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The Rescue of the Thrift Institutions and the Federal Savings and Loan Insurance Corporation (FSLIC)

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The current problems of the beleaguered thrift industry illustrate how endogenous inherent market forces that lead to financial innovation and financial fragility interact with inept regulation and intervention to create conditions conducive to a financial crisis. Furthermore, the response of the regulators, analysts and Congress to these problems reflects the Smithian "priors" which now ~~have come to~~ dominate the generally-held theory that defines ~~concerning~~ apt policy intervention.

The tenuous structure fragility of the United States savings and loan institutions and the Federal Savings and Loan Insurance Corporation (FSLIC) was endangered by the sharply ~~revealed with~~ rising interest rates that followed the shift of the Federal Reserve to practical monetarism ~~in the late 1970's~~. On a mark to market basis the rise in interest rates led to a marked erosion of the equity base of the thrifts. On a current income basis, the attenuation of the spread between returns and the cost of money was eating away the artificial "book value" equity.

Both asset restriction (to home mortgages) and deposit rate ceilings (which were imposed on thrifts by the Interest Rate Adjustment Act of 1966) prevented thrifts from diversifying and shortening their asset maturities and from retaining deposits as interest rates rose. While thrifts were able to respond to the outflow of small deposits into money market mutual funds after the introduction of Money Market Certificates in 1978 and Small Saver Certificates in 1980, disintermediation, the erosion of the deposit base, which was a serious problem, continued to be a problem in the early 1980's (Cooper and Fraser, p.3 and p. 184) Moreover, nothing was done ~~to ease asset restrictions on the thrifts.~~

~~The~~ Three major pieces of bank legislation in the 1980's attempted to address the plight of the thrifts and to strengthen the position of the FSLIC. The first of these, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), eliminated deposit rate ceilings by 1986, allowed thrifts to issue interest-paying deposits, ~~and to~~ expand consumer loans, issue credit cards and offer trust services (C&F, p.116). But the reforms of 1980 were not sufficient. ~~Thrifts were unable to stay afloat with~~ The sharply rising interest rates of 1981-82 further eroded equity. By 1982 many were technically (mark to market) insolvent. In March of 1982, Congress ~~ef~~ passed a Joint Resolution asserting that the full faith and credit of the U. S. government stood behind federal deposit insurance liabilities (Kane, 1987). Much of what has transpired since then can be interpreted as efforts by Congress and the administration toward ... the financial implications of this joint resolution.

The Garn-St. Germain Depository Institutions Act of 1982, passed in October, was directed at both saving the thrift industry and speeding up new deregulation (C&F, p. 127). The act allowed ~~the~~ Federal deposit insurers greater discretion in resolving institution failures. They were permitted to arrange interstate mergers and acquisitions by non-financial corporations and to issue net worth certificates to enhance the book capital of failing institutions. * At the same time, the inexperienced and inadequately staffed thrifts were permitted to venture into financing activities markets and liability instruments that previously were restricted to banks.

What are net accounts for Net Worth certificates

While Garn-St. Germain made it easier for the FSLIC to forestall and, hopefully, prevent the liquidation of thrifts with negative net worth, it also encouraged go-for-broke behavior by the (reconstructed) surviving institutions (Hanwick, 1986). This policy put at risk the solvency of the FSLIC. The bet by the Congress and the FSLIC that rates would come down and revive the thrifts was lost when the fall in interest rates from 1984 to 1986 was accompanied by systemic declines in oil, land and real estate prices that devastated the assets ~~values~~ of many deposit institutions. In 1986, 347 out of 540 savings and loan associations reporting losses were insolvent (Schwartz, 1987). In 1987, 10 percent of ~~them~~ were insolvent and one third experienced losses. Sixty percent of the failed firms were in Texas. (Kester, 1987).

By early 1987, FSLIC was unable to fund ~~continue to~~ either a payoff of depositors or ~~finance~~ purchase and assumption packages for insolvent thrifts (Kester, 1987). The 1982 Joint Resolution guaranteeing the deposits of thrifts by Congress, ~~no doubt, helped to~~ prevent a collapse of the thrift industry and averted a major financial crisis at this time. ~~Finally~~ In August 1987, Congress passed a refunding ~~bailout~~ plan for F.S.L.C. To reassure the public, Congress confirmed its full faith and credit guarantee of "all insured deposits" in Title IX of the Competitive Equality Banking Act of 1987 (CEBA).(cite act)

true? supportable? citation?

The CEBA was a direct response to the imminent failure of the FSLIC. Title III of CEBA created the Financing Corporation whose purpose is to fund insurance operations ~~raise cash~~ for the FSLIC. ~~An infusion of funds from~~ The Federal Home Loan Bank Board is to infuse funds to ~~is to be used by~~ the Financing Corporation which is to be used to purchase zero coupon Treasury securities. These securities will ~~back~~ finance the which will use the funds to either pay off or merge failed thrifts

payment of the principal on ~~the~~ $10.8 billion in debt securities that the Financing Corporation is empowered sell to the public. ~~The~~ ~~proceeds of which~~ $10.8 billion prior to are to be ~~invested in~~ transferred to the FLSIC. Interest on the Financing Corporation liabilities will be paid by ~~payments due on these securities are to come~~ from assessments on ~~the~~ surviving thrifts. While the ~~backing with~~ Treasury securities guaranteed the principal, the bill provides no ~~insurance~~ federal government substitute of the interest payments to debt holders, exposing ~~them~~ holders of the issued debt to ~~interest rate~~ risk by default and interest rates. This imposes additional costs on otherwise solvent and profitable thrifts. Why the Congress chose this circuitous, ~~and~~ more costly, and quite likely futile route to "bailout" the FSLIC is not known. ~~but~~ It is likely that concerns about the rising budget deficit and the desire the provide a "market" solution ~~are at its core~~ lead to this choice.

The ~~developing~~ continuing crisis of the thrift industry and the FSLIC reflects many of the problems created by inept responses to market innovation and evolution by the regulators. The liabilities of the thrifts were made more rate sensitive ~~without~~ before the market accepted market determined rates on thrift assets. ~~concomittent flexibity in asset composition~~. The deposit insurer, aided and abetted by Congress, ~~then~~ set up institutional arrangements that encouraged go for broke behavior, by often newly insolvent, in order to reduce the short run ~~costs of~~ need for resolving the crisis ~~in the thrift industry~~ precipitated by rising interest rates. ~~But~~ In the long run, the costs will be higher and the damage to the industry greater than had Congress come up with the funds for the ~~money today~~ to promptly liquidate insolvent thrifts. If the ~~thrifts don't recover,~~ numbers add up however there ~~inevitably~~ will be a depositor payoff ~~either~~ by the FSLIC acting as the agent for ~~or~~ Congress. or by the Solvent thrifts ~~are being made to pay for this rescue and at the same time~~ through new and higher assessment

Citation

my interpretation of events. (also see Kane, Romer, Horwitz)

moderate
to measure

Solvent and prosperous thrifts

~~required to compete in a deregulated market.~~ ~~They are~~ likely to pay the ~~[illegible]~~ exit fees and leave the system after the one year moratorium imposed by CEBA has expired. This response will reduce the ~~cash flow of the FSLIC and~~ funding base for these bonds of the Financing Corporation.

~~But the error is in concluding~~ The opposition that ~~the~~ inept responses by Congress and the regulators are the sole cause of the crisis in the thrift industry and the FSLIC does not stand scrutiny. Had the thrifts been free of asset restrictions, interest rate ceilings, and deposit insurance protection, perhaps they would not have been no less vulnerable to interest rate fluctuations or the systemic declines in oil, real estate and farm prices given their basic structure of borrowing short to lend long or the evaporation of the cash flows in oil real estate and farm land that supported their assets. ~~(Bank positions in the early 1930's do not confirm this conjecture True? Supportable?)~~ ~~But~~ Deposit insurers, nor ~~and~~ the institutions they insure, can~~not~~ weather system-wide and contagious losses. Systemic failures cannot be contained by letting them run their course unless there is a willingness to accept deep depressions. Nor can the costs of ~~these~~ ~~failures~~ offsetting serious cash flow shortfalls be avoided by cosmetic arrangements that merely ~~serve to put off the inevitable~~ pile further unsupportable cash commitments upon a weak structure. ~~But~~ Apt intervention that recognizes the need to establish new initial conditions, however, that is, ~~the need to~~ payoff depositors, liquidate insolvent thrifts and scale back deposit insurance coverage, may even present potentials for loss reduce the long run cost and speed the transition to a more robust industry.

Set up by regulation!! not by their own volition

I can argue this is due to regulation that the coopted thrift would behave to avoid systematic risk..

For evaluation section at end 1 note

Mexican debt crisis bring unbundled some cong!

Discount strips zero price

PV of ~~[illegible]~~ guaranteed