industry was uncomplicated. Revenue was generated by interest on home mortgage loans and also by fees charged to the borrower at funding.[6] The major expense item was the cost of funds required to make the loans.[7] Funds were raised by accepting deposits, mostly retail savings and time deposits. Funds were also raised through below market rate advances from the Federal Home Loan Banks.[8] The FHLB's not only provided the thrifts with a cheap source of funds, their stock, which all thrifts were required to hold, also paid

---

[6]. _See_ Exhibit A; Source, _Combined Financial Statements of FSLIC Insured Institutions_, 1987, pp. III-VIII, & 1984, p. IX.

[7]. _See_ Exhibit B; Source, _Combined Financial Statements of FSLIC Insured Institutions_, 1987, pp. III-VIII, & 1984, p. IX..

[8]. _See_ 12 U.S.C. {1429 (1932) (empowering Federal Home Loan Banks to lend to thrifts). Hereafter Federal Home Loan Banks will be referred to as "FHLB's".

excellent dividends.[9] Rates paid on deposits were set by Federal Reserve Board Regulation Q which limited the rates payable on all retail deposits.[10] Reg Q also provided a relative advantage to thrifts allowing them to pay up to 1/4% more than commercial banks. This was to compensate thrifts for their inability to accept demand deposits, a major source of interest free funds for commercial banks and to steer credit resources into the housing sector.

The difference between the interest earned on mortgage loans and the cost of funds comprised the lion's share of net income. Profitability was determined by dividing net income by the regulatorily required capital base. The margin between the cost of funds and the rate charged for loans so dominated the business that it was the factor through which all other parts of the business were interpreted. Non-interest expenses and non-loan products were all viewed as a means to maintain the margin through attracting deposits more cheaply or making it possible to charge a higher rate on mortgage loans.[11]

All thrifts shared this basic economic equation because the

---

[9]. Sam Zuckerman, "Home Loan Bank Dividends Expected to Drop", American Banker, August 17, 1989, pp. 1&12. FHLB dividends provided 28% of the income reported by solvent members of the San Francisco FHLB.

[10]. Regulation Q, as amended 12 C.F.R. {217 (1986). Hereafter the Regulation will be referred to as "Reg Q". Reg Q limited the interest payable on savings accounts and retail time deposits by commercial banks beginning in 1933. S&L's were brought under its jurisdiction in 1966.

[11]. Lowell L. Bryan, Breaking Up The Bank: Rethinking an Industry Under Siege, 1988, pp. 8-9.

regulation induced market structure prompted each thrift to emulate the others. The structure of the industry was oligopolistic despite the presence of over 3,000 thrift competitors and over 14,000 commercial banks. The oligopolies were sustained by branching restrictions. Every locale had its collection of thrifts and banks which competed against each other. Except in a few money centers, extraterritorial competitors had little impact on the market.

The profitability of the oligopoly was maintained on the cost side by Reg Q, the federally subsidized deposit insurance, and by below market FHLB advances. On the lending side of the equation the oligopolistic structure of the market allowed thrifts to simply pass along all reasonable costs of doing business to their borrowers in the form of higher rates and fees. Profitability was all but insured.

But profitability was limited. The oligopolistic pricing of loans at the arbitrary rate needed to cover all costs of the business could be sustained only so long as the oligopoly was maintained. Thrifts were thus locked in the competitive prisoner's dilemma often found in regulated oligopolies. Any attempt to differentiate amounted to defection. Given the generally unstable nature of any oligopoly it is unsurprising that repeated defections did occur. Wave after wave of innovation, started by defectors from the monopoly, was followed by the rest of the industry to avoid competitive differentiation.[12] The net result was a gradual increase in non-interest expense, unrelated to the fees those expenses were to generate, and with no impact on intraindustry competitive standing.[13]

The operational result of this strategic stalemate was that thrifts operated as an integrated provider of a bundle of services. Since cost of funds dominated expenses and since non-loan products were offered only to compete in the basic business, expenses for all products were pooled into a single cost unit and then offset against the revenues produced by lending. There was practically no attempt at activity or product cost accounting.[14] This pooling of costs and revenues caused thrift managers, like bank managers, to miss the crucial fact that part of their customer base was cross subsidizing other customers. For years large depositors had been accepting rates on their deposits below the market rate for those funds. This was partly due to the deposit insurance provided by the government below cost. But the greatest reason why large volume depositors were not drawn into the money markets was because rates had been low and stable enough for the past 3 decades that money market rates were never more than a few points above the Reg Q ceilings. The difference was not enough to spur the development of an alternative depository industry.

---

12. Bryan, Supra, note 11, at 9.

13. Id, at 17.

14. Id, at 9-10.

Another missed aspect of the thrift business, obscured by 30 years of steady profitability, was the exposure of the industry to interest rate swings. Thrifts supplemented their margin on a matched term basis by mismatching their terms on the yield curve. They took in mostly short term deposits, passbook accounts and CD's. These deposits were legally available to the depositor with some required notice but practically available on demand. The mortgage loans they generated had 10, 20, and 30 year maturities. As long as rates remained steady the mismatch was a profitable one.

One of the major weaknesses of the system however was political rather than economic. The thrift industry had established what was generally acknowledged as the most effective lobby in Washington. Thrifts were evenly spread across the country giving them a national presence. Their executives and board members often included some of the more prominent members of the community who tended to wield some political influence. The public interest charter of the industry also endeared them to the government. Trouble in the thrift industry meant trouble to savers and home buyers, a major and disproportionately powerful segment of any constituency. The thrift industry itself leveraged these favorable attributes by integrating the industry with the regulators. This action, more skeptically referred to as regulatory capture, will be discussed in some detail below.
The weakness of this favorable political and regulatory position is that since the market was oligopolistic and the regulator was

permissive there was no discipline on the industry. It took the catastrophic losses of the 1980's to break the political power of the industry and the violence of the break will handicap the industry for years into the future.

The Breakdown

The breakdown of the oligopolistic market system began with the sharp upturn in rates in the late 1970's.[15] The immediate crisis resulted from the mismatching of terms in thrift asset and liability portfolios. As their liabilities quickly repriced to the prevailing market rates their assets remained at the previous market levels. This threw the industry into a negative spread position on their portfolios.[16]

Thrifts had to continue to buy deposits even at the unprofitable levels in order to maintain their liquidity. They could have sold off assets instead but the rise in interest rates had also devalued their mortgage portfolios. As long as deposits were bought and the loans were carried at book value the thrifts appeared to have adequate capital. A sell off of mortgage loans would have led to a realization of the market value of the thrifts'

---

15. See Exhibit E; Source, Combined Financial Statements of FSLIC Insured Institutions, 1987, pp. III-VIII, & 1984, p. IX.

16. See Exhibit C; Source, Combined Financial Statements of FSLIC Insured Institutions, 1987, pp. III-VIII, & 1984, p. IX.

portfolios exposing their undercapitalization.[17]

Market rates rose so fast in 1978 and 1979 that the Reg. Q. ceilings forced thrifts to compete for uninsured deposits which were outside the purview of Reg. Q. Thrifts had to be empowered to compete for insured deposits by the repealing of Reg Q.[18] During the period when money market rates were high but the vestiges of Reg Q continued to hold down deposit rates the money market mutual fund business exploded and developed the infrastructure necessary to become a lasting competitor of depository institutions. Worst of all, the depositors who were attracted by the money market funds were those high dollar depositors who were currently providing the subsidy to the industry and the other thrift customers.

These customers moved to the money markets to recapture the subsidy for themselves. The absence of deposit insurance was unimportant since the assets of most money market funds, U.S. Treasury Bills, GNMA's and highly rated corporates, involve minimal risk.[19] The creation of the money market fund industry changed the nature of the disintermediation from being not only temporary and rate driven but structural as well. The large depositor subsidy was permanently broken and thrifts would henceforth have to compete

---

17. See Exhibit D; Source, Combined Financial Statements of FSLIC Insured Institutions, 1987, pp. III-VIII, & 1984, p. IX.

18. Repealed pursuant to the order of the Depository Institution Deregulation and Monetary Control Act, 12 U.S.C. { 3501 (1980).

19. "GNMA's" refers to a bond or other obligation secured by the guaranty of the Government National Mortgage Association.

not only with banks but also with the money markets for deposits.

Another change resulting from higher rates was that as deposits flowed into money markets, new securities were required to satisfy the burgeoning investable funds. The mortgage industry responded with a massive increase in securitization of loans. The amount of government backed secured mortgages outstanding grew from practically zero in the mid-1970's to over $600 billion in 1986.[20] Government agencies such as FNMA and GNMA enabled mortgages to be funded more cheaply than thrifts could fund them with deposits and also provided a higher yield to former depositors than could be obtained from the thrifts even after the repeal of Reg. Q.[21]

Securitized lending is an economically more efficient way to make certain types of secured loans. The sources of the improved efficiency include; better matching of interest rate risk to investors, transparency of credit risks, capital costs required are less than intermediary, lending and the avoidance of regional and sectoral concentration that plagues originators who fund their own loans.[22] Securitized lending also avoids the cross subsidies that distorted the bank loan market. When the cost of deposits began to track money market rates in 1984 this produced a levelling of the cost of funds between the securitizers and the intermediary

---

20. Bryan, Supra, note 11, at 76.

21. "FNMA" is the acronym commonly used to reference the Federal National Mortgage Association.

22. See, James A. Rosenthal & Juan M. Ocampo, "Analyzing the Economic Benefits of Securitized Credit", Journal of Applied Corporate Finance, Vol. 1, No. 3, Fall, 1988, pp. 32 et seq.

lenders.

The captive market that had formerly been required to accept the passing on of any cost incurred by the entire oligopoly now had a substitute available. Mortgage bankers, commercial banks and some thrifts began to specialize in generating mortgages while investment banks and some larger commercial banks and mortgage companies specialized in packaging the loans for the securities market.[23]

The industry found itself unable to compete in this new environment. They were outbid for deposits by the money markets and were undercut on the mortgages by the securitizers. Their business had become unbundled and the flow of funds from savers to investors now effectively bypassed them. Even in the low margin clerical aspects of their business they were beset by competition. Uncoupled from the funding consideration the servicing of mortgages began to evolve into a scale intensive, capital intensive business in which few thrifts were prepared to compete.[24] Only in the writing of mortgages were thrifts still able to utilize their major remaining strength, their customer knowledge and contacts.

The Regulatory Response

---

[23]. Craig J. Goldberg & Karen Rogers, "An Introduction to Asset Backed Securities", Journal of Applied Corporate Finance, Vol. 1, No. 3, Fall, 1988, pp. 20 et seq.

[24]. See generally, Bryan, Supra, note 11.

As their losses in the rate mismatch became compounded with their inability to compete in the new market environment thrifts began to suffer and fail.[25] The FSLIC was driven into insolvency by the failing thrifts and was forced to resort to propping up the dead members of the industry like financial zombies. This propping up took the form of permitting thrifts to misstate their capital, earnings and assets so that the FSLIC could appear to be legitimately allowing the thrifts to remain open.[26] Requirements for purchasing a thrift were lowered to attract capital to the industry.[27]

The most significant regulatory change was the vast expansion of powers granted to thrifts so that they could search for profitability outside their traditional business.[28] Thrifts were empowered to invest in real estate, personal loans, commercial loans, and numerous marginally related businesses. Supervision of thrifts was curtailed to control regulator costs and the effect of the moral hazard of deposit insurance was seen in its starkest

---

25. See Exhibits F & G; Source, Combined Financial Statements of FSLIC Insured Institutions, 1987, pp. III-VIII, & 1984, p. IX.

26. See e.g., 46 Fed. Reg. 50048-01 (1981) codified at 12 C.F.R. {{ 561 & 563 (allowing thrifts to amortize losses on sold assets).

27. See e.g., 51 Fed. Reg. 30956 (1986) codified at 12 C.F.R. {{ 543 et seq.

28. See Exhibit H; Source, Combined Financial Statements of FSLIC Insured Institutions, 1987, pp. III-VIII, & 1984, p. IX.
See e.g., Garn-St Germaine Depository Institutions Act of 1982, Pub. L. No. 97-320 (allowing thrifts greater involvement in commercial lending, leasing, consumer lending, educational lending, commercial paper, and corporate debt securities).

light.

Thrifts that had already lost all or much of their capital saw themselves as merely waiting for the insurer to close them. Therefore, during the period in which the insurer allowed them to remain open because the insurer itself was insolvent the decapitalized thrifts had nothing to lose and everything to gain. They increased the risks in their portfolios dramatically in an effort to earn their way out of insolvency before they were closed by the regulators. If they succeeded and recreated their capital the stockholders received the benefit. If they failed the loss fell to the insurer.

This strategy obviously involves growing the firm quickly so that the new, high yielding assets can overpower the low yielding mortgages.[29] Unfortunately, to fund their growth these undercapitalized thrifts bid up the price of deposits for the entire market. The effect became so pronounced that the Federal Home Loan Bank of Dallas actually began brokering deposits from healthy thrifts to the unhealthy ones in insurable amounts so that the unhealthy thrifts would not drive the cost of deposits up beyond the profitable reach of the healthy firms.

During this period many new investors entered the thrift industry. Entrepreneurs, often real estate developers, saw ownership of a thrift as a means to getting below market funds to invest in their projects, such investments were now permissible

---

[29]. See 135 Cong. Rec. H2553-02 (June 14, 1989) (Comments of Rep. Gonzalez).

under the regulatory regime. Thrifts became involved in Wall St. arbitrage, commercial real estate development, junk bonds, and a host of other non-traditional, and usually high risk businesses.[30]

For a brief period in the mid 1980's these strategies appeared to be gaining ground for the industry. Average profitability was up and industry health seemed to be improving. But by the late 1980's the mirage faded as the high risk investments began to produce the inevitable losses.[31] In some cases the previous income had been generated by up front fees to the borrower that had been funded out of the proceeds of the loan itself.[32] The predominant conclusion of the high risk, growth thrifts was deeper and deeper losses. The losses were, in many cases, compounded by fraud and gross mismanagement often by those recently lured into the industry by the promise of government subsidized funds and broad investment powers.

The insurer, already overburdened by the failures in the industry, lost billions.[33] Their political credibility as an

---

30. See 134 Cong. Rec. H1091-03 (October 21, 1988) (Comments of Rep. Leach).

31. See Exhibit F; Source, Combined Financial Statements of FSLIC Insured Institutions, 1987, PP. III-VIII, & 1984, p. IX.

32. Norman Strunck and Fred Case, Where Deregulation Went Wrong: A Look At The Causes Behind Savings and Loan Failures in The 1980's, 1988, p. 74.

33. Bureau of National Affairs, "Cost to Resolve Savings and Loan Mess May Be Higher Than Estimated, Says GAO", 53 BBR 665, November 6, 1989 (A GAO report stated that the FSLIC lost $66 billion in 1988, which increased its deficit to $75 billion. This is the largest deficit ever posted by a corporation, public or private).

effective regulator was destroyed. The losses were so great that the Congress was forced to make a massive infusion of taxpayer funds into the system to salvage the deposit insurance regime.[34]

II. THE CONDITION OF THE PRE-FIRREA S&L INDUSTRY

Financial Condition

The industry which the FIRREA confronted was one in almost total disarray. Decapitalized by the negative interest rate spread in the early 1980's, the industry went on to lose more money when the massive expansion into alternative assets began to turn sour later in the decade. The insolvency of the industry insurer caused the situation to worsen as bankrupt thrifts were kept afloat to postpone the cost of shutting them down. By the time the legislative response was completed the industry was in dire need of recapitalization and regulatory support. A cross sectioning of the industry by profitability, capital adequacy, and region should concisely describe its condition.

As of year-end 1988 there were 3,174 S&L's in the United States. In terms of profitability, 69% of the industry was

[34]. Bureau of National Affairs, "Cost to Resolve Savings and Loan Mess May Be Higher Than Estimated, Says GAO", 53 BBR 665, November 6, 1989 (The administration predicted that the bailout would cost $275 billion over 33 years. The GAO says it could be nore).

surviving and 31% was failing dramatically.[35] The aggregate profit generated by the over 2,000 solvent S&L's was $5.3 billion.[36] At the same time the less than 1,000 thrifts that suffered losses in 1988 generated an aggregate loss of $16.4 billion.[37] The net effect was that the unprofitable one third of the S&L industry totally dominated the aggregate profitability and caused a net industry loss of $11.1 billion.

In terms of capital adequacy, 365 thrifts, 11.5% of the industry, were estimated to be insolvent by Generally Acceptable Accounting Principles.[38] However, the capital shortage was not as bad as the profitability situation. Insolvent institutions represented only 8.2% of the assets of the industry, thus exhibiting a statistical concentration amongst smaller thrifts.[39] This assessment is further supported by the fact that the industry was, in aggregate, solvent. The approximately one tenth of the

---

35. See Exhibit I; Source, Sheshunof, S&L Quarterly, December, 1988.

36. Sheshunof, S&L Quarterly, 1988.

37. See Exhibit M; Source, Sheshunof, S&L Quarterly, December, 1988.

Sheshunof, Supra, note 36.

38. See Exhibit J; Source, Sheshunof, S&L Quarterly, December, 1988.

Hereafter Generally Acceptable Accounting Principles will be referred to as "GAAP".
The number of GAAP insolvent institutions had been as high as 505 during March of 1988 but had been reduced to 365 by regulatory action during the second half of the year. Sheshunof, Supra, note 37.

39. See Exhibit L; Source, Sheshunof, S&L Quarterly, December, 1988.

industry which was GAAP insolvent had negative capital of $10.7 billion while the solvent remainder had regulatory capital of $69.8 billion, leaving the industry with a composite capital of $59.1 billion.[40]

At first glance one would have little hope for an industry where one tenth of the members were insolvent and one third of them losing so much money that industry-wide insolvency would be imminent. But the capital of the industry was naturally concentrated in those thrifts which had maintained profitability. Assuming an enlightened regulator, the insolvent institutions which were also generating the losses would eventually fail and be removed from the market.

The collinearity of losses and insolvency were also regionally concentrated in the state of Texas. Of the net $11.1 billion loss in 1988, $9.7 billion of it was generated within the state of Texas.[41] A regional breakdown of the return on assets of the solvent portion of the industry highlights the concentration of losses in Texas and other southwestern states. The average ROA for the solvent nine tenths of the industry was .26%. The midwest, northeast and southeast were all in the black at .33%, .23% and .06% respectively. The west and north central regions posted modest losses of -.1% and -.72% respectively. The average ROA for

---

[40]. Sheshunof, Supra, note 36.

[41]. The total repossessed assets held by the insolvent S&L's was $25.5 billion, over half of them, $13.8 billion, were located in Texas. Sheshunof, Supra, note 36.

southwestern, solvent thrifts was -7.81%.[42] This data denotes that, at least in the southwest, the situation would continue to worsen.

Operational Condition

In addition to its weak financial condition the industry had no competitive strengths in either its traditional business or in the businesses it had newly been empowered to enter. In the traditional mortgage market, deposit rates tracked the rate on Treasury Bills and other money market instruments. Thrifts were forced to fund more of their assets with high cost CD's often generated by outside brokers or a thrift's own money desk. These deposits flowed quickly and easily in response to very small changes in comparative rates and thrifts that developed a dependency on them had to maintain a cost of funds at the top of the market to sustain their liquidity.

On the asset side, mortgage loans were being generated by non-thrift mortgage bankers and increasingly by commercial banks.[43] These businesses had larger and more sophisticated operations which

---

42. See Exhibit K; Source, Sheshunof, S&L Quarterly, December, 1988.

Sheshunof, Supra, note 36.

43. Phil Roosevelt, "Banks Surpass Thrifts In Mortgage Originations", American Banker, September 29, 1989. For the first time since the Department of HUD started keeping records, 19 years ago, commercial banks made more real estate loans than thrifts. Commercial banks made 38% of all real estate loans and thrifts made 35%.

gave them a cost advantage in generating the loans. The scale and sophistication of the competitors also assisted them in addressing their loans to the securities market.[44] They had sufficient scale to produce the mortgages needed to support a securities issue internally while most thrifts had to sell their loans to a larger packager. The competition also had the sophistication and technology to package the loans themselves and reap the profits of the securitization fee. Most thrifts were reliant on investment banks or these same competitors to provide packaging and securitizing expertise.[45]

Outside of their traditional market S&L's were attempting to make money in everything from junk bonds to real estate investment with minimal rates of success. Not only did their funding disadvantage now make them the high cost provider of funds they also seemed to lack the discretion necessary to choose new targets for their assets. During the late 1980's the greatest cause of thrift losses in these new lines of business seemed to be their lack of experience or knowledge outside of their traditional field. Control systems were all but non-existent. Investments were made under the pressure of mounting losses in the traditional business and were aimed at achieving maximum yield immediately.

---

44. Bryan, Supra, note 11, at 68.

45. Juan M. Ocampo & James A. Rosenthal, "The Future of Securitization and the Financial Services Industry", Journal of Applied Corporate Finance, Vol. 1, No. 3, Fall, 1988, pp. 90 et seq.

Political Condition

Perhaps the worst barometer of the industry's future was their new reputation in Congress and before the regulators as the party responsible for the enormous bailout. Their former congressional supporters had become so enraged at the cost of the bailout that much of the FIRREA's industry control provisions seemed to have a retributive flavor. Their friendly regulator, the FHLBB, had been replaced with the FDIC and an administrative regulator, the OTS, whose exclusive mandate was to be as tough on thrifts as the OCC was on banks.[46]

Yet the FIRREA purports to be a rebuilding of the industry. In the following section we shall review the statute itself, according to the three functional elements of the regulatory regime; the insurance system, the risk containment system, and the failure system. Then we shall determine the substantive impact of the bill on this unpopular industry.

III. THE FIRREA

A. The Insurance System

1. Structural Change

Two Insurance Funds, One Insurer

---

[46]. The FHLBB, OTS, OCC, and FDIC will be defined below.

The FIRREA effected a structural change in the regulatory regime that manages and deploys the insurance system for S&L's. The Federal Savings and Loan Insurance Corporation was abolished and its function of insuring S&L's was transferred to the Federal Deposit Insurance Corporation.[47] The old FSLIC fund, however, is not to be merged with the FDIC's fund for insuring commercial banks. Instead those two funds will remain separate within the FDIC. The old FSLIC fund has been renamed the Savings Association Insurance Fund and the old FDIC fund was renamed the Bank Insurance Fund.[48]

The abolishment of the FSLIC was partly driven by its destitute financial state, partly by a structural flaw within the S&L regulatory system, and partly by a perceived failure by incumbent regulatory personnel. In early 1987 the General Accounting Office of the federal government declared the FSLIC insolvent as of year end 1986, in fact, over $6 billion insolvent.[49]

---

[47]. Hereafter the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation will be referred to as the "FSLIC" and the "FDIC", respectively. FIRREA, {201 amends the Federal Deposit Insurance Act, 12 U.S.C. { 1811 et seq. as amended (1987) to allow the FDIC to insure Savings Associations.

[48]. The Savings Association Insurance Fund will hereafter be called the "SAIF"; the Bank Insurance Fund will hereafter be called the "BIF".

[49]. R. Dan Brumbaugh, JR, Thrifts Under Siege, 1988, p.51. Discussions of regulatory restructuring, and personnel failures will follow later in the paper.

The aggregation of insurance functions within the FDIC seems to be a credit to the political power and savvy of FDIC Chairman, William Seidman. Throughout the legislative process Seidman lobbied the Congress for increased power for his agency.[50] Faced with a shortage of credible alternatives the Congress made the only obvious choice, to combine the insurance functions in the FDIC.

Seidman was able to prove his agency's competence to manage the thrift insurance problems by his management of over 230 insolvent S&L's during the summer of 1989 as the FIRREA worked its way through Congress and while the FSLIC was incapable of handling the caseload.[51] The added responsibility however so encumbered the FDIC's resources that they were forced to ask state regulators to bear more of the field examination burden.

In may of 1989 the FDIC had only 1,971 field examiners with plans to expand to 2,222 by year-end.[52] Some of the FDIC's detractors noticed this overextension and tried to warn the Congress that expanding the scope of the FDIC too far could put it

---

[50]. At one time Seidman requested that the congress authorize the FDIC to be the primary federal regulator of state chartered S&L's. Barbara A. Rehm, "Seidman Urges FDIC Oversight of State Thrifts", American Banker, May, 9, 1989, pp. 3 & 13.

[51]. Barbara A. Rehm, "Seidman Urges FDIC Oversight of State Thrifts", American Banker, May, 9, 1989, pp. 3 & 13. A further tribute to Seidman's political savvy is that the FSLIC was forced to pay the expenses of the FDIC for their management of the insolvent thrifts.

[52]. Barbara A. Rehm, "Strained FDIC Asks States to Take Over More Exams", American Banker, May 8, 1989, pp. 1 & 14.

in danger of following the path of the FSLIC into the cycle of understaffing, inadequate supervision, industry failure and finally regulatory failure.[53] In spite of such precautionary rhetoric the FDIC came out of the legislative process with both insurance funds, increased funding ability, and broader regulatory powers.

To help it perform its increased responsibilities the liquidity and funding capacity of the FDIC has been increased.[54] The FDIC's borrowing limit from the treasury has been increased from $3 billion to $5 billion.[55] All advances, however, must be approved by the Treasury. More valuable than the enhanced borrowing authority is the expressed federal guaranty for both its funds. The FIRREA provides that both the SAIF and the BIF carry the full faith and credit of the United States.

The twin funds are to remain separate in all practical respects. Assessments for one may not be deposited in the other and disbursements from either fund may only be made to or for the

---

[53]. Barbara A. Rehm, "Fed's Johnson Says Overextended FDIC May Put Banking Industry in Jeopardy", American Banker, May 1, 1989, pp. 1 & 15.

[54]. Besides the inclusion of a new fund and increased funding, the FDIC has also been expanded from three directors to five. Two will be ex officio, the Comptroller of Currency and the Director of the Office of Thrift Supervision. The other three will be appointed by the president with the consent of the senate and after 1993 only three of the five members may be from the same political party. Directors cannot work for insured institutions while in office and may not be affiliated with a Reserve Bank or a Federal Home Loan Bank, nor can they hold stock in any insured institution. See FIRREA, {2.03

[55]. FIRREA, {218.

benefit of members of that same fund.[56] Despite the separate funds, however, the functions of the FDIC may be integrated for the two insured groups. The FIRREA provides that expenses of the FDIC are to be allocated as much as possible between the funds on a direct costing basis. Where expenses cannot be traced to a particular fund the expenses are to be shared by the two funds on a percentage of the FDIC's total assets basis.[57]

Two Logos, One Guarantor

Logos shall also remain distinctive by the type of institution being insured. The FIRREA provides that insured SA's are to display a logo which does not mention any governmental agency but only; 1) states that insured deposits are backed by the full faith and credit of the United States, 2) States that deposits are insured to $100,000, and 3) displays the symbol of the American eagle.[58] Insured banks have the option of displaying a logo meeting the above description, or, complying with the pre-FIRREA logo

---

56. The Clear intent of the Congress is not to force the commercial banking industry, through increased assessments and diversion of BIF funds to SA's, to finance the failures of the thrift industry.

57. FIRREA, §211. There is a certain illogic in this costing scheme. If one industry is failing and its fund is being depleted, more costs will be incurred in supervising members of that industry than in supervising members of the healthier industry.

58. Section 221 of the FIRREA amends §18 of the Federal Deposit Insurance Act (12 U.S.C. § 1828 as amended (1987)) to provide for the new logo standards.

rules.[59] The FDIC is to police the logo requirements and may promulgate any regulations necessary to insure their enforcement.

The legislative battle over the appropriate logo for SA's appears to have been one of the most heated. The banking lobby was extremely concerned that the SA's not be permitted to bear FDIC logos on their doors. They argued that it would hurt the banks' reputation to have their insurance thought of as identical to the SA's insurance. The SA's argued that logo decals must be the same for all insured institutions in order to guarantee a level playing field in the market for deposits. The Bush administration was reported to have originally supported the position of the S&L's.[60] Certainly since both funds are now guaranteed by the United States government there is no difference between the insurance funds from the consumers perspective.[61]

The irony of the situation is that in spite of their victory in the battle over separate logos the banking lobby lost the more critical war of the ability to advertise FDIC coverage. The FIRREA

59. FIRREA, {221

60. Jim McTague, "New Rescue Law Permits Thrifts to Advertise Coverage by FDIC", American Banker, August 16, 1989, pp. 1 & 13.

61. Paul Horvitz, University of Houston Banking Professor, pointed out that given that both funds now carry the full faith and credit of the government the only reason for having two logos is to fool the public into thinking that the funds are somehow different. If this subterfuge is successful the net result will be that SA's will have to pay a premium over banks for their deposits. Paul M. Horvitz, "Congress managed to Bungle the Bailout", American Banker, September 16, 1989, p. 4.

proscribes SA's from bearing the FDIC logo but does not mention whether SA's can advertise that they are FDIC insured. Consequently, after the bill was signed into law the FDIC issued an opinion declaring that SA's could advertise FDIC insurance and need not explain the difference between the BIF and the SAIF.[62] The banking lobby has promised to fight the FDIC opinion.[63]

2. Premium Assessments.

Assessment Rates

One source of funds for financing the bailout will be an increase in insurance assessments. Assessment rates for the SAIF have been set presently at .208% of insured deposits and are scheduled to increase to .23% in 1991 before they will decrease to .18% in 1994 and further decrease to .15% in 1998. The Bank Insurance Fund's assessment rate, currently set at .083% is scheduled to be raised to .12% in 1990 and further raised to .15%

---

[62]. Jim McTague, "New Rescue Law Permits Thrifts to Advertise Coverage by FDIC", American Banker, August 16, 1989, pp. 1 & 13.

[63]. See Bureau of National Affairs, "ABA, Commercial Banks Decry Advertising By Thrifts That Reference 'FDIC Insured'". 53 BBR 699, (Nov. 13, 1989); See also Barbara A. Rehm, "Banks Furious Over Thrifts Use of 'FDIC-Insured'", American Banker, August 28, 1989, pp. 1&12.

in 1991.[64]

The schedules are only Congressional guidance for the FDIC who has the authority to raise the assessment rates if necessary to restore the funds. However, the discretion of the FDIC to raise the rates is capped by a statutory ceiling of .325% of deposits and a maximum annual increase of .075%.[65] The maximum rates set by the Congress are also to apply to all insurance related assessments against members. Any assessments made by the Resolution Trust Corporation are to be deducted from the maximum allowable assessment of the FDIC.[66]

In 1985 the FSLIC increased its funding by assessing an additional 1/8 of 1% of deposits on thrifts. The Competitive Equality Banking Act also provided funding for the FSLIC by forcing the Federal Home Loan Banks to contribute much of their undivided profits to the fund.[67] By 1987 the special assessments totalled $3.4 billion.[68] The FSLIC had the power to make an emergency, one time assessment of an additional 1% of deposits but even at year

64. Section 208 of the FIRREA provides the FDIC with power to assess both types of institutions and also supplies the schedule of assessment rates. Assessment rates and target reserve ratios are to be set by the FDIC for both funds annually.

65. The FDIC is also prohibited from raising the SAIF assessment rate above the scheduled rate before 1995. The BIF assessment rate may not be raised above the scheduled rate before 1995 either unless the fund falls below the target reserve ratio.

66. Hereafter the Resolution Trust Corporation will be referred to as the "RTC".

67. Pub. L. No. 100-86 (1987).

68. Norman Strunk & Fred Case, Supra, note 32, at 5.

end 1986, when the fund was $6 billion in the red, they refused to make the assessment. At that time a 1% of deposits assessment would have eliminated 1/4 of the industry's GAAP net worth, almost certainly creating more problems for the fund than it would solve.[69]

Target Ratios

The FDIC has also been given Congressional guidance as to the proper level at which to maintain the two funds. The target ratio of fund reserves to insured deposits was initially set at 1.25%. The FDIC has the authority to change that target if it fears significant risk of future losses to the fund.[70] The FDIC's discretion over the target reserve ratios is capped at 1.5% of insured deposits.[71]

Assessments collected by the FDIC in excess of the target reserve ratios are considered a supplemental reserve and ultimately are to be rebated to the members of the fund if found to be unneeded to maintain the fund. The FDIC does have the power, for an unspecified period of time, to maintain the supplemental reserve

---

69. R. Dan Brumbaugh, JR, Supra, note 49, at 33.

70. The language of the House version of the bill, allowing the FDIC to raise the target only for a "probable risk" to the fund was eschewed in favor of the Senate version that required only a "significant risk". The Joint Explanatory Statement of the Committee of Conference states that the Senate language was adopted in order to clearly avoid a possible inference from the House language that the FDIC's fear of loss must be judged "more likely than not" in order to raise the target reserve ratios.

71. FIRREA, {208.

to fund future expected losses, only rebating the income and the principal of the supplemental reserve as they determine the money not to be needed.[72]

Both the assessment rates and the target ratios for the two funds are to be set independently. This will allow the FDIC to instill a measure of interindustry risk based pricing into the insurance system. The authority to independently set rates and the FDIC's ability to vary those rates according to the respective risks within the industries will have an impact on the attractiveness of the various industries. Mispricing the rates in one fund versus the other could lead to an inefficient allocation of capital. Investors would respond to the FDIC distortion of the risks and rewards of the competing industries rather than to the underlying economics of the businesses.

This problem existed before the FIRREA. FSLIC and FDIC assessment rates were always set independently of one another. But under the old regime both were set by the Congress with very little discretion left in the hands of the insurers. Whether allowing the FDIC to set assessment rates is more efficient than allowing Congress this discretion turns on whether the FDIC is a better assessor of risk than Congress. This is an empirical issue for which, as yet, the FDIC has given us no data points. A theoretical comparison suggests that while either body could accurately assess the risks, the FDIC, being insulated from

---

[72]. Id.

political pressure, would be better equipped to effectuate rates commensurate with the risks.[73]

3. Insurance Pooling

Dividing the Pools

To maintain the integrity of both insurance funds and to avoid interindustry subsidization of the bailout the FIRREA places some strict limits on the ability of institutions to change their coverage from one fund to the other. The FDIC is forbidden from approving any such changes, with some notable exceptions, for five years after enactment.[74]

In addition, to maintain adequate coverage in both pools, any institution changing pools must pay both an exit fee to the fund which they leave and an entry fee to the fund into which they enter. The entry fee is to be set by the FDIC and the exit fee jointly set by the FDIC and the Secretary of the Treasury.[75]

Complete separation of the insurance funds to insulate banks from the cost of the bailout was a major victory for the banking

---

[73]. Giving the FDIC discretion over the assessment rates would also tend to have an upward bias on both rates, because of their natural risk aversion as the insurer.

[74]. The five year moratorium extends the moratorium placed on changing insurance funds originally established in August of 1987. See Competitive Equality Banking Act, Pub. L. No. 100-86, {306 (h).

[75]. FIRREA, {206.

industry. Banks now have the potential to begin receiving rebates from their assessments as early as 1993.[76] This would reduce the net insurance premium on banks to between 7 and 8 basis points, lower even than the pre-FIRREA assessment rates.

The potential for reduced rates stems from a FIRREA provision which alters the way the FDIC funds its expenses. Formerly, current expenses were to be paid out of current assessment income or, if current assessment income was insufficient, from future assessments. Both the principal and interest income of the fund was to remain untouched. Under the new regime current expenses are to be paid first out of investment income, then from assessment income and finally out of the principal of the fund.[77] This new system would increase the riskiness of the funds themselves if the Treasury had not been superimposed as a guarantor of both funds.

It is conceivable, however, that the banking industry will ultimately loose this advantage over the thrifts. If the time at which banks are to begin receiving rebates coincides with the Treasury's funding of the bailout the rebates would have a two fold effect on the federal budget. Since the assessments are part of the government's budgeted income, their rebate would enlarge the

---

[76]. John Quinn, chief bank statistician for the FDIC predicted that the BIF would be able to reach the 1.25% reserves to deposits and make a partial rebate by 1993, with a full rebate of the added assessment in 1994. Rebecca Cox, "Bailout Provision May Ultimately Cut Bank Premiums" American Banker, August 14, 1989, pp. 1 & 14.

[77]. Rebecca Cox, "Bailout Provision May Ultimately Cut Bank Premiums" American Banker, August 14, 1989, pp. 1 & 14.

deficit. At the same time, Treasury expenses would also impact the budget. It could be politically infeasible for the Congress to allow both of those budget costs simultaneously.

Crossing the Divide

Conversion from one fund to the other is broadly defined. It includes conversions resulting from mergers between members of different funds and any transfer of an obligation to pay depositors from a member of one fund to a member of the other.[78] The FDIC is permitted to approve some partial conversions within the five year moratorium in certain circumstances.[79] The FDIC may also authorize conversions as part of an assisted sale of a troubled SA.

To permit conversion under these circumstances the FDIC must make a determination that the amount of money saved by the SAIF in the conversion is greater than the amount of income foregone by the SAIF over the remaining life of the moratorium.[80] If the assisted

---

78. FIRREA, {205.

79. The amount of deposits transferred may not exceed 35% of either the transferring institutions total deposits as of May 1, 1989, or the total deposits of the institution as of the date of transfer.

80. The structure of this limitation will mean that a lesser savings to the SAIF will be required later in the moratorium than in the earlier stages of it. As the moratorium approaches termination the amount of assessment income foregone by the SAIF will decline both through less years available for assessments and by the declining rates after 1991. Practically, the FDIC will be able to dispense with this requirement in the case of assisted sales of troubled SA's after the final assessment in the final year of the moratorium.

SA is an RTC member then the savings analysis must be made by the RTC and the RTC must agree to the conversion. The FDIC may permit conversions from the BIF to the SAIF on the same grounds as SAIF to BIF conversions.

The entry and exit fees have been set by the FDIC and the Secretary of the Treasury.[81] The entry fee was intended to keep new entrants into either fund from diluting that fund. To execute this intention one would expect entry fees to approximate the target ratio of fund reserves to insured deposits. In fact, the fee was set well below that ratio. The FDIC set the entry fee for bringing SAIF insured deposits into the BIF at .8% of core deposits.[82] The fee can be paid by the institution over up to five years at no interest.[83]

The FDIC and Treasury originally had some dissention regarding the appropriate exit fee. The FDIC wanted to keep the fee low enough to avoid impacting bank mergers with failing SA's while the

---

[81]. The FDIC had sole discretion over the setting of entry fees and over the setting of exit fees for conversions taking place after December 31, 1997. Only exit fees for conversions before Jan. 1, 1997 were to be set by FDIC/Department of Treasury consensus.

[82]. 55 Fed. Reg. 10406-101 (1990), codified at 12 C.F.R. { 312. Core deposits are generally described as those not likely to leave the institution with a minor change in interest rates, typically estimated at 60% of an institutions total deposit base. See Bureau of National Affairs, "FDIC Approves Treasury-Proposed Exit Fee, Adopts Interim Entrance Fee Rule", 53 BBR 460 (October 2, 1989); See also Jim McTague, "Regulators Split on Fee for Exiting S&L Deposit Fund", American Banker, September 25, 1989, pp. 1&6. The fee was established by the FDIC on September 22, 1989.

[83]. FIRREA, {206.

Treasury wanted to keep the fee higher so as to decrease the likelihood that Treasury funds would have to be paid into the SAIF. The regulators finally settled on .9% of core deposits.[84]

The definition of a conversion has also been the subject of some interagency dispute. To date, the FDIC has not charged the .9% exit fee to banks which purchased the deposits of liquidated SA's and then converted them to the BIF. The Treasury department claims such purchases are conversions and should be charged appropriately, the FDIC claims that they are not.[85]

The Congress was forced to extend the moratorium by the twin forces of reduced powers for SA's and increased assessments and other costs. With the breadth of thrift investment powers now equal to or less than those of commercial banks, thrifts must be coerced to remain SAIF members. This moratorium is an admittance by the lawmakers that the insurance is mispriced across insured institutions.

The FIRREA attempts to differentiate its efforts to maintain the funds from changes it makes on the acquisition of thrifts by commercial banks. Title II permits SAIF members to switch from S&L charters to bank charters during the moratorium as long as they remain SAIF members. A bank holding company may still merge a

---

[84]. Jim McTague, "Fund Switch Fees Expected to Curb Appetite for S&L's", American Banker, September 28, 1989, pp. 1& 15. Experts claimed the fee was too high and that it would negatively impact the number of bank acquisitions of failing thrifts.

[85]. Jim McTague, "U.S. Presses FDIC to Collect Fees from S&L Buyers", American Banker, October 10, 1989, p.2.

subsidiary SAIF member into a subsidiary bank and transfer all of the deposits of the SAIF member into the BIF member bank. But, that portion of the deposit base of the BIF member bank will continue to be assessed by the SAIF and will continue to pay SAIF rates.[86]

4. Cross Guaranties

The New Insurance Policy

The FIRREA gives the FDIC new authority which alters the unit of insurance coverage for multi-institution holding companies. The statute provides that affiliated, insured institutions shall cross guarantee each other for the insurer's losses. The FDIC has the authority to collect any loss to the fund due to one institution from any commonly controlled institution.[87] The FDIC has the discretion to waive this liability and to divide the obligation amongst any and all insured affiliates of the failed institution.[88]

86. For the Federal Reserve Board to approve such mergers the bank must be at least two times the size of the S&L in total assets. The merger may not bring the bank out of compliance with its own capital requirements. There are also ample rules regarding how the losses created by the failure of such a merged institution will be divided amongst the insurance funds. FIRREA, {206.

87. Common control is broadly defined to include any institution that shares the same holding company with, or that is a subsidiary of, the institution causing the loss to the FDIC. This would include both parent, subsidiary relationships and sister type affiliated relationships. FIRREA, {206.

88. Various exemptions are available under the statute. Limited Partnership institutions can be exempted from the assessment. A five year exemption exist for those affiliates of BIF member institutions that purchased a failed SAIF member prior

The affiliate so assessed is required to pay the assessment upon notice. The FDIC must provide the institution with notice within two years of the loss. The FDIC can, however, assess the affiliate before experiencing the loss. They are empowered to assess the affiliate for the FDIC's own estimate of the loss calculated in good faith.

Despite the immediate payment provision, the FDIC is required to consult with the appropriate agency to set a schedule for payment that will not threaten the safety of the affiliate institution.[89] The rights of the FDIC to its assessed losses are superior to shareholder or affiliate claims against the assessed affiliate, but subordinate to depositor and some other claims. The corporation's claim may not be frustrated by the exercise of any right held by any private party that would disenable the institution to pay the assessment.

The FDIC lobbied the Congress for this provision because of experiences the insurer had with multi-bank holding companies allowing certain affiliates to degenerate, with the loss going to the FDIC, while keeping others healthy for the benefit of the stockholders. The alleged last straw was the Dallas based MCorp closings where although 20 banks in the system failed the FDIC

---

to enactment, and a corollary exemption for affiliates of SAIF members who purchased failed BIF members. The five year exemption also covers those affiliates of institutions that acquired the failing institution by foreclosure. Some former FSLIC assisted acquisitions are also exempted.

[89]. FIRREA, {206.

could not force the holding company to contribute.[90] The constitutionality of the FDIC's new powers remains untested.[91]

The Multiple Effects of Insurance Change

The effect of this new power on the value of failing thrift institutions will doubtless be extremely negative.[92] If the FDIC is unwilling to waive the cross-guaranty in the future, healthy

---

[90]. The FDIC has sued MCorp (the holding company) for $847 million alleging various counts of unjust enrichment. They are proceeding under the general theory that MCorp wrongfully required the failing subsidiary banks to pay dividends to the holding company despite their desperate condition.

The FDIC is already utilizing its new powers and again the venue is Texas. The First State Bank in Pflugerville, Texas failed and the FDIC has made an assessment against an affiliated bank, First National Bank in Canton, Texas, to pay for the insurers losses.

[91]. The new rule also violates basic tenets of corporate law regarding limited shareholder liability and corporate separateness. The FDIC's ability to collapse all of the insured affiliated institutions into one entity for insurance purposes would make it possible for an insured corporate investor in an S&L to have its losses from that investment exceed its investment.

[92]. Steve Klinkerman, "Provision Dims Appeal of S&Ls for Bank Firms", American Banker, pp. 1 & 12.

Attempts to exempt selected institutions from the cross-guaranty rules were congressionally shattered by the Leach amendment. Several Congressmen, including House Banking Committee Chairman, Gonzales, attempted to exempt certain institutions from the new rules. But a growing tide of anger and resentment among the law makers at the cost of the bailout gave the Leach amendment, which stripped the bill of 9 separate protectionist amendments, the political energy to pass by a margin of 411 to 8. Robert M. Garsson, "Special Interests Lose Out as Congress Gets Tough", American Banker, June 19, 1989, pp. 1& 11. To his credit, Congressman Gonzalez, detecting the political change of wind, sought to avoid the embarrassment for his patron institution and asked that his amendment be struck from the bill before the vote was taken on the Leach amendment.

thrifts and banks will be far less likely to purchase insolvent thrifts. Instead, potential purchasers will wait until the institutions fail and purchase their assets or deposits, or they will require the FDIC to invest substantial funds in the purchase so as to protect them from potential transmitted losses.[93]

The new power could also perversely impact the FDIC's own incentives in dealing with failing thrifts. If a failing institution is part of a well capitalized multi-institution holding company the FDIC might be less inclined to closely monitor the institution knowing that the deductible on its policy of insurance is the capital of all the affiliated institutions. The FDIC might also take less care in disposing of the assets of a failed thrift in such a situation.

But the FDIC must face the possibility that there will be a concentration of failures in the future. Large, multi-institution holding companies will support their failing affiliates to avoid paying for the loss under the cross guaranty rules. If those affilliates fail to recover the drain on the entire entity will lead to a much larger, multi-institutional failure.

The new law will doubtless impact the strategies of multi-

---

[93]. Steve Klinkerman, <u>Supra</u>, note 92.

Negative impacts on this market will be translated into negative impacts on the RTC, currently insuring the unhealthiest members of the thrift industry and currently looking to market those thrifts. Given that increased losses to the RTC from an inability to sell its inventory will ultimately accrue to the taxpayers, one could expect political pressure, both from the Treasury and the Congress, to focus upon the FDIC as it sets its policy in this area.

institution holding companies themselves. The loss of financial separateness will call for closer management at the holding company level and greater spreading of risk and capital throughout the system.[94] Banks and thrifts will manage the new exposure by restructuring assets within the holding company.

Because holding companies and uninsured affilliates are not covered by the cross guaranty rules, former valuable assets residing in the insured institutions will be transferred to the holding company or to an uninsured affiliate to avoid the transmittable loss from one insured affiliate to the other.[95] It is conceivable that in the wake of the cross-guaranty rules insured institutions will operate from buildings, use computer systems and lease furnishings owned by their holding companies, rather than by the institutions themselves.

5. Risk Based Premiums

One very noticeable absence from the FIRREA's changes to the insurance system was the introduction of risk based insurance

---

[94]. Moody's investor service is reportedly already reviewing its ratings for multi-institution holding companies. The new ratings will reflect the cross-guaranties by homogenizing ratings across affiliated institutions. Some will be upgraded, others downgraded depending on their prior relationship to the average of the holding company. Michael Weinstein, "S&L Law Spurs Rating Review By Moody's", American Banker, August 24, 1989, pp. 1 & 16. The cost of debt for thrifts will adjust accordingly, standardizing costs at the holding company level.

[95]. Steve Klinkerman, Supra, note 92.

premiums. The FDIC is required by the legislation to study and submit a report on the efficacy of risk based premiums but is prohibited from implementing them without explicit Congressional approval.[96]

Risk based premiums have long been recognized as a potential solution to the moral hazard created by deposit insurance. As early as 1982, the Garn-St. Germain Act required that the FDIC, FSLIC and National Credit Union Administration, the federal insurer of credit unions, study the deposit insurance system and determine, among other things, the feasibility of risk based premiums.[97]

The current system suffers from the fault of fixed premiums irrespective of the risk thrown off on the insurer by any particular institution. Without the ability to price insurance according to risk the regulators resorted to imposing increasing administrative burdens on the riskier thrifts. More frequent visits, requests for reports, and the imposition of cease and desist orders instilled discipline into the system.[98]

---

[96]. The FDIC report on risk based premiums is due before the Congress by January 1, 1991. FIRREA, §220. If the FDIC proposes to impose a risk based premiums regime the report must include a timetable and plan for implementation. The Congress has required itself to respond to the report with a recommendation to the Chairperson of the FDIC within 180 days of the submission of the report.

[97]. Pub. L. No. 97-320 (1982).

[98]. See generally, Edward J. Kane, The Gathering Crisis in Federal Deposit Insurance, (1985), chapter 1. This kind of increased premium can be even more costly for the regulator than for the insured institution, serving to decrease the assets of the fund as the thrift became riskier rather than increasing them as would be actuarially required.

Despite the risk based regime's theoretical ability to control the moral hazard problem, some critics, including Paul Horvitz, claim that such regimes are unnecessary. Horvitz points out the fact that another means of limiting the loss of insurers and imposing the costs of increased risk on the institutions that produce them is to close all insolvent institutions at or before the point of insolvency.[99]

The difficulty with the Horvitz suggestion, and with risk based insurance premiums, is the problem of imperfect information. For an insurer to close an institution at the point of insolvency it must be able to detect when the market value of the firm's liabilities exceeds the value of its assets.[100]

6. Deposit Insurance Coverage

Another option foregone by the FIRREA was the alteration of the deposit insurance coverage available to depositors. Many industry observers have long prescribed this as a necessary change to avert the problems of moral hazard within the industry. A government panel lead by the Treasury Department is to perform an extensive study of the insurance system and altering the coverage

[99]. Paul M. Horvitz, "Why Risk-Related Insurance premiums Are No Answer", <u>American Banker</u>, May 26, 1989.

[100]. The risk measuring system would also have to keep pace with the thousands of institutions seeking to avoid it through innovation.

is reportedly on the agenda.[101]

The committee will examine alternatives such as limiting depositors to only one insured account per institution and lowering the $100,000 ceiling They will also examine other, more drastic modifications to the insurance system such as private insurance, forcing insured institutions to practice market value accounting, closing institutions before they become technically insolvent, and other changes.[102]

In addition to insuring multiple accounts of one depositor in an institution, the current rules have also permitted many firms to market deposit insurance to their customers. Pension funds currently use Bank Insurance Contracts to pass insurance on the deposits of the fund directly through to the members, $100,000 per member's proportional interest. The current market for Bank Insurance Contracts is approximately $150 billion and growing by $35 billion annually.[103]

B. The Risk Containment System

1. Regime Change

---

[101]. FIRREA, {1001; See also Rebecca Cox, "Next Battleground: Deposit Insurance Reform", American Banker, August 17, 1989, pp. 1 & 12.

[102]. Rebecca Cox, Supra, note 101.

[103]. Robert M. Garsson, "Insurers Caution House on Raising Deposit Coverage", American Banker, September 21, 1989, p. 2.

Office of Thrift Supervision

The FIRREA abolished the Federal Home Loan Bank Board and transferred its supervisory functions to a new entity, the Office of Thrift Supervision.[104] The OTS is to function after the model of the Office of the Comptroller of the Currency. The Director of the OTS is to have the same general powers and status as the Comptroller.[105] The Director is granted all of the powers of the Federal Home Loan Bank Board except those powers that were regranted to other agencies, or were derived from a section of legislation repealed by the FIRREA.

The OTS is within the Department of the Treasury and the Secretary of the Treasury is generally responsible for the functions of the OTS. The Director, however, has considerable independence from the Treasury. The FIRREA provides that the Secretary of the Treasury may not intervene in any matter or proceeding before the Director unless such intervention is provided for by law.[106]

The previous Chairman of the Federal Home Loan Bank Board, M.

---

104. Hereafter the Office of Thrift Supervision will be referred to as the "OTS".

105. The Director of the OTS is appointed by the President with the consent of the Senate for a term of five years. To help insure the fidelity of the Director of the OTS he or she is forbidden to have any financial interest in any depository institution. FIRREA {301, Sub {3.

106. Id.

Danny Wall, was statutorily installed as the Director of the OTS until his current term expires.[107] This appointment was engineered this way so as to avoid a Senate confirmation hearing.[108] It has been reported that Senator Jake Garn provided this escape for his friend, Wall and that doing so cost him so much political capital that he was unable to impact the legislation in any substantive manner.[109]

The function of the Director is to provide for the examination, safe and sound operation, and regulation of SA's. The public policy rhetoric is continued in the FIRREA in that the Director is explicitly charged with making sure the SA's provide ample housing credit in a safe and sound fashion.[110] The Director is empowered to promulgate regulations necessary to carry out his congressional mandate.

The power and authority of the Director has been limited, both

---

107. "The Chairman of the Federal Home Loan Bank Board on the date of enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 shall be the Director [of the OTS] until the date on which that individual's term would have expired." FIRREA, {301, Sub {3.

108. It was reportedly thought that such a hearing could be very damaging to Mr. Wall's career, given that some Senate leaders consider him partially responsible for the current crisis. See e.g., 135 Cong. Rec. S2564-01 (March 15, 1989) (Comments of Sen. Pryor) ("The last time we saw secrecy of this type by the FSLIC was during the consummation of the ill-fated December deals when Danny Wall unilaterally committed this Government, our taxpayers, to billions of dollars of Government guarantees....").

109. Jay Rosenstein, "Some Caught The Brass Ring, Others Were Unhorsed", American Banker, August 10, 1989, p. 2A.

110. "The Director shall provide for the ... safe and sound operation, ... of savings associations." FIRREA, {301, Sub {4.

by the Congress and by other agencies. If the FDIC becomes concerned about the condition or operation of a particular SA, the Board of the FDIC can request that the Director of the OTS take action. If within sixty days the Director has failed to take action then the FDIC can take action itself.[111] The FDIC Board and the Director of the OTS are further required by the FIRREA to set out certain exigent circumstances under which the FDIC could take action without regard to the sixty day waiting period.

The Director's regulatory authority is also circumscribed by the OCC. All policies and regulations established by the Director to provide for the safe and sound operation of SA's are required to be no less stringent than the regulations established by banking agencies. The Director is empowered to set accounting standards for SA's but is required to incorporate GAAP standards to the extent required by banking agencies.[112] Given the condition of the thrift industry and the recent history of lax regulatory accounting standards, the Director has until January 1, 1994 before he is statutorily required to demand full compliance.

The risk containment regime for thrifts will, after the FIRREA, much more closely resemble that for commercial banks. Policymakers have been urged to promote uniformity in financial

---

111. The FDIC Board need only determine that either the SA is in an unsafe or unsound condition, or, that failure to take the prescribed action will result in the continuance of unsafe or unsound practices.

112. FIRREA, {301, Sub {4.

regulation for several years.[113] The legislature has been trying to solve the dysfunctionality of the regulatory regime by promoting uniformity through enhanced cooperation. The FIRICA of 1978 created the Financial Institutions Examination Counsel to promote uniformity amongst regulators' policies and procedures.[114]

Irvine Sprague, former Director and Board Member of the FDIC described the council as ineffective.

> "The tone was set on day one. FHLBB representatives generally were silent or they abstained on any issue of consequence. They did not appear at all interested in supervisory standards, honest accounting rules, or adequate capital standards.* (Footnote- These chickens came back to roost in the late 1980s as Savings and Loans failed in disgraceful numbers.) The Fed, FDIC, and OCC representatives eyed each other warily. NCUA people knew they were different. Nothing

---

113. See e.g. Commission on Money and Credit in the 1960's, The Hunt Report, 1971, The Financial Institutions Act, 1973 & 1975, The Financial Institutions and the Nation's Economy Study, the Financial Reform Act of 1976. Ornstein, <u>Savings Banking An Industry in Change</u>, 1985, p. 284.

114. 12 U.S.C. { 3301 (1978).

had really changed."[115]

The FIRREA takes an entirely new approach, centralizing administrative control rather than requiring cooperation and communication. With both insurance funds located within the FDIC, uniformity in the administration of the funds will result as a matter of efficiency. With both the OTS and OCC now under the general direction of the Treasury, the imposition of uniform policies will tend to drive those two offices towards similar practices and procedures.

Federal Home Loan Banks

Despite the demise of the Federal Home Loan Bank Board, the Federal Home Loan Bank system survived the FIRREA's regulatory restructuring. The new regime seeks to separate the elements of regulatory power to provide more disciplined oversight of the industry. Under the new regime, the FDIC will insure the SA's and the Federal Home Loan Banks will retain their function of providing credit and liquidity to the industry.[116] The OTS will have the power to charter SA's and will also examine and supervise them subject to the power of the FDIC to preempt the OTS in the case of

---

[115]. Irvine H. Sprague, Bailout, 1986, p. 238-239.

[116]. FIRREA, §709, et seq.

a finding of unsafe practices.[117]

Multiple problems caused the failure of the Bank Board regulatory system. These include capture by the industry, faulty internal structure, misplacement within the government bureaucracy, and mismanagement of key regulatory functions.

The capture of the Federal Home Loan Bank system began at its inception. During the midst of the depression Congress needed help and industry information to design a practical solution that would stop the failures and protect the economy. The U.S. League of Savings Associations, the national industry trade group, was the party who possessed that information and they willingly supplied it to the Congress, shaping their own regulator from birth.[118] President Hoover put the leadership of the United Savings League, onto the first Federal Home Loan Bank Board and the league helped to draft the FSLIC legislation.[119]

The familiar relationship between the Bank Board and the U.S. League continued throughout the life of the Board. From 1950 to 1980, differences between the industry and the Board on proposed legislation would be hammered out between them in private so that

117. FIRREA, {301, Sub {4.

118. One of the first members of the Bank Board declared: "practically every plan or general proposal of the league was adopted by the Government in full or in modified form and thrown into the breach to stabilize the situation and prevent a sweeping collapse." Morton Bodfish, "The Depression Experience of Savings & Loan Associations in the United States," Address delivered in Salzburg, Austria, 1935, quoted in R. Dan Brumbaugh, JR, _Supra_, note 49, at 24-25.

119. _Id_. at 25.

a unified front could be presented to Congress.[120]

The former structure of the Federal Home Loan Bank system concentrated all of the regulatory functions for the industry under the single auspices of the Federal Home Loan Bank Board. The Bank Board had chartering, supervisory and originally examining authority. The FSLIC, under the direction of the Bank Board performed the insurance function. The Federal Home Loan Banks, also under the authority of the Bank Board performed the credit and liquidity provision functions of the industry. Unlike the banking regime, there was no competing or counterbalancing regulator to force discipline into the system.[121]

Another failure of the old thrift regulatory system was that while bank regulators are funded independently, the Bank Board had to rely on Congressional budget allocations for its operating budget. The Bank Board was also subject to the Personnel Classification Act, which restricted the salaries they were able to pay their staff.[122] The FDIC, Federal Reserve Board and OCC were

---

120. Norman Strunk & Fred Case, Supra, note 32, at 25.

121. An example would be the ability of the Bank Board to charter a thrift where one was not needed, for political reasons. The Board could provide the charter, require the FSLIC to grant insurance to the new institution, even if such a grant was not warranted, and require that the area Federal Home Loan Bank grant credit to the new institution providing it with low cost funding for operations. By contrast, if the OCC were to attempt to charter a bank improvidently, the independence of the FDIC would provide a separate check on the OCC's power. The FDIC could deny insurance and the Federal Reserve Board could refuse to allow the newly chartered institution access to the discount window.

122. Compare FIRREA, §301, Sub §3.

not subject to the Act and were able to pay their employees considerably more.[123]

The FHLBB's inability to provide competitive remuneration combined with the structural flaws and simple mismanagement to produce a failure of the regime's examination system. The number of the FSLIC's examiners actually declined each year between 1981 and 1984 as the number of troubled thrifts increased dramatically.[124] The new powers which thrifts were beginning to exercise also went well beyond the expertise of the field examiners. In at least one district the FSLIC had to borrow examiners from the FDIC to decipher the complicated hedging done by some of the thrifts and to determine the financial status of the institutions.[125]

The Congress no doubt hopes that relocating the FSLIC examination function within the FDIC will help to improve the quality of thrift examinations. To the extent that the former quality differential resulted from the wage disparity between bank and thrift examiners such a coupling of bank and thrift examiners would not be necessary. But such an alignment should help in speeding the dissemination of more advanced examination procedures and information. The new regulatory structure will provide for

---

123. See e.g., 12 U.S.C. {{ 305, 306 (1935) (Federal Reserve Board Agents and Assistants); 12 U.S.C. { 482 (1956) (OCC Examiners).

124. Norman Strunk & Fred Case, Supra, note 32, at 138.

125. Id. at 133.

more sound and accurate examinations of thrifts.

FHLB Advances

The FIRREA has sought to tighten the requirements for SA's to obtain credit from the FHLB's. Under the new restrictions only members of the FHLB may receive advances.[126] Qualified Thrift Lenders that are members of their district FHLB have priority over non-Qualified Thrift Lenders's for available FHLB funds.[127] Non-QTL advances may be no more than 30% of the FHLB's total advances and advances to non-QTL members may only be for providing funds for home financing. For a non-QTL, FHLB member to receive an advance, it must have adequate FHLB stock under a formula which weighs the thrift's FHLB stock against its FHLB advances and the amount of its assets invested in qualified thrift investments.[128]

FHLB advances were formerly one of the greatest benefits of holding a thrift charter. Federally chartered thrifts could borrow

---

[126]. Section 710 of the FIRREA deletes all references to non-member borrowings from {9 of the Federal Home Loan Bank Act (12 U.S.C. { 1421 et seq.) (1932).

[127]. Hereafter Qualified Thrift Lender will be referred to as "QTL".

[128]. FIRREA, {714. See note 139 and accompanying text for the definition of qualified thrift investments.

up to 20 times the amount they had invested in FHLBB stock.[129]

Members in the FHLB system automatically had the right to borrow from their FHLB. Non-members could borrow, but only if they were in the home financing business and were under the supervision of a government agency. Non-members, however, had to pay a 1/2% to 1% interest rate premium, further enhancing the competitive advantage for thrifts.[130]

Policing Powers

The enforcement powers of all of the agencies have been dramatically enhanced by the FIRREA, particularly their ability to pursue suspected criminals. Regulators have been granted authority to issue notice to and proceed against any "affiliated party" for up to six years after that party's affiliation with the depository institution has terminated.[131] The six year statute of limitations was made retroactive so that the agencies could pursue the numerous parties whose alleged criminal acts may have caused part of the recent crisis.

---

129. See 12 U.S.C. { 1430 (1987). In fact, FHLB advances were required to be the almost exclusive source of non-depositor funding. No FHLB member could borrow a sum equal to more than 10% of their savings accounts from anyone other than their FHLB. Franklin H. Ornstein, Supra, note 113, at 191.

130. Franklin H. Ornstein, Supra, note 113, at 216.

131. Affiliated party is broadly defined to include agents, employees, and directors, Under certain circumstances it can include consultants, joint venture partners, and outside contractors, including lawyers and accountants. FIRREA, {901.

Troubled and newly acquired depository institutions and their holding companies have been targeted for more specific controls over management and directors. The new measures apply to any institution which has been chartered less than two years, recently undergone a change of control, is not in compliance with the minimum capital requirements, or has otherwise been determined to be in a troubled condition. The appropriate agency may forbid any individual it considers untrustworthy from being elected a director or hired as a senior executive of such an institution.[132]

The fines to be assessed against S&L holding companies and their affiliates for providing false, misleading, or late information have been stiffened. The FIRREA provides that the OTS may assess penalties for such infractions on a scale of severity graded by the degree of intent of the offending institution.[133] The increased powers granted under the FIRREA will make quality directors increasingly difficult to attract.[134]

It has been estimated that 20% of thrift failures from 1985 through 1987 were principally caused by fraud and insider trading.

---

[132]. FIRREA, {914.

[133]. If the institution is inadvertently late or misleading in its reports then the OTS may fine the institution up to $2,000 per day. If the institution fails to prove inadvertence by a preponderance of the evidence standard then the fine is up to $20,000 per day. If the S&L holding company or its affiliate is found to have knowingly, or with reckless disregard, been late or misleading then the fine is the lesser of $1,000,000 per day or 1% of total assets. FIRREA, {911.

[134]. Stephen R. McSpadden, "FIRREA Expands Civil Enforcement Powers of Regulators, Increases Penalties Allowed", 53 BBR 427, September 25, 1989.

More than 20% of the FSLIC's total losses over that same period are said to stem from fraud and insider abuse.[135]

The FSLIC unknowingly contributed to the problem when, in an effort to broaden the market for failed thrifts, the insurer lowered the minimum number of shareholders required for an insured thrift from 400 to 1.[136] Where only a few shareholders are involved, and particularly if all of those are insiders, there is no one with a financial interest, outside of the insurer, to monitor management and prevent them from denuding the corporation.

2. Investment Powers of S&L's and Holding Companies

S&L's

The express limitations of the FIRREA are not extraordinary. The most important aspect of the risk management section is the discretion that it leaves to the regulators. The FIRREA provides that the FDIC, in conjunction with the OTS and with the advice of state thrift supervisors, may create a list of activities prohibited to SAIF members.[137]

---

135. Norman Strunk & Fred Case, Supra, note 32, at 15.

136. Id. at 16.

137. See FIRREA, {221. This is the inverse of the approach of the Federal Reserve Board's Regulation Y list which sets out all of the activities presumptively legal for bank holding companies to undertake.

The Director of the OTS can determine that a particular SA may not continue to own a particular subsidiary. To require divestiture the Director must determine that continued ownership of the subsidiary constitutes a risk to the SA's continued safety. After such a determination has been made either the OTS or the FDIC can order divestiture of the offending subsidiary.[138]

Specific limitations on the powers of SA's were enacted through the familiar vehicle of the Qualified Thrift Lender status provisions. QTL's currently must have 60% of total tangible assets in qualified thrift investments.[139] That percentage must be maintained for three out of every four quarters and two out of every three years. Beginning July, 1, 1991 the QTL test will increase to holding 70% of assets in qualified thrift investments.[140]

Beginning one year from enactment, thrifts which fail to establish and maintain QTL status face the choice of either converting to one or more bank charters or continuing to operate

---

[138]. FIRREA, {221.

[139]. Qualified thrift investments include; 1) loans, equity investments or securities of the thrift or any of its subsidiaries that re related to domestic residential real estate or manufactured housing, 2)the value of property used by the SA or any of its subsidiaries to conduct its business, 3) liquid assets required to be maintained under this Act, and 4) fifty percent of the value of all residential mortgage loans originated and sold within ninety days (mortgage banked loans). Elements three and four may not be counted for more than 10% of the tangible assets of the SA. FIRREA, {303.

[140]. Under certain conditions the Director may grant exceptions to these tests. FIRREA, {302.

under their thrift charters with additional limitations. Such SA's may not receive any additional advances from a FHLB. They must also repay all outstanding FHLB advances as promptly as can prudently be done without endangering the safety and soundness of the S&L.[141]

While QTL thrifts need only satisfy the requirements of the thrift regulatory regime, non-QTL thrifts may not invest in or engage in any activity unless that activity is permissible both for national banks and for SA's.[142] It must divest any investments in any subsidiaries that engage in any activity impermissible either for national banks or SA's. Non-QTL SA's may not establish any branch or office that could not be established if the SA were a national bank located in the SA's home state.

The SA would be subject to the same statutes and regulations regarding payment of dividends as if it were a national bank. Holding companies of non-QTL SA's must register as bank holding companies under the Bank Holding Company Act of 1956.[143]

Any bank chartered under this process must still pay SAIF rates until December 31, 1993.[144]

As late as the end of July the House and Senate Conference Committee seemed prepared to raise the QTL test to 70% immediately.

---

[141]. FIRREA, {221.

[142]. This requirement extends to investments in subsidiaries.

[143]. <u>See</u> 12 U.S.C. { 1841, <u>et seq.</u> (1956).

[144]. <u>See</u> FIRREA, {303.

The Association of Thrift Holding Companies were aggressively lobbying for a lower percentage test.[145] They maintained that if the mission was to bailout the industry raising the QTL percentage requirement in housing related loans would be a mistake. They argued that it was easier to lose money in housing loans than in many other lines of business.[146]

The forced divestiture of non-conforming subsidiaries was a politically charged element of the FIRREA. S&L's with non-conforming subsidiaries did not wish to be forced to divest them. The banking industry, not wanting to compete with non-QTL thrifts, other commercial banks for their purposes, wanted to force the divestiture immediately. The legislative compromise was that although the regulators could still force divestiture, the subsidiaries could be sold to the holding company of the SA and in some circumstances could be sold for a promissory note. This would allow the income of the subsidiary to continue to flow to the SA as interest rather than as dividends.[147]

Other limitations upon thrift asset deployment powers include

---

[145]. Robert M. Garsson & Jay Rosenstein, "Bill Would Force Thrifts to Hold More Mortgages", American Banker, pp. 1& 37.

[146]. There would appear to be no inherent problem with thrifts holding any particular asset category as long as portfolio is well diversified with assets having a negative covariance to interest rate movements or economic cycles.

[147]. FIRREA, (222; See also, Robert M. Garsson & Jay Rosenstein, Supra, note 145.

a more or less total ban on investing in junk bonds.[148] Any thrift holding a portfolio of junk bonds is required to divest it as quickly as is prudently possible, but in any event before July 1, 1994.[149]

The ban on junk bonds was an important loss for the thrift industry. Many thrifts had acquired portfolios of high yield securities in an attempt to reach for higher net income and earn their way out of insolvency or near insolvency.[150] The ban on junk bonds had been voted down in numerous committee votes. But when the magnitude of the bailout began to come to light lawmakers were so angered by the amount of S&L failures and by the fact that the taxpayers would ultimately be called upon to pay for those failures that when the vote came to the floor the junk bond proscription passed easily.[151]

Investment powers explicitly reserved to the thrift industry are spelled out by the FIRREA in some detail. SA's may issue credit cards and may make various types of loans without limitation

---

148. Junk bonds are described in the Act to be any bonds not of investment grade, meaning not rated in one of the top four quality ratings by at least one national rating service. Certain securities are explicitly excluded. FIRREA, {222.

149. FIRREA, {222.

150. Pre-1990, there was a growing appreciation for junk bonds as investments due to a perceived undervaluation of them by main stream investors. <u>See e.g.</u>, Kevin J. Perry & Robert A. Taggart, JR., "The Growing Role of Junk Bonds in Corporate Finance", <u>Journal of Applied Corporate Finance</u>, Vol. 1, No. 1, Spring, 1988, pp. 37, <u>et seq.</u>

151. Robert M. Garsson, "Options Dwindling for Stunned S&L Lobby", <u>American Banker</u>, June 19, 1989, pp. 1&11.

as to their percentage of capital or assets.[152] Investments that may be made without limit include U.S. government securities or securities guaranteed by the U.S. government, FHLB, FHLMC or FNMA securities, state or municipal securities, mortgage backed securities, and investments that satisfy liquidity requirements.[153] SA's may also make unlimited deposits in other financial institutions as long as these institutions are insured.[154]

Other varieties of loans are permissible in limited amounts.[155] Commercial and industrial loans are permitted up to 10% of the institutions assets.[156] Loans secured by non-residential real estate are permissible up to 400% of capital.[157] Thrifts may make

---

152. This unlimited category of loans includes loans secured by deposits, loans secured by residential real estate, home improvement loans, loans to finance manufactured housing, loans to federally regulated financial institutions or to SEC regulated broker dealers which are secured by assets in which the SA has the power to invest in directly, any loans guaranteed by the federal government or government agency, loans insured under the National Housing Act and others.

153. State and municipal securities are limited in that no more than 10% of the SA's capital may be invested in the securities of any one issuer.

154. The FIRREA does not require that all SA deposits in other financial institutions be insured, only that the institutions in which the deposits are placed be insured. This leaves the hole open for SA's to place uninsured jumbo CD's in insured institutions at higher rates than insured deposits.

155. FIRREA, {301, Sub {3.

156. This variety of loans represents the traditional turf of the commercial banking industry.

157. The OTS can permit a greater concentration in this type of lending if it makes a determination that such a concentration would not be unsafe for the SA involved. Such a determination and subsequent permission, however, must be followed by closer regulatory monitoring of the SA.

consumer loans up to 30% of assets and may invest in tangible personal property for resale up to 10%. Loans limited to 5% of thrift assets include education loans and unsecured construction loans. Thrifts may invest in service corporations up to 3% of assets.[158] SA's may still perform trust services with certain limitations and only with OTS approval.

Beginning in the depression era all thrift loans had to be secured by 1 to 4 family homes. There was a strict prohibition against writing second mortgages and all collateral had to be within a fifty mile radius of the home office. Maturities longer than 20 years were prohibited as were loans with a loan to value of collateral greater than 80%.[159]

Responding to an industry that was hemmohraging losses due to a negative interest rate spread, the Bank Board gradually loosened the restrictions on SA's until, by the early 1980's, thrifts enjoyed a wide open range of investment opportunities. The maximum maturity on home loans was raised from 30 to 40 years. The Board authorized renegotiable rate mortgages and abolished the geographical restrictions on real estate loans.[160] The DIDMCA

---

158. One half of all investments over 1% of assets must be oriented to community development. FIRREA, {301, Sub {5.

159. Norman Strunk & Fred Case, Supra, note 32, at 17.

160. The Board also authorized thrifts to make unsecured loans and to buy commercial paper and corporate debt securities up to 20% of assets, to issue credit cards and offer trust services. See 45 Fed. Reg. 76104 (1980), codified at 12 C.F.R. { 541, et seq.

relieved thrifts of the requirement that all of their mortgages be first liens.[161] In 1981, the Bank Board eliminated all loan to value requirements.

In October of 1982 the Board authorized thrifts to hold consumer loans up to 30% of assets. The Board raised the percentage of assets a thrift could invest in commercial real estate loans from 20% to 40%. In November of 1982 the Board authorized thrifts to hold debt securities and to count them towards their liquidity requirements if they were properly hedged.[162]

The new restrictions on the thrift investment powers comes at a very odd time in history. With the European Economic Community standardizing its markets in 1992 globalization of financial services is expected to accelerate. To compete with the large, concentrated, and multi-powered banks of Europe and Asia, American bankers have been calling for further deregulation of their

---

161. Depository Institutions Deregulation and Monetary Control Act, Pub. L. No. 96-221 (1980), implemented by 45 Fed. Reg. 52173 (1980), codified at 12 C.F.R. { 525, et seq.

162. See 47 Fed. Reg. 50201 (1982), codified at 12 C.F.R. {{ 523, 545, and 563.

Despite grants of powers to trade in hedging instruments and to align the asset and liability sides of their balance sheets, thrifts were slow to close the interest rate gap. In March, 1986, the interest rate gap was a negative 21%, sensitive to rising rates, and half of what it had been in March, 1984. Still, at negative 21%, the gap is large enough that a 100 basis point rise in interest rates would produce a $2 billion loss for the industry, enough to wipe out the industry's entire 1986 net income. R. Dan Brumbaugh, JR. Supra, note 49.

investment powers.[163]

The bankers are supported by the regulators; Seidman, Clarke and Greenspan have all indicated that bank powers should be deregulated particularly the proscriptions against underwriting securities.[164] The regulators justify their position by pointing to the increased competition in 1992 and asserting their desire to have a competitive American banking industry. The gap between commercial banking and thrifts created by the FIRREA will widen as regulators pour out new authority on banks to enable them to compete in global markets.

Holding Companies

SA holding company regulation has been placed in the hands of the Director of the OTS.[165] The Director has broad discretion to limit holding company activities. If the Director determines that the activities of an S&L holding company are endangering the subsidiary SA then the Director may issue directives to the holding company or to any of its subsidiaries.[166]

---

163. Jay Rosenstein, "Regulators Say Banks Need New Powers", American Banker, September 27, 1989, pp. 1& 14.

164. Id.

165. FIRREA, {301, Sub {10.

166. The directives so issued would have the effect of a final cease and desist order. The Director may use these directives to limit the payment of dividends by the SA to the holding company, to limit transactions between the SA and the holding company,or to limit any activities of the SA that might tend to make the liabilities of the holding company fall upon the SA. FIRREA, {301,

To enforce its powers over S&L holding companies the Director may promulgate regulations, conduct investigations of S&L holding companies, hold proceedings, or bring actions against them in District court. The substantial fines discussed above for S&L's submitting false, late, or misleading reports to the OTS also apply to S&L holding companies.

Within 90 days of becoming an S&L holding company the S&L holding company must register with the Director of the OTS. The S&L holding company must provide information as required by the Director and is subject to OTS examination.[167] Multi-S&L holding companies may not commence any business except for; furnishing management services to their SA's or its subsidiaries, conducting insurance agency or escrow business, holding, managing or liquidating SA assets, acting as a trustee under a deed of trust, or conducting any other business which the Federal Reserve Board has declared permissible for bank holding companies.[168]

Before an S&L holding company can begin conducting any of these activities the S&L holding company must obtain the approval of the OTS. New multi-S&L holding companies have two years after becoming S&L holding companies to come into compliance with the statute.[169] S&L holding companies may not purchase additional SA's

---

Sub {10.

167. FIRREA, {301, Sub {10.

168. Id.

169. Unitary S&L holding companies remain unregulated as to activities.

or SA holding companies without prior approval from the OTS.[170]

S&L holding companies were first brought under the regulatory network by the 1968 S&L Holding Company Act.[171] Permissible activities of holding companies were a function of whether the holding company owned one S&L or multiple S&L's. S&L holding companies which owned only one thrift, so called unitary S&L holding companies, were unrestricted as to the activities of the holding company or uninsured affiliates so long as the S&L met the QTL test of the Internal Revenue Code.

The FSLIC permitted multiple S&L holding companies, as well as those unitary holding companies whose thrifts failed the QTL test, to perform only limited non-thrift activities. Permissible activities included operating insurance agencies, escrow businesses, data processing, developing unimproved real estate and completing tax returns.[172]

Other Restrictions on S&L's

Omnibus portions of the statute prohibit thrifts from branching interstate unless the target state would permit a state chartered SA to branch in from the federally chartered thrift's

---

170. FIRREA, {301, Sub { 10.

171. The S&L Holding company Act defines an S&L holding company as any company which controls an insured S&L or any other S&L holding company.

172. See 12 C.F.R. { 584.2-1 (1987).

home state.[173] SA's are forbidden to tie credit to other goods or services. They may not pay interest on demand deposits.[174] Activity restrictions extend to the activities of SA subsidiaries.[175]

Enforcement powers for SA activity restrictions are explicitly granted to the Director of the OTS.[176] The Director's examiners may examine not only federal SA's but also their affiliates as necessary to determine their impact on the health of the SA.[177] The Director is statutorily provided with access to all records, officers, documents and other items or persons necessary for proper examination.[178]

Various portions of the law seek to regulate the competition between state chartered and federally chartered institutions. As of January 1, 1990, state chartered SA's may not engage as principal in any activity that federal SA's are prohibited from engaging in unless the FDIC approves the activity and the state SA

---

173. FIRREA, {301, Sub {10.

174. FIRREA, {301, Sub {3.

175. When an SA acquires a subsidiary, or wishes to perform a new activity through an existing subsidiary, the SA must notify the FDIC and the OTS 30 days prior to the acquisition or commencement of the activity.

176. FIRREA, {301, Sub {5.

177. Id.

178. The Director may sue to force disclosure if it is not satisfied by the thrift's cooperative efforts. Newly chartered SA's will also bear the scrutiny of the Federal Home Loan Banks under their power to order examination of their borrowers as all new SA's are automatically members of their area FHLB.

is in full compliance with capital standards.[179] No state or municipal government may discriminate in taxing federal SA's as compared to any comparable financial institution.[180] Conversions between federal and state charter are permissible with OTS approval.[181]

The FIRREA's need to control the competition between state and federally chartered S&L's has its roots in the philosophy of regulatory competition and the dual regulation system.[182] During the early 1980's states such as California, Texas, and Florida granted state chartered institutions broader investment powers.[183] Reportedly many state regulators had neither the ability nor the inclination to adequately supervise the new powers they had granted their institutions.[184]

---

[179]. FIRREA, {222.

[180]. FIRREA, {301, Sub {5.

[181]. Id.

[182]. One of the drawbacks of having more than one chartering authority in any one market is that the two authorities will tend to compete on laxity of regulatory impositions. This competition in laxity can produce the, so called, "race to the bottom" where both authorities seek to outdo each other in expanding permissible powers, lowering capital requirements, and other forms of regulatory forbearance.

[183]. See 135 Cong. Rec. H2739-03 (June 15, 1989) (Statement of Hon. Stan Parris) ("As I previously indicated, California, Texas, Florida, and Louisiana have lead the way in liberalizing direct investment and loan powers for their state chartered thrifts. They are also states where the FSLIC is uncovering the most troubled institutions.")

[184]. Norman Strunk & Fred Case, Supra, note 32, at 81.

3. Capital Requirements.

The FIRREA's Capital Regulations and Requirements

Capital requirements and special restrictions upon those institutions that failed to meet them were also the subject of major revisions. The FIRREA provides that the regulatory capital standards adopted by the OTS must be no less stringent than those applied to national banks by the OCC.[185] The Director must set uniform capital standards for all thrifts.[186]

Failure to comply with capital requirements results in an *a priori* establishment that the thrift is unsafe and thereby subject to more intense regulation by the Director. The OTS may demand that an unsafe SA produce a plan for reaching compliance with the requirements. Once produced by the SA the Director has the power to prohibit deviation from the plan.[187]

The Director is required to establish 3 separate capital requirements; a leverage limit, a tangible capital requirement, and a risk based capital requirement. The Director's discretion is limited by a statutory floor of 3% of total assets for the leverage limit and 1.5% of total assets for the tangible capital requirement. The risk based capital requirements may deviate from

---

185. FIRREA, {301, Sub {5.

186. *Id*.

187. FIRREA, {301, Sub {3.5.

those required for commercial banks but must not be less stringent overall.[188]

Despite heavy lobbying by the industry, formerly allowable goodwill is to be phased out of capital computations.[189] The industry, however, was successful in gaining permission to include up to 90% of the value of mortgage servicing rights in each of the capital requirements.[190] S&L's are permitted to consolidate the equity positions in all of their subsidiaries to compute their total capital position except for the equity in those subsidiaries which are engaged in an activity that is beyond the power of a subsidiary of a commercial bank.[191]

Unlike commercial banks, the S&L industry had a statutory capital requirement almost from the inception of the regulatory

---

188. The Director is also required to impose minimum liquid assets requirements on the industry. The OTS is to establish an aggregate percentage of assets which must be held in cash, Federal Reserve Bank or FHLB balances, deposits in FHLB's or FHLB members, high rated, liquid, corporate debt instruments with less then 3 years to maturity, high rated, commercial paper with less than 270 days to maturity, certain mortgage backed securities with less than 1 year to maturity, and other liquid assets. FIRREA, {301, Sub {6.

189. FIRREA, {301, Sub {5.

190. There are some exceptions to this rule.

191. FIRREA, {301, Sub {5.

regime.[192] But, after the portfolio drag and disintermediation of the late 1970's the thrift industry found itself seriously out of compliance with regulatory capital minimums. There were inadequate funds in the FSLIC to close all of the failing thrifts. There were inadequate supervisory resources to examine and monitor all of the thrifts that were beneath the capital minimum.

So the FHLBB, in December, 1981, reduced capital minimums to 3% for all institutions at the request of the U.S. League.[193] To encourage potential buyers of failed S&L's the FSLIC permitted purchasers to inject even the nominal amount of capital required in land instead of cash.[194]

Redefining Capital

When lowering the minimum capital level was no longer feasible the Bank Board was forced to redefine capital. To do so the Board adopted Regulatory Approved Accounting, ("RAP"). RAP allowed thrifts to include various items in their net worth computation

---

[192]. The National Housing Act of 1934 required all insured institutions to have a Federal Insurance Reserve Account equal to 5% of share accounts and to maintain a net worth equal to the Federal Insurance Reserve Account plus 20% of items that had been scheduled. See 12 U.S.C. § 1701, et seq. (1934). Commercial bank regulations did not stipulate minimum capital levels until 1983.

[193]. Norman Strunk & Fred Case, Supra, note 32, at 31.

[194]. This made it particularly easy for developers to enter the thrift business, especially if they were able to overvalue the land contributed in lieu of a capital contribution.

that would not have been permitted under GAAP.[195]

Thrifts were permitted to include goodwill, subordinated debt securities, all redeemable mutual capital certificates, and any non-permanent preferred stock with at least one year left to maturity in their net worth calculation.[196] Thrifts could also revalue their land, buildings and other appreciated assets, on a one time basis, and include that appreciation in their equity base.[197]

The Congressional battle over the inclusion of goodwill in capital computations ended in a compromise that required its ultimate elimination but provided a phase out period to lessen adjustment costs. The original position of the administration was to take goodwill out of capital. The thrifts of course wanted goodwill retained so that they could avoid having to generate fresh capital to replace it. The thrifts felt justified in their position because regulators had previously urged the industry to include goodwill in order to increase paper capital.

The administration offered a compromise that would have allowed regulators to determine whether goodwill should be stricken from the particular thrift's balance sheet. The regulators would

---

[195]. See 135 Cong. Rec. H2739-03 (June 15, 1989) (Statement of Hon. Stan Parris).

[196]. See 54 Fed. Reg. 26094 (1989). The Bank Board had previously permitted thrifts, with FSLIC approval, to sell subordinated debt as a source of funding provided it was no more than 50% of the thrift's net worth and matured in no less than 7 years.

[197]. Franklin H. Ornstein, Supra, note 113, at 180.

be charged with determining whether that particular firm had added goodwill to its equity account at the urging of regulators.[198] Industry spokespeople were willing to accept the compromise but only if the regulator was forced to hold a hearing before the goodwill could be forced out of equity.[199] The thrifts, however, were able to place mortgage servicing rights into the capital calculation.[200]

Limiting Growth of Undercapitalized Thrifts

One observable indicia of the moral hazard in the pre-FIRREA thrift industry was the enormous growth rates experienced by insolvent or near insolvent thrifts.[201] The explosive growth

---

198. Robert M. Garsson, "Showdown Seen On House Floor Over Goodwill", American Banker, June 14, 1989, pp. 1& 24.

199. Former House Speaker Jim Wright was a contributing complication in this struggle. Wright, one of the industry's friends in the Congress, was so enrapt in defending himself against ethics charges that he was unavailable to move the bill through the House before industry opponents had time to organize. Robert M. Garsson, "S&L Lobby Gaining ground in Effort to Ease Capital Rules", American Banker, May 26, 1989, pp. 1& 23. The goodwill elimination was reportedly also a casualty of the resentment lawmakers felt over the size of the bailout and their perception of the industry's culpability.
Robert M. Garsson, Supra, note 151. The goodwill phaseout aspect of the bill passed by a wide margin due to this resentment.

200. The S&L industry currently holds approximately $1.9 billion in purchased servicing rights. Jim McTague, "S&Ls Chalk Up a Small Victory on Mortgage-Servicing Rights", American Banker, July 31, 1989, p. 12.

201. See e.g., 50 Fed. Reg. 6891 (1985) codified at 12 C.F.R. {{ 561, 563, 570, 571 & 584 (discussing the observable growth rates of insolvent thrifts).

usually strained capital ratios, further increasing the risk to the insurer. In recognition of this disastrous set of perverse incentives the Congress has granted the OTS the power to restrict the growth of SA's not meeting minimum capital requirements.[202]

Before January 1, 1991, the Director *may* restrict the growth of any SA not in compliance with capital requirements and may require that SA to submit a plan.[203] After January 1, 1991, the Director *shall* prohibit asset growth of undercapitalized SA's and shall also impose other limitations on the offending SA, such as restricting dividends.[204] The Director may also restrict the growth of any SA that the OTS determines is taking excessive risks or paying excessive rates for deposits.[205]

The heavy dependency of troubled thrifts upon brokered deposits prompted the Congress to limit the use of brokered funds by "troubled institutions".[206] Section 2, subsection 224 of the FIRREA prohibits troubled institutions from accepting brokered deposits.[207] Renewals and rollovers of previously accepted deposits count as an acceptance and are equally forbidden by the statute.

---

202. FIRREA, (301, Sub (5.

203. *Id*.

204. *Id*.

205. The Director has only limited power to grant exemptions from these requirements. *See Id*.

206. A troubled institution is defined by the FIRREA as one that does not meet the applicable capital requirements. *See Id*.

207. The FDIC may waive the prohibition under certain conditions and may impose additional restrictions as it sees fit.

A money desk operated by the institution, itself, would fit under the broad definition of broker but is excluded as long as it does not distort the local market for funds.[208]

Brokered deposits were seen as the key instrumentality by which insolvent S&L's funded their massive growth during the late 1980's. The aberrant growth was well documented. In 1984, the thrift industry grew 20% while commercial banking grew only 10%.[209] Some institutions relied on brokered deposits for 50% to 70% of their deposits.[210]

In March, 1984, the FHLBB attempted to cure the brokered deposit problem by regulatory fiat. The Board denied FSLIC insurance coverage for all brokered deposits. The Securities Industry Association and others sued and by June 20, 1984 had procured an injunction against the implementation of such regulations. The court held that the FHLBB and the FDIC, which

[208]. Money desks may not offer interest rates "significantly higher than the prevailing rates of interest on deposits offered by other insured depository institutions having the same type of charter in such depository institution's normal market area." FIRREA, {224.

[209]. R. Dan Brumbaugh, JR., Supra, note 49, at 70.

[210]. In June of 1963 brokered deposits had been limited to no more than 5% of an institution's total deposits. The Depository Institution Deregulation Monetary Control Act repealed the restriction in an effort to deregulate the industry. Norman Strunk & Fred Case, Supra, note 32, at 92.

As of the end of March, 1989, thrifts held $76 billion in brokered funds, approximately 7.9% of their total deposit base. Jay Rosenstein, "Thrift Bill Expected to Pass With Limits on Brokered Funds", American Banker, May 17, 1989, pp. 1& 14.

had passed similar regulation had exceeded their authority.[211]

During the legislative creation of the FIRREA, political observers thought that the limitations on brokered funds might not have sufficient political support to be put into the bill. Not only did the money brokers oppose the limitation but Comptroller of the Currency, Clarke saw the measure as a turf war between the OCC and the FDIC. Clarke decried the measure as unnecessary and ineffective and argued that regulatory supervisors, not the insurer, should be responsible for curbing abuses in brokered funds.[212]

No Less Stringent Than Commercial Banks

The requirement that capital requirements be no less stringent for thrifts than for commercial banks leaves open the question of whether thrifts will have to abide by the risk based capital requirements that will go into effect in 1992. The risk based capital scheme requires an adjusted capital base of 8%.[213]

In 1986 the Board instituted some de facto risk based considerations into the calculation of capital. Greater equity was required to capitalize assets in direct investment, land loans,

---

211. Securities Industry Ass'n v. FDIC, 595 F. Supp. 73, (D.D.C. 1984).

212. Jay Rosenstein, "Thrift Bill Expected to Pass With Limits on Brokered Funds", American Banker, May 17, 1989, pp. 1&14.

213. See 54 C.F.R. { 4186 (1989).

letters of credit, and other perceived risky investments.[214]

Last year M. Danny Wall began a study to develop a formula for forcing thrifts to capitalize interest rate gap risk.[215] This was an innovative move on the part of the Board since even the Basl accord did not propose capitalizing against interest rate risk. However, Mr. Wall has more recently stated that the report of the study will not be ready in November, 1989 as planned.[216]

In September, 1989, Comptroller of the Currency, Clarke announced that he planned to set a 3% minimum capital floor below the risk based capital rules that would become effective for all national banks in 1992.[217] S&L's, under the FIRREA's provision pegging S&L capital to national bank limits, would face the same restrictions. Representative Gonzalez stated that S&L's would have to meet the 3% core capital test immediately but would have until 1995 to meet the 6% leveraging ratio requirement.[218]

---

[214]. See 51 Fed. Reg. 33565 (1986), codified at 12 C.F.R. ch. V & {{ 561 & 563.

[215]. The FHLBB began attempting to force S&L's to contain interest rate risk as early as 1984. See 49 Fed. Reg. 19307-02 (1984).

[216]. Jim McTague, "Plan to Measure S&L Rate Risk is Postponed", American Banker, September 22, 1989, pp. 1 & 16.

[217]. Barbara A. Rehm, "It's Clarke v. Seidman on Capital Plan", American Banker, September 21, 1989, pp. 2&16.

[218]. Jim McTague, "Gonzalez says S&L Regulators Misreading Law", American Banker, September 15, 1989.
Comptroller Clarke received considerable criticism for his proposal, including that of two noted academics, Litan, of the Brookings Institute and R. Dan Brumbaugh, JR, both of whom urged the House Banking Sub-Committee on Financial Institutions to maintain the current capital minimum of 6%. The academics argued that the S&L crisis, itself, should have taught regulators to make

C. The Failure System

1. Regulatory Powers

The enhanced power of the FDIC and the OTS to put thrifts into conservatorship or receivership will alter the regulators' bargaining position against the industry. Before the FIRREA, the financial embarrassment and understaffing of the FSLIC made threats to close large, insolvent thrifts incredible. Conditions necessary for closing a thrift were also restrictive. The recapitalized SAIF and the powers of the Director will serve to increase their influence over failing thrifts and potential acquirors.

The Director may appoint a conservator or a receiver for a federally chartered SA if it is insolvent. The Director may make an appointment if there is a substantial dissipation of assets.[219] Thrifts may be closed for having an unsafe business condition, for having less than the mandatory capital levels, for willful violation of a cease and desist order, for concealment of records,

---

sure equity holders have as large a stake in the institution as possible in order to mitigate the effects of the moral hazard of fixed rate deposit insurance. Litan and Brumbaugh pointed to evidence that commercial banks are beginning to make large real estate loans without hedging the interest rate gap risk leaving them wide open to a repeat of the S&L debacle of the early 80's. Jim McTague, "Big Risks Seen by Economists in 3% Capital", American Banker, September 18, 1989, pp. 1&37.

[219]. FIRREA, {301, Sub {5.

or if the Director determines that the SA is unlikely to be able to pay its depositors in the ordinary course.[220] If a thrift violates laws or regulations or operates in such a way as to make insolvency likely then the Director may close it. If the board of directors of a thrift consents to being closed the OTS may close it.[221] If the thrift loses its membership in the area FHLB or if it loses its insurance coverage it can be forced into receivership or conservatorship.[222]

State SA's may be put into receivership or conservatorship by the Director if it is insolvent, dissipating its assets, if it is in an unsafe condition, or if it is not likely to be able to meet depositors demands. The Director may also order the closing of state chartered thrifts if the Director determines that the SA has, or is likely to, incur losses that will substantially deplete its capital.[223] If the thrift is violating laws or regulations or is operating in an unsafe fashion likely to render it insolvent or otherwise prejudice its depositors then the Director may put the thrift into receivership or conservatorship.[224]

However, for state chartered thrifts the Director must either get the permission of the state supervisor for such a move or must

---

220. Id.

221. Id.

222. FIRREA, {301, Sub {3.

223. FIRREA, {301, Sub {5.

224. Id.

first inform the state authorities of its plans, wait 30 days, and then respond to the concerns of the state regulator before ordering the receivership or conservatorship.[225]

Once the Director has appointed a conservator or a receiver it may replace those parties without warning. The FDIC is designated in the statute as a permissible appointee as conservator or receiver, not withstanding any state or federal law to the contrary.[226]

The OTS is required to appoint the Resolution Trust Corporation as receiver for all failed thrifts for the first three years after enactment and thereafter may appoint the FDIC as conservator but must appoint it as receiver.[227] The FDIC may appoint itself as conservator or receiver for an insured state chartered institution if the current conservator or receiver is not performing adequately.[228] Once appointed the FDIC is not subject to the control of any state or federal agency in performing its duties.[229]

The statute grants the FDIC the power, as conservator, to do whatever is necessary to put a troubled institution into a sound

---

225. Id.

226. FIRREA, {212.

227. Id.

228. Such as not providing funds to depositors in a timely fashion. See Id.

229. However, the institution in receivership or conservatorship remains under the regulatory authority of its primary regulator. See Id.

condition and carry on its business. As receiver the FDIC may liquidate the SA, create a new SAIF member or BIF member. As either conservator or receiver the FDIC may merge the thrift, sell off some of its assets, pay obligations of the SA, determine the validity of and pay claims, and perform all other necessary functions.[230] The FDIC also has the power to promulgate regulations to enforce its powers as receiver and conservator.

2. Repudiation of Contracts

The FSLIC had previously found itself restricted in its activities as conservator or receiver by contracts entered into by the previous management of the thrift. Many of these contracts were disfavorable to the thrift and were sometimes inordinately favorable to other enterprises controlled by the managers or stockholders of the thrift. In cases involving such unfavorable contracts but wherein they are unable to avoid the contracts on fraud grounds the FDIC now has the power to disaffirm any contract of a thrift for which it is acting as receiver or conservator.[231]

To invoke the disaffirmance power the FDIC must find that the institution is a party to the contract, that the contract is burdensome, and that its disaffirmance would promote the orderly

---

[230]. Id.

[231]. The disaffirmance power applies to leases as well as contracts for services but does not apply to contracts between the institution and the Federal Reserve Board or a FHLB. See Id.

disposition of the thrift's affairs. Damages available for recovery by the party suffering the disaffirmance are limited to direct compensatory damages. Lost profits and punitive damages are unavailable.[232]

IV. THE IMPACT OF THE FIRREA ON THE S&L INDUSTRY

A. The Traditional Economics

In this section we will examine the impacts of the new legislation and examine how the regulation will change the market structure of the thrift industry. An analysis of this change in structure will provide the basis for some predictions as to the economic fate of the industry. In the traditional mortgage lending business, profitability was determined by interest on assets, minus costs of funds and other expenses divided by the capital required to support the firm. We shall examine the FIRREA's impact on each of these elements in turn.

Interest Revenue

The FIRREA will limit the interest yield on assets by the risk containment system's imposing tighter restrictions on types of assets permitted. With the percentage of qualified thrift

---

232. Id.

investments required to remain a QTL rising to 70% of assets the majority of financial thrift assets must move to mortgages. Higher yielding alternatives like junk bonds or real estate development have been eliminated or severely restricted by the new regime.

Thrifts were previously moving out of the mortgage market because of the price competition from commercial banks and securitizers. Even the well capitalized thrifts had increased their holdings in consumer and commercial loans in an attempt to improve asset yield.[233] The FIRREA will, by statutory fiat, force them back into mortgages, an area where they possess relatively few strategic advantages.

One of the biggest impacts on interest revenue will not come from either of the three structural changes discussed above but rather from the structure of the bailout provisions.[234] Since all thrifts are required to be FHLB members they must buy and hold FHLB stock. Some thrifts received 28% of their income from dividends on FHLB stock. With the earnings of the FHLB's redirected to help pay for the bailout all of the FHLB's will pay lower dividends at least for the near future.[235]

---

233. See Exhibit H; Source, Combined Financial Statements of FSLIC Insured Institutions, 1987, pp. III-VIII, & 1984, p. IX.

234. See Bureau of National Affairs, "FIRREA Provisions Will Burden FHLBanks; Bank Membership Unlikely, FHLBank Reps Say", 53 BBR 532 (October 16, 1989).

235. FIRREA, {511; See also, Sam Zuckerman, "Home Loan Bank Dividends Expected to Drop", American Banker, August 17, 1989, pp. 1&12. The San Francisco FHLB will reduce its dividends by 50% for the next 2 to 3 years.

Interest and Other Expenses

The cost of funds has been increased by the changes to the insurance regime which raised insurance assessment rates. The differential between banks and thrifts currently stands at .125% of deposits. The differential will drop to .08% in 1990 and 1991. Bankers hope that potential rebates to BIF members will result soon after that as their fund reaches the ceiling set in the statute.[236]

The regulators have made it almost impossible to avoid this differential by the level of fees levied against those institutions which want to shift from one fund to the other. The total fee of 1.7% of core deposits would be over ten times the total differential.[237] The separation of the pools and the maintenance of separate logos also enables depositors to continue differentiating between the two types of insurance, possibly forcing thrifts to continue to pay a premium over bank rates.[238]

Thrifts may still change their charters to banks, but former thrifts will remain in the SAIF fund. Regulators had hoped that

---

[236]. Rebates would of course increase the differential between bank and thrift cost of funds. Rebecca Cox, "Bailout Provision May Ultimately Cut Bank Premiums", American Banker, August 14, 1989, pp. 1&14.

[237]. Since the 1.7% would be charged against only roughly 60% of deposits it would be only 1.02% of total deposits. That would still be over 12 times the differential.

[238]. See note 61 and accompanying text.

thrifts purchased by commercial banks would be changed over to the BIF by those banks and that the fees levied on the change would help to fund the bailout. Such hopes seem to have been foreclosed by the Treasury itself, the potential benefactor of the fees, when it set the fees prohibitively high.

The risk containment system will also increase the cost of thrift operation. The improved enforcement powers and harsher penalties of the risk containment system are going to make the compensation required to attract top flight thrift officers and directors much higher, if it can still be done at any price. Director and executive insurance will also rise commensurate with the risks to the insured of future regulatory penalties.[239]

The changes in the failure management system will also increase the operating costs of thrifts. The FDIC will be a much more demanding insurer of thrifts and the OTS, required to regulate on a par with the OCC, will be more assertive than the old FHLBB. These invigorated regulators will place more constraints on thrifts and more demands for information and compliance. This is a very real, though amorphous, cost to the operation of a firm. The costs of regulatory compliance and reporting are also non-revenue producing which makes them essentially come directly from profits.

While this will increase the overall cost of operating a

---

[239]. See Bureau of National Affairs, "FDIC Technical Amendments Could Raise Cost of D&O Insurance, Attorney Says", 52 BBR 904 (April 24, 1989).

thrift, it is arguably not a comparative disadvantage vis a vis commercial banks. Given that the insurer is now common for both industries and that the regulatory scrutiny is required to be the same, regulatory compliance for thrifts should only be raised to the level already required of commercial banks.

The thrifts did escape without the worst of all possible worlds. The FIRREA did fail to apply risk based premiums which will allow thrifts to continue to try and innovate risk into their operations faster than regulators can officially block them with regulatory or statutory changes. This will force regulators to rely more heavily on the less efficient system of ad hoc increases in regulatory compliance costs to contain the risk taking of thrifts. The insurance system also left the coverage of insurance at its arguably superfluous levels which will allow thrifts to continue to take in deposits at a federally subsidized cost.

Capital

The risk containment system added to the capital cost of the industry by raising the required capital. This increases the cost of operating a thrift as that additional capital must now be serviced and the cost of servicing capital is well above the cost of servicing debt, particularly government subsidized deposits. Again, however, since the capital requirements are to be on a par with those required for commercial banks the capital requirement should not create a comparative advantage for either industry.[240]

One of the unanswered questions about the FIRREA's capital requirements is how many thrifts they will quickly force out of the business. The industry, the competition, the RTC, Treasury, FDIC and OTS all have a vested interest in trying to keep an appropriate balance between stabilizing the industry with greater discipline and eliminating the industry with unreachable requirements.

As of July, 1989, the average capitalization for the total thrift industry was 2.7%.[241] Industry data recently showed 1,886 thrifts with positive earnings and core capital greater than 3%. Two hundred and seventy-seven had negative earnings but greater than 3% core capital. Another 277 had positive earnings but core capital less than the requisite 3%. 506 thrifts were in the unenviable position of having negative earnings and core capital less than 3%.

The OTS stated that approximately 70% of the solvent thrifts could meet the minimum capital requirements.[242] This 70%, fortunately for the SAIF, includes all five of the nation's five largest thrifts. The average capital to assets of the thrifts with

---

240. The equal capital does reveal a disadvantage for thrifts when compared to the unequal powers of S&L's and banks.

241. Jay Rosenstein, "Net Outflows at Thrifts Hit 9-Month Low", <u>American Banker</u>, September 12, 1989, pp. 1& 46.

242. Bureau of National Affairs, "OTS Adopts Three-Part Capital Rule; 800 S&L's May Fail the New Requirements", 53 BBR 689, November 13, 1989.

both positive earnings and greater than 3% core capital was 6%.

The remaining third of the industry may find it very difficult and expensive to raise capital. Industrywide earnings are down and thrift stocks have not kept pace with the Dow Jones Industrial Average. For the 451 S&L's with positive capital, but less than 3%, to attain the 3% minimum they must raise an aggregate of $6.4 billion.[243]

The risk containment system arguably increases the cost of capital by limiting the businesses in which thrifts are authorized to engage. With 70% of its assets in qualified thrift investments a movement in the home mortgage market will threaten thrifts significantly. Far more so than if their assets were more evenly spread over a variety of financial markets.

Even a mortgage portfolio fully hedged for interest rate risk is subject to changes in mortgage demand, changes in lending technology (such as securitized lending) and changes in regulatory environment (such as the introduction of mortgage bankers to the FHLB system). The increased risk inherent in a concentrated portfolio will raise the cost of capital for all thrifts.

The insurance regime will also raise the cost of capital by its new cross guaranty regulations. Potential insured buyers, especially banks and well capitalized thrifts, would otherwise have bid up the price of thrift capital. But the cross guaranty rules make thrift acquisitions so risky to insured owners that they will

---

[243]. Phil Roosevelt, "Thrifts Find Options Limited In Efforts to Increase Capital", American Banker, August 10, 1989, pp. 1& 24.

be unwilling to purchase any but the best capitalized thrifts. The difficulty of accurately assessing the asset quality of a thrift portfolio makes the stock of all but the best capitalized thrifts a potential liability. The increased risk of owning thrift stock, post FIRREA, has already begun to increase the cost of capital for thrifts.

The altered failure management system has also worked to decrease the attractiveness of thrifts as an acquisition and so to have increased their cost of capital. The FDIC has greater powers to close or manage an undercapitalized thrift thereby increasing the risk of loss to the equity holders. Again, since the FDIC already applies more strenuous failure management to commercial banks this increase in the cost of thrift capital should not be considered a disadvantage relative to commercial banks but rather only with the thrift's cost of capital under the old regime.

Non Traditional Business

If the regulatory impact on the traditional thrift business appears negative its impact on their ability to expand into more profitable lines of business is disastrous. With mortgage loans and other qualified thrift investments soon to be required to make up 70% of the thrifts' assets little room is left for profitable diversification.

Former attempts to increase yields such as junk bond investment have been forbidden. Commercial loans are to remain the environs of commercial banks as thrifts can invest no more than 10% of their assets in loans of that type. Non-residential real estate is limited to 4 times a thrift's capital. Thrifts have been forced back into the mortgage lending business from which they fled in the 1980's. The best opportunity remaining for thrifts outside of mortgage lending will be in consumer lending in which they can invest up to 30% of assets.

The legislation deals at some length with the fate of those thrifts which fail to maintain their required 70% in qualified thrift investments. That fate is that they will be superrestricted, only allowed to invest in assets that would be permissible for both thrifts and commercial banks.

Multi-thrift holding companies that own non-conforming thrifts will also be treated as bank holding companies. Unitary thrift holding companies escaped increased regulation but their importance is limited by the continuance of the limitations on branching.[244]

B. The Post FIRREA Industry Structure

To develop a more vivid picture of the thrift environment let us build it by starting with the Pre-FIRREA industry, add on the economic impacts discussed above, regulations, technology, market conditions and the residue of the previous regulatory regime. Recall that at year-end, 1988, the S&L industry was losing massive

---

244. Thrifts cannot branch interstate except within the nascent multistate compact regimes.

amounts of money in aggregate. The industry was 30% unprofitable and 10% GAAP insolvent. As of July, 1989, the industry average capital base was less than the old regulatory minimum.

Consider the operational characteristics of the current thrift industry. The former regulatory oligopoly lulled thrifts into the practice of pooling costs and revenues and offering services out of competitive pressure without regard to the profitability of those services. Thrifts today have no history or capability in controlling costs. They do not even have the cost accounting systems necessary to make cost control decisions. These systems can be developed but they will require both time and money, two commodities in short supply during an insolvency crisis.

Now consider the business which the FIRREA forces thrifts back into, retail mortgage lending in a geographically limited market. S&L's must be predominantly pure mortgage lenders due to the QTL restrictions. They are effectively relegated to consumer finance due to the limit of no more than 10% of their assets in commercial loans. This will also restrict them to taking mostly consumer deposits as commercial lenders can require borrowers to keep their deposits where they get their loans.

The FIRREA restricts their geographic expansion by limiting them to interstate expansion only in accordance with regional compact laws. Any attempt to defect from these restrictions without changing to a commercial bank charter will only further limit the powers of the thrift.

In the previous subsection we saw the economic impacts which the FIRREA will have on the economics of this traditional business. They will suffer from disadvantages in revenue generating power, cost of funds, expenses, and capital requirements.

But the element that absolutely condemns the traditional intermediary thrift lender to unprofitability is the new securitization technology. Securitized lending has caused an unbundling of the lending function and has allowed numerous competitors to enter the thrifts' traditional market. Securitized lenders will be able to undercut thrifts on cost of funds and on the administrative cost of generating the mortgages.

Survival Strategies

Given the statutory limitations on thrifts, their current fiscal and operating conditions, and the new technology, three generic strategies exist whereby a thrift can, at least temporarily, enjoy some profitability. The first is applicable only to small thrifts in remote and uncompetitive markets. These thrifts can continue under the status quo, take deposits and make home and consumer loans.

Thrifts generally still have competitive strengths in their knowledge of the local lending markets, their deposit customer franchise, and their government subsidized deposit insurance. Thrifts in remote, uncompetitive markets, where the securitization technology has not yet penetrated and where the deposit subsidy still exists can continue to leverage these three advantages and remain profitable.

This strategy is clearly limited and will erode when securitization and money market deposits come to the community. In prior times these things have been kept out by the high cost brick and mortar distribution channel of financial services. But the power of these new technologies is now being delivered even through the cumbersome channels of the mails and over the telephone. Any thrift attempting to compete under the old economic model, even in a rural area, will begin to feel the affects of disinterdediation.

The second strategy is available only to larger thrifts. They could embrace the securitization technology and utilize their scale to become low cost originators and packagers of loans, funding those loans through the securities markets. The larger thrifts would have the adequate scale to produce or buy enough mortgages to package their own securities.

The lack of funding required would mitigate their disadvantages in the cost of fund raising. Real estate and consumer loans are the easiest and most popular securitized loans to make so the thrifts would not suffer a lending powers limitation. The thrifts would again have the local knowledge necessary to generate the loans efficiently and with less assets on the books there would be a mitigation of their cost of capital disadvantage.

The shortcomings of this strategy are that most thrifts have very little expertise in the investment banking type functions required to package mortgages for securities issues. Another area where thrifts lack expertise is in controlling costs. Failure in cost control is particularly damaging in a high volume, low margin business as this would be. Thrifts would also be limited in expanding their origination scale by the anti-branching restrictions maintained by the FIRREA. These thrifts could grow by acquisition but would face the risk of loss infection through the cross guaranty rules.

A third generic strategy is available for smaller thrifts that have some unique expertise. These thrifts can operate in niche markets by providing high levels of service and offering innovative loan and deposit products to customers.

In small niche markets geographic limits are unimportant. The thrift's high levels of local knowledge should give it an advantage in understanding its customers and allow it to offer more appropriate services. Many services can be franchised from larger banks or other providers so scale is not critical. Premium pricing would help mitigate the cost of funds disadvantage. Trust services are permissible under the FIRREA and securitization would be inappropriate since it would lower the thrift's control over customer service.

The drawbacks of this strategy are that it is not obvious what to do with the deposits. Thrifts in this upscale niche might begin to look more like portfolio managers. Few thrift managers have any skill in this area. Control systems, which most thrifts lack, are also important in a high service business. There are limits to the thrift's being able to compete with investment banks and commercial banks in this area. By being forced to buy franchised services the thrift loses control over the quality of those services, a critical element to control in a premium market. It would also expose the thrift to having its customers stolen by the service originator, or, at least to having the originator pull the value back from the thrift by raising the price charged for the originator's product.[245]

The critical element about each of these strategies is that there is nothing unique brought to any of them by the thrift's charter. There is nothing that the thrift could do under any of the three that a commercial bank could not do cheaper and with more flexibility. This leads us to the conclusion that, notwithstanding the bailout and recovery rhetoric of the bill, the value of a thrift charter has been eviscerated by the FIRREA. The critical question remaining is how and where the industry will migrate.

V. CONCLUSIONS ON THE FUTURE OF THE INDUSTRY

Exit Strategies

Given that the value of a thrift charter is negative under most strategies and of no positive value under others it requires

245. Such a strategy would also require higher than average capital in order to attract larger depositors who would be willing to pay for higher service.

no great analysis to predict that the number of thrifts will decrease substantially over the next decade.[246] The more difficult and more politically and economically important question is what avenues of exit the thrifts will take. The three available alternatives are conversion to commercial bank charter, acquisition by a commercial bank, and failure.

The first option is the most likely road for many of the healthier thrifts. It will allow them to compete with commercial banks without the portfolio restrictions of the FIRREA and to pursue alternative specialized niches in any number of businesses. For the next five years however these converts will operate under an unescapable cost disadvantage due to their remaining in the SAIF insurance pool.[247]

Changing their charters will also not alter a thrift's basic lack of control systems, cost accounting or extradindustry knowledge. Nor will it transform an already undercapitalized balance sheet into one that will survive. The commercial banking

---

[246]. One category of thrift likely to be sustained by the regulation is that group of thrifts belonging to non-financial industry, unit thrift holding companies. A thrift owned by the Ford Motor Company or American Express is likely to remain a thrift despite the strategic disadvantages because these institutions would not be eligible for becoming bank holding companies due to their activities beyond the scope of Reg. Y.

[247]. The market perception baggage of being former thrifts may further disadvantage converted thrifts if they move into more complex financial areas such as portfolio management or commercial finance.

industry itself is consolidating.[248] Thrift converts that seek to enter the traditional banking fields of commercial lending and business deposit services will find competition already fierce and accelerating.

During the creation of the FIRREA it was widely thought that one way to finance the bailout would be to facilitate the sale of sick thrifts to commercial banks. Banks were eager to buy thrifts in many states due to the relaxed branching rules that thrifts had enjoyed there. Banks in these states could dramatically extend their deposit gathering presence by purchasing a thrift that already had an extensive branch network.

The cross guaranty rules of the FIRREA, however, chilled commercial bank interest in purchasing any but the healthiest thrifts. Banks are simply unprepared to place their own capital at risk in order to purchase a member of an industry that has recently suffered such severe hardship, particularly when weak assets can be hidden from all but the most severe examination.

The purchase option, therefore, will predominantly occur in pieces. Banks will try to purchase physical branches and deposits without purchasing a thrift's assets. Banks can even move these deposits into the BIF as long as the total deposits purchased comprise no more than 35% of either the bank or the thrift. But the wholesale purchase of the thrift industry by the banks, as was predicted by many pre-FIRREA, is out of the question.

---

[248]. Bryan, Supra, note 11, at 106.

Given the difficulties of these two avenues of exiting the business it will take some time for the disassembly of the industry to occur. During the interim the overcapacity in the financial services sector will increase rivalry amongst both thrifts and banks.[249] This will drive down profitability for both types of institutions. But thrifts, because of the uncompetitiveness of their charters, will bear the brunt of the losses. In addition to the failures that will occur amongst the converted commercial banks, due to their non-competitive thrift attributes, there will be some failures of thrift institutions that cannot see profitably exiting through the other two routes.

Substance Over Form: Bailing Out the Insurer

The rhetoric employed in the FIRREA's history suggested that its purpose was to reestablish the industry. The FIRREA was consistently referred to as the thrift bailout bill. Our analysis has concluded that it will in fact drive the industry into near extinction. The substance of the legislation revealed its true purpose which was to bailout the insurer. The cost of the bailout and the avoidance of its recurrence became the overriding factors in restructuring the regulatory regime.

The insurance regime was restructured to raise more money through higher assessments, to insulate the insurer with cross

[249]. Id, at 31-33.

guarantees, and to provide for tighter regulatory management of the insurance system by requiring thrift regulators to emulate their banking counterparts. The risk management system limited the powers of thrifts and raised their capital requirements so that they would throw off less risk on the insurer. The failure system was redesigned to give the insurer greater bargaining power over failing thrifts and prospective purchasers, thereby allowing them to bear less losses from failed thrifts. All of these systems were redesigned for the purpose of providing that another insurer failure, with its commensurate loss to taxpayers, did not occur.

Such a regulatory redesign may have extremely deleterious effects on the industry. In seeking to justify the legislature's lack of concern for the future of the industry two possible rationales present themselves. One source of unconcern for the industry, which was evident throughout the legislative process, was a general retributive attitude towards the thrifts. The industry was attributed with responsibility for the enormous losses to the taxpayers and therefore any suffering they experienced as a result of the changes was only proper.

The other possible source of Congress' lack of concern was that the Congress recognized the overcapacity in the industry brought on by the emerging securitization technology and determined to use the regulatory reform to remove excess capacity. Glimpses of such planning might be evident in the default to commercial bank status accorded to thrifts who fail the QTL test.[250]

The Failure of Substance: FIRREA Endangers the Insurer

Regardless of the source of their disconcern for the industry the legislature clearly evidenced a preference for saving the insurer regardless of the effect on the industry. But this unbalanced view misses a crucial reality of the insurance system. Without perfect information on the part of the insurer its health will always be partly a function of industry health. If thrifts could always be closed at the moment of insolvency the only costs to the insurer would be the administrative costs of managing the closure. But since determining the market value of a thrift's assets is such an imprecise science the insurer must bear losses when they close thrifts that have negative net worths.

The FSLIC failed, in part, because the industry was so thoroughly sick that it had nowhere near the resources to adequately monitor and close the failing thrifts. If the FIRREA renders the exit routes from the thrift industry sufficiently expensive, and the operation of thrifts under the FIRREA sufficiently unprofitable, the intense rivalry resulting from the maintenance of excess capacity could cause a further deterioration in industry performance.

---

250. However, since the commercial banking industry is also experiencing overcapacity the evidence of such planning is logically limited.

This decline in performance would put increased pressure on the insurer to supervise and close the failing thrifts, demanding additional expenditures of insurer funds. The regime which was created to protect the insurer from loss may, by making the industry unprofitable and unavoidable, cause more losses for the insurer.

It will remain to be seen whether adequate discretion has been left to the insurer and the regulators to facilitate industry exit on an ad hoc basis. If so this would allow the insurer to escape some of the losses due to the industry shakeout. At worst these problems should begin to surface soon and the continued separation of the funds will allow the insurer to trace the problems directly to the thrift industry. Such tracing and early recognition will allow the FDIC to cast the problem as an inherited one and make it more politically reasonable for them to return to the legislature for more money to fund further industry losses caused by the FIRREA.

Exhibit A
Mtge Income Dominant until mid- 1980's

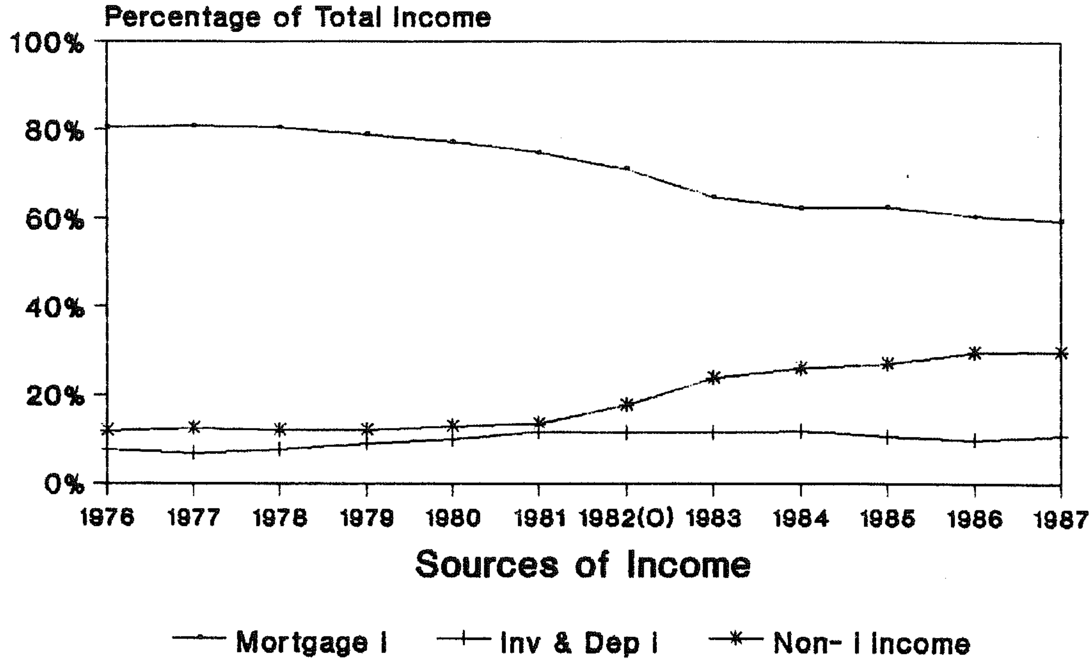


Exhibit B
Cost of Funds Dominates Expenses

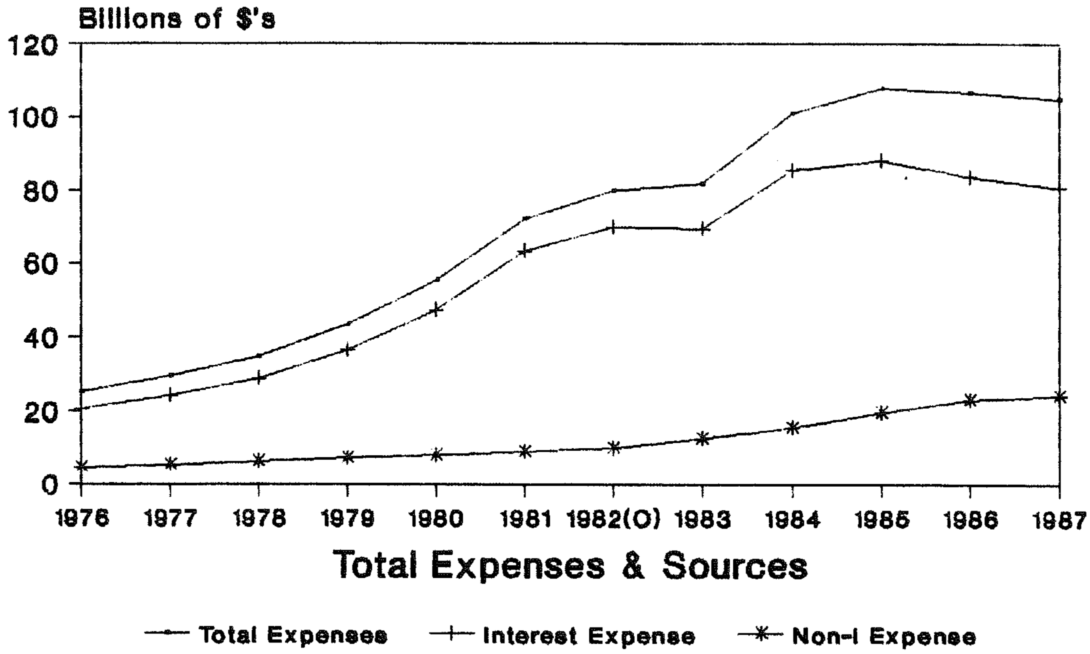


Exhibit C
S&L's Suffer Negative Spread, 79-81

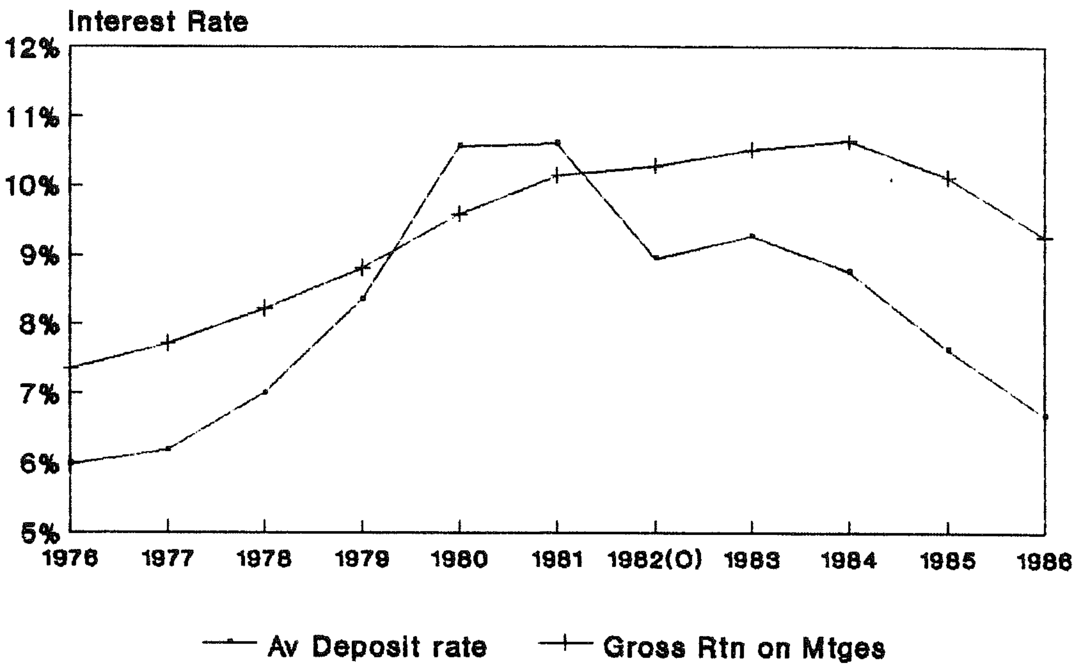


Exhibit D
Capitalization Falls, 1979- 1982

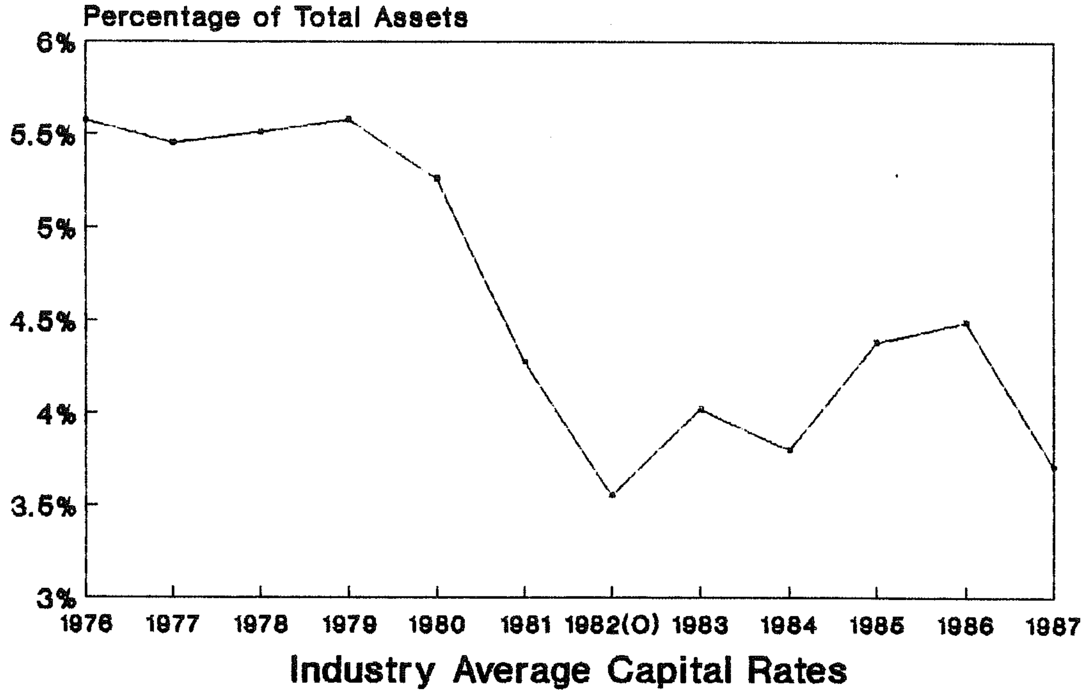
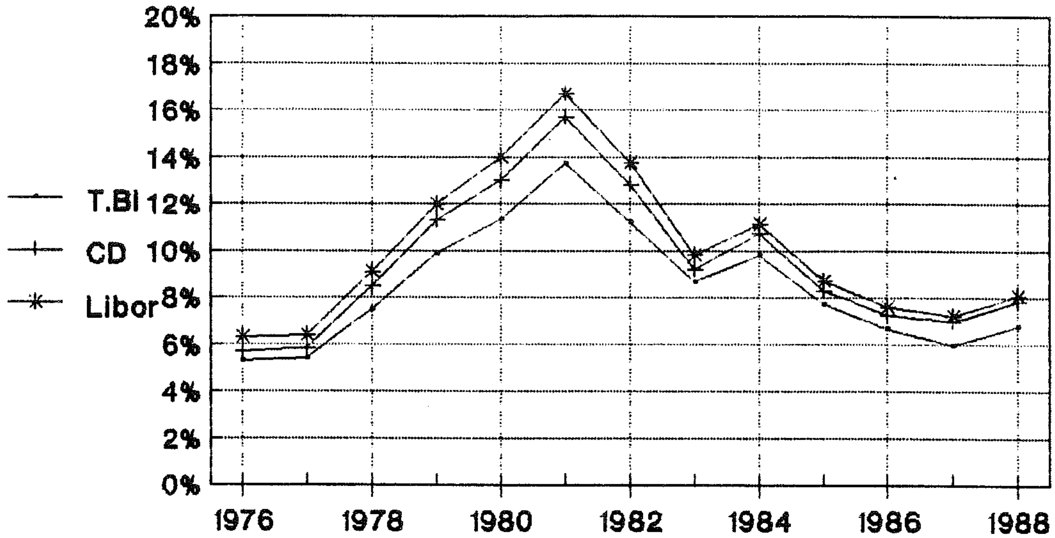
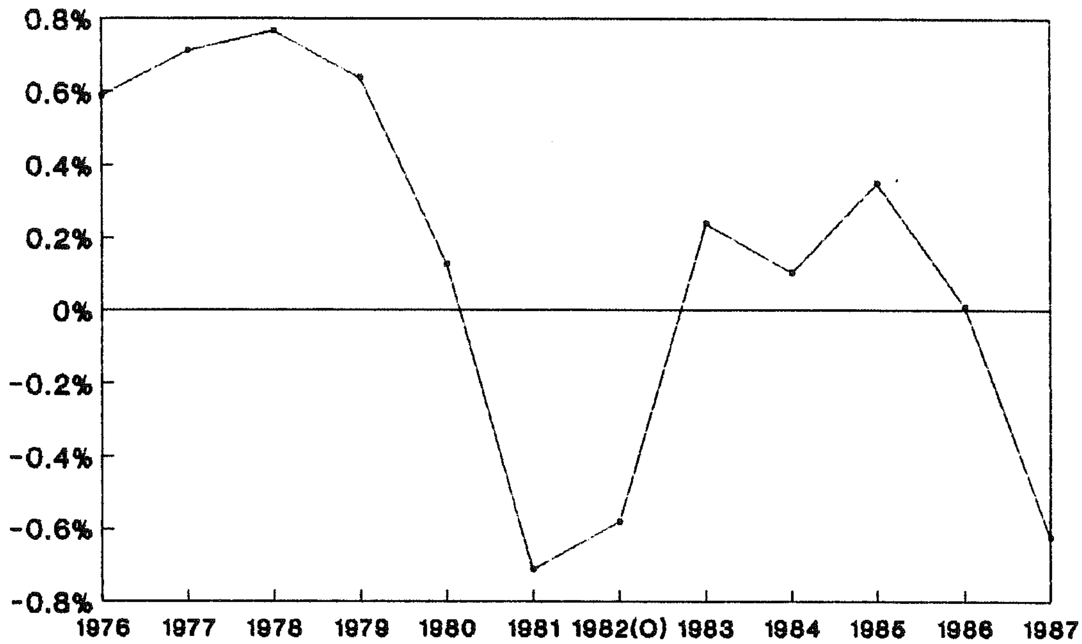


Exhibit E
Interest Rates Climb in Late 1970's



T.Bl	5.32%	7.48%	11.33%	11.21%	9.81%	6.66%	6.78%
CD	5.7%	8.46%	13%	12.81%	10.74%	7.27%	7.84%
Libor	6.3%	9.1%	14%	13.76%	11.14%	7.59%	8.04%

Exhibit F
S&L's Suffer Tremendous Losses '81-'82



Return on Average Assets

Exhibit G

Failures Peak in 1982 & 1987

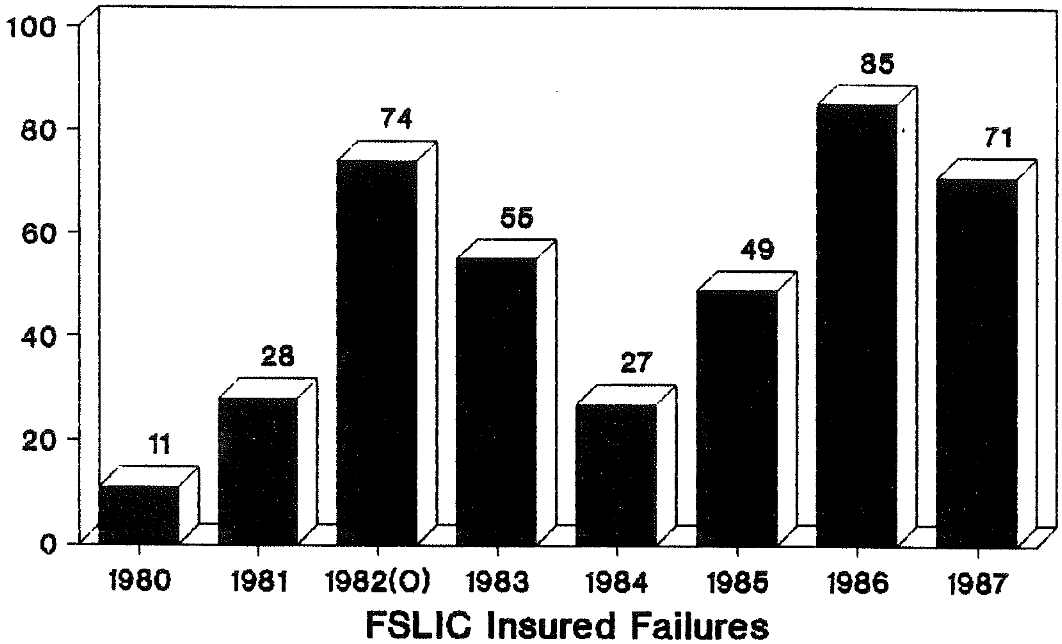
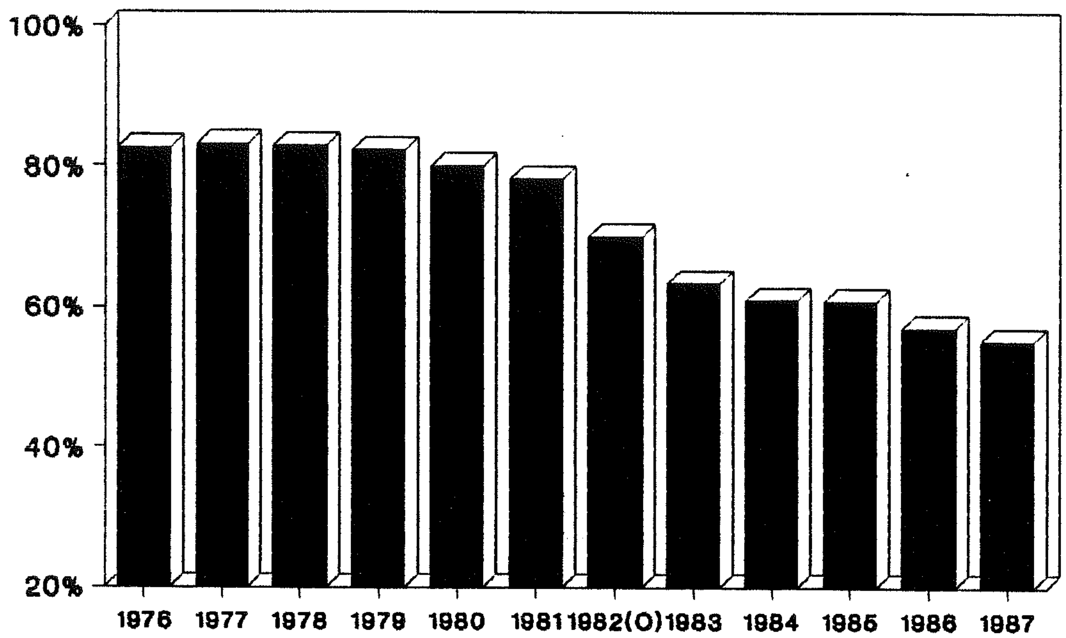


Exhibit H
Mortgage Investment Declines 1981- 1987



Mortgages as a % of Total Assets

Exhibit I
One third of Industry Unprofitable

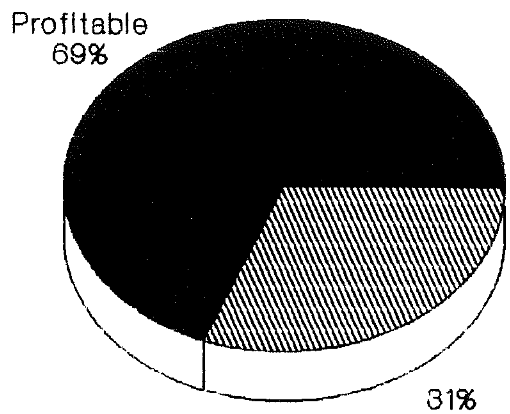


Exhibit J
One Tenth of Industry Insolvent

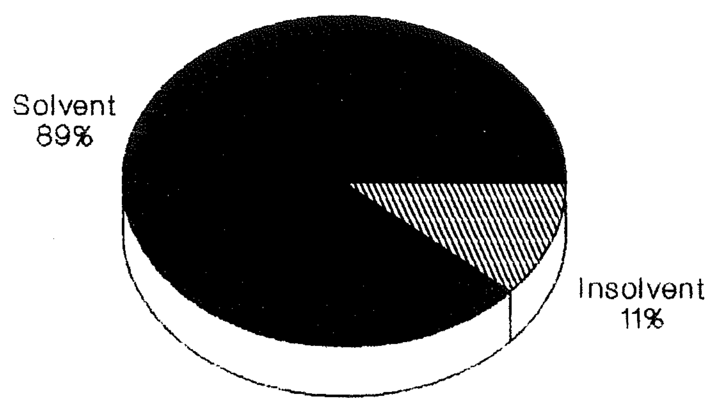


Exhibit K
Losses Concentrated in Southwest Region

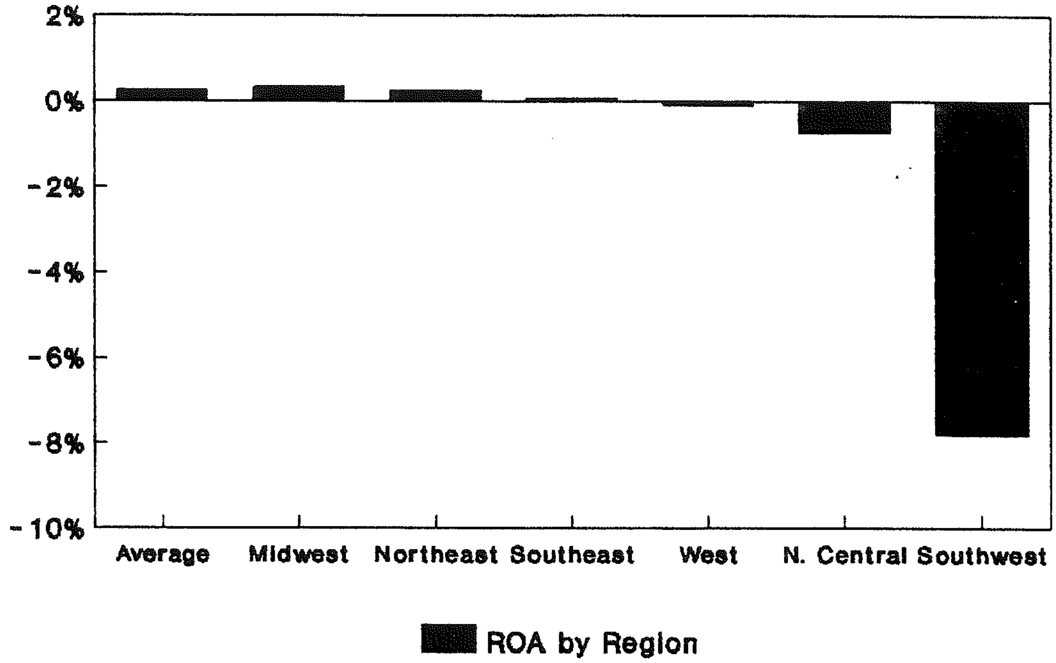


Exhibit L
8% of Industry Assets Held by Insolvents

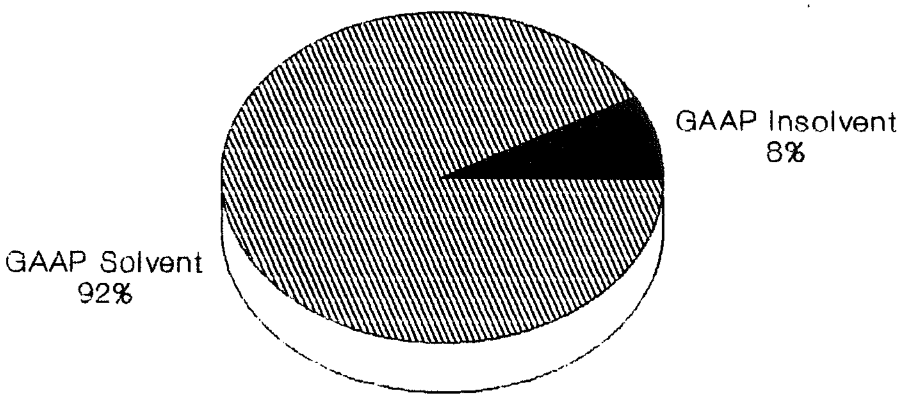


Exhibit M
Industry Shows Massive Net Loss in 1988