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The Festering U.S. Deposit-Insurance Mess

1. Introduction

As financial markets and institutions have gone global, proposals for financial reform have centered on re-engineering the network of national regulatory machines. However, the U.S. deposit-insurance mess provides considerable evidence that the world's greatest regulatory difficulties do not reside in instrumental defects. They are rooted in incentive defects that systematically encourage government officials to misoperate their machines when they find themselves under stress.

The fundamental weakness is the lack of a timely accountability for losses that accrue to taxpayers from governmental acts of financial misregulation. In the U.S., regulatory officials have been allowed to fashion and publicize misleading indices of the quality of their own performance.

Discretion to misinform the public about the state of a deposit-insurance fund's net reserves and to control the timing and accounting cost of observable deposit-institution failures invites politicians and regulators to cover up emerging problems and to put off painful adjustments to someone else's watch. It pays them to do this because the U.S. press and public do not understand the tradeoffs involved. They blame officials disproportionately for the particular problems that happen to surface while they are in office and tend to not to penalize them for the anticipatable future damage that they create by adopting short-sighted policies.

2. The Roots of the Mess

It is dangerous to mistake a high or rising rate of failure for banks and thrifts as evidence of poor current performance by a country's deposit-institution regulators. This is because current failures tend to lag by many, many months the economic insolvencies that are finally being resolved. More important, treating the failure rate as the principal index of regulatory success tends to increase the length of this lag. It encourages regulators to prescribe counterfeit remedies that leave the task of resolving difficult insolvencies for their successors to handle. Routinely imposing a predictable series of escalating penalties on institutions whose net worth or capital base declines would be a good economic policy for taxpayers. But it promises to subject regulatory managers to career-damaging criticism and to time-consuming and unpleasant administrative appeals and civil lawsuits. In many cases, it is politically and administratively easier to temporize: to gamble that a decapitalized firm can grow out of its problems on its own.

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However easy it may be in the short run not to enforce capital requirements for troubled firms, this policy is expensive in the long run. It has greatly increased the present discounted value of the costs of operating the federal deposit-insurance system. For over two decades, top regulatory officials, federal politicians, and thrift-institution trade associations cooperated in denying and covering up the size of their industry's growing capital shortage. They did this by using and creating accounting gimmicks to delay the formal realization of developing losses and by trying to discredit the efforts of outside critics to size the need to recapitalize the deposit-insurance funds realistically.

Today, the losses accrued by hopelessly insolvent thrift institutions that were insured by the now-defunct Federal Savings and Loan Insurance Corporation (FSLIC, pronounced "Fizz-Lick") are recognized as a national scandal. Even though the insolvencies of over 1,400 thrifts have been formally resolved since 1980, at least 25 percent of the nation's 2,600 surviving thrifts are in so tenuous a position that they could not survive without implicit or explicit government assistance.

For taxpayers and better capitalized competitors, it is costly to let crippled firms borrow against government insurance. This is because once the value of an insured firm's assets sinks far below the value of liabilities its managers' risk-taking incentives become greatly distorted. Their most reasonable hope of generating returns for the enterprise's owners is to expand the institution's federally guaranteed funding base and to invest the funds raised in a blatantly speculative manner. If the new bets pay off, the firm regains its solvency. Even if the new bets lose, dividends and salaries can be received in the interim, while the responsibility for paying off lost bets falls on the deposit insurer.

Deposit-insurance officials cannot easily overcome these incentives. From a narrow career point of view, officials' own best strategy is often to gamble that they can help troubled firms to "grow out of the problem" by undertaking long-shot new lending and funding activities that exploit federal guarantees to renew and expand the lost "bets" of the past.

A growth-obsessed insolvent thrift may be aptly described as an institutional zombie. The economic life it enjoys is an unnatural life-in-death existence. If its deposit debt were not insured, its creditors would promptly inter its corporate corpse. They would do this by taking control from stockholders when it became clear that their contribution to net worth was exhausted. In effect, a zombie transcends its natural death from accumulated losses by hooking into an expensive life-support system financed by federal taxpayers.

Preserving basket-case firms is a perversion of the purpose for which deposit-insurance support systems are intended. But the passage of time has greatly distorted the abused and undermaintained 57-year-old machinery of federal deposit insurance.

Efficiency requires that repairs must be given priorities before they are started. Years of deferring the escalating losses imbedded in deposit-insurer promises to depositors at zombie and near-zombie firms have generated a huge repair bill. Not only has most of the bill remained unpaid, the meter is still running. The longer federal politicians have waited to present this bill to taxpayers, the larger it has become. The 1989 Bush Administration plan for cleaning up FSLIC's losses (as amended by Congress) underestimated the present discounted value of the bill by about one-third, set up faulty machinery for salvaging the assets held by troubled thrifts, and deferred the task of comprehensive deposit-insurance reform until after the 1990 election.

Although the Bush plan included some useful measures, it diagnosed deposit-insurance problems too narrowly and too wishfully to clean up the mess once and for all. The plan asked Congress only to set up a scheme for financing the greater part of FSLIC's unpaid repair bill and to establish additional regulatory powers and new bureaucratic structures for overseeing thrifts and for liquidating (i.e., reprivatizing) the assets of insolvent thrifts that government bureaus must take over in settling FSLIC's accounts. Although the plan's new regulatory framework was advertised as establishing "bank-like" capital requirements for thrifts, U.S. capital stand-

ards for banks have softened in recent years. Moreover, the provisions adopted fell far short of even this flawed ideal. Legislators left many wrecked firms on the street by authorizing what are still dangerously low minimum levels for thrift capital and by allowing troubled firms to meet these minimum requirements gradually and in artificial ways. Wrecked firms' desperate pursuit of profit opportunities bids deposit interest rates up and loan rates down to unsustainable levels. The resulting squeeze on industry profit margins spreads weakness to healthy banks and thrifts that must compete with them and deters private capital from moving in to recapitalize the industry.

3. Deficiencies in the Will To Regulate

When many firms fall into trouble at the same time, U.S. authorities have shown repeatedly that they lack the political will to enforce capital requirements. To prevent undercapitalized banks and thrifts from creating new generations of zombies, it is necessary to mandate statutorily that deposit-insurance bureaucrats report and reserve for developing losses in timely fashion. Without such responsibility, politicians and deposit-insurance bureaucrats find it too easy to commit taxpayers in off-budget fashion by providing generous credit support. The failure to develop a reliable system of future controls on back-door spending by politicians and deposit-insurance bureaucrats stands as the glaring inadequacy of the legislation crafted in 1989 and 1990.

To appreciate how badly taxpayers need such controls, one must understand how and when FSLIC's losses came to be so large. One way that parties with a stake in preserving regulators' opportunities to cover up developing problems seek to sidetrack salient reform is by promoting self-serving mischaracterizations of the sources of the underlying problem. Taxpayers and politicians lack a scientist's concern for how incompletely the theories they adopt may explain the mess to be cleaned up. In sorting through alternative diagnoses of the causes of the U.S. deposit-insurance mess, elected politicians have been drawn to theories that imply easy solutions. These superficial and wishful diagnoses are attractive because they allow politically and personally painful adjustments to be postponed.

4. Washington's Two Particularly Dangerous Misdiagnoses

Two seductive misdiagnoses underlie the August 1989 and October 1990 legislation that is supposed to prevent a recurrence of the mess. KANE (1989a and b) calls these incomplete analyses the bad-apples theory and the excessive-deregulation theory.

Bad apples in the barrel? The bad-apples theory holds that the essence of the mess is thievery and incompetence by thrift managers: the bad luck of having suddenly developed a concentration of bad and dishonest managers in a single industry. Adherents to this theory see the issue as one of identifying the "bad apples" and keeping them and others like them out of the industry in the future. Because this theory blames industry managers rather than government officials for the mess, it is a Washington favorite. On this theory, the major reform needed was to develop tougher criminal and civil penalties for fraud and mismanagement by managers of federally insured financial institutions. This was accomplished in October 28, 1990 by passing legislation that contains numerous provisions broadening definitions of deposit-institution crime and increasing penalties and civil liability for crimes by managers of U.S. banks and thrifts.

The bad-apples theory explains some but not all of the facts. It is consistent with two observations. First, government studies (e.g., U.S. GENERAL ACCOUNTING OFFICE, 1989) have found that to some degree fraud was present in two-thirds to three-fourths of the insolvencies FSLIC chose to resolve during its final years. Second, many of the loans and investments made by failed thrifts prove to have been intensely speculative ones that exposed thrifts to fraud by partners and borrowers.

However, the issue is not how frequently fraud and speculative activity are observed, but how much of FSLIC's total losses may be fairly attributed to willful managerial fraud and mismanagement. When one looks closely, most instances of fraud turn out to be relatively inconsequential. Despite the existence of a few giant lootings, managerial violations of law or stockholder rights cannot be made to account for more than 10 to 20 percent of the bill run up on FSLIC. One student of the debacle, thrift consultant Bert Ely, estimates that managerial fraud accounts for only 3 percent of FSLIC's bill.

Much of what an untutored observer might deem to be fraudulent reporting of an insured thrift's earnings and financial condition is completely legal under the generally accepted accounting principles (GAAP) that currently govern financial disclosure. The principal weakness of these principles is their reliance on historical-cost valuation. GAAP directs deposit-institution accountants generally not to recognize formally what they could easily see to be developing losses on still-maturing loans and investments. GAAP creates a presumption for valuing unmatured assets at their acquisition costs even when irrefutable and easily observed evidence exists that their market values have declined substantially. To create the appearance of profitability and solvency where these conditions do not truly exist, managers of federally insured thrifts did not have to engage in acts of actionable fraud.

For public officials to use this theory to exonerate themselves, they must answer two deeper questions. First, why didn't they discover fraud and misleading accounting reports in timely fashion and correct the situation promptly? Why did they permit insured thrifts' authority to engage in misleading reporting to be expanded by adopting regulatory accounting principles in September, 1982 that were dangerously more lenient than GAAP?

The bulk of the exorbitantly risky loans and investments that insolvent thrifts put on their books in recent years reflect good rather than bad management. They are best understood not as managerial actions that clearly and immediately harmed stockholders, but as clever gambles. Go-for-broke gambling was made attractive by perverse incentives created by decisions of FSLIC officials to forbear from enforcing requirements for minimum capital at troubled thrift institutions. Far from violating their fiduciary duties to stockholders, zombie managers who placed high-stakes gambles enriched their stockholders at the time the bets were placed. This enrichment occurred because, as a federally insured thrift loses its stockholder-contributed capital, it finds itself able to book additional high-stakes long-shot bets without exposing the firm's stockholders to much risk of further loss. The essence of a long-shot undertaking is that it offers the possibility of great rewards but little chance for success. Deposit insurance asymmetrically shifted the deep downside of a zombie's long-shot bets to FSLIC (and to federal taxpayers who ultimately back up FSLIC), while allowing the owners and managers of the highflying firm to receive interim payments and to keep the lion's share of the upside potential of the long-shot bets they managed to book.

The bad-apples theory attributes thrift-institution losses predominantly to bad management and fraud induced by inadequate legal penalties. But this theory fails to explain why managerial mistakes and deceptive reporting burgeoned at thrift institutions specifically in the 1980s. The follow-up question that a complete theory must answer is: why were the penalties too low in the 1980s, but not before? The answer is that the number of thrifts that federal regulators allowed to operate in an economically insolvent stage surged then. When and as losses destroy the market value of the net capital assets of a firm whose debt enjoys credible outside guarantees, the rewards from participating in legal and illegal forms of deceptive reporting and in highrolling patterns of investment become progressively larger.

Thrift economic insolvencies surged in the 1970s each time that inflation accelerated. This is because inflation-induced increases in interest rates drove down the market value of the lower-interest-rate mortgages that constituted these firms' principal asset. Low-rate mortgages lost value because they could offer only a fraction of the interest rate that

Table 1: Number of GAAP Insolvencies and Insolvency Resolutions at FSLIC-Insured Institutions, 1975-1989.

An "insolvency resolution" is defined as a regulator-induced cessation of autonomous operations. It includes liquidations, supervisory mergers or acquisitions, conservatorships, and near-conservatorships such as the Federal Home Loan Bank Board's Phoenix and Management Consignment Programs.
"GAAP-insolvent institution" is defined as an institution whose net worth is less than or equal to zero under Generally Accepted Accounting Principles (GAAP).
Information for 1975-79 and 1988 and 1989 was collected in 1988, 1989, and 1991 by telephone from Federal Home Loan Bank Board, Office of Thrift Supervision, and Resolution Trust Corporation (RTC) files; 1980-1988 (June) information comes from BARTH/BRADLEY (1988), whose figures differ slightly from and are presumably more exact than older sources.

Year	Insolvencies Resolved by FSLIC or its successor	GAAP-Insolvent Institutions
1975	11	17
1976	12	48
1977	10	38
1978	4	38
1979	4	34
1980	32	43
1981	82	85
1982	247	237
1983	70	293
1984	36	445
1985	64	470
1986	80	471
1987	77	515
1988 (through June)	130	496
1988	233	364
1989	320*	427

Note:
* Approximate only. In February 1989, responsibility for handling problem institutions was formally transferred to the Federal Deposit Insurance Corporation and in August 1989 to its RTC subsidiary. In 1989, FSLIC fully resolved 10 insolvencies, while the RTC fully resolved 37 cases. At yearend 1989, 263 institutions were in RTC conservatorships, but some of these may have been in a FSLIC near-conservatorship at yearend 1988. In 1990, 316 insolvencies were fully resolved, but because the number of conservatorships fell from 263 to 179, the number of new cases resolved can only be accounted as 232.

new mortgages earned and that thrift depositors required. The shortfall in mortgage interest can be thought of as a form of partial default on thrift assets.

Because GAAP accounting does not require low-rate mortgages to be written down immediately to acknowledge the impact of this partial default, accounting records badly misstate the timing of industry losses. Declines in market value associated with the sharp interest-rate increase of 1979-1982 made themselves felt in an accounting sense over time as operating losses that eroded thrift capital in a delayed fashion.

Table 1 provides evidence of misregulation in that, after a surge in GAAP insolvency became observable in 1981, it was accompanied by a slowdown

rather than speedup in FSLIC resolution of accounting insolvencies after 1982.

Too Much Deregulation? A second misdiagnosis finds favor with some members of the financial industry (e.g., O'CONNELL (1988)) and seems to be given wide credence by the press and lay public. This view focuses on explaining the timing of the surge in GAAP insolvencies. It maintains that FSLIC and its client institutions were ruined by a few specific decisions Congress made in 1980 and 1982 that relaxed some longstanding constraints on the activities and business decisions thrifts could undertake. The subtext supporting this theory shades into the bad-apples theory, in that it presumes that thrift-institution managers are chronic bumblers. Supposedly, the government must help these hopelessly underequipped souls to make appropriate decisions about the explicit interest rates they can afford to pay on deposits. Nor can these misfits be expected to exercise prudently the wide range of consumer lending, real-estate development, and other asset powers established by the financial reform acts of 1980 and 1982. This theory's implied solution has three parts: pay FSLIC's bill, restrict thrift activities as before, and reintroduce ceilings of some kind on thrift deposit rates.

This diagnosis emphasizes that widespread accounting insolvency occurred after the allegedly decisive regulatory mistake of letting thrifts compete more closely with banks. However, a strategy of restrictive reregulation of thrifts' permissible activities can't be a complete solution to the mess. This is because, on a properly appraised economic basis, widespread economic insolvencies actually developed in the 1970s *before* the allegedly critical legislation was passed. The inevitable delay between economic insolvency and its realization in GAAP records means that the insolvencies predated the policy measures that the excessive-deregulation theory supposes to have caused them. Removing deposit-rate ceilings and expanding thrift asset powers neither brought zombie thrifts to their current sad state nor are these policies helping to keep them there. Today, the 1989 legislation's rollback of thrift investment powers is simply another factor discouraging the flow of private capital into the thrift industry.

Long before it was decided to remove deposit-rate ceilings in 1980, the ceilings had lost most of their effectiveness. Deposit institutions had developed a range of noncash ways of delivering de facto interest to depositors and a large proportion of the industry was already economically insolvent. What raising the formal limits of deposit-insurance coverage to $100,000 per account name and giving thrifts broader investment powers did do was to increase the capacity of zombie firms to undertake sizeable and risky financial plays in a hurry. But the basic policy mistake (which is being repeated by the Bank Insurance Fund at this very time) lay in helping decapitalized firms to operate as zombies in an environment that was rich in opportunities to raise and lose funds quickly.

Rough measures of the GAAP-neglected impact on the thrift industry of interest-induced losses were constructed on an appraisal basis for 1971 through 1983 by KANE (1985) and with somewhat greater precision for 1980 through 1984 by BRUMBAUGH (1988). Table 2 reports the ratio of the appraised market value of net worth to total assets at FSLIC thrifts, between 1971 and 1984. The table shows that thrifts lay in crisis since at least 1971 and that the industry's shortage of enterprise-contributed capital became particularly severe between 1979 and 1982. Although the 1983 and 1984 calculations record a distinct improvement in industry capitalization, circumstances make the appraisal methods used less relevant for the post-1982 era than they were before. The principal circumstance is that the method of asset appraisal focuses on only one source of market-value fluctuation: that due to changes in interest rates. As the thrift business grew more complex after 1980 and especially after 1982, the economic risks that affected the market value of their assets and liabilities became more complex, too. A second problem is that these calculations throw healthy and diseased firms together. FSLIC's losses in zombie thrifts cannot strictly be offset by the positive capital positions recorded for healthy competitors.

Table 2: Estimates by KANE (1989a, p. 102) and BRUMBAUGH (1988, p. 50) of the Ratio of the Appraised Market Value of Net Worth to Total Assets at FSLIC-Insured Thrifts, 1971-1984 (in percent).

Year	Adjusted Kane estimates*	Brumbaugh estimates
1971	-3.77	
1972	-5.43	
1973	-4.64	
1974	-7.55	
1975	-7.77	
1976	-7.25	
1977	-6.62	
1978	-6.87	
1979	-9.32	
1980	-12.78	-12.47
1981	-15.41	-17.32
1982	-10.63	-12.03
1983	-6.03	-5.64
1984		-2.74

Note:
* The adjustment consists of reducing Kane's estimates (which treat mortgages as perpetual bonds) by one-third to reflect the finite maturity of mortgage assets.

These two qualifications coalesce in that many of the deeply insolvent thrifts whose interest-induced 1979-82 losses were ignored used the respite provided by post-1982 FSLIC capital forbearance to load up with other kinds of long-shot risks. Many of these new risks carried the additional attraction of allowing an insolvent thrift to capitalize and front-load fees for future services as immediate net income without simultaneously deducting the future opportunity costs of performing these services. For at least three-fourths of this era's zombie thrifts, the post-1982 capital gains on their mortgage portfolios induced by falling interest rates were not sufficient to offset losses incurred on speculative loans and investments.

KANE (1991) estimates the market value of FSLIC's unbooked loss exposure during 1985-1989. He finds that, between September 30, 1985 and FSLIC's shutdown on August 9, 1989, the industry's increasing loss exposure roughly doubled the shortfall in FSLIC reserves. In these 46.3 months, FSLIC's unpaid bill advanced from $86 billion to $161 billion.

The roots of the industry's wave of accounting insolvencies lie not in the abuse of new powers, but in two other facts and circumstances. These consist of: (1) declines that operative accounting schemes ignored in the market value of low-interest-rate mortgages acquired under pre-1980 rules and (2) aggressive post-1980 real-estate plays. With appropriate contract adjustments, most zombies could have undertaken most of their post-1980 real-estate investments as high-interest-rate mortgage loans under pre-1980 rules had these rules remained in force. The downside risk of a mortgage loan that incorporates an inflated property appraisal and a high loan-to-value ratio closely approximates that of an equity investment in the real estate collateral. Contract interest would not be paid on such a loan unless the underlying real estate project prospered.

The 1989 legislation embodies the excessive-deregulation theory in its definition of what constitutes a "qualified thrift." Adopting this theory creates unacknowledged and presumably unintended pressure for large-scale migration of the business of healthy thrift institutions to nondepository subsidiaries, holding-company affiliates, and other charter forms. Forcing thrifts to specialize to a high degree in mortgage-related assets undermines the future viability of the portion of the thrift industry that managed to fight its way back to health and promises to shrink the thrift sector by transferring activities and assets to other sectors of the financial industry through a combination of organizational spin-off, charter conversion, and commercial-bank acquisition.

Traditionally, thrifts earned their profits by borrowing savings from consumers at combined interest and servicing costs that lay below the interest rate they could earn on mortgage loans. Table 3 indicates that thrifts faced a declining earnings spread in home-mortgage lending from 1983 on. The down-

Table 3: Average Explicit Earnings Spread on New Mortgage Lending at FSLIC-Insured Institutions, 1965-1989 (in percent per annum).

Columns 1 and 2 are taken mostly from U.S. LEAGUE OF SAVINGS INSTITUTIONS (1989, pp. 30 and 24). Savings Deposits are defined to include all types of savings; by 1987, this includes passbook, NOW and Super NOW, Money-Market, and fixed-maturity accounts. Column 3 is merely the algebraic difference between corresponding entries in the first two columns. Column 4 is calculated as the ratio of operating expense to yearend total assets, using figures given on pp. 49 and 52 of the Sourcebook. The last column reports the difference between the entries in columns 3 and 4. Final figures for 1988 and preliminary figures for 1989 were supplied telephonically by Diana Cheseldine of the U.S. League of Savings Institutions.

Year	Effective Interest Rate on Conventional Loans on New Homes	Explicit Interest Cost of Savings Deposits in FSLIC-insured Savings Institutions	Average Explicit Earnings Spread on New-Home Mortgage-Lending	Operating-Expense Ratio for FSLIC-Insured Institutions	Average Net Earnings Spread on New-Home Mortgages
1965	5.81	4.25	1.56	1.06	0.50
1970	8.45	5.14	3.31	1.11	2.20
1971	7.74	5.30	2.44	1.06	1.35
1972	7.60	5.37	2.23	1.05	1.18
1973	7.96+	5.51	2.45	1.12	1.33
1974	8.92	5.96	2.96	1.19	1.77
1975	9.00	6.21	2.79	1.20	1.59
1976	9.00	6.31	2.69	1.20	1.49
1977	9.02	6.39	2.63	1.18	1.45
1978	9.56	6.56	3.00	1.20	1.80
1979	10.78	7.29	3.49	1.25	2.24
1980	12.66	8.78	3.88	1.28	2.60
1981	14.70	10.71	3.99	1.35	2.64
1982	15.14	11.19	3.95	1.42	2.53
1983	12.57	9.71	2.86	1.53	1.33
1984	12.38	9.93	2.45	1.58	0.87
1985	11.55	9.03	2.52	1.83	0.69
1986	10.17	7.84	2.33	1.97	0.36
1987	9.31	6.92	2.39	1.93	0.46
1988	9.18	7.20	1.98	1.77	0.21
1989	10.13	7.91*	2.22	2.10*	0.12

Notes:

\+ New series

* Preliminary

ward trend in this spread traces to three sources: unsustainably aggressive bidding for deposits and mortgage loans by zombie thrift institutions; growing competition for mortgage-lending opportunities and depositor savings from government-sponsored mortgage corporations and from members of

the securities industry; and declines in the market value of prepayment options on new mortgages implied by the downward readjustment of mortgage interest rates.

Forcing healthy thrifts to cut back nontraditional lines of business that they have found profitable increases the benefits of relocating these lines into related corporate entities, of selling out to commercial banks, and of converting the thrift charter to another corporate form. It should not be surprising that the private capital that is needed to replace the (unbudgeted) government capital that implicitly finances much of the assets lodged in zombie thrifts today is not rushing to take either the zombies or their assets off taxpayer hands. I believe that would-be investors would prefer to convert the franchises acquired into bank branches or holding- company affiliates almost as quickly as applicable laws permit.

5. A Complete Theory: The Incentive-Breakdown Theory

These unsatisfactory theories underlie the solutions enacted in 1989 and 1990, even though economic analysts trace the industry breakdown primarily to governmental failure to force troubled institutions to recapitalize themselves before stockholder or mutual capital could be exhausted (BARTH/BRADLEY, 1989; BENSTON/KAUFMAN, (1988); BRUMBAUGH, 1988; KANE; SCOTT, 1989; SHADOW FINANCIAL REGULATORY COMMITEE, 1989; U.S. GENERAL ACCOUNTING OFFICE, 1989; WOODWARD, 1990). What broke down in the thrift industry was the enforcement by Congress and the FSLIC bureaucracy of in-place regulatory deterrents to socially wasteful risk-taking. In effect, federal authorities offered perverse incentive payments both to undercapitalized thrifts that used accounting gimmicks to hide their insolvency and to any thrift whose managers were willing and able to skew their investments toward aggressive, go-for-broke deals. In the process, zombie thrifts and FSLIC itself became interconnected Ponzi schemes [1]. Not reserving for FSLIC's developing loss exposure in troubled thrifts during the 1970s and early 1980s permitted authorities to cover up the depth and breadth of thrift-industry problems as well as to hide the unbudgeted, but burgeoning costs to taxpayers of having to validate the promises FSLIC continued to make to depositors at insolvent thrifts.

The zombie population reached its outlandish size in three ways. First, for FSLIC thrifts, supervisory monitoring and information development systems were flagrantly inadequate. Indeed, officials responsible for running FSLIC found it propitious to mask oversight problems, since this let them postpone the need to deal with them until someone else's watch. Second, it is natural for stockholders and managers of a troubled but federally guaranteed firm to prefer not to dilute their existing equity. Then and now, no supervisory mechanism requires the recapitalization or closure of a failing deposit institution when it nears insolvency. This is true regardless of whether assets and liabilities are valued at market or at their historical acquisition cost. Third, papering over operating and valuation losses was accomplished in two ways: by accounting gimmicks that overstated revenues, understated costs, and labeled debt as capital and by treating zombie institutions as viable as long as they could raise new funds. Most insolvent firms could avoid failing a simple fund-raising test because FSLIC guarantees of their deposits enhanced their credit and because they possessed additional opportunities to borrow by collateralizing their good assets to support loans from regional Federal Home Loan Banks and other nondeposit creditors.

The incentive-breakdown explanation has been upheld in at least one federal court. In summarizing factual findings from the bench, Judge Jack B. Weinstein held in 1989 U.S. regulators and lawmakers to blame for the high-risk loans that ruined Flushing Federal S&L in New York [2]. His finding cited testimony that supervisory officials had encouraged Flushing's directors to be less conservative in their lending because the association was running at a loss. After noting that this conclusion

does not condone criminal and incompetent activity, he stated:

> "... Congress and the Home Loan Bank Board are directly responsible for what happened here. The government, in removing adequate controls over this bank, led to the activities now complained of."

The Federal Home Loan Bank Board (or FHLBB) was the administrative agency responsible for managing FSLIC. Judge Weinstein went on to note that Flushing's losses were a "microcosm" of the billions of dollars of losses that are "a result of the failure of the federal government to do what it should have done in supervising and controlling" thrift institutions.

The point is that, although corruption and managerial weaknesses may well flower once an insolvent firm's speculative bets begin to go sour, fraud and missmanagement by managers of insured institutions were neither the dominant nor the decisive factors feeding FSLIC's losses. Most of the damage to FSLIC and to federal taxpayers was inflicted by FSLIC's own inadequate systems for measuring, managing, and pricing client risk. FSLIC followed procedures that shot its fund and federal taxpayers in the foot.

The FHLBB bureaucracy running FSLIC (acting under counterproductive constraints on their monitoring and loss-resolution activity imposed by Congress) adopted a strategy of denying their fund's growing financial problems, suppressing critical information, granting regulatory forbearances, and extending inadequately supervised new powers to troubled, clients [3]. Although this strategy protected the reputations of top regulators and members of congressional banking committees, it broke faith with taxpayers [4]. Among the strongest examples of faith-breaking behavior are House Speaker Jim Wright's publicly documented efforts to prevent the closure of a series of deeply insolvent Texas thrifts and the success that the owner of Lincoln Savings and Loan met in persuading five senators to lobby the FHLBB to take the Federal Home Loan Bank of San Francisco off its case when it was moving to close it down. It is revealing that in increasing penalties for fraud and fiduciary violations for managers of federally insured entities, the corrective legislation of 1989 and 1990 contains no penalties for federal regulators who choose not to reserve for readily appraisable losses or who use smoke-and-mirrors accounting to cover up inadequacies in their own bureaucratic performance.

Officials claim to have been blindsided by the expanding costs of deposit-insurance subsidies to risk-taking. If true, their ability to overlook developing evidence testifies to an insensitivity to their need to analyze the long-run consequences of the policies they follow. What is most disturbing about this insensitivity is that it suggests a systematic anesthetization of official consciences to the moral dimensions of the tradeoffs that political pressure leads them to foist on underinformed taxpayers. In choosing not to reserve explicitly for appraisable or de facto losses that were plainly developing in decapitalized clients, FSLIC officials strengthened the industry's credibility before Congress and therefore its capacity to lobby against more-effective regulation. Not reporting loss appraisals meant that client losses had to make themselves felt in official accounting records before regulators could begin to bring them under control.

6. 1989 Legislation and the Treasury's 1991 Reform Plan

The Bush-initiated Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) focused on paying the largest part of FSLIC's unpaid bill by taking over the worst several hundred of the nation's roughly 750 zombies. But the legislation was silent on the need to establish accountability for the insolvency-resolution process. Eighteen months later, objective procedures still have not been developed to establish: how firms are to be targeted for takeover, liquidation, or merger; how such actions are timed; and how to make sure that healthy deposit institutions and other taxpayers get

full value for the funds they supply. In the absence of an adequate accountability mechanism, prospects for arbitrariness, waste, and corruption remain terrifying (KANE, 1990).

FIRREA embodies four principal elements:

1. An underestimate of the cost of resolving existing insolvencies at FSLIC-insured thrifts;
2. A financial mechanism for funding this cost from two sources:
   (a) increased deposit-insurance premiums for thrifts and banks and
   (b) general tax revenues;
3. A commitment to impose "bank-like" regulatory and supervisory standards on thrifts;
4. A reassignment to the Federal Deposit Insurance Corporation (FDIC) of bureaucratic responsibility for resolving thrift insolvencies and for operating the controls used to discipline future risk-taking by thrift institutions.

Congressional debate prior to passing FIRREA provides additional confirmation of the incentive-breakdown theory. Although Congressional committees reworked all four aspects of the plan President Bush submitted, prolonged controversy attended three issues: the stringency of thrift capital requirements; mechanisms for overseeing decisions made by the FDIC; and whether to borrow the funds to resolve thrift insolvencies on budget through the Treasury or off budget through an unnecessarily expensive special financing corporation. All three issues were reworked to lessen Congressional accountability. What made the first two issues so stubborn was the desire by many members of Congress to find ways to go easy on troubled thrifts without having to accept responsibility for the future costs of doing so. The solution adopted gives the FDIC day-to-day freedom to manage individual insolvencies as they see fit, but substantially constrains the FDIC's ability both to prevent future insolvencies and to establish that a troubled thrift is legally insolvent. FIRREA did this by prohibiting the FDIC from imposing bank-like capital requirements quickly, both by setting up a series of mandatory grace periods and by authorizing artificial ways of accounting for thrift capital. What made budget treatment controversial was the willingness of President Bush and many members of Congress to devote billions of dollars in unnecessary interest costs to the public-relations task of fostering public confidence in a Gramm-Rudman-Hollings balanced-budget law that was going to be circumvented de facto regardless of formal budgetary treatment.

In claiming that FIRREA put the FSLIC mess behind us, lobbyists and politicians disingenuously wanted taxpayers to presume that the FDIC could readily accomplish two amazing feats: raising weak thrifts' capital to a bank-like percentage of assets quickly enough to prevent the emergence of a new generation of zombies and using asset-growth limitations, enhanced cease-and-desist powers, and tougher criminal and civil penalties to prevent future abuse of deposit-insurance guarantees.

The legislation's apparent faith in the FDIC to carry this burden was its most disturbing feature. Nothing in the plan confronted the deep incentive conflicts that tempted FHLBB officials (with the explicit and implicit encouragement of Congress) to put off needed insolvency resolutions by lowering effective capital requirements in often-tricky ways during the late-1970s and early 1980s.

Insolvency resolution continues to be triggered by cosmetically softened accounting measures of the value of enterprise-contributed capital rather than its market value. Moreover, the legislation failed to impose a formal obligation on the FDIC to intervene strongly and predictably into the affairs of every capital-deficient firm before exhaustion of the market value of its capital becomes a serious threat.

The plan's economic weaknesses have resisted correction precisely because they were designed to serve as political stratagems. Underestimating and misconceiving the problem pleased some members of Congress by shaving statistical projections of the insolvency-resolution expenditures that had to be incorporated into the explicit federal budgets of the next few fiscal years. It also kept the tax and regulatory burdens that had to be projected for healthy thrifts, commerçial banks, and the general taxpayer low enough to make it hard for these parties to feel

harmed enough to scuttle the plan. At the same time, it continued to let undercapitalized thrifts and banks shift the downside of their operations to the taxpayer and to frame as matters for legislative and regulatory discretion rather than for market determination the issues of what powers an insured firm may exercise, what is capital, and when an institution must be recapitalized or closed. This maintains congressional opportunities to collect tribute by offering to make lobbyist-driven changes in the rules of financial competition and to perform behind-the-scenes "constituent services" for owners and managers of institutions that become decapitalized.

FIRREA also required the U.S. Treasury Department to conduct a study of deposit insurance and to propose additional reforms. The proposals contained in the report that was ultimately released in February 1991 fall markedly short of establishing a system of predictable and escalating market-like discipline for troubled banks. The Treasury's plan fails to specify a reproducible, nondiscretionary criterion that would mandate regulatory intervention. Nor does it insist that troubled institutions recapitalize before the market value of their net worth becomes negative. Authorities would remain free to tailor specific regulatory penalties to individual situations. Finally, they would retain the right to extend unlimited insurance coverage based on criteria that they could easily manipulate to support actions that would harm taxpayers' economic interests.

The result is that taxpayer losses remain uncapped and profit margins for healthy banks and thrifts continue to be undermined. Deposit-insurance personnel are left working unnecessarily close to the edge of an accounting and bureaucratic disaster. The threat of this disaster is slowly unraveling public and especially foreign confidence in U.S. deposit institutions.

7. A Better Plan

The roots of the deposit-insurance mess lie in longstanding defects in political and bureaucratic accountability. The overriding problem is that covering up troublesome evidence and engaging in regulatory forbearance is, given the short horizons and narrow career interests of politicians and bureaucrats, a rational response to the emergence of widespread industry insolvency. The current system confronts authorities with a painful tradeoff between protecting general taxpayers' economic interests and incurring the displeasure of politically strong regulatory clients and their various political allies.

To constrict this tradeoff, political-bureaucratic incentives must be reconstructed. Taxpayers must make politicians and deposit-insurance officials surrender discretion they now enjoy with respect to the information they report and the forbearances they give.

Deposit-insurance managers must be made to test the adequacy of their pricing and risk-management policies by regularly auctioning off understandable pieces of their insurance coverage in private markets for reinsurance. To forestall coverups, deposit insurers and their clients must be required — under penalties for fraud — to estimate the long-run costs of regulatory forbearances honestly and in timely fashion. They must also be required to force a prompt recapitalization of troubled institutions and federal insurance funds whenever capital deficiencies are found to exist.

To lessen Congressional pressure for granting myopic forbearances, appraised losses in agency budgets should be passed into the federal budget in the year they occur. This would provide an informational framework in which market and political forces would push deposit insurers to enforce timely recapitalization of troubled firms. In addition, members of Congress should be required to report all efforts to win forbearances for constituent firms to their ethics and banking committees for examination and potential sanction. These committees should also hold regular hearings during which outside experts are asked to assess compliance with these new requirements by regulators and politicians. Finally, to lessen the advantage of incumbency, it would help if all incumbent members of Congress

were required to donate half of the campaign contributions they receive to their party to fund campaigns by challengers of incumbents of the opposite party in other electoral districts.

This informational framework should apply to banks as well as to thrifts. Market-value measurements are needed to provide regular appraisals of the economic net worth of each federally insured enterprise and of the deposit-insurance funds that stand behind them. A threshold for reorganizing an insured institution's affairs should be established at a positive rather than negative level of enterprise-contributed net worth. Net worth itself ought to be defined net of the contribution to equity a firm receives from federal deposit insurance. An institution's capital consists of funds that stand in front of insurance reserves. These funds are measured by the market value of each institution's net assets (i.e., assets minus liabilities). Although a number of transitional difficulties need to be addressed, workable procedures can be agreed upon for routinely marking balance sheet and off-balance-sheet positions to market. The key to carrying out these measurements is to place the burden on management to report - subject to criminal and civil penalties for fraud - its "best estimates" of relevant balance-sheet values.

Footnotes

[1] A Ponzi scheme is an enterprise that survives simply by expanding its liabilities at a faster rate than its interest and dividend payments expand. The enterprise pays interest and dividends not out of economic earnings, but from new funds collected from lenders and investors.

[2] United States vs. Cardascia, U.S. District Court, Eastern District of New York, Docket No. 88-CR626, Feb. 23, 1989.

[3] Evidence supporting this hypothesis is provided by two former FHLBB Chairmen in FEDERAL HOME LOAN BANK BOARD (1989). One acknowledges that his estimates of "the depth of the thrift problem at that time [1982] were about $100 billion," that "Congress played a major role in forbearance," and that "there was a consensus of those in power that constrained the parameters within which the regulator could operate."

[4] This point is developed in detail in KANE (1989a).

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