Articles

The Unending Deposit Insurance Mess

EDWARD J. KANE

The thrift institution deposit insurance mess is rooted in defects in political and bureaucratic accountability. Under existing incentives, covering up evidence of poor regulatory performance and relaxing binding capital requirements are rational governmental responses to widespread industry insolvency. Similarly, aggressive industry risk taking is a rational response by thrift managers to regulatory forbearances. Far from acknowledging these incentive defects, the Bush plan for cleaning up the mess adopts theories that spotlight other causes: specifically, poor thrift management and the deregulation of thrift institution activities and of deposit interest rates. To end the mess, politicians and regulators must jettison these comfortable theories and surrender discretion that permits them to finesse the need to budget for governmental financial commitments.

LOSSES ACCRUED BY INSOLVENT THRIFT INSTITUTIONS [savings and loan (S&L) associations and savings banks] have become a national scandal. Even though the Federal Savings and Loan Insurance Corporation (FSLIC) has formally resolved insolvencies at more than 1000 thrifts since 1980, at least 25% of FSLIC's remaining client base could not survive without implicit or explicit government assistance. At these crippled firms, the value of assets has dropped so far below the value of liabilities that managers' only reasonable hope of generating profits has been to expand the federally guaranteed funding base and to invest the funds raised in a blatantly speculative manner. Their intention has been 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. If the new bets pay off, the thrift regains its solvency. If the new bets lose, the losses fall on the deposit insurer.

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 had not been insured, its creditors would have taken control from stockholders once it became clear that the thrift's 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 obviously not a purpose for which the deposit insurance support system was intended. But the passage of time has greatly distorted the abused and undermaintained 55-year-old machinery of FSLIC.

Efficiency requires that repairs must be given priorities before they are started. Years of deferring the escalating losses imbedded in FSLIC's promises to depositors at zombie and near-zombie firms have generated a huge unpaid repair bill, one on which the meter is still running. The longer federal politicians have waited to present this bill to taxpayers, the larger it has become. The February 1989 Bush plan for cleaning up FSLIC's losses, as amended by Congress in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (*1*), estimates the present discounted value of this bill at roughly $125 billion.

Although the Bush plan includes some useful measures, it diagnoses FSLIC's problems both too narrowly and too wishfully to end 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 (that is, denationalizing) the assets of insolvent thrifts that government bureaus must take over in settling FSLIC's accounts (*1*). Although the plan's new regulatory framework is advertised as establishing "banklike" capital requirements for thrifts, the provisions adopted fall far short of this ideal. They mandate dangerously low minimum levels for thrift capital, allow troubled firms to meet these requirements in artificial ways, and provide an overly long 5-year phase-in period before they take full effect.

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

To appreciate how badly taxpayers need such controls, one must understand how and when FSLIC's losses came to be so large. Some parties have a stake in preserving regulators' opportunities to cover up developing problems. One way these parties have sought to sidetrack salient reform is by promoting self-serving mischaracterizations of the sources of the underlying problem. In sorting through alternative diagnoses of the causes of the S&L deposit insurance mess, 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.

The Bush Plan's Dangerous Misdiagnoses

Two seductive misdiagnoses underlie the Bush plan. Kane (*2*) calls these false analyses the "bad apples" theory and the excessive deregulation theory. It is important to recognize how incompletely these theories explain the development of the mess.

The author is Everett Reese Professor of Banking and Monetary Economics, The Ohio State University, Columbus, OH 43210. This paper was written while the author was visiting professor, Center for Financial System Research Arizona State University, Tempe, AZ 85287.

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. On this opinion, which has been promoted energetically by more than a few government officials, the major reform needed is to apply tougher criminal and civil penalties for fraud and mismanagement to managers of federally insured financial institutions.

This theory is consistent with two important facts. First, government studies (*3*) emphasize that fraud was present (to some degree) in two-thirds to three-fourths of the insolvencies FSLIC chose to resolve in recent years. Second, many of the loans and investments made by failed thrifts were intensely speculative ones. 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 managerial fraud and mismanagement. When one looks closely, it is hard to argue that violations of law or stockholder rights can account for more than 10 to 20% of the bill FSLIC has run up.

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 govern financial disclosure. The principal weakness of these historical cost valuation principles is that they direct deposit institution accountants generally to eschew the formal recognition of developing losses on still maturing loans and investments. They created 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. Moreover, the authority of insured thrifts to engage in misleading reporting was deliberately expanded by FSLIC's adoption of even more lenient regulatory accounting principles in September 1982. 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.

Similarly, the bulk of the exorbitantly risky loans and investments that insolvent thrifts put on their books in recent years are best understood not as managerial actions that clearly and immediately harmed stockholders but as clever gambles that were fostered 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 high-flying 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 in effect 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 high-rolling patterns of investment become progressively larger.

Thrift economic insolvencies surged in the 1970s each time that inflation accelerated, because inflation-induced increases in interest rates drove down the market value of 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 new mortgages earned and that thrift depositors required. The shortfall in mortgage interest can be treated as a form of de facto default on thrift assets.

Because GAAP accounting does not require low-rate mortgages to be written down immediately to acknowledge this de facto default, accounting records misstate the timing of industry losses. Declines in market value associated with the sharp interest rate increase of 1979 to 1982 made themselves felt in an accounting sense over time as operating losses that eroded thrift capital in a delayed fashion. A surge in GAAP insolvency did not occur until 1981 and was accompanied by a slowdown in FSLIC resolution of accounting insolvencies from 1983 through 1987 (Table 1) (*4*).

Too much deregulation? A second misdiagnosis is being promoted by some members of the financial industry (*5*) and seems to be given wide credence by the press and lay public. This view's virtue is that it appears to account for 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 to relax several longstanding constraints on the activities and business decisions thrifts could undertake. The subtext supporting this portrayal mischaracterizes thrift institution managers as deserving but underequipped souls who need government help to make appropriate decisions about the explicit interest rates they can afford to pay on deposits and who cannot be expected to exercise prudently the wide range of consumer lending, real estate development, and

Table 1. Number of GAAP insolvencies and insolvency resolutions at FSLIC-insured institutions, 1975 to 1988. An insolvency resolution is defined as a regulator-induced cessation of autonomous operations. It includes liquidations, supervisory mergers or acquisitions, and loose forms of conservatorship such as the FHLBB's Phoenix and Management Consignment Program. A GAAP-insolvent institution is defined as an institution whose net worth is less than or equal to zero under GAAP. Information for 1975 to 1979 and 1988 was supplied by James Barth, chief economist, Office of Thrift Supervision, Department of the Treasury; 1980 to 1988 (June) information is from Barth and Bradley (*4*), whose figures differ slightly from and are presumably more exact than older sources.

Year	Insolvencies resolved by FSLIC	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 (June)	130	496
1988	233	364

other asset powers established by the financial reform acts of 1980 (*6*) and 1982 (*7*).

This diagnosis emphasizes that widespread insolvency followed in the wake of the allegedly decisive regulatory mistake of letting thrifts compete more closely with banks. The implied solution has three parts: pay FSLIC's bill, restrict thrift activities as before, and reintroduce ceilings of some kind on thrift deposit rates. However, a strategy of restrictive reregulation of thrifts' permissible activities cannot be the solution because, on a properly appraised economic basis, widespread industry insolvencies actually developed in the 1970s. The inevitable delay between economic insolvency and its realization in GAAP records means that the insolvencies predated the policy measures that the deregulation theory supposes to have caused them. Removing deposit rate ceilings and expanding thrift asset powers did not bring zombie thrifts to their current sad state, and these policies are not helping to keep them there. Moreover, reversing either or both of these disputed deregulation measures would inhibit the future flow of private capital into the thrift industry.

Long before Congress decided to remove deposit rate ceilings in the 1980 legislation (*6*), 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 (*6*) and giving thrifts broader investment powers (*6, 7*) did do was to increase the capacity of zombie firms to undertake risky financial plays in a hurry. But the basic policy mistake lay in helping a great number of decapitalized firms to operate as zombies in an environment that was rich in opportunities to raise and lose funds in a hurry.

Rough measures of the GAAP-neglected impact on the thrift industry of interest-induced losses have been constructed on an appraisal basis for 1971 through 1983 by Kane (*8*) and with somewhat greater precision for 1980 through 1984 by Brumbaugh (*9*). 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 have been 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 1982. 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 that market value of their assets and liabilities became more complex, too. A second problem is that these calculations combine healthy and diseased firms. FSLIC's losses in zombie thrifts cannot strictly be offset by the positive capital positions recorded for healthy competitors.

Table 2. Estimates by Kane (*8*, p. 102) and Brumbaugh (*9*, p. 50) of the ratio of the appraised market value of net worth to total assets at FSLIC-insured thrifts, 1970 to 1984.

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

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

These two factors coalesce in that many of the deeply insolvent thrifts whose interest-induced 1979 to 1982 losses had been neglected 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.

The roots of the industry's wave of insolvencies lie not in the abuse of new powers but in two other circumstances: (i) declines that operative accounting schemes ignored in the market value of low-interest-rate mortgages acquired under pre-1980 rules and (ii) aggressive post-1980 real estate plays. With appropriate contract adjustments, a zombie could have undertaken most post-1980 real estate investments as high interest rate mortgage loans under pre-1980 rules had these rules remained in force. Contract interest would not be paid on such a loan unless the underlying real estate project prospers and 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.

The Bush plan embodies the excessive deregulation theory in its definition of what constitutes a "qualified thrift" (*1*). 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 has 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. Thrifts have faced a declining earnings spread in home mortgage lending during recent years (Table 3) (*10*). The downward trend in this spread can be traced to unsustainably aggressive bidding for deposits and mortgage loans by zombie thrift institutions, to growing competition for mortgage-lending opportunities and depositor savings from government-sponsored mortgage corporations and from members of the securities industry, and to 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 lines of business that have proved profitable for them will increase the benefits of relocating these lines in related corporate entities, of selling out to commercial banks, and of converting to other charter forms. Similarly, the investors who must provide the sizable pool of private capital that is needed to replace the unbudgeted government capital that implicitly finances much of the assets lodged in zombie thrifts today may prefer to convert the franchises acquired into bank branches or holding company affiliates as quickly as applicable laws permit.

The Incentive-Breakdown Theory

Although these unsatisfactory theories underlie the solution envisaged by President Bush, the industry breakdown can be traced primarily to governmental failure to force troubled institutions to recapitalize themselves before stockholder or mutual capital was exhausted (*2, 4, 8, 9, 11*). 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 (*12*). 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 and to hide the unbudgeted, but burgeoning, costs to taxpayers of validating the promises FSLIC continued to make to depositors at insolvent thrifts.

The zombie population reached its present 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 because 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. 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 by accounting gimmicks 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 had additional opportunities to borrow in collateralized forms 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 recently held U.S. regulators and lawmakers to blame for the high-risk loans that ruined Flushing Federal S&L in New York (*13*). His finding cited testimony that Federal Home Loan Bank Board (FHLBB) 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 (*13*, p. 741): "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 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 (*13*, p. 741) "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 flower once an insolvent firm's speculative bets begin to go sour, fraud and mismanagement by managers of insured institutions were neither the dominant nor the decisive factors feeding FSLIC's

Table 3. Average explicit earnings spread on new mortgage lending at FSLIC-insured institutions, expressed in percentage per annum. Columns 2 and 3 are taken from (*10*, pp. 30 and 24). Savings deposits are defined to include all types of savings; by 1988, this includes passbook, negotiable order of withdrawal (NOW) and super NOW, money market, and fixed-maturity accounts. Column 4 is the algebraic difference between corresponding entries in columns 2 and 3. Column 5 is calculated as the ratio of operating expense to year-end total assets, using figures given in (*10*, pp. 49 and 52). The last column reports the difference between the entries in columns 4 and 5.

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	7.16†	2.02	1.77†	0.25

*New procedures for compiling this time series were adopted from 1973 on. †Preliminary figure.

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 insurance 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 (*14*). Although this strategy protected the reputations of top regulators and members of congressional banking committees, it broke faith with taxpayers (*15*). Among the strongest examples of faith-breaking behavior are former House Speaker Jim Wright's well-publicized efforts to prevent the closure of a series of deeply insolvent Texas thrifts (*16*) and the success that the giant Lincoln Savings and Loan met in persuading five senators to lobby the FHLBB to take the Federal Home Loan Bank of San Francisco (which was moving to close it down) off its case (*2*). In increasing penalties for fraud and fiduciary violations by managers of federally insured entities, the Bush plan (*1*) exempted federal regulators who do not reserve for readily appraisable losses and who use "smoke and mirrors" accounting to cover up inadequacies in their regulatory performance.

The claim by officials of having been blindsided by the expanding costs of deposit insurance subsidies to risk taking testifies to their insensitivity to the need to analyze the long-run consequences of the policies they follow. This insensitivity suggests a systematic anesthetization of official consciences to the moral dimensions of the trade-offs 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.

The Bush Plan Revisited

The Bush-initiated FIRREA (*1*) focuses 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 fails to establish full accountability for the insolvency resolution process. Objective procedures must be developed and promulgated 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 are terrifying.

FIRREA embodies four principal elements (*1*):

1) A proposed estimate of the cost of resolving existing insolvencies at FSLIC-insured thrifts.

2) A financial mechanism for funding this cost from two sources: increased deposit insurance premiums for thrifts and banks and general tax revenues.

3) A commitment to impose banklike 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 over FIRREA provides additional confirmation of the incentive-breakdown theory. Although congressional committees reworked all four aspects of the Bush plan, prolonged controversy attended three issues that centered on minimizing congressional accountability. These issues involved stringency of thrift capital requirements, mechanisms for overseeing decisions made by the FDIC, and consideration of whether to borrow the funds to resolve thrift insolvencies on-budget through the U.S. Treasury or off-budget through an unnecessarily expensive special financing corporation. 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 making themselves clearly accountable 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 it substantially constrains the FDIC's ability to prevent future insolvencies and to establish that a troubled thrift is legally insolvent. The FIRREA prohibits the FDIC from imposing banklike 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 has put the FSLIC mess behind us, lobbyists and politicians disingenuously want taxpayers to presume that the FDIC can readily accomplish two amazing feats: (i) raising the capital of weak thrifts to a banklike percentage of assets quickly enough to prevent the emergence of a new generation of zombies and (ii) 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 is its most disturbing feature. Nothing in the plan confronts 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 would continue to be triggered by cosmetically softened accounting measures of the value of enterprise-contributed capital rather than its market value. Moreover, the legislation fails 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 strategems. Underestimating and misconceiving the problem pleased some members of Congress by shaving statistical projections of the insolvency resolution expenditures that must 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, commercial 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 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.

The result is that taxpayer losses remain uncapped and deposit insurance personnel are left working unnecessarily close to the edge of an accounting and bureaucratic disaster that could unravel public and especially foreign confidence in U.S. deposit institutions.

A Better Plan

The roots of the deposit insurance mess lie in long-standing defects in political and bureaucratic accountability. The overriding problem is that covering up troublesome evidence and engaging in regulatory forbearance is, at least for strictly self-interested 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 trade-off, political and 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. To forestall cover-ups, deposit insurers and their clients must be required to estimate the long-run costs of regulatory forbearances honestly and in a timely fashion. 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 forbearance for constituent firms to their ethics and banking committees for examination and potential sanction. Finally, these committees should hold regular hearings during which outside experts are asked to assess compliance with these new requirements by regulators and politicians.

This informational framework should apply to banks as well as to thrifts. A threshold for reorganizing an insured institution's affairs should be established at a positive rather than negative level of net worth (*17*). Ideally, net worth itself should be defined in terms of the market value of an institution's net assets (that is, assets minus liabilities). Although a number of transitional difficulties need to be addressed, workable procedures can be agreed on for marking to market on-balance sheet and off-balance sheet items at frequent intervals to provide regular appraisals of the economic net worth of every federally insured enterprise and of the deposit insurance funds that stand behind them.

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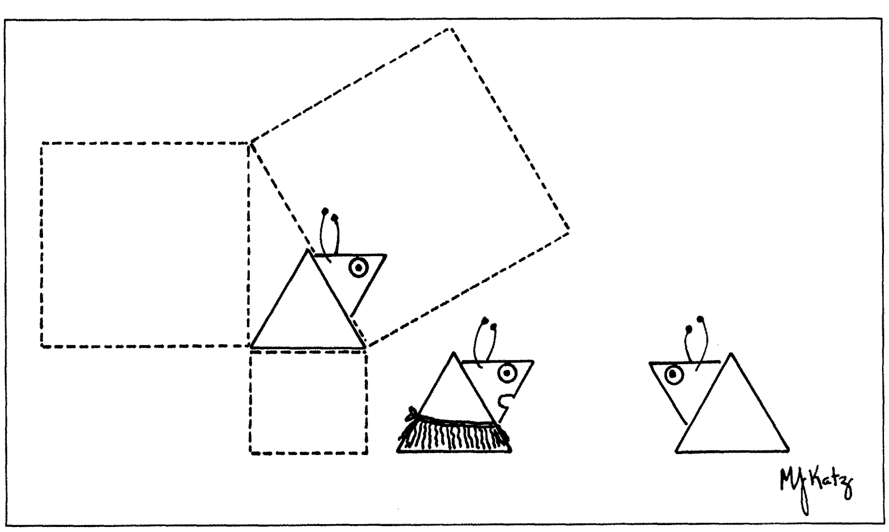
12. A Ponzi scheme is an enterprise that survives simply by expanding its liabilities at a faster rate than its interest and dividend payments expand. The enterprise pays interest and dividends not out of economic earnings but from new funds collected from lenders and investors.
13. United States *v.* Cardascia, U.S. District Court, Eastern District of New York, docket No. 88-CR-626 (23 February 1989).
14. Evidence supporting this hypothesis is provided by two former FHLBB chairmen [in *The Future of the Thrift Industry*, Proceedings of the Fourteenth Annual Conference of the Federal Home Loan Bank of San Francisco, San Francisco, CA, 8 and 9 December 1988 (Federal Home Loan Bank of San Francisco, San Francisco, 1989), pp. 61–68]. One acknowledges that his estimates of "the depth of the thrift problem at that time [1982] were about $100 billion" (p. 62), that "Congress played a major role in forbearance" (p. 63), and that "there was a consensus of those in power that constrained the parameters within which the regulator could operate" (p. 65).
15. This point is developed in detail in (*2*).
16. U.S. Congress. House. Office of Special Outside Counsel, Committee on Standards of Official Conduct. *Report of the Special Outside Counsel in the Matter of Speaker James C. Wright, Jr.*, 101st Cong., 1st sess., 21 February 1989.
17. G. J. Benston and G. G. Kaufman, *Monogr. Ser. Financ. Econ. 1988-1* (1988); K. Scott, *Bus. Lawyer* **44**, 907 (May 1989); "An outline of a program for deposit insurance and regulatory reform," statement No. 41 (Shadow Financial Regulatory Committee, Chicago, 13 February 1989).



"We're getting ready for a costume party. Gerald is going as the Pythagorean theorem."