

# THE FSLIC IS "BROKE" IN MORE WAYS THAN ONE

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As a result of both the savings and loan industry crisis that began earlier in the decade and inappropriate regulatory policies, the FSLIC is now "broke." Its bankruptcy makes it principal among the thrift industry regulators because the plight of the FSLIC prevents it, as well as the other S&L regulators, from taking the actions needed to ensure the future prosperity of the industry. Regulators have been forced to make "second best" regulatory responses that are frequently so ineffective they render the system of regulatory policies itself "broke." In turn, this set of destitute policies, together with punitive actions from Congress and the administration requiring healthy thrifts to bear the burden of industry clean-up, could conceivably bankrupt the entire savings and loan industry.

The most important regulatory error, which will be the focus of this paper, is the decision to allow large numbers of insolvent and low-capital S&Ls to continue functioning, often for long periods of time and almost as a matter of course. The continued operation of these bankrupt institutions exposes the insurance corporation to moral hazard and the S&L industry to adverse selection as the owners and managers of insolvent insured thrifts are given the opportunity to enjoy any benefits from the gambles they undertake with depositors' funds while passing the losses to their insurer, healthy thrifts, or the taxpayer. These losses have proved heavy and are rapidly increasing the degree of the FSLIC's insolvency.

The continued operation of thrifts that have failed the market test of survival of the fittest, threatens the viability of the industry itself

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through adverse selection. Healthy thrifts must compete with weaker institutions enjoying regulatory preferences and subsidies. If this situation is allowed to continue indefinitely, the subsidized weak could bring down the marginally solvent and, ultimately, even the strong institutions, causing many more industry participants to fail.

Moreover, all thrifts are now paying higher insurance premiums in order to provide the FSLIC with the resources it needs to begin resolving the industry's problems. In this respect, the additional premiums put healthy thrifts at a disadvantage in competing with nonthrift depository institutions such as commercial banks, savings banks, and credit unions. The strongest thrifts are beginning to flee the industry by obtaining bank charters and shifting to the Federal Deposit Insurance Corporation, a stronger insurer. The viability of the S&L industry itself may be threatened as the strong flee while the weak and at least some of the marginal deteriorate.

Many argue that the new portfolio powers granted earlier in the decade have given thrifts opportunities to undertake exceptional risks. The call for reregulation has been made, therefore, and the Federal Home Loan Bank Board has responded by reimposing some portfolio restrictions. Indeed, it is inappropriate to allow insolvent firms to gamble at the FSLIC's expense, but while deregulation may have given insolvent S&Ls additional ways in which to gamble, it has also provided benefits to sound institutions, their borrowers, and depositors. Unless we are careful, sound as well as weak thrifts and the consumer could be forced to relinquish those gains. The exigencies of restraining the activities of failed S&Ls should be kept separate from the discussion of what powers are appropriate for sound depository institutions.

In short, the S&L industry has become polarized. Most of the strong institutions are prospering, but many insolvent thrifts are deteriorating rapidly, and some of the marginally solvent savings and loans are approaching failure. This situation has occurred at a time when the interest rate environment has been favorable for S&Ls (an advantage that may be departing as interest rates rose sharply during the second quarter of 1987). It is possible that a replay of the interest rate crisis that devastated the industry at the beginning of the decade will occur, making it all the more crucial that the existing problems be dealt with quickly.

## On Being Broke

Traditionally, the FSLIC has imposed on federally insured S&Ls an annual insurance premium of one-twelfth of 1 percent of total

deposits. For 50 years this premium was adequate to cover FSLIC expenses and the cost of resolving the problems of weak institutions. However, the price of dealing with but some of the industry's recent problems has been so high that two years ago the FSLIC imposed an additional annual "special assessment" of one-eighth of one percent of total deposits, causing thrifts to pay 20.8 basis points to the FSLIC for each \$100 of deposits. The special assessment raises S&L costs above those of the commercial banks, which currently pay to the FDIC only 8.5 basis points per \$100 of deposits. Thus, because of their insurer's plight, S&Ls are at a competitive disadvantage when compared to banks and other depository institutions.

Despite the extra assessment, the FSLIC's primary and total reserves have declined since 1983 and have fallen far short of meeting its obligations, as Table 1 shows. Indeed, the General Accounting Office declared the Corporation insolvent early in 1987 and estimated it faced a negative net worth of \$6 billion in May 1987.<sup>1</sup>

**TABLE 1**  
**FSLIC INSURANCE FUND RESERVES**  
**(IN BILLIONS OF DOLLARS)**  
**1980-85**

December	Primary Reserves <sup>a</sup>	Secondary Reserves <sup>b</sup>	Total Reserves
1980	5.67	0.79	6.46
1981	5.70	0.60	6.30
1982	5.69	0.61	6.30
1983	5.76	0.66	6.42
1984	4.89	0.72	5.61
1985	3.78	0.77	4.55

<sup>a</sup>Primary reserves, in principle, are immediately usable by the FSLIC because they derive from the regular and special assessment premiums paid by thrifts to the FSLIC and from any interest earned on insurance fund investments.

<sup>b</sup>In the early 1960s, falling FSLIC reserves led to legislation requiring thrifts to prepay insurance premiums into a secondary reserve account. Although the requirement was eliminated in the 1970s, some prepaid premiums and accumulated interest remain. The secondary reserve was not readily available for FSLIC use as it remained an asset on S&L books. Thus, when GAO forced the FSLIC to write off the secondary reserve during the 1986 financial audit, it resulted in a dollar-for-dollar reduction in industry net worth, further increasing the difficulties of some problem thrifts.

SOURCES: *Examination of Financial Statements of the Federal Home Loan Bank Board and Related Agencies*, GAO/AFMD-82-58, March 1982; GAO/AFMD-83-65, April 1983; GAO/AFMD-84-47, May 1984; GAO/AFMD-85-60, July 1985; *Financial Audit Federal Savings and Loan Insurance Corporation's 1985 and 1984 Financial Statements*, GAO/AFMD-86-65, July 1986.

<sup>1</sup>See U.S. General Accounting Office (1987).

At the same time, estimates of the cost of resolving the problems facing the FSLIC have been rising. Table 2 shows that both the number of S&Ls that are insolvent using generally accepted accounting principles (GAAP) and the value of assets in failing thrifts rose each year from 1980 through 1985. The Federal Home Loan Bank Board (FHLBB) reports that the average cost of disposing of failed thrifts in 1984 was almost 15 cents per dollar of assets.<sup>2</sup> Extrapolating this average cost yields an estimated total cost of \$16.9 billion for closing all thrifts that were insolvent in 1984.

To make matters worse, the FHLBB has said that the average cost of merging or liquidating failed thrifts has been rising lately, although it has not released recent point estimates of its costs. GAO has data showing that costs associated with liquidations have risen sharply since 1984, but it has no data on recent merger costs. Data in Table 3 indicate that the numbers of liquidations have been increasing relative to the numbers of mergers, even though mergers are usually less costly, so it would appear that average resolution costs have indeed been rising.

The number of insolvent thrifts and the value of their assets remained relatively constant during 1985 and 1986, but as the per dollar disposal cost has risen, total potential demands on the insurance fund have also soared. If average disposal costs have risen to, say, 25 cents per dollar of assets, total potential demands on the insurance fund in 1987 could exceed \$28 billion. Early in 1987, the Bank Board estimated the cost of closing just the thrifts that were insolvent under the more lenient regulatory accounting principles (RAP) at \$23.6 billion.

## Resolution Options

The Bank Board uses three types of final resolution for failed S&Ls, all of which cause the insolvent institution to cease to exist. Liquidation is the first type of action listed in Table 3. The term is frequently understood to mean a payout to depositors. Today, however, payouts are rare because they are often costly, and the FSLIC does not have the necessary funds at hand. Recently, liquidations have involved passing insured deposits to another institution. The deposit liabilities are matched by both sound and unsound assets from the failed S&L or from some other firm, cash, or FSLIC promissory notes. Typically, the FSLIC takes over the worst assets.

Mergers have historically been the most cost-effective and, hence, the preferred way of disposing of failed thrifts. Two types of regu-

<sup>2</sup>See U.S. General Accounting Office (1986).

TABLE 2

ESTIMATES OF FSLIC LOSSES ON INSOLVENT INSTITUTIONS' ASSET PORTFOLIOS, 1980-86<sup>a</sup>  
(IN BILLIONS OF DOLLARS)

December	Number of Insolvent Institutions	Total Value of Assets	Potential Dollar Losses to the FSLIC <sup>b</sup>			
			5 Percent	15 Percent	25 Percent	35 Percent
1980	16	0.12	0.01	0.02	0.03	0.04
1981	53	11.82	0.59	1.77	2.96	4.14
1982	222	63.51	3.28	9.53	15.88	22.23
1983	281	77.76	3.89	11.66	19.44	27.21
1984	434	101.58	5.08	15.24	25.39	35.55
1985	449	112.93	5.65	16.94	28.23	39.52
1986 <sup>c</sup>	445	112.76	5.64	16.91	28.19	39.47

<sup>a</sup>Insolvent institutions have zero or negative GAAP net worth. We have calculated the GAAP net worth of institutions by subtracting from their reported regulatory net worth those items not consistent with GAAP. Industry participants have questioned some FHLBB regulations related to the valuation of assets and reserves that may be more rigorous than would be required under GAAP. To the extent this is true, our estimates of GAAP net worth may be understated and, thus, the number of institutions insolvent under GAAP, overstated. Data to further refine our GAAP estimates are not collected by the Bank Board nor are they available elsewhere to our knowledge. Such adjustments to GAAP net worth as may be appropriate, therefore, cannot currently be done. While further research may be necessary, the Bank Board has said that such adjustments would not substantially alter the picture of the industry provided by currently available information.

<sup>b</sup>Dollar losses to the FSLIC assuming 5, 15, 25, and 35 percent losses on the assets of institutions that are liquidated or merged. In 1984, the average cost to the FSLIC of dealing with failed institutions was 14.7 percent of assets.

<sup>c</sup>Data are for September 1986.

SOURCE: FHLBB Semiannual and Quarterly Financial Statements, 1980-86.

TABLE 3  
DISPOSITION OF INSOLVENT INSTITUTIONS<sup>a</sup> 1980–86

FSLIC Action	1980	1981	1982	1983	1984	1985	1986
Liquidations <sup>b</sup>	0	1	1	6	9	10 <sup>c</sup>	21 <sup>d</sup>
Supervisory Mergers <sup>e</sup>	21	56	166	31	13	11	4
FSLIC Mergers <sup>f</sup>	11	23	46	33	17	22	22
Total Resolutions	32	80	213	70	39	43	47
Allocations to MCP <sup>g</sup>	0	0	0	0	0	25	29 (17) <sup>h</sup>
Total Number of Insolvent Institutions <sup>i</sup>	16	53	222	281	434	449	445 <sup>j</sup>

<sup>a</sup>An insolvent institution is defined to have GAAP net worth less than or equal to zero.

<sup>b</sup>Liquidations include depositor payoffs and transfers of deposits backed by cash, FSLIC assets or notes, or a combination of these to other, often newly created, institutions.

<sup>c</sup>In two 1985 liquidations, assets in receiverships were transferred to newly created S&Ls that became MCPs.

<sup>d</sup>Twelve institutions placed in liquidating receiverships in 1986 were actually transformed into newly created MCPs. Thus here and for two cases in 1985, the liquidating receivership was used, not to close institutions, but to create MCP institutions.

<sup>e</sup>In a supervisory merger, the Bank Board compels the institution to merge, typically without financial assistance, because the S&L failed to meet regulatory capital and other requirements.

<sup>f</sup>In a FSLIC merger, the insurance fund provides financial assistance as an inducement to the acquiring institution.

<sup>g</sup>Allocated initially to the management consignment program (MCP) in any given year.

<sup>h</sup>The MCP definition was changed early in 1987. Seventeen institutions originally classified as MCPs in 1986 were declared to be non-MCPs as of December 31, 1986, because they had not gone through conservatorship or receivership. These 17 institutions are *not* included in the 29 shown above as having been added to the program in 1986.

<sup>i</sup>At the end of the year, except 1986.

<sup>j</sup>By September 1986.

SOURCES: FHLBB and FSLIC.

latory merger are available to the Bank Board.<sup>3</sup> A supervisory merger is arranged by the Bank Board without financial assistance. The FHLBB has the power to force a thrift to merge if the institution becomes insolvent or if it is operating in an unsafe and unsound manner. In the second kind of regulatory merger, the FSLIC does provide assistance—in the form of assets, notes, or cash.

In the past two years, mergers have become more difficult to arrange. Bank holding companies and thrifts can now traverse state boundaries much more readily than before, and consequently the franchise value of a failed thrift in another state has been reduced. Connell (1987) has pointed out a second reason. The FSLIC can no longer afford to take over the problem assets of a failing thrift. But an “unclean bank,” containing problem loans that will require considerable management effort to collect, is not an attractive acquisition target. These disadvantages are reflected in the reduced number of mergers,<sup>4</sup> particularly unassisted mergers. As shown in Table 3, unassisted mergers decreased from 166 in 1982 to 4 in 1986, and the number of assisted mergers declined from 46 in 1982 to 22 in 1986.

To take up the slack as the number of institutions needing attention was rising, the Bank Board introduced the management consignment program (MCP) in 1985. Under this program the managers of failing S&Ls are removed and replaced by tried and trusted officers, often from other, more successful thrifts. In 1985 and 1986, over one-third of Bank Board actions against failing institutions were allocations of S&Ls to the MCP. Such allocations cannot be regarded as problem resolutions, however, as participants in the program typically continue to be unprofitable and, hence, remain insolvent. Indeed, it is unclear that the program is stemming the FSLIC's economic losses in the way its creators had hoped.

The juxtaposition of rising demands and declining resources has inhibited FHLBB actions to correct the problems of insolvent and weak S&Ls. As Table 3 shows, 32 S&Ls were merged by supervisory action or with FSLIC assistance in 1980. At the end of that year only 16 GAAP insolvent thrifts remained in operation awaiting disposition. In 1981 and 1982, however, the numbers of problems and actions both rose dramatically, to 222 and 243, respectively, as the S&L crisis escalated with rising interest rates.

<sup>3</sup>Regulatory mergers should be distinguished from voluntary mergers organized without the regulators' involvement.

<sup>4</sup>Catherine England and Thomas Huertas have pointed out two further reasons. Federal Reserve restrictions make bank holding company acquisitions of thrifts unattractive, and the FSLIC's insolvency makes the value of its indemnifications to acquirers of failed thrifts of questionable value.

Since 1982, the number of resolutions effected has decreased—to just 49 in 1985—as the number of insolvent institutions has risen—to peak at 449 at the end of 1985. Forbearance, a popular political platform in early 1987, was then being forced on a reluctant Bank Board because it lacked the money to deal with the problems facing it. In the mid-1980s, the FSLIC's impending bankruptcy prevented necessary actions from being taken and induced the Bank Board to adopt other, sometimes inappropriate, stop-gap policies.<sup>5</sup> At the same time, allowing insolvent thrifts to continue operating has given them opportunities to “go for broke.” As the gamblers tend to lose, and to “lose big,” more often than to gain, the demands on the FSLIC have escalated rapidly. Thus, the regulators have allowed an untenable situation—a vicious cycle of deterioration—to develop.

## Delay

At the end of September 1986, 445 GAAP insolvent thrifts awaited disposition. Some had been allowed to operate without capital for extended periods of time. GAO (1987) has shown that of the 222 thrifts that were insolvent at the end of 1982, 145 continued to operate four years later, and 80 of them were still insolvent and incurring heavy losses despite the favorable interest rate environment they had experienced in the interim.

At the height of the S&L interest rate crisis in 1982, forbearance had appeared to be a viable policy. It would give thrifts time to use the new powers granted under the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 to adjust their portfolios and recover. It would also allow interest rates to fall as the business cycle progressed. The anticipated decline in rates was expected to reduce S&L costs more rapidly than their revenues, returning many to profitability and solvency. Furthermore, the market value of S&L assets would be increased by falling interest rates, reducing the FSLIC's costs of disposing of those institutions that did not recover.

So early in the 1980s, delaying the declaration of failure appeared to be an acceptable policy to Congress and the Bank Board. But this policy entailed risks. By definition, insolvency means that the value of an institution's liabilities (L) exceeds that of its assets (A). In this

<sup>5</sup>For example, the Bank Board proposed to severely restrict S&Ls', particularly state-chartered S&Ls', powers to make direct investments. It later revised its proposal to allow strongly capitalized thrifts more latitude. The Bank Board has severely curtailed growth. Its demands for faster loan-loss write-offs and higher appraisal standards have encountered strong opposition from the industry.

situation, it is difficult for a firm, especially one that is not growing, to earn profits and accumulate capital. Achieving these goals requires that the rate of return earned on assets ( $r$ ) exceed that paid on liabilities ( $c$ ) by a margin great enough to counterbalance the deficiency in assets.

Where an institution is solvent ( $A > L$ ), any rate of return on assets greater than the rate paid on liabilities is sufficient to ensure profitability. But for an insolvent institution,  $r > c$  is a necessary but not sufficient condition for profitability. Absent capital gains or losses the sufficient condition is,

$$\frac{r}{c} > \frac{L}{A}$$

That is, the greater the degree of insolvency, the higher the return on assets ( $r$ ) needs to be in relation to the return on liabilities ( $c$ ) to ensure positive profits.

In an efficient market, earning higher rates of return demands taking additional risks. Managers of solvent firms have their jobs and financial interests at stake, so they are likely to be risk-averse. But managers of insolvent firms have little at stake under the present system of deposit insurance. They expect the Bank Board to relieve them of their positions sooner or later anyway unless they recover. They may be willing to gamble in the hopes of recovery, therefore, because the losses they incur will be borne by others.

### The Propensity to Take Risks

The FHLBB has asserted that some activities are more risky for S&Ls than others. In particular, the Bank Board's staff claims that investments in acquisition, development, construction, and commercial loans and direct investments in real estate and service corporations are particularly risky. Data to verify these claims are not publicly available. Moreover, modern finance theory reminds us that it is inappropriate to consider the variability of returns to a single asset in isolation. Rather, the effect of the activity on the risk of the portfolio as a whole is the relevant consideration for institutions deciding whether or not to undertake a new activity.

The fact that these activities became permissible for most S&Ls only recently suggests, however, that inexperience may lead S&Ls to make a larger than average number of mistakes. In this case the activities can be risky both in isolation and in the context of the portfolio as a whole.

The interest rate and credit risks inherent in traditional S&L mortgage lending are now well-known, and procedures are available for

controlling them. But credit risks in the newer activities may be less well understood. Moreover, there may be an adverse selection problem facing S&Ls entering new markets—the good borrowers may well stay with their traditional lenders while the bad credit risks attempt to convince the new lenders to trust them.

### Evidence on Risk Taking

Tables 4 and 5 present data on various forms of potential risk exposure for S&Ls. These tables examine the portfolio composition of thrifts nationwide and in the five states (California, Florida, Louisiana, Oklahoma, and Texas) that have experienced the most problems with their thrifts and/or their real estate markets during the mid-1980s. In the tables, S&Ls are divided into three groups: (1) GAAP insolvent, (2) low capital (that is, positive net worth below 3 percent of assets), and (3) well-capitalized thrifts (with net worth above 3 percent of assets).

Table 4 shows that there is a substantial variation among states in the percentage of assets devoted to direct investments and to acquisition and development loans.<sup>6</sup> Moreover, it tends to be the insolvent firms that engage most prominently in these “risky” activities. For example, insolvent thrifts nationwide and in 4 of the 5 states (but not in Oklahoma) held more commercial loans than the national average for S&Ls. Insolvent S&Ls as a group and in 4 of the 5 states (Louisiana being the exception) held more acquisition and development loans than the solvent institutions for the nation as a whole or in the individual states. Insolvent thrifts nationwide and in California, Oklahoma, and Texas, held a greater proportion of their assets as direct investments than the average S&L.

At the same time, insolvent thrifts also held fewer mortgage assets of all kinds: fewer total mortgages, fewer home mortgages, and fewer mortgage-backed securities. (See Table 5.) Judging exposure on interest rate risk is difficult because the Bank Board does not release the data that would allow estimates of the difference in the duration of assets and of liabilities. Given this limitation, exposure must be inferred from the division of the mortgage portfolio between fixed rate and adjustable rate instruments.

In general, insolvent thrifts nationally and in the states examined held both fewer fixed and fewer adjustable rate mortgages (FRMs and ARMs, respectively) than their solvent counterparts. Exceptions occurred in Florida and Oklahoma, however, where failed thrifts

<sup>6</sup>Data on construction loans are not included because they have not been released by the Bank Board.

TABLE 4

## ASSET COMPOSITION FOR ALL FSLIC-INSURED INSTITUTIONS AS OF SEPTEMBER 30, 1986

Designation	Net Worth Category	Net Mortgage Loans and Contracts	Commercial Loans	Consumer Loans	A&D Loans <sup>a</sup>	Liquid Assets <sup>b</sup>	Direct Investments <sup>c</sup>	Deferred Losses	Goodwill
Total	Less than or = to 0%	62.08	2.33	5.48	5.07	4.78	4.33	2.57	1.48
Industry	Between 0 and 3%	71.76	1.58	4.36	3.65	4.72	3.19	0.60	2.29
	Greater than 3%	70.84	1.74	4.10	2.13	5.63	2.48	0.15	2.24
	Total Industry	70.21	1.76	4.30	2.80	5.32	2.84	0.50	2.18
	California	Less than or = to 0%	58.54	1.85	2.32	1.82	3.09	12.14	0.55
California	Between 0 and 3%	78.25	0.32	1.48	0.80	4.07	3.99	0.04	1.88
	Greater than 3%	73.54	1.05	3.40	1.09	4.61	3.88	0.07	1.71
	Total State	73.89	0.92	2.90	1.06	4.42	4.29	0.08	1.70
	Florida	Less than or = to 0%	52.88	3.72	4.71	4.31	8.08	1.63	1.26
Florida	Between 0 and 3%	71.56	2.22	5.73	4.28	4.64	1.67	0.25	2.29
	Greater than 3%	66.27	3.11	5.67	2.19	7.16	2.24	0.22	2.93
	Total State	66.36	2.95	5.60	2.89	6.63	2.05	0.32	2.56
	Louisiana	Less than or = to 0%	59.08	3.18	6.79	3.93	5.50	1.05	1.66
Louisiana	Between 0 and 3%	69.01	1.77	6.35	2.59	4.24	1.33	1.18	2.57
	Greater than 3%	66.71	0.58	7.00	9.35	3.90	8.37	0.29	2.65
	Total State	65.12	1.59	6.80	6.22	4.43	4.64	0.89	2.11
	Oklahoma	Less than or = to 0%	69.99	1.33	7.18	2.84	3.47	1.44	3.48
Oklahoma	Between 0 and 3%	71.20	2.84	6.50	2.04	3.04	0.81	0.05	0.12
	Greater than 3%	72.35	2.13	6.29	2.49	5.10	1.07	0.04	0.25
	Total State	71.48	2.02	6.50	2.51	4.28	1.13	1.02	0.18
	Texas	Less than or = to 0%	57.15	2.72	4.90	20.04	3.48	8.86	1.00
Texas	Between 0 and 3%	67.27	3.07	3.70	15.02	3.82	7.86	0.15	2.58
	Greater than 3%	66.80	1.69	4.13	15.29	3.65	6.70	0.08	3.64
	Total State	65.35	2.48	4.10	15.98	3.70	7.58	0.27	2.78

<sup>a</sup>Acquisition and development loans.

<sup>b</sup>Cash, deposits, and investment securities excluding valuation allowances.

<sup>c</sup>Residential and nonresidential property and service corporations excluding valuation allowances.

SOURCE: FHLBB Quarterly Financial Statements, September 1986.

**TABLE 5**  
**COMPOSITION OF MORTGAGE ASSETS FOR ALL FSLIC-INSURED INSTITUTIONS, ON SEPTEMBER 30, 1986**

Designation	Net Worth Category <sup>a</sup>	Net Mortgage Loans and Contracts <sup>b</sup>	Home Mortgages	Mortgage-backed Securities	Fixed-rate Mortgages	Adjustable Rate Mortgages
Total	Less than or = to 0%	62.08	31.93	7.52	26.31	26.39
Industry	Between 0 and 3%	71.76	34.88	17.46	36.83	26.62
	Greater than 3%	70.84	41.45	12.20	32.83	30.77
	Total Industry	70.21	38.89	13.21	33.17	29.31
California	Less than or = to 0%	58.54	26.30	4.85	19.16	31.34
	Between 0 and 3%	78.25	29.34	33.00	48.96	22.17
	Greater than 3%	73.54	40.45	9.60	20.68	43.88
	Total State	73.89	37.30	14.62	26.93	38.44
Florida	Less than or = to 0%	52.88	28.27	7.27	19.11	26.18
	Between 0 and 3%	71.56	45.15	7.23	32.90	29.95
	Greater than 3%	66.27	40.87	12.26	34.27	24.33
	Total State	66.36	40.78	10.59	32.58	25.86
Louisiana	Less than or = to 0%	59.08	33.52	6.47	24.66	21.80
	Between 0 and 3%	69.01	43.39	4.78	29.78	30.31
	Greater than 3%	66.71	43.18	3.98	30.76	21.10
	Total State	65.12	40.52	4.87	28.82	23.50
Oklahoma	Less than or = to 0%	69.99	38.62	5.98	24.43	32.50
	Between 0 and 3%	71.20	40.56	5.74	23.93	34.96
	Greater than 3%	72.35	43.10	8.00	32.68	27.61
	Total State	71.48	41.39	7.05	28.85	30.25
Texas	Less than or = to 0%	57.15	18.62	2.72	16.17	26.70
	Between 0 and 3%	67.27	23.77	7.22	18.56	37.07
	Greater than 3%	66.80	24.19	15.83	29.10	29.28
	Total State	65.35	23.05	9.80	22.22	32.28

<sup>a</sup>Rows do not sum to one because they encompass overlapping categories.

<sup>b</sup>Mortgages on 1 to 4 family residences.

SOURCE: FHLBB quarterly Financial Statements, 1986.

held more ARMs than the state average. The ratio of FRMs to ARMs is below unity (except in Louisiana) for insolvent thrifts, while it is often above one for solvent S&Ls. From these limited data, insolvent thrifts do not appear to be more exposed than the rest of the industry to interest rate risk, but they do potentially face more credit risk.

### The Vicious Cycle

The insolvent savings and loans are typically incurring heavy losses (see Table 6) causing the degree of their insolvency, and hence the FSLIC's need to redress the growing deficiency in assets, to continue increasing. As few insolvent thrifts recover, demands on the FSLIC's funds escalate. Insolvent thrifts were, for example, experiencing losses at an annual rate of 5 percent of assets in the third quarter of 1986 (Table 6). At this rate, delaying disposal of these thrifts by one year would add \$5.6 billion to the FSLIC's resolution costs.

In the fall 1986, there were 3,234 S&Ls: 67.7 percent were well-capitalized with GAAP net worth of 3 percent or better, 18.5 percent were solvent but weak with capital below 3 percent, and 13.7 percent were insolvent.

The data presented in Table 6 show that two-thirds of the insolvent thrifts were incurring negative total and operating profits.<sup>7</sup> These losses occurred despite the fact that the economy was favorable during this period in most parts of the country. Interest rates were lower than at any other time in the decade, the economy was in its fourth year of an expansion, the demand for mortgages was strong, and funds were available to meet the demand.

In this environment, most well-capitalized thrifts, except those in markets depressed by the decline in energy and agricultural product prices, were profitable. For example, 66.9 percent of the solvent but weak thrifts and 88.4 percent of the well-capitalized savings and loans were profitable in the third quarter of 1986 despite the increasing loan loss write-offs that the Bank Board was imposing at that time.

### Inappropriate Responses

This paper has shown that the S&L industry is polarized. The weaker section of the industry is exposed to credit risk, and because

<sup>7</sup>During the second half of 1986, the Bank Board required many S&Ls to take additional loan loss write-offs. Some analysts have explained the losses experienced by S&Ls at this time by referring to these write-offs. However, the present analysis shows that many S&Ls, particularly the insolvent ones, were incurring operating losses in addition to suffering from charges against nonoperating income.

**TABLE 6**  
**INCOME AND PROFITABILITY OF FSLIC-INSURED INSTITUTIONS IN SEPTEMBER 1986**

Designation	Net Worth Category	Number of Institutions	Percent in Category	Total Assets (Billions)	Average Return on Assets*	Total Industry Profits (Billions)	Number Profitable	Percent Profitable	Net Operating Profit (Billions)
Total Industry	Less than or = to 0%	445	13.70	112.70	-5.00	-1.40	148	33.26	-.74
	Between 0 and 3%	598	18.50	282.50	-0.09	-0.07	400	66.89	-.07
	Greater than 3%	2191	67.70	747.90	0.82	1.54	1936	88.36	1.92
	Total Industry	3234	100.00	1143.00	0.02	0.06	2484	76.81	1.10
California	Less than or = to 0%	30	13.70	13.90	-7.60	-0.26	4	13.33	-.19
	Between 0 and 3%	30	13.70	66.80	0.32	0.05	20	66.67	.00
	Greater than 3%	158	72.40	218.20	1.08	0.59	138	87.34	.73
	Total State	218	100.00	299.10	0.51	0.38	162	74.31	.55
Florida	Less than or = to 0%	19	12.90	7.40	-4.12	-0.07	4	21.05	-.04
	Between 0 and 3%	26	17.60	20.35	0.00	0.00	17	65.38	.01
	Greater than 3%	102	69.30	55.80	0.38	0.05	73	71.57	.06
	Total State	147	100.00	83.60	0.12	-0.02	94	63.95	.03
Louisiana	Less than or = to 0%	26	25.40	4.30	-3.50	-0.04	7	26.92	-.02
	Between 0 and 3%	23	22.50	3.70	-0.79	-0.01	12	52.17	.00
	Greater than 3%	53	51.90	7.50	1.12	0.02	43	81.13	.02
	Total State	102	100.00	15.60	-0.65	-0.03	62	60.78	.00
Oklahoma	Less than or = to 0%	14	26.40	2.80	-2.90	-0.02	0	0.00	-.01
	Between 0 and 3%	11	20.70	1.60	-1.10	0.00	1	9.09	.00
	Greater than 3%	28	52.80	5.40	-0.30	0.00	14	50.00	.00
	Total State	53	100.00	9.90	-1.19	-0.03	15	28.30	-.01
Texas	Less than or = to 0%	66	23.60	16.70	-15.50	-0.65	6	9.09	-.35
	Between 0 and 3%	74	26.50	43.10	-1.90	-0.21	21	28.38	-.20
	Greater than 3%	139	49.80	37.70	0.03	0.00	86	61.87	.00
	Total State	279	100.00	97.60	-3.50	-0.86	113	40.50	-.57

\*Returns are annualized

SOURCE: FHLBB Quarterly Financial Statement, September 1986.

its gambles have been largely unsuccessful, it is deteriorating rapidly. The demise of the weaker S&Ls is imposing increasing demands on the FSLIC insurance fund, and at the same time it is prejudicing the successful operations of healthy thrifts. The FSLIC is insolvent and cannot provide the funds necessary to dispose of the problem S&Ls, so it is searching for other ways to contain the deteriorating situation it faces.

One response to the current problem is to reregulate the industry, asking Congress to remove some of the provisions of the 1980 and 1982 deregulation acts. The evidence in this paper suggests that insolvent thrifts should not be allowed *carte blanche* to engage in end-of-game plays. But it presents no evidence either for or against deregulation or reregulation for the industry as a whole. Restraining the weak does not imply that the strong necessarily should be similarly shackled. The question of what powers should be granted to healthy thrifts—or sound banks—is a separate one that is worthy of separate and careful consideration.

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