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Getting off the Back of a Tiger: The Deposit Insurance Crisis in the United States

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ABSTRACT

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I. Introduction

Crises in financial markets and wide-spread failures of financial institutions are marked characteristics of the 1980's. These phenomena may be more prevalent in the United States than in the other financially important centers. As a result, the seemingly irresistible drive to deregulate the financial services industries that dominated policy in the United States, since the 1970's, has been replaced by a search for an appropriate structure of intervention and regulation to maintain the orderly functioning of financial institutions and markets.

Rising financial institution failures have caused the near collapse of U. S. federal deposit insurance, a premium-funded insurance program set up by Congress in 1934 to protect small deposits at bank and thrift institutions.[1] As a result of this crisis, Congress has been forced to intervene to maintain public confidence in this 55 year old institution, once thought to be the cornerstone of the stability of the U. S. banking system and the economy in the post war era.[2]

1 - In the United States, there are different legal entities that insure deposits nationwide: the Federal Deposit Insurance Corporation (FDIC) that insures deposits in banks and the Federal Savings and Loan Corporation (FSLIC) that insures deposits in thrift institutions. The immediate crisis in 1987 that required federal government refinancing is in the FSLIC. An FDIC crisis has not yet emerged. We will use the term "deposit insurance" when doing theory. The specific evidence will be drawn from the separate agencies.

2 - Milton Friedman and Anna J. Schwartz in A Monetary History of the United States 1867-1960 (Princeton: Princeton University Press, 1963) state, " As we have seen in earlier chapters, banking panics have occurred only during severe contractions and have greatly intensified such contractions, if indeed they have

The crisis of deposit insurance is that the funds accumulated from member premiums are insufficient to offset the negative net worth of a rising number of insolvent institutions.[3] The manner in which this crisis is ultimately resolved is likely to affect the mix of institutions and markets engaged in the financing of various segments of the economy, as well as the availability of interest-earning, default-free, liquid assets. In a significant sense the future of mass depository institutions is at stake.[4]

The current breakdown of deposit insurance is not a new phenomenon. State deposit guaranty systems, as far back as the Safety Fund System of New York State in the 1840's and as recent as the Ohio and Maryland state funds in 1986, have succumbed to insolvency. The illiquidity and insolvency of deposit insurers at the federal level, however, adds a new, and serious, dimension to the problem, for federal deposit insurance carries the full faith and credit of the federal government. Much depends upon how this guarantee is fulfilled.

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not been the primary factor converting what would otherwise have been mild contractions into severe ones. That is why we regard federal deposit insurance as so important a change in our banking structure and as contributing so greatly to monetary stability--in practice far more than the establishment of the Federal Reserve System." pp. 441-441.

3 - The deposit insurance corporations can resolve deposit institution insolvency in several ways. 1) They can close the failed institution and pay off insured depositors. With the proceeds that are left from of the liquidation of the assets of the institution, insurance reserves are reimbursed, and uninsured depositors and other creditors are partially paid off. 2) They can help arrange a merger with a viable institution. Mergers often require financial assistance from the deposit insurer to offset the failed deposit institution's negative net worth. 3) When no buyers can be found and the payoff of depositors cannot be financed, the deposit insurer may take over the failed institution and install new management in an effort to revive it.

4 - Although the international stock market crash of October 19-20, 1987 did not directly and immediately have an impact upon the institutions with insured deposits, it did adversely affect the fortunes of market-oriented intermediaries, the investment banking firms and the organizations, such as mutual funds, whose assets are mainly market instruments.

The dilemma confronting economic policymakers is how to resolve the deposit insurance crisis without initiating adverse macroeconomic repercussions; that is, how to get off of the back of a tiger without being eaten by the tiger. If "deposit insurance" is allowed to default, which means that the government guarantee is repudiated, a market solution for insolvency and illiquidity will take place. The resulting liquidation of the assets of negative net worth institutions and the flight to quality by depositors are likely cause a reduction of investment and thus initiate a major recession or even a depression. If the guarantee is honored, the refinancing of the deposit insurance corporations will expand federal government debt and more than likely will lead to a rise in bank reserves. This infusion of debt and high-powered money into the economy will produce a further depreciation of the dollar and may well set the stage for a burst of inflation.

The Congress and the current Administration continue to assert the full faith guarantee of insured deposits even as they resist funding either the liquidation or the merger of member institutions with negative net worth. Policymakers seem to be placing their bets on a Micawber solution, i.e. that "something will turn up". This passive, government response also reflects the credence gained during the Reagan era of the theory that a government that intervenes least, intervenes best. The identification of the problem and the proposed solutions in this paper rest on a different view, that financially-complex economies require interventions to contain endogenous instabilities.

II. Priors and Policy

Every analyst and commentator approaches issues of government regulation of financial institutions and the need for intervention in financial markets with "priors" that reflect views about the fundamental characteristics of capitalist economies with sophisticated and ever-evolving financial structures. These priors may be rational and conscious - which hopefully is the case for economists (although prejudice often intrudes) - or emotional and subliminal, which is undoubtedly true of many in politics and the press.

In the United States over recent years economic policy has been overtly dominated by the theoretical tradition of Adam Smith. This tradition holds that if each worker, consumer, businessman or financier follows his own self interest he is guided, as if by an invisible hand, to advance the good of society. In the language of modern economics this becomes the proposition that "A competitive equilibrium is a Pareto optimum".

As a result of this dominance, government regulation of finance is often approached from the Smithian perspective, even though the invisible hand proposition has never been shown to be valid for financially-complex economies. Only under very restrictive conditions, which are at great variance with what is true of the real world, has the existence of a competitive equilibrium been proven. Moreover, neither the uniqueness nor the stability of a competitive equilibrium has been demonstrated.[5] Economic theory offers no support for non-interventionist policy regimes and unregulated finance in systems as complex as the modern economy.

It is not unusual, however, for policy arguments to be advanced which assume that decentralized and unregulated markets in a complex, financially-sophisticated economy produce a stable, and optimal, growth trajectory.[6] With such priors, if the economy exhibits an unstable growth trajectory, the blame for

5 - See Kenneth Arrow and Frank H. Hahn, General Competitive Analysis (San Francisco: Holden-Day, Inc. 1971). and Bruno Ingrai and Giorgio Israel, "General Economic Equilibrium Theory: A History of Ineffectual Paradigmatic Shifts," Fundamenta Scientiae, Vol. 6 No. 1, 1-45 and Vol. 6 No. 2, 89-125 (1985).

6 - The most sophisticated of such arguments comes from Rational Expectations theory. See Robert E. Lucas, Jr. "Expectations and the Neutrality of Money," Journal of Economic Theory 4 (April 1972), pp. 103-24, reprinted in Robert E. Lucas, Jr. Studies in Business Cycle Theory (Cambridge: MIT Press, 1981).

the deviation is imputed to the system of regulation and intervention which, in a strict Smithian view, is always mischievous.

III. Our Priors

Our priors are not Smithian; they are Post Keynesian. In Post Keynesian theory the endogenously-determined processes of capitalist economies become incoherent as a result of their own dynamics. Post-Keynesian theory is consistent with the well-established, mathematical proposition that complex non-linear systems are likely to exhibit incoherence from time to time.[7] By imposing constraints, reasonably coherent behavior can be generated out of non-linear systems whose internal dynamics lead to a breakdown of the system.[8] Analytically, constraints can be interpreted as interventions that stop the endogenous dynamics and start them up again with "new" initial conditions. Deposit insurance is just such an intervention that can be interpreted as thwarting the endogenous thrusts to incoherence.

In general, economic regulation and intervention can lead to reasonably coherent behavior for an economy which, if left alone, would degenerate into incoherence.[9] By aborting or containing incoherence, apt regulation can be constructive.

But apt regulation to prevent or contain incoherence needs to be designed. It cannot rest upon mere mathematical knowledge about the characteristics of

7 - Coherence refers to the variables in a system being connected logically or naturally, as by a common principle. General economic equilibrium is an extreme form of coherence. For a mathematical development of the concept of coherence see, Richard L. Day, "Irregular Growth Cycles", American Economic Review (1982). Also see Arrow and Hahn, op.cit., Chapter XII.

8 - J. M. Blatt, "On the Econometric Approach to Business-Cycle Analysis", Oxford Economic Papers (1978).

9 - See H. P. Minsky, "Monetary Systems and Accelerator Models," American Economic Review (December 1957),859-883.

complex non-linear equation systems nor upon historical data about episodes of economic instability and crises. Apt intervention depends upon knowledge, i.e. a theory combined with a command of the "facts" of what makes a particular economy at a particular time susceptible to episodes of incoherence. This requires a model of how finance, production and household behavior relate and interact.

The Financial Instability Hypothesis version of Post Keynesian theory is just such a model. Profit seeking agents who finance holdings of capital assets, invest in real resources and manage money are essential actors in the economy. They are also the catalysts that transform a stable growth trajectory into one that is likely to explode or collapse. In Post Keynesian theory, normal developments in capitalist economies include crises and business cycles as well as the transformation of initially robust financial structures into fragile structures, such as has occurred in the past forty years.

The Financial Instability Hypothesis also explains why regulatory structures eventually become obsolete or perverse. The normal, profit-seeking activities of agents lead to innovation in order to create new sources of profits; innovations can be in products, processes or finance. The search for profits also drives agents to avoid, evade and adapt to the structure of regulation and intervention put in place to constrain incoherence. In time this undermines the effectiveness of a regime of intervention that "stabilizes the unstable system". Therefore if regulation is to remain effective, it must be reassessed frequently and made consistent with evolving market and financial structures.[10]

Because of its explicit consideration of how the financial structure of an economy becomes hospitable to instability, the Post Keynesian perspective throws

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10 - Hyman P. Minsky, Stabilizing An Unstable Economy (New Haven: Yale University Press, 1986) and Paul Davidson, Money and the Real World (New York: Wiley, 1972) are two statements of Post Keynesian theory that emphasize monetary relations.

light on the current problems of deposit insurance in the United States. The problems today are the result of competition for profits that has transformed an initially robust financial structure into a fragile system and in so doing made obsolete the structure of deposit insurance established 50 years ago. In particular, as the financial system evolved, payouts from deposit insurance reserves have become systemic and frequent rather than isolated and intermittent. When one institutional insolvency breeds multiple offspring, insurance reserves that would be adequate for individual insolvencies are quickly exhausted.[11]

IV. The Transformation of Finance

To summarize our priors, apt regulations and interventions can contain the intermittent thrusts to incoherence inherent in the normal functioning of decentralized markets in financially-sophisticated economies. Any regulatory structure imposed on such an economy, however, will eventually breakdown and become ineffective, as agents learn how to evade, avoid and adapt to regulation and intervention. What is an apt structure at one time is likely to become inept at a later date.

Any regulatory structure imposes out of pocket costs, foregone opportunities and rigidities upon organizations that operate in a dynamic, evolutionary and innovative economy. All too often regulations become frozen in stone and vested interests grow up that benefit from and therefore seek to perpetuate the existing regulatory regime. Furthermore regulators and interveners are often taken over by the regulated, which makes change and adaptation difficult.

11- See Claudia Campbell and Hyman P. Minsky, "How to Get Off the Back of a Tiger or, Do Initial Conditions Constrain Deposit Insurance Reform?" Conference on Bank Structure and Competition: Proceedings (Federal Reserve Bank of Chicago,1987), pp.253-267.

Eventually markets are either ill-served by regulation or prices in the market become such that it pays to evade or avoid the regulation. By creating new institutions and novel instruments, profit seeking agents exploit the opportunities offered by price differentials. Because of the universal validity of the proposition that there is nothing new under the sun, the novel feature is often the return of previously outlawed practices under new guises.[12] A good example is the survival of state banking in the United States in the face of the monopoly of currency issuance granted to the National Banks during the Civil War.[13]

V. The Making of Bank Runs

The image of runs was set in the 1930's. As in the popular film, It's A Wonderful Life, depositors in imperfect queues clamored to exchange their deposits for currency. Such runs, and the fear of runs, forced the sale of assets for cash (i.e. what banking jargon calls "the making of position by the sale of position") and led to banks hoarding cash. The underlying cause of runs is some prior losses on assets, the emergence of non-performing assets. As making position by selling assets lowers the price of assets, a cascade of unrealized paper losses takes place. These paper losses spread the "run" from bank to bank.

12- As Henry Simons noted, "Banking is a pervasive phenomenon, not something to be dealt with merely by legislation directed at what we call banks. The experience with the control of note issue is likely to be repeated in the future: many expedients for controlling similar practices may prove ineffective and disappointing because of the reappearance of prohibited practices in new and unprohibited forms. It seems impossible to predict what forms the evasion might take or to see how particular prohibitions might be made more than nominally effective." Henry Simons, "Rules Versus Authorities in Monetary Policy", Journal of Political Economy, 1936, reprinted in Henry Simons, Economic Policy for a Free Society (Chicago: University of Chicago Press, 1948, p. 172).

13- The development of money market funds in response to the rising interest rates of the 1970's shows the pervasiveness of banking, discussed by Simons, op. cit., for money market funds are nothing more than banks with limited service functions.

Bank hoarding of cash means that loans are cut back or restricted. This leads primarily to a decline in bank financing of investment and, sometimes, of consumption. The decline in bank-financed spending causes a decline in profits and wages. With aggregate profits down, an increment of borrowers cannot fulfill their payment commitments; non-performing assets increase. Thus runs spread, and unless intervention aborts the process, a collapse of the system becomes imminent.

A. The Financial Instability Hypothesis and Runs

The Financial Instability Hypothesis explains bank runs. When there is reason to believe that the cash flows to a bank or other deposit institution will fall short of what is needed to fulfill responsibilities and induce depositors to roll over maturing instruments, runs occur.

For a modern financial economy to operate well, cash flows from production must validate prior debt commitments. In a layered system, an intermediary remains viable if the cash flows from financial assets are sufficient to validate liabilities. This cash flow from "contract" fulfillment may be supplemented by negotiating the sale or the pledging of assets. A break in the chain of cash flows initiates a financing crisis.

Systemic bank runs create such breakdowns. The rapid withdrawal of deposits forces banks to try to get cash by selling assets on the market. Such forced sales reduce asset prices, making it harder for initially unaffected institutions to meet payment commitments to depositors. As a result, marked to market values of portfolios of institutions holding the same types of assets decline. If the need to sell assets to make position is not contained by lender of last resort refinancing, then the runs lead to a decline of bank intermediation. Banks stop lending and hoard cash.[14]

Systemic bank runs or any type of collapse or suspension of cash flows will force central bank intervention to avert a crisis. This is an important implication of the Financial Instability Hypothesis. Federal deposit insurance, by preventing the losses to covered deposits, has acted as a non-discretionary lender of last resort. However, deposit insurance makes the insured institution dependent on the government's guarantee.[15] Net worth can be eroded and become negative, making the institution insolvent, without inducing runs as long a depositors are confident that they are protected by insurance.[16]

Modern runs, in a regime of deposit insurance, do not take the form of queues of depositors clamoring for currency. Modern runs involve a refinancing crisis initiated by uninsured depositors.[17] The collapse of the Continental Illinois Bank in 1984 was brought about when banks throughout the world withdrew their multi-million dollar, uninsured deposits. The deposits at Continental Illinois were

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14- For example, the collapse of stock prices on October 19-20 was accompanied by a decline in bank lending to block traders. Wall Street Journal Nov. 20, 1987, p. 1.

15- Deposit insurance has been a substitute for deposit institution capital. This was noted by Peltzman in 1970 and is obvious in 1988. See Sam Peltzman, "Capital Investment in Commercial Banking and Its Relationship to Portfolio Regulation", Journal of Political Economy 78 (Jan/Feb 1970)

16- As an example, the "lifeline letter" from the Federal Home Loan Bank Board is all that is preventing a cut off of funds from Wall Street lenders to the insolvent Financial Corporation of America, the largest thrift institution in the U. S. whose net worth is currently negative. See David B. Hilder, "Financial Corp. is Anxious over Bank Board", Wall Street Journal (Jan. 29, 1988).

17- Revell argues for the insurance all deposits, including interbank deposits, where the goal of deposit insurance is to reduce risk in the financial system. See Jack Revell, Solvency and Regulation of Banks: Theoretical and Practical Implications (University of Wales Press, 1975), p. 109.

the "reserve" deposits for Eurodollar banking. The Federal Reserve refinanced Continental Illinois to contain the run of these deposits.[18]

The second phase of the Continental Illinois intervention took place when the Federal Deposit Insurance Corporation purchased the assets that Continental Bank had pledged for loans from the Federal Reserve Banks and infused sufficient cash in the bank to validate all deposits, both insured and uninsured. In this process, the deposit insurance guarantee was extended beyond the Congressionally mandated limit of $100,000. This expansion of insurance coverage took place without any concomitant increase in premiums or provision of additional funds to the insuring agencies. The use of accumulated reserves to protect other than the well defined, contractually limited, insured deposits set a precedent that is a major factor in the 1987 crisis in deposit insurance.[19]

B. <u>The Emergence of Insolvency Without Runs</u>

The sharp and protracted rise in interest rates in the late 1970's and early 1980's had an adverse effect on the net worth of thrift and other deposit institutions. In as much as the rise in interest rates reflected a shift in government policy, the use of deposit insurance reserves to contain and offset this development may well have been unwarranted.[20] In particular, the mutual savings banks and

18- According to Irvine H. Sprague who was Chairman of the FDIC at the time, another reason for refinancing Continental Illinois, was the concern for the liquidity of over 2000, and the solvency of 50 to 100, correspondent banks with deposits in Continental Illinois. Irvine H. Sprague, <u>Bailout: An Insider's Account of Bank Failures and Rescues</u> (New York: Basic Books, Inc. 1986) p. 155.

19- In the Franklin National case of 1974-75, the bankrupt bank was kept alive by the Federal Reserve Bank of New York until almost all of its large denominated certificates of deposit were run off. When it was finally declared insolvent, Franklin National's funding consisted of insured deposits and loans from the Federal Reserve Bank. It may have been a mistake not to have made the Fed take losses on its loans to Franklin National.

20- Revell argues that because monetary policy and prudential regulation are not independent, these functions should be consolidated under one agency, preferably the central bank. This would force the central bank to consider the effects of the savings and loan associations were locked into assets that reflected long-standing government policies. With changes in these policies, the thrift institutions were unable to adjust rapidly enough to avoid a serious erosion of their equity.

Net Fund Income in Thrift Institutions

The income of financial intermediaries is derived from managing a fund and receiving fees for services. Fund income arises from the excess of earnings on assets over the costs of liabilities. The costs of liabilities consist of interest paid and services supplied to depositors, either free or at a fee that is well below the cost of supplying the services. An example of such services is the "free" checking that banks offered depositors in the era of deposit rate ceilings and zero interest demand deposits.

Fee income consists of service charges of various kinds, including, in American practices, various fees that are assessed when mortgages are originated. As there has been an active secondary market in mortgages throughout the post World War II era, financial intermediaries need not hold mortgages they originate. Some fee income arises from sales of mortgages in the secondary markets. The originating institution often collects additional fees for servicing the mortgages they sell.[21]

As we entered the high interest rate period, income earning assets of the savings and loan associations and the mutual savings banks in the United States consisted mainly of long-term fixed interest, fully amortized mortgages with initial terms to maturity running 20-30 years. Therefore net fund income of these mortgage holding institutions was sensitive to fluctuations in the cost of liabilities,

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changes in monetary policy on the liquidity and solvency of banks. See Revell, op.cit. p. 127.

21- Securitization of mortgages by savings and loan institutions has enhanced their fee income.

that is, the interest paid on ordinary deposits as well as on retail (small denomination) and wholesale (large denomination of $100,000 or more) certificates of deposit.

A decline in net fund income can sharply erode the equity base of the institution. For example, if the pattern of interest rates and other costs leads to a negative fund income that is one percent of assets then a thrift with 6 percent equity can lose 16 percent of its equity in one year even though it possesses a sophisticated ability to manage assets.

Thus the viability of the savings and loan associations and the mutual savings banks depended upon maintaining a stable, low interest rate environment or guaranteeing low financing costs. This was accomplished for most of the post war period by imposing interest rate ceilings on various insured liabilities and a monetary policy regime that sustained low and slowly changing interest rates.

Competition from Money Market Funds

Money market funds started in the early 1970s and became quite large in the late 1970's as interest rates rose. Money market funds were able to pay significantly higher rates than were the deposit institutions. The result was funding problems and disintermediation at mortgage holding institutions.

Modest changes in regulations in the 1970s enabled the thrifts to better respond to the outflow of deposits into money market mutual funds when rates rose, even as this raised their deposit costs. However, no legislation was passed until 1980 and 1982 to ease asset restrictions that prevented thrift institutions from diversifying and shortening their asset maturities.[22] While deposits became more

22- Koehn finds that asset restrictions severely affect the profitability of thrift institutions. See Michael F. Koehn, Bankruptcy Risk in Financial Depository Intermediaries (Lexington, Ma.: D. C. Heath and Co., 1979).

interest sensitive, the income earning assets of the thrifts remained predominantly in the form of long term, fixed rate mortgages.

The Volcker fight against inflation, which deemphasized interest rate stability and substantially increased deposit costs, would have had only minor negative effects on the net fund income of thrift institutions and the reserves of the deposit insuring agency if thrift institution portfolios had consisted mainly of floating rate mortgages. For floating rate mortgages to be the rule in 1979, however, the shift from fixed rate mortgages would have had to begin in 1969 or so! As it was, the equity of the thrifts was significantly eroded by the extended period of high funding rates that occurred after 1979.

The Role of Deposit Insurance in Deposit Institution Failures

The Smithian interpretation holds that manager incompetence, regulation and exploitation of deposit insurance are to be blamed for the rising rate of deposit institution insolvencies.[23] In this view deposit insurance creates conditions under which managers will increase risk exposure. This higher risk implies higher expected insolvency rates and the depletion of deposit insurance fund balances. To remain actuarially sound, the deposit insurers must raise premiums. The remedy that has been proposed is some form of coinsurance or risk-related insurance premiums.

Throughout the post-war era deposit insurance confronted cases of fraud or gross incompetence. Indeed, this was what it was set up to do. But deposit insurance, no matter how its premiums or payoffs are structured, is viable only when fraud or incompetence is at issue; deposit insurance is unable to cover

23- See, for example, Edward J. Kane, The Gathering Crisis in Federal Deposit Insurance (Cambridge, Mass.: The MIT Press, 1985) and George J. Benston and George G. Kaufman, "Risk Solvency Regulation of Depository Institutions: Past Policies and Current Options," Staff Memorandum (Federal Reserve Bank of Chicago, 1988).

bankruptcies brought about by policy regimes that include fixed rate long term mortgages, market term funding, and protracted periods of high and variable market rates in which net fund income remains negative.

If periods of rising and quickly changing interest rates, such as ruled after 1979, are to be consistent with the payment of market rates to depositors and a free flow of mortgage funds, then the long term fixed rate, fully amortized mortgage has to be abandoned. In truth, that is what happened in the early 1980's. Floating rate and short term mortgages, which require refinancing after four or five years, came into widespread use. The substitution of floating rate for fixed-rate mortgages in the portfolios of institutions that specialize in mortgage financing is necessary for them to remain viable in an unprotected environment.

VI. The Rescue of the Thrift Institutions and the FSLIC

The emergence of systemic thrift institution insolvency that occurred after 1979 was not costless even though runs were avoided. The thrift institution failures depleted the reserves and threatened the solvency of the FSLIC. The problem confronting the deposit insuring agencies and the Congress in 1987 was not the prevention of a deposit institution panic. This had been accomplished by federal deposit insurance. At issue was who would bear the cost of the containment of this crisis and whether this cost could be minimized?

Three major pieces of bank legislation--the Deposit Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), the Garn-St. Germain Depository Institutions Act of 1982 (Garn-St.Germain) and the Competitive Equality Banking Act of 1987 (CEBA)--attempted to address the plight of the thrifts and the FSLIC.

The DIDMCA eliminated deposit rate ceilings by 1986 and allowed savings and loan associations to issue interest-paying checkable deposits, expand consumer loans, issue credit cards and offer trust services.[24] But these reforms were not enough to halt the erosion of the equity of the mortgage holding institutions. By 1982 many were mark-to-market insolvent, even as their equity, as conventionally measured by historic asset values, was diminishing.

In 1981 the FSLIC insurance fund used for resolving thrift failures was being quickly depleted, threatening the public's confidence in thrift institutions.[25] In March of 1982, Congress passed a Joint Resolution asserting that the full faith and credit of the U. S. government stood behind federal deposit insurance liabilities.[26] Much of what has transpired since then can be interpreted as efforts by Congress to avoid fully funding this Joint Resolution.

Garn-St. Germain, passed in October of 1982, was directed at both saving the thrift industry and speeding up the deregulation of the deposit institutions.[27] The act gave federal deposit insurers greater discretion in resolving institution failures. The FSLIC was permitted to arrange 1) interstate mergers of thrifts and 2) acquisitions by non-financial corporations of insolvent thrifts. Furthermore, to enhance the net worth of failing institutions, the FSLIC was allowed to exchange promissory notes for "net worth" certificates issued by the thrifts. These certificates were treated as capital on the books of thrift institution, even though they were no more than an accounting gimmick which inflated the net worth of the thrifts. At the same time, markets and instruments previously restricted to banks were opened to thrifts. Specifically, thrift institutions could invest up to 55

24- Kerry Cooper and Donald R. Fraser, <u>Banking Deregulation and the New Competition in Financial Services</u> (Cambridge, Mass.:Ballinger Publishing Co., 1986). p. 116.

25- <u>Ibid</u>., p. 160.

26- Edward J. Kane, "No Room for Weak Links in the Chain of Deposit Insurance Reform", <u>Journal of Financial Services Research</u> I (1987), pp. 77-111.

27- Cooper and Fraser, <u>op. cit</u>. p. 127.

percent of their assets in certain types of commercial loans.[28] Many of the thrifts lacked the experience and the staff to operate profitably these markets.

Garn-St. Germain gave the FSLIC greater scope to avoid liquidating thrifts with negative net worth. However, keeping equity impaired institutions operating encouraged "go for broke" strategies by managers and owners.[29] Hanwick (1986) argues that very risky investments with high expected returns, if successful, may have been the only chance for problem thrifts, teetering on the edge of insolvency or already insolvent, to become viable again.[30] In thrifts with negative net worth and in reconstructed thrifts, which were created by large infusions of FSLIC equity, owners and managers had virtually nothing to lose and a lot to gain from adopting high risk investment strategies. Such strategies had large potential payoffs if all went well even though the expected return was negative. Deposit insurers had an incentive to condone the risky strategies of the thrifts for success would obviate the need to expend insurance funds. When these risky "bets" paid off as "expected", a further deterioration of the net worth of the deposit institutions occurred, which increased the unfunded liability of the FSLIC.

Congress, like the thrifts and the deposit insurers, gambled. Its members bet that interest rates would come down and revive the thrifts, so that there would be no need to fund the full faith and credit guarantee of insured deposits as promised in the 1982 Joint Resolution. Congress has lost this gamble. When inflation and nominal interest rates did decline from 1982-1984, systemic declines in oil, farmland and real estate prices and incomes in regions dependent upon oil and

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28- Other changes included an increase in consumer lending limits from 20 to 30 percent of assets and permission to invest in state and local government revenue bonds. Cooper and Fraser, op. cit.

29- See Kane, op. cit.

30- Gerald A. Hanwick, "A Model of S&L Failure and 'Go-For-Broke' Management Behavior" (Unpublished Manuscript: George Mason University, Sep. 1987) agriculture took place. This led to widespread loan defaults. As a result, the cash flows that supported the payment commitments of many deposit institutions were devastated. Thrift institution losses because of interest rate movements were augmented by an explosion of non-performing assets. Many thrifts that survived the assault on their net worth by interest rate volatility succumbed when loan defaults exploded.

The combination of negative fund income due to interest rate volatility and non-performing assets took their toll on the U. S. savings and loan institutions. By 1986, 347 out of 540 savings and loan associations that reported losses were insolvent.[31] In 1987, 10 percent of the thrifts were insolvent and one third experienced losses. Deflation in oil prices and real estate subjected regional thrifts to greater losses. Sixty percent of the failed institutions were in Texas.[32]

By early 1987, FSLIC was unable to fund either a payoff of depositors or purchase and assumption packages for insolvent thrifts.[33] With the assets of the FSLIC depleted, the 1982 Congressional Joint Resolution, guaranteeing insured deposits, was the only thing that prevented a massive run by thrift industry depositors and a major financial crisis. In August of 1987, after much higgling and haggling over dollar amounts, Congress passed a modest plan to rescue the FSLIC. With the Competitive Equality Banking Act of 1987 (CEBA), Congress attempted to shore up public confidence in the deposit institutions. Title IX of this package confirmed the full faith and credit guarantee of "all insured deposits".

31- Anna J. Schwartz, "The Lender of Last Resort and the Federal Safety Net" Journal of Financial Services Research I (1987), pp. 1-17.

32- Bill Kester, "S&L Problem is Far from Being Solved", St. Louis Post Dispatch (Dec. 9, 1987).

33- According to Kester, op.cit., the FSLIC needs an estimated $25 to $45 billion to properly liquidate or merge insolvent thrift institutions. In 1987, the resources of the FSLIC were a negative $6 billion.

The Competitive Equality Banking Act of 1987

As the third legislative intervention to protect the thrift institutions in the 1980's, the CEBA was a response to the inability of the FSLIC to fulfill its insurance obligation. In Title III of CEBA, Congress created the Financing Corporation whose purpose is to finance deposit insurance operations of the FSLIC.[34]

The structure of financing in this act is complex. The Federal Home Loan Bank Board is to invest funds in the Financing Corporation. These funds will purchase zero-coupon, long term, Treasury securities. Upon maturity these securities will finance the repayment of principal on $10.8 billion in debt securities that the Financing Corporation is to sell to the public. The proceeds of the $10.8 billion sale of bonds are to be transferred to the FLSIC, which will use the funds to either liquidate and payoff or to merge failed firms. Interest on the Financing Corporation liabilities is to be paid from assessments on surviving insured thrifts.[35]

While the Treasury securities assure the principal, the bill provides no government guarantee of the interest payments on the Financing Corporation bonds. This means that bondholders face a possible default on interest payments by the Financing Corporation. This default risk will be reflected in the interest

34- The Financing Corporation in name recalls the Reconstruction Finance Corporation which helped to refinance failed banks, factories and farmers during the Depression era.

35- There are some similarities between this package and the proposal to resolve the Mexican debt crisis. The Mexican government plans to issue $10 billion of marketable bonds, which will be exchanged for the existing $15-$20 billion of Mexican debt to U.S. banks. The principal on the Mexican bonds will be collateralized by a purchase of $2 billion in zero coupon U. S. Treasury bonds payable in $20 years. However, the interest payments on the new Mexican bonds will depend upon "the full faith and credit" of the Mexican government. See Jeffrey Sachs, "Mexico Plan a Model for Other Debtors", Wall Street Journal (Jan. 19, 1988) p. 30.

rates on the bonds.[36] It is likely that concerns about the rising budget deficit and the desire to provide a "market" solution led to the refinancing method chosen by Congress for the rescue package. But it also reflects the evasion by Congress of its full faith and credit responsibility.

In Title III of the CEBA Congress evaded the responsibility it accepted in Title IX. The Congress is obligated under Title IX of CEBA to fund insured deposit payoffs if the FSLIC is unable to do so. Instead, the costs of keeping the FSLIC in business are being forced upon both insolvent and profitable thrifts at a time when they must compete directly with other financial institutions for assets and liabilities.

The CEBA placed a one year moratorium on the right of institutions to withdraw from the FSLIC. In addition, when institutions do withdraw they must pay an exit tax. But profitable thrifts will have an incentive to build up their equity so they can leave the FSLIC and buy insurance from the financially more robust FDIC. If this happens, the interest obligation of the Financing Corporation will increasingly be borne by the less viable thrifts who remain in the FSLIC. If assessments are increased to make up for lost members, the competitive position of remaining thrifts will continue to be weakened. The funding base for the bonds of the Financing Corporation is likely to be eroded.

The Congressional rescue package forces the FSLIC to resolve institution failures with insufficient reserves. As a result, FSLIC decisions will continue to be weighted heavily by short run cost considerations, which tends to make financing the purchase and assumption of failed institutions cheaper than liquidating

36- Citing a statement by the Shadow Financial Regulatory Committee concerning the refinancing of the FSLIC through the Financing Corporation, Lindley Clark emphasizes this point, "the Treasury could sell such bonds and at a lower interest cost (than the Financing Corporation)--$100 million a year lower." Lindley H. Clark, "Financial Rules: The Shadow Seeks Answers", Wall Street Journal (Nov. 25, 1987), p. 14.

institutions and paying off insured depositors. Consequently, many of the problem and reconstructed institutions, safe under FSLIC umbrella, will continue to take excessive risks in attempts to survive. The negative expected value of this risk exposure will increase the unfunded liability of the FSLIC. In the long run, the costs to the United States Treasury will be higher and the damage to the thrift industry greater than if Congress had promptly accepted its full faith and credit responsibility and provided the funds necessary to liquidate insolvent thrifts.

VII. Conclusion

Federal deposit insurance always carried an implicit commitment of the full faith and credit of the government that insured deposits will not depreciate in their nominal value. In the 1987 partial refunding of the Federal Savings and Loan Insurance Corporation this guarantee was made explicit. However neither the Congress nor the Administration has supplied the funds to offset the negative net worth of depository institutions: they wish to avoid the larger deficit and the addition to overt government debt required to finance either closing failed thrifts or making them financially viable. The opportunistic legislation that has been passed offers only transitory relief. The shortage of funding prevents the deposit insurers from taking actions necessary for a long run solution.

Had the thrifts been free of asset restrictions, interest rate ceilings, and deposit insurance protection, perhaps, they would have been less vulnerable to interest rate fluctuations or to the systemic declines in oil, real estate and farm prices. However, the history of unregulated and uninsured banks and thrifts does not confirm this conjecture; epidemics of financial institution failures during unregulated eras are well documented.[37]

37- C. P. Kindleberger, Mania, Panics and Crashes: A History of Financial Crisis (New York: Basic Books, 1978).

The fundamental lesson from experience is that neither deposit institutions nor the deposit insuring agencies can weather system-wide and contagious losses. Moreover, intervention, such as deposit insurance, is effective only if reflects the understanding that systemic failures are normal outcomes of dynamic, financially-complex economies. The effects of systemic failure on the economy can be minimized by providing default free assets. Deposit insurance converts assets of small net worth households that would have been subject to default risk into default free assets. By protecting small depositors against fraud and poor management, the insurance of deposits has its place as a regularization of one facet of central bank responsibility.

The appropriate response of deposit insurers to both idiosyncratic and systemic failures is to liquidate failed organizations and payoff insured depositors. However, premium-funded deposit insurance reserves cannot act as a substitute for lender of last resort interventions or insulate deposit institutions from major shifts in government policy. In an economy where systemic instability occurs, the viability of deposit insurance is always contingent upon the full faith and credit obligation of the state. Full faith and credit responsibility means that, if necessary, deposit insurance payouts will be funded by general revenues.

In a Post Keynesian perspective the gains from deposit insurance and other interventions are the greater stability and growth of the economy. Post Keynesian theory imputes the greater overall success of the economy in the forty year period since World War II, as compared with other similar periods in our economic history, to the impact of big government and regulation in stabilizing the economy. Because the benefits of financial stabilization are generalized, the use of general revenues to fund the contingent government liability of deposit insurance is justified.[38]

So how does the economy get off the back of a tiger without being eaten by the tiger? The answer is "with knowledge, understanding, and care."

38- See Douglas W. Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity" Journal of Political Economy 3 (1983) p. 401-419 for a discussion of deposit insurance as a public good.

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