Short-Run Financial Solutions for Troubled Thrift Institutions

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I. Introduction

Currently, a large number of thrift institutions are facing rather severe immediate financial pressures. The strain originated, for the most part, from the historical policy of acquiring long-term fixed rate mortgages at the same time the institutions were issuing short-term deposits. Subsequent increases in the general level of interest rates and an increased capability for individual savers to directly tap alternative money market instruments have resulted in low or negative earnings, deposit outflows, and a significant reduction in the market value of mortgage loans held in institutional portfolios. The situation has been exacerbated in the late 1970s and early in this decade by a sizable downward tilt to the yield curve. Indeed, the marginal cost of funds to some institutions reached 20 percent in 1981.

In spite of the current situation, many of these institutions operate in market areas and have managerial skills that seem to offer rather bright prospects for the future. While some of the troubled institutions are not likely to generate a sufficient level of profitable business activity to assure their long-run viability, others, in stable or growing market areas, would normally be expected to earn profits sufficient to appropriately compensate for the financial capital invested in them. An important economic issue then is to determine *if* and *how* policies ought to be constructed to permit institutions with long-run prospects for success to survive the short-run pressure of insolvency.

While one might argue that managerial actions ought to reap the rewards of their past actions, there are at least three arguments for contemplating some regulatory adjustment or form of aid to the industry. First, regulatory policy in the 1950s and 60s inhibited any attempt on the part of institutions to diversify into asset and liability services that would have helped to insulate the institutions from interest rate fluctuations.[1]

Second, the increase in interest rates that has been a major cause of the pressure, was induced, in large part, by government fiscal and/or monetary policies.

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[1]Explicit constraints on services the institution could and could not offer, tax incentives for investments in mortgages, and deposit rate regulation helped to create the specialized institutions with which we are now concerned.

Third, there are some potentially heavy "bankruptcy costs" of allowing short-run failure when there is an expectation of long-run viability. There are costs to chartering new institutions as well as costs of liquidating the failing firm. These costs do not always fall on those that have agreed to bear the risks (stockholders, bondholders, and managers). The public participates directly if there is an effect on the services offered in this limited entry industry, and of course, the public participates indirectly in sharing these costs through FDIC and FSLIC insurance of accounts. Moreover, some have argued that the most significant factor in the bankruptcy of many institutions would be the social costs incurred if, as a result of the failures, the public becomes less willing to commit funds to thrifts. Simply, it is not clear that either social or private costs would be minimized by bankruptcy and forced reorganization through the liquidation of these institutions.

This paper examines the potential success as well as the costs and benefits of a variety of plans that have been offered to permit thrifts to bridge the gap between short-run financial stringency and long-run profitability. In doing so, we address in detail the question of insolvency and bankruptcy, explore for conditions within which it is optimal for insolvent firms to remain in business, and point out the nature of possible wealth (or "me-first" type) transfers associated with proposed solutions. Importantly, the basis for our conceptual development and evaluation of alternative strategies rests primarily on the third argument, the cost-benefit rationale for assistance. Our approach does not depend on the argument that the thrifts' current position is the fault of someone else.

II. Insolvency and Bankruptcy: The Theory

The Claims

The typical thrift institution has three classes of claimants: equity holders, insured depositors, and uninsured creditors. These groups follow a rather complex rule for sharing both the risk inherent in thrift operations and the proceeds from their operations. Equity, of course, is the residual claimant. Insured and uninsured depositors share a senior claim that typically requires a proportional payoff to both groups. The complexity arises because of the insurance of accounts that effectively shifts the insured depositors' risk position to the FDIC or FSLIC (to the extent that the insurance agency is able to meet these depositor claims).[2]

[2]Precisely what would be the claimant position of the insured depositor in the event of bankruptcy of the insurance agency is not clear. This is not an academic question, since at least some types of risk in this industry cannot effectively be insured against through the pooling of funds concept of insurance that is currently followed by the FDIC and FSLIC.

However, because the FDIC-FSLIC has regulatory powers and responsibilities, it is placed in a different position than that of the uninsured depositors or other uninsured creditors.[3] Thus, while the claims of the insurer and the uninsured depositor have equal seniority, the ability of the insurer to take actions that may affect the uninsured depositors' position is an important aspect that differentiates these two creditor groups.[4] Viewed from the perspective of the institution's management, the purchase of deposit insurance, while entitling it to issue almost risk-free deposits at low rates, also forces the institution to operate under the regulatory umbrella managed by the insurance agencies. In so doing, it affects the capital market's perception of the risk of both insured and uninsured deposit accounts. Moreover, the regulatory framework provides a greater degree of control over the institution than would ordinarily be present in any noncontrolled debtor-credit arrangement. The net result is an arrangement of claimants that differs not in terms of the payoff per dollar of liquidated assets, but in terms of the actions that may be taken to affect the size of the pool of funds to be shared. Since the pool itself can be influenced, the value of the claim of each creditor group is affected.[5]

In order to specify the claimants' position in bankruptcy it is necessary to specify three stages or states for the troubled institution. These states we term insolvency, bankruptcy, and continuance. Insolvency refers to the situation whereby the institution has violated *either* a contractual obligation (e.g., not met the required payment of principal or interest on some deposits) *or* a condition emanating from the regulatory policy enforced by the insuring agency that would provide the creditor with the ability to force the firm into a state of bankruptcy. The primary FSLIC regulation now in force that provides the insurance agency with the power to force bankruptcy is the requirement that thrifts maintain book net worth above 4 percent of deposits. The agency has substantial latitude for action, however, so the conditions that define insolvency are in part dependent on agency enforcement procedures regarding all rules and regulations.

Bankruptcy is that state that leads to the liquidation of the firm including the sale of assets and liabilities. It is an absorbing state in the sense that

[3]In the analysis that follows we do not discriminate between uninsured depositors and other uninsured senior creditors. In some cases there are subordinated creditors. Any real differences that may exist between these groups could be incorporated, though its relevance to identifying optimal insurance agency policies is of secondary importance. We refer to all uninsured claimants as "uninsured depositors." Since in a failing institution the insurance agency stands in the place of the insured depositor, we refer to the combined FDIC-FSLIC-insured depositor claim as "FDIC-FSLIC."

[4]In practice, there is some recognition by the FDIC, at least, of its effect on uninsured account holders. In the resolution of both the Bank of Commonwealth (1972) and First Pennsylvania (1980) cases, the size and nature of uninsured creditor claims seem to have been a factor in arriving at a solution. See Paul Horvitz "Insurance Agency Assistance to Failing Banks and Thrift Institutions," testimony before House Subcommittee of Commerce, Consumer and Monetary Affairs, July 16, 1981.

[5]There seems to be no explicit policy or regulation that discloses the limits of FDIC-FSLIC actions. This ambiguity undoubtedly influences the perception of uninsured deposit risk, thereby influencing equilibrium return as well as the extent to which uninsured deposits are demanded.

the institution does not continue to exist in the form in which it has operated previously. Assets are sold, stockholder value is reduced to zero, and all claims of depositors are resolved.

Continuance refers to the state wherein the firm continues operations. Depositors' claims are not resolved, but are left to the future course of economic events. Equity value is not reduced to zero though, as we will see, the equity value of an insolvent firm may be substantially reduced in correcting the insolvent situation. In practice, the differences between bankruptcy and continuance can be ambiguous. The forced merger of an insolvent firm by the FSLIC at a price that reflects the market value of assets and deposits seems to lie somewhere between the two categories. Nevertheless, the categorization will prove convenient for judging the viability of actions that may be taken by the insurance agencies or others to treat the current problem. Obviously, from a state of insolvency the firm can move either to bankruptcy or to continuance.

To specify the claims in these three states, we adopt the following definitions:[6]

A_L = Liquidation value of the assets (including mortgages, cash, buildings, and other assets)

A_T = Liquidation value of the thrift charter and branch system

P_c = Present value of expected future long-run profits in continuance

B_c = Value of FSLIC-FDIC claim in continuance

E_c = Value of equity claim in continuance[7]

D_c = Value of uninsured depositor claim in continuance

B_b = Value of FSLIC-FDIC claim in bankruptcy

D_b = Value of uninsured depositor claim in bankruptcy

A_{BV} = Book value of the assets

The value of the institution in continuance, P_c, will back claims of the three groups and is simply the sum of the individual claimants' values, or

$$P_c = B_c + D_c + E_c.$$

[6]This analysis is based on a model developed by Jeremy Bulow and John B. Shoven. See "The Bankruptcy Decision," *The Bell Journal of Economics*, Autumn 1978.

[7]At this juncture it is not important to discriminate between stockholder-owned and mutual thrift institutions. The value of an equity claim can be present regardless of whether that claim can be extracted from the firm in the form of dividends. The difference may be important in measuring the costs of alternative insurance agency policies, but is not important in defining relative debt and equity positions.

The liquidation value resulting from the firm entering the bankruptcy state is given by,

$$A_L + A_T = B_b + D_b,$$

or, in other words, the claims that are made by the FDIC-FSLIC and the uninsured depositors in the event of bankruptcy will be equal to the liquidation value of assets, plus the value that may be secured by the sale of the firm's charter and branch system. Regulatory policy may prohibit certain actions in liquidation (e.g., it may not be possible to sell the charter and branch system rights causing A_T to be zero), but within the regulations, liquidations would follow a course that would lead to the maximum obtainable value for liquidated assets.

The firm's book value is,

$$A_{BV} = B_{BV} + D_{BV} + E_{BV}.$$

In our forthcoming analysis, book values, not surprisingly, will play no role in the evaluation of alternatives *except to the extent that book value concepts are imbedded in regulations of the insurance agency that define insolvency*. Thus, while no economic decisions of the claimants will rest on the evaluation of book values, the calculation does carry some importance in that its value prescribes required actions of the agency that emanate from statutory or regulatory policy.

In fact, the current situation in which liquidation values are well below book values, has put the insurance agency in the position of being concerned with a firm's solvency when, according to FDIC-FSLIC book value rules, insolvency cannot be declared. This may prevent the insurance agency from taking early corrective action to protect its claim even when it is in the best interests of the agency to do so. There are some other regulatory policies they can fall back on, such as close supervision, but insolvency cannot be used as the force to permit the agency to protect creditor positions.

The Claimants' Decisions

The insuring agency's actions regarding insolvent firms will depend on the relationship between liquidation value and its value as a going concern. For the insolvent firm whose market value, P_c, falls short of its liquidation value,

$$(1) \qquad [P_c = B_c + D_c + E_c] < [A_c + A_T = B_b + D_b],$$

social and private costs will be minimized by a forced liquidation of the firm. The liquidation of such firms has been performed by the insurance agencies in the past. However, if market value exceeds liquidation value,

$$(2) \qquad [P_c = B_c + D_c + E_c] > [A_L + A_T = B_b + D_b]$$

then bankruptcy will not be the optimal course of action to be adopted by the insurer. It is important to remember that bankruptcy costs lead to this latter possibility.

While the above inequalities are sufficient to indicate the cases in which aid to an institution can be justified, they do not consider the incentives that may be held individually by each claimant group. The maximum incentive for each group would occur when that group takes over all claims, P_c, and incurs obligations represented by the other groups' claims in continuance, less the opportunity cost of the claim received if bankruptcy occurs. Thus, the maximum potential benefit to each group in continuance is:

(3)

EQUITY	$P_c - D_c - B_c = E_c$
INSURANCE AGENCY	$P_c - D_c - B_b$
UNINSURED CREDITORS	$P_c - B_c - D_b$

For example, the uninsured depositors would be willing to invest up to the amount indicated if they were able to take over all future claims valued at P_c. The amount represents the value they would receive as sole owners of the firm less the opportunity cost of their claim in bankruptcy less the claim to pay off the insured depositors at the set amount B_c (which may be less than, equal to, or greater than the par value of the insured deposits).[8]

Similarly, the insurance agency has the incentive to invest up to the value of the firm less the claim paid to the uninsured creditors less the opportunity cost of their claim in bankruptcy. Equity holders, of course, would be willing to invest up to E_c.

What these relationships show is that it may be beneficial for individual claimant groups to engage in actions to prevent bankruptcy of some insolvent firms. They also serve to point out that private groups (other than the insurance agency) may have an *incentive* that is not much different than the public sector incentive to insure continued operations. Whether or not the costs of moving the firm out of insolvency to continuance are less for the uninsured creditors or equity holders than they are for the insurance agency is an issue that is considered when we evaluate alternative solutions in the following sections.

[8]These amounts represent the properly discounted present value of future cash flows. They are not monetary future amounts. The willingness to commit these funds implies that returns from further investment in the institution supply higher returns than could be achieved elsewhere. If this were not true, the amounts indicated in the text would be invested elsewhere earning the same return. There would be no particular incentive for investment in *this* thrift. The uniquely large returns that are sufficient to persuade these groups to invest in this insolvent institution are justified, in our analysis, by the presence of large bankruptcy costs that result in part from limitations on entry. For these reasons, the investment of these funds constitutes an opportunity offering excess returns (up to the limit specified). But this amounts to nothing more than an assumption that the institution may be worth more alive than dead, even though its current liquidation value falls short of its current (book) obligations.

For each of the claimants to agree to any plan for the firm to move to the continuance state the following quantities must exceed zero,

(4)	EQUITY	$E_c > 0$
	INSURANCE AGENCY	$B_c - B_b > 0$
	UNINSURED CREDITORS	$D_c - D_b > 0$

Simply, for the creditor group to approve of the continuance of the firm, its claim in continuance must exceed its claim in bankruptcy. These are minimum conditions that must exist to justify continuance as viewed by each creditor group. Thus, while it may appear that equation (2) is the only condition that must be met to justify continuance, in the proposed resolution leading to continuance, each group will assess its own absolute position, indicated in (4). The maximum possible benefit is given by (3).

In general, it is not true that if the condition set forth in (2) is satisfied then (4) will be satisfied. There are two reasons for this that relate to the position of uninsured creditors vis-à-vis the insurance agency, and to "me-first" transfers of wealth. Both are moral hazard type problems.

Influence of the Insurance Agency on Uninsured Creditor Claims. The sharing rule employed to allocate claims between the insurance agency and the uninsured creditors is confounded by the influence of the agency's regulatory and statutory power. Whereas the insurance agency and the uninsured creditors both have an equal claim on the assets of the organization in the event of liquidation, the regulatory and statutory powers that are held by the insurance agency allow it to take actions that directly affect the well-being of the uninsured creditors' claims. In other words, the action that can be taken by the insurance agency, while not affecting the proportionate distribution of claims in the event of liquidation, may have an effect upon the amount of those claims, B_b, through their effect on the timing or method of liquidation. Obviously, market perceptions of how the insurance agency is likely to act in the case of liquidation will affect the *ex ante* ability of thrifts in or approaching insolvency to obtain deposits.

"Me-First" Transfers. The second issue that requires an evaluation of the condition contained in (4) pertains to the effect of the resolution on the individual claims in continuance (E_c, D_c, B_c). In particular, it is possible for a solution to be structured so that *either* the insurance agency or the uninsured creditors have claims in continuance that are less than their claim in bankruptcy, even when (2) is satisfied. This possibility occurs as a result of the inherently higher level of risk of the claims in continuance versus those in bankruptcy. Liquidation *will* pay off B_b and D_b to the claimants. However, B_c and D_c (and E_c) are values that represent expected discounted future claims where the ultimate resolution may be less than or more than those expected at the time continuance is adopted. If the solution that is adopted provides for very low payoffs to the insurance agency, if future profits are low, and only moderately high payoffs if future profits are very

high, then it is possible for B_c to be below B_b and for bankruptcy to be preferred by the agency (though clearly not preferred by equity or possibly uninsured creditors who stand to gain from the low value of B_c).[9] Or, if the solution provides low payoffs to uninsured creditors if future profits are low, without allowing them a commensurate share in high profits if they are generated, then D_c will be low. In this case the "me-first" wealth transfer would be to either the agency or the equity holders.[10]

The claims in continuance, D_c and B_c, in other words, depend on the distribution of possible outcomes of the firm's future operations. The incentive for the FDIC-FSLIC is to construct a set of claims with continu-

[9]For example, a thrift institution that has a high book value and low liquidation value could take actions to sell off low risk assets (cash or short-term loans and securities) to buy high risk assets (long-term mortgages, construction loans, real estate management subsidiaries). If purchased at equilibrium rates, the equity position is enhanced (a "me-first" transfer) since they would capture the top end of the distribution of returns if the risky investment were successful. Creditor positions would be made worse off, since creditors would receive the low end of the distribution if the investments turned out poorly, yet would receive only a limited return if they turned out well.

[10]The incentive structure existing among the claimants can be clarified with an example constructed, for simplicity, in a risk neutral world, where

$$P_c = 110 = E_c + B_c + D_c$$
$$A_L = 90$$
$$B_{BV} = 65$$
$$D_{BV} = 30$$

The values in continuance represent the claims if the firm continues operations and is valued at 110. The values in bankruptcy pay off at the rate of (90/95) so,

$$B_b = (65)(90/95) = 61.58$$
$$D_b = (30)(90/95) = 28.42.$$

Suppose the firm continues in operation, being saved from insolvency by a 5 commitment of funds from the insurance agency for a total creditor position of 70. In return, the insurance agency shares equally in all amounts generated in excess of the fixed claims of the uninsured (30) and insured depositors (70). The risks are such that there are two equally probable outcomes after the firm is saved from bankruptcy; netting 75 and 145 respectfully. The payoffs for each claimant given the structure of the solution are:

			Expected Value
Outcome	**75**	**145**	**110.00**
D_c	$(30)(75/100) = 22.5$	30	26.25
B_c	$(70)(75/100) = 52.5$	$70 + [145 - (70 + 30)].5 = 92.50$	72.5
E_c	0	$[145 - (70 + 30)].5 = 22.50$	11.25

A comparison of expected values of wealth positions with continuance and values with liquidation suggests that the ownership of the firm and the insurance agency have an incentive to see the firm continue. The uninsured depositors do not have this incentive, since D_b is 28.42 which exceeds D_c of 26.25. A change in the rule for sharing the proceeds from continuance would markedly alter the incentives. If the FSLIC-FDIC received only a maximum return equal to their deposits (70), then the value of B_c would be

$$B_c = .5\,(52.5) + .5\,(70) = 61.25,$$

which is less than their bankruptcy claim of 61.58. Clearly the nature of the insurer's incentives to aid an insolvent institution depends on the structure of its participation in the continuance.

ance that assures that B_c exceeds B_b and that D_c exceeds D_b, and thus prevents possibly large "me-first" transfers. This could be done by devising a sharing rule for proceeds in continuance that either (i) constrains the firm's risk position, (ii) increases the fixed obligation of the firm to the insurer and uninsured depositors, or (iii) allows participation of the insurer or uninsured depositors in the residual profits generated (i.e., an ownership share).

It seems particularly important to establish solutions that prevent "me-first" incentive transfers of wealth to equity holders that are created from these creditor relationships. This is all the more important because the FDIC-FSLIC solution is not likely to be one that will be disciplined by market forces (either in the sense of the market establishing how much of the firm the creditors should receive or in terms of restrictions that management and equity holders would place on themselves to make the solution least costly to them).

It is important, moreover, to understand the position of the uninsured depositors (regardless of the quantity of uninsured deposits now held at thrifts) and other creditors. Perception of less than adequate "me-first" protection as a possible outcome from FDIC-FSLIC solutions would result in a diminution of uninsured deposit inflows or an increase in deposit outflows for all short-term uninsured deposits. Longer-term creditors are in a less enviable position, though, since their claim cannot be called due instantaneously—even if the FSLIC declares the firm insolvent (by the 4 percent rule). Also, lack of protection of other creditors may deprive the thrifts of the ability to secure trade credit or bonded indebtedness. The insurance agency must worry about these events since they would affect book net worth and might precipitate insolvency. In addition, the withdrawal of funds by uninsured depositors at par serves to shift the loss faced by the uninsured (par value less the claim in bankruptcy) to the insurer.

On the other hand, there are some reasons to argue that private incentives for continuance may exceed those of the insurance agency. These relate to the ability of private versus insurance agency abilities to absorb the increased risk that is created out of continuance. In particular, some of the increased variance of outcomes with continuance are diversifiable risks for the private sector, and are, therefore, risks for which the private sector would not demand compensation (e.g., a larger share of the firm). The portfolio position of the insurance agencies is much less well diversified. An investment of additional funds in the thrift industry, and an acceptance of added thrift obligations will proportionally increase the agency's risk exposure. Little of it will be diversified away because of the concentration of the portfolios.[11]

[11]This appears to be an argument in favor of having the insurance obligations of the FDIC and FSLIC be made an explicit guarantee of the U.S. government. At least this would be true if there were costs involved in the failure of the insurance fund to meet its insurance obligations.

Summary

A number of conclusions can be drawn that are central to our analysis of proposed specific solutions.

1. The government, through the FDIC-FSLIC, has a definite, direct financial stake in the resolution of current and future expected thrift insolvencies.
2. There are incentives for private as well as public solutions to the current situation.
3. The investment methods and sharing rules developed to allow continuance of an insolvent institution will directly affect the relative wealth positions of equityholders, the insurer, and the uninsured creditors.
4. The future actions of uninsured depositors and creditors, which can relieve or aggravate a potential insolvency, will be influenced by perceptions created out of the methods adopted to resolve insolvencies.

III. Book Value and Insolvency: Practical Concern of the Insurer

While many thrift institutions currently find the liquidation or market value of their assets to be below the book value of creditor claims, there is little pressure from the existing regulatory structure to constrain their actions. Since an interagency agreement in the 1930s, banking institutions are not closed or subjected to disciplinary actions by supervisors because of this condition (though they may be harassed to some extent by examiners). The agreement recognizes that an institution with a positive value based on expectations of future operations should not be required to close simply because the liquidation value, A_L or A_L plus A_T, is less than total creditor claims. Only as the *book value* of assets approaches the *book value* of liabilities under current supervisory legislation and regulation can action be taken. In particular, regulations are triggered when book value declines to specified levels, according to the following regulations:

1. savings and loan associations must maintain net worth equal to 4 percent of deposits;
2. New York mutual savings banks cannot pay interest on deposits when net worth is less than 5 percent of deposits;
3. banks cannot accept deposits when net worth is negative.

Book and liquidation values are related, of course, since operations of the firm may "reveal" on the books the true worth of assets. In particular, the book realization of liquidation values, and thus insolvency can occur as a result of the forced liquidation of assets necessitated by either negative earnings or deposit outflows.

Deposit outflows may arise because of creditor qualms about the safety or operating viability of the institution (as in the Greenwich Savings Bank

case), or, more commonly, because depositors see opportunities for higher returns elsewhere. If the deposit outflow leads to the need to sell assets, book value of the institution declines.

The book value position can also decline if earning assets yield less than the current cost of funds. Operating losses will ultimately be charged to surplus, thus bringing the firm closer to insolvency.

But if liquidation values are not a basis for closing an institution, it is not logical to close an institution because of a negative net book value, since book value measures are not at all related to the criteria justifying either continuance or bankruptcy. Unfortunately, as we have noted, a number of real economic events are triggered by book value considerations. Laws and regulations that *require* actions when arbitrary ratios are violated are inappropriate. Where they exist, the institutions and supervisory agencies should make use of whatever creative accounting techniques are available to defer recognition of losses. In this respect, the recent decision of the FHLBB to allow deferral of losses on the sale of mortgages is a correct one.

The decline in net book value can come about, as we have noted, from operating losses or from deposit outflows. Our evaluation of alternative solutions attempts to deal directly with the earnings and liquidity problems. Obviously, earnings and liquidity are not independent issues, and solutions to one problem may exacerbate the other. Many solutions to the liquidity problem may have a negative impact on earnings. The institution that meets a liquidity problem by selling off assets with book values near market is probably selling its higher yielding assets, and the institution that borrows to meet a deposit outflow is probably paying high marginal rates, both of which affect earnings. In principle, in the absence of deposit rate ceilings, a thrift could attract sufficient insured deposits to offset any deposit outflow by paying a high rate, but the effect on earnings may be fatal. On the other hand, most solutions to the earnings problem will not adversely affect the liquidity situation.

IV. The Choice: Insolvency to Liquidation

Our theoretical statements have suggested the nature of the FDIC-FSLIC stake in the continued operation of troubled thrift institutions. While one can debate whether broad public policy considerations warrant assistance to an ailing Lockheed or Chrysler, the federal government's stake in ailing savings institutions requires that, at the very least, consideration must be given to the ways in which the insurance obligation can be met at the least possible cost (i.e., the implication of $B_c > B_b$).

If an insured institution is placed in bankruptcy, the insurance agency has an obligation to see that insured depositors have their funds made available to them as soon as possible. The FDIC or FSLIC can do this by paying out cash to the insured depositors and attempting to recover as much of the outlay as possible by liquidation of the assets of the failed institution. Alternatively, the agency can try to arrange a transaction whereby an existing healthy institution (or newly organized one) will purchase the assets and assume the liabilities of the failed institution. The

price that an acquiring institution will offer reflects the location(s) and the goodwill of the insolvent institution, A_T, as well as the value of its assets and liabilities, A_L and creditor claims. The price will include a premium over book value if the liquidation value is high enough. Such a "bankruptcy" solution may be optimal [as in equation (1)], and may provide for full protection to all creditors of the failed institution, not just the insured depositors. While the purchase and assumption (P & A) is a form of liquidation, it does represent a means of capturing the value of A_T, which may be lost in a straight liquidation of assets.

In fact, the benefits of a merger, rather than a payoff of insured deposits, are such that liquidation is only used very rarely by the FSLIC, and is used by the FDIC only in the case of relatively small banks. The fact that the FDIC has used the payoff route more frequently than the FSLIC is not due to differences in their respective laws (though there are some modest differences), but rather to differences in the nature of the institutions handled. Commercial banks are all stock institutions, while most of the savings and loan associations insured by the FSLIC are mutuals. Most commercial banks have some significant volume of uninsured deposits and other uninsured liabilities. Nearly all of the liabilities of savings and loans until recently have been insured deposits. In a deposit payoff, uninsured depositors share the loss with the insurance agency. If there are no uninsured deposits, any positive premium makes the merger route cheaper than a payoff, but that is not necessarily the case when there are uninsured depositors. Further, the willingness of an acquiring institution to pay a premium depends on its ability to hold on to the business acquired, generally by converting the acquired institution into a branch. In some states, the branching laws do not allow that option. This is frequently a problem for the FDIC (Texas, for example, is a unit banking state with more than its fair share of bank failures), but is not for the FSLIC. Moreover, as we have seen recently, the lack of a suitable merger partner within the same state as the failing institution is not a fatal barrier to the FSLIC though it would be to the FDIC.

If the value in continuance is less than the liquidation value, then the practical choice is between formal liquidation or an informal liquidation through a forced merger. Merger in this sense is a form of liquidation in that the institution no longer exists as a separate competitive entity. A premium that results in a price greater than A_L (reflecting A_T) is not sufficient justification for allowing or promoting a merger if $P_c > A_L + A_T$. In such a case, means of continued operation should be explored.

V. Insolvency to Continuance: The Possible Solutions

Each solution considered in the paper attempts to address, and where possible measure, four characteristics of the solution. First, we specify the mechanics of the solution. In particular we attempt to identify whether the benefit is conferred through an effect on reported net worth, reported earnings, or the firm's cash flow or liquidity position. Second, we indicate the likely success of the proposal. Will the method pave the way for the firm to

move from bankruptcy to continuance? Third, we assess the costs of the solution. Fourth, we measure the extent to which there are either positive bequests made to institutions that are not in need of assistance, or "me-first" type wealth transfers that affect the costs to or willingness of claimants to participate in the solution.

Solutions Involving the Write-Up of Net Worth

When an institution becomes insolvent in the sense we have defined it—violation of a contractual obligation or hitting some regulatory trigger—then the supervisory agency must take some action. However, in those cases, when the insolvency is the result of a regulatory trigger rather than failure to meet a contractual obligation, it may be possible to resolve the insolvency (or avoid its occurrence) by means of rule changes or purely paper transactions that increase book value.

Consider the institution that is forced to sell mortgages at a loss to meet liquidity needs, and that loss reduces net book value below some regulatory trigger level (4 percent or 0). It may be possible to avoid insolvency if the accounting rules allow deferring recognition of the loss. There is, of course, no particular economic justification for setting the time of recognition of the loss, which is a real loss, at the time of sale of the asset (in fact, the loss has probably been generated in prior accounting periods). Such an accounting change benefits several claim holders. Equity holders are clearly benefited if the alternative is liquidation or merger. Uninsured creditors almost certainly benefit if the alternative is liquidation, since the liquidation value of the assets is less than book value. The insurance agency as well as others may gain if the institution will be profitable in the long run. Keeping the institution afloat until profitability returns, when keeping it afloat only involves an accounting rule, is clearly cheaper than the costs involved in liquidation or arranging a merger.

However, it is difficult to be selective with industrywide accounting rules. Some of the benefit in reported earnings and book value will be received by institutions not in need of any assistance. That is not a problem in this case, since it takes no expenditure of real resources to produce this benefit, though this is an issue that must be confronted in other types of assistance. More important is the fact that institutions without long-run profitability prospects will benefit and be enabled to continue in operation longer than they would without the accounting change. The longer an institution losing money is allowed to continue in operation, the greater the ultimate cost to the insurance funds.[12] We believe that it is this real cost consideration rather than dedication to the purity of accounting principles which lies behind the FDIC's reluctance to adopt this accounting treatment.

[12]We have noted that when the equity holders perceive $A_L + A_T < B_c + D_c$, they may adopt a risky strategy that can lead to greater losses to the insurer and to uninsured depositors. See also Horvitz, "A Reconsideration of the Role of Bank Examination," *Journal of Money, Credit and Banking*, November 1980, pp. 656–57.

The principal attraction of this accounting change is that it may benefit the net worth position of savings institutions with little (immediate) cost to the government or the insurance funds if there are relatively few institutions that should be forced out of business. It is possible to build on that approach by means of an infusion of contingent obligations (better described as "funny money"). An ailing institution issues new "equity" to the Treasury or to the insurance fund in exchange for the government's contingent IOU. The government redeems the IOU with real money only in the case of failure. It is reasonable to view this as the equivalent of equity because, from the point of view of uninsured creditors, it provides the same kind of protection against failure that an infusion of new "real" equity would. This approach would have the same distribution of benefits as the accounting change (in an accounting sense, this represents nothing more than capitalizing the value of deposit insurance and putting it on the balance sheet). It has an important advantage in that it can be limited to those institutions that were assessed as being profitable in the long run, and to those in need of assistance. When the profitable institution has rebuilt its surplus accounts, the government-supplied equity can be retired along with the contingent obligations.

These paper transactions benefit the failing institution's equity holders, who do not contribute to the solution. Our theoretical analysis indicates that equity holders should be willing to invest additional funds if the institution has long-run profitability, and it should be possible to structure a deal that benefits both equity holders and the insurance funds by requiring an investment or sacrifice by both. If the failing institution is stockholder owned, it would be reasonable to require some new equity investment from existing or new owners as a condition for the government's participation. If the owners are unwilling to invest further, that may be a good indication that they do not expect the institution to be profitable in the long run, and in that case it is in the insurance fund's interest that the deal not go through.

Moreover, since the insurance group receives no greater claim than the book value of insured deposits, there is likely to be a sizable "me-first" wealth transfer from this form of continuance. All claimants face increased risk with continuance, but the agency and uninsured creditors receive no additional return if the future results in high profits. Thus, even though the scheme is a paper transaction, it would be prudent for the insurance agency to demand either participation in the profits or guarantees that would prevent sizable "me-first" wealth transfers. If this is not done, it will be necessary to limit in some way the risk-taking proclivities of the equity holders.

If the failing institution is a mutual, then perhaps there need be less concern that the government program is benefiting or enriching private stockholders. However, it may be possible to gain some equity involvement by seeking conversion of the institution to a stock organization. We suspect that even in market conditions that exist today, it would be possible to attract some interest in an equity investment in a savings and loan that will receive government assistance and has opportunities to earn a profit in the future.

Solutions to Liquidity Problems

The paper transactions discussed above are aimed at the problem of an institution's book value dropping below some regulatory trigger, and do not deal with insolvency in the sense of an inability to meet depositor withdrawals.

Liquidity is the most serious *potential* problem facing the thrifts, but it has not yet become a substantial problem for the industry as a whole. Although the early 1980s appear to be the worst in thrift industry history, deposit outflows have been limited to relatively short duration. As long as there is confidence in the insurance system, deposit outflows from fear of capital loss will not be significant. Since thrifts can now offer savings instruments paying market rates—MMC, All-savers, 2½ year certificates—there is little reason to expect a stepped-up pace of withdrawals to obtain higher rates.

Some individual institutions, of course, have faced and will face severe liquidity squeezes. Fortunately, several programs are in place that should be sufficient to deal with the liquidity problems as they arise. It is important to recognize that our concern is insolvency that might be brought about by a deposit outflow. The institution can meet the need for cash by selling assets, but selling assets at a loss can also trigger insolvency. Useful solutions to the liquidity problem must involve means of generating cash without the need to sell assets at a loss.

FHLMC Swaps. The Federal Home Loan Mortgage Corporation has begun a program of swapping its certificates for mortgages held by thrifts on a roughly even trade basis (certificates carry an interest rate ¼ percent less than that on the mortgages). These certificates can be used as collateral for retail repurchase agreements (mortgages cannot be used for this purpose), thus affecting the flow of investible funds. This program does not involve any subsidy, since the swap is on an even interest rate basis. Also, it allows the government agency to aid the thrifts in obtaining funds, without the need for the agency to go to the market for funds itself (though the effect on aggregate demand may be the same).

The success of the program would depend in large part on the elasticity of demand for repurchase agreements which is likely to be quite high. Moreover, the added funds are not likely to come directly from the thrifts' current deposit portfolio, thus mitigating a potentially adverse effect on earnings.

The program could provide ammunition for insolvent institutions to create sizable "me-first" transfers if the new funds were channeled to riskier investments. In this event, the insurance fund would clearly be the net loser.

Mortgage Pay-through. The mortgage pay-through participation is an innovation that has some earnings benefits as well as on thrift deposit flows. Under this device, the thrift sells bonds secured by its mortgage portfolio, but is not required to recognize any loss as it still holds the mortgages. As the bonds can be sold at the going market rate on AAA corporates, the thrift gains the opportunity to increase current earnings by rein-

vesting the proceeds in higher-yielding short-term assets. The mechanism should induce some incremental deposit inflow since pooled mortgages that are paid off before maturity provide a basis for lifting the portfolio yield above the pay-through rate.

As is true of the bookkeeping entries, encouraging thrifts to adopt such a program involves no cost to the government. The net cost to the thrift system will depend on the relative elasticities that define the extent of fund flows and their source. Obviously, to the extent the program is successful, the benefits would accrue to all institutions. The "me-first" transfers would be similar to those mentioned in discussing FHLMC swaps. While several issues have been successful, it is not clear how large the potential market for such an instrument would be.

Borrowing. Liquidity problems can be handled directly by thrift institutions borrowing from their Federal Home Loan Bank or from the Federal Reserve. Federal Home Loan Bank lending capacity is large, and can be boosted by the system's $4 billion line of credit from the Treasury, but it is not unlimited. The Home Loan Banks charge a rate on their advances that is based on their cost of funds. Since their cost of funds is likely to be lower, as a federal agency, than a savings and loan (particularly one with liquidity problems and potential costs of bankruptcy), the cost is less than most alternative sources of funds for the savings and loan. This tends to make the Home Loan Banks "lenders of first resort," and requires a form of nonprice rationing to deal with borrowing requests. Such loans are a simple and efficient means of meeting liquidity needs of eligible thrifts, but an inefficient means of improving earnings. Given the current situation, we believe it is important to keep this source of liquidity available to those institutions facing a liquidity problem, rather than simply handed out to those seeking to make a profit on the spread between the rates charged by the FHLBs and open market rates.

The lending program of the FHLBs must be coordinated with the Federal Reserve discount window. Under the Monetary Control Act, thrifts were given access to the discount window on the same basis as member banks, but Federal Reserve rules had required that such institutions first exhaust their borrowing ability under specialized lending programs, i.e., the FHLBs or the credit unions' Central Liquidity Facility. This creates a problem when the Federal Reserve discount rate is lower than the Home Loan Bank rate, and provides an advantage to those mutual savings banks that do not belong to the FHLB system. As is typical, the Federal Reserve has responded to this problem with a complicated set of rules, reserving room for a wide dose of administrative discretion rather than relying on price as an allocative device. Some of the administrative costs of policing the discount window could be eased by establishing a nonbargain rate on such borrowing. Because we have a preference for use of the price system to minimize the need for rationing by administrative means, we would prefer that there be no subsidy element in Federal Home Loan Bank or Federal Reserve loans to thrifts.

Full discussion of this rate-setting problem takes us far afield and into such monetary policy controversies as lagged reserve accounting. The problem of administration of thrift institution access to the discount window will get little weight in Federal Reserve consideration of such issues. Nevertheless, the fact that a liquidity facility with unlimited resources is in place for thrifts is an important source of confidence and helps assure that no thrift institution need be closed simply because of a lack of liquidity.

It seems clear from this review of liquidity needs and the means of meeting liquidity problems that sufficient facilities are in place so that such problems need not lead to sales of assets at prices requiring a reduction in book net worth.

While these programs do not involve any direct cost to the Treasury (as long as rates are unsubsidized), they do provide a benefit to the borrowing institution which would otherwise be unable to obtain funds or could do so only at a higher rate (a rate more in accord with their credit status). The benefits from providing liquidity which can prevent insolvency and liquidation flow to all claimants—uninsured creditors, equity holders, and the insurance funds—provided the institution will be profitable in the long run. If not, as we have noted earlier, prompt liquidation is in the best interests of the insurance fund. But in general access to these sources of liquidity does not require any demonstration of long-run profitability. For an institution that will probably not be profitable in the future and that has a low liquidation value, access to liquidity provides a strong temptation toward "me-first" transfers. The institution in that situation may find it attractive to convert its mortgage portfolio to cash, via a swap or pay-through, invest in more risky ventures (common stock, or real estate development), or play the futures market. If successful, the stockholders or managers benefit; if unsuccessful, the loss is borne by the insurance fund, since the stockholders and managers have little money at risk. Close supervision is required of those institutions that are operating only with the funds of the insurance agency at risk. This seems to be the major cost item for the borrowing solution.

Enhancing Earnings

Most insolvencies of thrift institutions have come about not from deposit outflows requiring asset sales at a loss but from operating losses reducing book value to the regulatory trigger. We have already discussed means of boosting reported book value, but this problem can also be attacked by taking steps to increase thrift institution earnings.

Broadened Powers. Earnings can be aided in the long run by the broadening of powers of savings and loans proposed by the FHLBB, at no cost to the Treasury. Such action is probably desirable, but it is clear that the powers being considered will have no immediate effect on earnings (though they may increase the market's perception of P_c). From the point of view of the Administration and the industry, this simply represents a good time politically to be putting forth such a proposal. Administration support for deregulation dovetails nicely with congressional desire to do

something for the thrifts, particularly since the Regulators Bill failed to pass earlier in the congressional session. These considerations could easily swamp commercial bank opposition to broader thrift powers. Broader powers do not seem to provide a solution to immediate insolvency problems. In addition, they would seem to affect the hidden cost of "me-first" transfers. If institutions that should be liquidated (because of low P_c) were in a position to use the broader powers to increase portfolio risk, the cost would eventually be borne by the insurance agency and uninsured depositors.

The All-Savers Certificate. The all-savers certificate allows institutions access to funds at a rate about 300 basis points below their current marginal cost of funds, without involving any advance of funds by the Treasury or the agencies. If the savings and loan industry could get, say, $30 billion in all-savers money, earnings would be increased by about $1 billion (and note that this does not require new money, but only a conversion of funds now in money market certificates). If that amount of earnings improvement were channeled to those institutions with lowest net worth ratios, it would be significant. In fact, however, much of the benefit will go to institutions not in weak condition, and at a heavy cost to the Treasury. That cost is greater, and the benefits less directed to institutions in need by allowing commercial banks as well as thrifts to offer the all-savers certificate. (There is, however, a compensating factor in that, to the extent that the benefit flows to healthy, profitable, tax-paying institutions, the cost to the Treasury is less.)

The fact that much of the benefit from the all-savers certificate flows to solvent as well as insolvent institutions that should be liquidated (low P_c) illustrates one of the central public policy issues inherent in the current problem. Our evaluations, based on bankruptcy cost considerations providing the impetus for assistance, would suggest that all-savers provides one of the most costly forms of resolution. On the other hand, if the basis for aid is that all thrifts have suffered from government policy, and all ought to be rewarded, then the fact that the all-savers benefits all thrifts would not be considered as a disadvantage. There is no doubt, however, that the net cost of the instrument in relation to the benefits derived from avoiding bankruptcy costs that would eventually be paid by the insurance fund are excessive.

Of course this public policy issue is not unique to financial institutions: federal loan guarantees benefited only Chrysler, but Ford and GM also benefited from the restrictions on imports of Japanese cars. Based on the cost criteria, our preference is to limit benefits to those in need. We believe that in most cases it is possible to structure a deal that does not involve a windfall to either the firm that should liquidate, or to the solvent firm.

Mortgage Warehousing. The all-savers concept grew after a lack of enthusiasm for other ideas, particularly a plan for the federal government to purchase low-yielding mortgages from thrifts at par. It is by no means clear that purchase of mortgages at par is a less desirable approach than the all-savers. The cost of purchasing mortgages by the Treasury depends upon

the volume of such purchases, and this goes to the issue of how broadly such a program would operate. If limited to purchases by the insurance fund from institutions that pose a threat to the fund, this may be a cost-effective means of channeling support to insolvent institutions. If the program is a general one, open to all holders of low-yielding mortgages, the cost could be high with much of the benefit to institutions not in need of assistance.[13]

When the mortgage purchase idea was first broached, it would have had wide applicability. Recently the idea has been reissued in a cut-down model, with substantial restrictions on eligibility (only institutions with operating losses for at least two quarters, and low book value). The windfall aspects to equity holders can be mitigated by requiring repurchase of the mortgages in the future at prices which reflect some of the benefit derived from the program. With this condition the program would significantly affect current (though not long-term) earnings which would have the desired effect on insolvency. "Me-first" transfers are not controlled under the mortgage warehousing proposal, though other conditions may be added to insure that receiving institutions do not substantially increase portfolio risk. The direct cost of the program will depend on the price at which the warehoused mortgages are resold to the institutions and the length of time they are held.

Targeted Advances. Some varieties of the liquidity programs discussed above have implications for improving earnings, particularly the mortgage pay-through and loans at less than the institution's alternative cost of funds. Loan programs with more explicit subsidies have long been part of the agencies' tool kit. The FHLB System "targeted advances program (TAP)" is aimed at savings institutions with low net worth ratios that are operating at a loss, and provides for an interest rate significantly below market rates (2 percent). Such programs can be of significant benefit to the recipient institutions, but require extension of large amounts of agency credit. Consider a $1 billion savings institution with losses at the rate of 1 percent of assets (a loss rate that may approximate that of the savings and loan industry in the second half of 1981), or $10 million per year. Elimination of that loss by means of such a subsidized loan program would require a loan of $500 million. Such a program is a logical one for periods in which few institutions have operating losses, or in which losses are small. The present situation swamps the resources that could be made available through a program like TAP at any reasonable cost.

Capital Infusion

The very magnitude of the problem, due to extremely high interest rates, allows a substantial benefit to be given to ailing institutions with only moderate cash outlays by the agencies. An interest-free loan or capital infu-

[13]But administrative costs are lower when the program is open to all. If decisions must be made as to eligibility, administrative costs rise and it takes much longer to move from application to actual assistance.

sion of only about $60 million could provide the $10 million income necessary to offset the losses of the $1 billion dollar institution hypothesized above. Of course, the interest earned by the thrift represents income foregone by the lending agency (say, FDIC or FSLIC). If interest rates were lower, the institution's losses would presumably be lower, but at that lower level of rates it takes a greater principal advance at zero interest to provide a given amount of earnings benefit. Of course, the amount of foregone interest income to the insurance agency would be less, but so would the savings from avoiding liquidation of a mortgage portfolio.

While both the FDIC and the FSLIC have authority to provide such assistance before failure, the FSLIC has been much more willing to use this technique than the FDIC. This difference is due in part to legal differences—provision of such assistance by the FDIC requires a finding that the continued operation of the institution being assisted is "essential to provide adequate banking service in the community." While the FDIC has stretched the interpretation of "essential" very far, the agency doubts that it can conclude, for example, that a particular mutual savings bank in New York City is essential for adequate banking service in its community.

This approach can result in a cost saving to the insurance agency, but serious public policy questions are involved. Such assistance represents a substantial benefit to the owners of the institution, who bear some responsibility for its plight, and may save uninsured creditors who might otherwise suffer a loss in case of failure. This is a more significant problem when the beneficiaries of the subsidy are stockholders who have voluntarily taken a risk of loss by their investment, and it is of less concern when a mutual institution is involved. In either case, the aid also benefits management of the failing institution. The insurance agencies have been sensitive to this problem, and have attempted to structure deals that avoid windfalls to stockholders or managements.

This means of dealing with the problem is illustrated by the FDIC's assistance to First Pennsylvania in 1980, the largest such transaction in FDIC history. The form of the assistance was a long-term loan at a rate well below the market (the typical form which such assistance has taken). The loan provided needed funds for First Pennsylvania which was unable to tap the CD market, and the subsidized interest rate helped the bank's earnings position. One novel element of the First Pennsylvania assistance that has important implications for dealing with troubled thrifts was that the FDIC received warrants to buy 13 million shares of First Pennsylvania stock at $3 per share. With 15.6 million shares outstanding, this represents the potential for very substantial dilution if the aid package is sufficient to turn the bank around. This approach represents a possibly efficient means of minimizing the windfall aspects of such assistance and substantially reduces the possibility of "me-first" transfers among claimants. That is, management and equity have no incentive to take excessive risk: if the risky policy is unsuccessful, management and equity lose, while much of the benefit from extraordinary success will be reaped by the FDIC through its warrants. This suggests that the unusual supervisory measures the FDIC has taken in First Pennsylvania, including participation in Board meetings,

may be unnecessary. The FSLIC has also indicated that in future cases in which it provides a capital infusion to troubled S&Ls, it will seek some form of equity participation. FSLIC authority to provide capital infusions is not limited by an essentiality test.

Both the FDIC and the FSLIC face problems in adopting such a program on a large scale. The FDIC problem is a legal one: the requirement that the recipient of such assistance be "essential" to its community. Legislation to change that is clearly desirable. We would prefer a change to a simple cost test rather than the confusing language in the "Regulators Bill" that referred to "severe financial conditions . . . threaten the stability of a significant number of insured banks." The FSLIC problem is financial. It may lack the resources to be able to make the magnitude of capital infusions necessary to meet the needs of all insolvent savings and loans.

A capital infusion at a zero interest cost is a substantial subsidy. It should be offered to a limited number of institutions that meet certain conditions. First, they must have prospects for long-run profitability. Without that, there is little chance that the advance can ever be repaid, and the costs of liquidating the institution will not be saved. Second, they should have zero or close to zero net worth. The purpose of capital accounts is to absorb losses, and as long as such capital is available, it should be the buffer before government funds are advanced. Third, the institution must be operating at a loss not due to current mismanagement. If the institution is profitable, net worth will be rebuilt, and a capital infusion is unnecessary, and if losses are due to current mismanagement (or excessive salaries, etc.), the losses from that source should be corrected first.

These conditions will limit the number of cases needing such assistance, but other terms should also be imposed that will make institutions reluctant to seek such assistance. Some restrictions on management may be appropriate, though insisting on the removal of top management or limiting salaries may be counterproductive. More important, the lending agency should have some means of recouping its foregone interest if the institution is successfully turned around. This can be done in various ways. In a stock institution, obtaining warrants, as the FDIC did with First Pennsylvania, is a promising approach. If the institution returns to profitability, and its stock price rises, the warrants will have value that compensates the lender. Moreover, the resulting dilution assures that stockholders do not unduly benefit from the advance of government funds.

In the case of a mutual institution, the concern about unduly enriching stockholders is of less concern, though there may be more reason to be concerned about benefits to management. Mutual institutions lack the pressure of stockholders seeing that management does not benefit itself at stockholder expense. In this case, the insurance agencies may have to play that role. While foregone interest cannot be recouped in the form of an equity claim, it is still possible to structure the deal in a way that brings financial benefit to the insurance agency in case of success. The capital instrument can be something like an income bond, in which interest is paid only if earned and in some proportion to earned income, or a note with a graduated interest rate.

The key issue is whether the resources of the insurance funds are sufficient to provide capital infusions of the magnitude required. Savings and loans lost $1.5 billion in the first half of 1981, and will probably lose $3 billion in the second half. The rate of losses is not likely to be exceeded in 1982, even if interest rates stay at current levels: interest income will continue to rise as older mortgages are rolled over; interest expense will rise at a slower rate (most funds are now at market rates and the all-savers will reduce interest costs). To make up that total loss would require an interest-free loan of about $40 billion—obviously an impractically high figure. However, many of the institutions incurring losses have ample surplus accounts to afford their losses for some time (such accounts now total close to $30 billion). As we have noted, the objective is to minimize the bankruptcy costs, and not to prevent thrift institution losses.

The Role of Deposit Insurance

At several points in this analysis we have alluded to the relevance of deposit insurance to possible solutions to the problems of the thrift industry. If the industry is to survive this period of difficulty and return to profitability, it is essential to maintain the confidence of its depositors. The reason that thrift institutions can continue to operate even though the value of their assets is less than their liabilities is that the bulk of their creditors are insured depositors who have confidence in the deposit insurance system. In the absence of that confidence, liquidity problems would become intolerable. The highest priority at the present time, therefore, is the maintenance of that confidence. The FDIC insurance fund is little more than 1 percent of insured deposits, and the ratio for the FSLIC is less. The question has often been raised as to what would happen if failures occurred in excess of the insurance funds' assets. The traditional answer has been that such an event is impossible, but that even if a cataclysm should swamp the funds' resources and borrowing capacity, the federal government would come to the rescue and meet its implicit obligation to assure the safety of insured deposits.

For the first time since the creation of the FDIC and FSLIC, that question has become a relevant one, and therefore, the traditional answer has become less convincing. The agencies have attempted to bolster confidence by seeking legislation to increase the borrowing authority of the FSLIC from $750 million to $3 billion. That seems to be the wrong approach and raises more questions than it answers. If the existing fund plus $750 million is not sufficient, how do we know that the fund plus $3 billion will be?

A more complete approach would make deposit insurance an explicit guarantee of the United States. Most of us believe that if the insurance funds were wiped out, the federal government would make good on the deposit protection anyway. If that is the case, then a direct acknowledgement of that intention (obligation) would cost nothing and would provide the ultimate in confidence to the insurance system. And if the intention is not to bail out the insurance system in case of collapse, that public policy position

should be confronted openly and resolved. This suggestion does not imply a belief that there is great risk of bankruptcy of the insurance funds, or any possibility of loss to insured depositors. It is precisely because there is no risk of loss that it is costless to make such a guarantee, and the guarantee by itself will serve to reduce any risk of the kind of liquidity crisis that could bring down a large number of thrift institutions.[14]

An alternative to a direct guarantee would be a merging of the FDIC and the FSLIC. The FDIC has greater resources than the FSLIC, and faces less risk of substantial losses in future months. This consolidation has been endorsed by the FDIC chairman. It can be justified on the basis of governmental organizational simplification and efficiency, and may be treated as part of a larger reorganization of the structure of the financial regulatory agencies that is justified on its own merits. But we would view this as a solution to an immediate problem, and should not wait for resolution of the broader problem of total agency reorganization.

VI. Conclusions

Many thrift institutions are in serious difficulty and are approaching insolvency. By virtue of the deposit insurance system, the government already has a major stake in the survival or failure of these institutions. We believe that in the long run, with present and enhanced operating powers, most well-run savings institutions can be profitable. In this situation, a profit-maximizing (or cost-minimizing) insurance agency will find it desirable to find ways to keep ailing institutions operating. Our concern is with means of minimizing bankruptcy costs, and not with other justifications for aid to thrift institutions. Since any savings institution that is insolvent on a book value basis will have a large deficiency if assets are liquidated at market value, there is a strong incentive to keep the institution in operation, even if government funds must be advanced. There are a variety of ways in which this can be done.

Keeping an insolvent institution operating also benefits the equity holders of the institution and uninsured creditors who would suffer a loss in liquidation. In order to avoid an undeserved benefit to stockholders, the solution should be structured so that stockholders contribute either in the form of new capital or in restrictions on their gain if the aid is successful in turning the institution around. Benefits to mutual institutions involve a similar problem though the magnitude may be different. Even here, however, it is necessary to provide for capture of some of the institution's profit potential by the insurance fund.

The need for provisions which allow the insurance agency to share in the profits if the rescue is successful is not just to minimize insurance agency costs but to prevent incentives for "me-first" transfers on the part of

[14]A sound argument can be made in favor of leaving some degree of risk in the depository system. Efficiency may be enhanced by the possibility of losses to uninsured depositors—this may lead to market pressures for conservatism that may reduce the need for government regulation (this is an argument for less than 100 percent deposit insurance). But there is no such argument in favor of risk in the deposit insurance guarantee itself.

the assisted institutions. Absent such provisions, there may be a tendency for thrifts to adopt riskier than normal policies. A profit-sharing provision thus reduces the need for direct supervision.

It is crucial to be able to distinguish between institutions that will be profitable in the future and those that will not. An institution that is not going to become profitable with normal operations is going to seek profit by taking unusual risk, since it has nothing to lose. Federal assistance to such institutions runs the risk of increased ultimate losses to the insurance fund and to uninsured creditors.

Regulatory agency rules based on book values that can trigger insolvency do not serve a useful purpose. Accounting devices or other means of affecting book values with no outlay of real resources have merit if they benefit institutions with positive prospects. Insolvency can be triggered by liquidity problems, but ample sources of liquidity are available to troubled institutions that need not involve significant costs to the Treasury or the regulatory agencies.

Insolvency can result from operating losses over a period of time. There are several alternative means of providing assistance to institutions with operating losses. The all-savers certificate is an extremely expensive means of subsidizing earnings, primarily because much of the benefit will accrue to institutions not in financial difficulty. We prefer a direct injection of insurance agency funds at a zero (or nominal) interest rate. This can be done in the form of a loan, or by purchasing mortgages at par. In either case, a deal can be structured that allows the insurance agency to recapture some of the benefits that accrue to the recipient if the assistance is successful in turning the institution around.

Maintaining confidence in the insurance system is important. While the FDIC has ample resources for the problems before it, the FSLIC would be strengthened by a government guarantee or by merger with FDIC. In any case, this is what the funds have been accumulated for, and now is the time to use them.

Discussion

Marshall A. Kaplan*

Unlike some others, Professors Horvitz and Pettit don't heap scorn upon assistance to thrifts that others would dismiss through the use of the pejorative term "bail out." Their major reason for endorsing short-run financial assistance to troubled thrifts arises from the social costs of permitting institutions with "long-run" prospects for success to be allowed to go under. They also argue that the problems that thrifts now find themselves in are largely the result of government policies. These have both produced high interest rates and yet constrained asset-liability powers of S&Ls in ways that made it impossible for them to exercise management strategies necessary to operate successfully in the present financial environment.

The willingness of Horvitz and Pettit to provide financial solutions for troubled thrifts is hardly unlimited, however. They are concerned about cost-effective solutions; and they pay scant attention to some of the proposals emanating from thrift trade groups. While they do not say so, I would guess that they believe that there is no "free lunch" solution for troubled thrift institutions and that the federal government's role in aiding thrifts financially will remain limited.

Much of their discussion is, in fact, limited to the role of the insuring agencies—the Federal Savings and Loan Insurance Corporation (FSLIC) and Federal Deposit Insurance Corporation (FDIC). The first topic that Horvitz and Pettit tackle is that of the theory of insolvency and bankruptcy. Although the theory that the authors propound may seem a little heavy going, it puts stress, in deciding on whether to permit a failing thrift to continue in operation, on the present value of expected future long-run profits (P_c). If P_c of a thrift institution is greater than the liquidation value of its assets plus the liquidation value (if any) of its thrift charter and branch system, bankruptcy may not be the optimal course of action to be adopted by the insuror.

The authors develop a sharing arrangement by which it is in the best advantage of the insuror, the uninsured depositors, and the equity holders (if any) of the thrift institution to each invest up to a certain amount to ensure the continuance of the thrift (as an independent entity?). The authors argue that it is mutually beneficial for all those who have a stake in the success of a thrift to act in ways to prevent bankruptcy even though the immediate situation seems hopeless. They point out rightly that it is the insuring agency that has the biggest incentive as well as the power to take the lead in working out a nonbankruptcy solution.

I believe that the authors have made their case for the insuror considering courses of action that will avoid bankruptcy; but it is not clear

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whether they have an operational theory. I have problems with putting into operational form a theory in which the key variable is the present value of expected future long-run profits through continuing the operations of the thrift. It is not at all obvious as to how one computes P_c when there are many possible future financial scenarios and uncertainties as to what the powers and strategies of thrifts will be in the future. Each of the three groups that have a stake in dealing with insolvency may have a different perception of the value of P_c. This creates obstacles to a sharing arrangement to the extent that it is to be agreed upon mutually. Nonetheless, I agree that the insuror needs to be innovative and free to take a wide range of actions unconstrained by unrealistic regulations. There is always a risk, however, that the insuring agencies may end up incurring greater costs if any perceived long-run profits don't materialize.

A major point of the paper is that FDIC and FSLIC actions to deal with insolvency are based on rules that utilize book values in the balance sheets of thrifts rather than market values and that this is misguided. The authors indicate concern, in particular, that the use of book value rules can prevent the insuring agency from taking early corrective action to protect its interests.

While the use of book values is misleading, I am concerned as to the implications when the authors indicate that book value rules prevent the insuring agency from taking early corrective action even when it is in the best interest of the agency to do so. If almost all thrifts currently have a negative net worth in terms of market value, does this mean that the FDIC and FSLIC should already be monitoring management decisions of all of these thrift institutions? I doubt that this is what the authors intend; but in any event the insuring agencies do not have the wisdom to monitor management decisions and take early corrective action for the very large number of thrifts that have still not triggered any violation of rules based on book values—and to do so would fly in the face of current efforts to deregulate the thrift industry.

The authors have correctly perceived that rules based on book values are not realistic trigger points for insuring agencies to become at least concerned. They have, however, avoided the more difficult problem of indicating what types of market value rules may be more appropriate.

Neither have the authors discussed what appears to be a key subject. This is the subject of what should constitute insolvency for a depository institution. The present tendency of insuring agencies is to use a rule that says that book net worth of approximately zero or close to zero provides a basis for declaring insolvency. Given the focus of the paper on insolvency, it is surprising that the authors nowhere discuss the rationale for this rule.

The authors are under the mistaken impression that the FSLIC can force an FSLIC-insured institution into bankruptcy if it doesn't meet the net worth requirement of roughly 4 percent of liabilities. Failure of such an institution to make progress toward meeting the net worth requirement gives the Bank Board's supervisory agency the ability to force through an involuntary merger; but the FSLIC does not consider bankruptcy, nor

could it do so legally, unless the institution meets the criteria for insolvency.

For most businesses, insolvency results from an inability to meet cash obligations. What make the situation different with respect to thrifts is the fact that almost all of them have access to Federal Home Loan Bank advances; and they now have access to Federal Reserve discount facilities, although under rather complex constraints. This rightly raises questions about a definition of insolvency for thrifts that relies upon ability to meet cash obligations.

While advances and discounts are not supposed to be used to keep an insolvent institution alive—or at least the FHLB System and Federal Reserve are not required to do so—it is not always easy for these authorities to tell whether the provision of advances or discounts is what is keeping the thrift afloat. Moreover, the whole history of the development of Bank System advances has been predicated on the belief that thrifts can legitimately have fundamental problems in the liquidity area that make it impossible for them to meet cash obligations because of a presumed handicap in accessing private markets adequately for funds even if they are in sound condition. This implies that there is nothing necessarily wrong about the need of a thrift to borrow from the Home Loan Bank System in order to meet cash obligations due and thereby stay solvent in this latter sense. This is undoubtedly part of what leads the FSLIC to use a net worth test rather than ability to meet cash obligations in gauging insolvency.

In recent years, there has been little attempt on the part of the Bank Board to take the remedies permitted by law when book net worth requirements are not met. When a very large proportion of insured institutions, as currently, are in the process of failing the net worth test, this test is not taken seriously. I think one can state that net worth requirements are cosmetic at the present time. Given the current heavy work load involved in dealing with institutions approaching insolvency, however we may define this latter term, the resources of the FSLIC are concentrated on monitoring the financial position of institutions approaching insolvency. The net worth book test itself is no longer the lever it may once have been. It is rather the definition used for insolvency that is far more important.

I am glad that Horvitz and Pettit do discuss the earnings and liquidity problems as partially independent issues. As they recognize, attempts to deal with one problem can often exacerbate another.

Let me turn to the section on "The Choice: Insolvency to Liquidation." Since my practical background in resolving thrift problems derives from my former position at the Bank Board, which administers the FSLIC, I am somewhat surprised at the amount of space given both in this section as well as in earlier sections to the liquidation option. As Horvitz-Pettit correctly recognize, liquidation is a rare event for FSLIC-insured thrifts. It is the FDIC that has tended to use this route more frequently, at least for small institutions.

Horvitz-Pettit correctly point out that the FSLIC has been more willing, or able, than the FDIC to take corrective actions through some form of assistance, before actual insolvency.

It needs to be emphasized that the FSLIC in its current decisions on what to do with insolvent or rapidly approaching insolvent thrifts is very much influenced currently by the Bank Board's belief that revolutionary changes in the financial markets now make it impossible to maintain anywhere near the present 3,900 FSLIC-insured S&Ls as independent entities. Thus, the FSLIC appears to be factoring into its assistance packages a predilection for encouraging mergers, some of a multiple nature, and creating institutions that it believes must be large enough to be viable over the long run. Whether Horvitz and Pettit agree with this strategy, I don't know, but it could be consistent with their emphasis on P_c as a controlling variable.

When Horvitz and Pettit discuss the need to make deposit insurance an explicit guarantee of the U.S. government, I find myself agreeing. Hardly any insured depositor is aware that federal insurance of accounts is contingent upon the availability of reserves in the appropriate insuring agency. We all know that, politically, the Congress and the Administration would not allow insured accounts not to be paid off because the insuring agency did not have adequate resources.

I might add a related issue here—the fact that, rightly or wrongly, insuring agencies will not permit the loss of confidence in the financial system that would ensue if a large depository institution became bankrupt and went into receivership. As a result, any rational person who wants to place deposits in excess of $100,000 under the same name in a single institution can do so with substantial security in the case of a large depository institution, but with much less security in the case of a small institution.

I have heard all of the arguments about why we need to force the private market place to provide discipline to depository institutions through its willingness or unwillingness to place uninsured funds in these institutions on the basis of its view of their financial soundness. However, it is manifestly unfair to have a situation where the risk of loss depends upon the size of the institution and may also appear to be viewed as a rather random decision. I would argue for no dollar limitation with respect to federal insurance of deposits, although whether this can be justified without a variable insurance premium based on risk is another matter.

With respect to the Horvitz-Pettit argument that insured deposits be explicitly guaranteed by the federal government, it needs to be pointed out that this could have an impact on how insolvencies are dealt with. Under the present system, insuring agencies feel under pressure to pursue solutions that do not reduce the size of the insurance reserves on a year-to-year basis because of the possible adverse impact that this might have on confidence in the insurance program—even though the average saver is not familiar with the insurance reserve funds. Insuring agencies would behave differently in many cases under an explicit government guarantee. This needs to be examined carefully in terms of whether the actions taken by insuring agencies would be worse or better as a result.

In the second half of the paper, Horvitz and Pettit turn to a wide-ranging discussion of both liquidity-based and earning enhancement solutions

for troubled thrift institutions. They comment favorably on the Bank Board's regulatory rule permitting as an option the deferral of losses from sales of underwater mortgages, and they comment on the possibility of generating cash and income by liquifying underwater mortgages in the form of pass-through mortgages or Freddie Mac participation certificates. These involve complex issues and are currently major Bank Board initiatives in dealing with short-run problems of thrifts. The regulatory accounting change on recognition of losses should make for better thrift management decisions and is long overdue, although whether it will be usable by publicly traded S&Ls whose deviation from generally accepted accounting principles (GAAP) will be noted by their accountants is a big question mark. However, unless we factor in possible tax and arbitrage benefits, which will have to be determined by each individual S&L, it does not change the underlying soundness of the thrift. It does, however, encourage wise management decisions that GAAP has impeded and could help over the long run those S&Ls that gain little or no benefits over the short run. The liquification of underwater mortgages is an interesting innovation that I endorse; but its likely contribution to income through reverse repos is likely to be small and it can, under certain conditions, add to losses.

Horvitz and Pettit discuss solutions to depository industry problems that also provide benefits to healthy institutions. They mention the All Savers Certificate, in particular. If its objective is to deal with seriously troubled institutions, the All Savers Certificate is hardly cost effective. Horvitz and Pettit are correct in saying that some type of sufficiently targeted purchases of low yielding mortgages from troubled thrifts could have been cheaper than the All Savers Certificates.

There is little doubt in my mind that "All Savers" came about because Congress was upset about the free market approach of the Administration toward the plight of thrifts when their constituents—both thrift management and depositors—were so concerned about what they perceived as a scary situation. It also must be remembered that the thrift industry has been tightly regulated by the federal government in the past and that it grew up in an atmosphere in which it expected to be protected by the federal government, especially when regulations impeded its own ability to pursue appropriate asset-liability management.

I agree with Horvitz and Pettit that liquidity has not become an actual problem for the thrift industry as a whole so far despite widespread concern. As further evidence for their viewpoint, I note that S&Ls have raised about as much funds so far this year as they did during the comparable period last year despite the much greater adverse publicity about the plight of thrifts this year. As a result, the growth in mortgage loan holdings and assets of S&Ls this year has not been much different from last year. What has changed is the type of funds that S&Ls have been getting this year as compared to last year. Deposits of S&Ls have shown very little net increase so far this year and none if we do not consider jumbo CDs as deposits but rather recognize that they are, in substance, a form of market rate-determined borrowing. S&Ls have placed a substantially greater reliance both

upon Federal Home Loan Bank advances and upon short maturity uninsured funds derived from the private market place.

I agree with Horvitz and Pettit that the broadening of powers of S&Ls will have no immediate effect on earnings and is really a long-run restructuring measure that is being pushed because this is a propitious political climate in which to do so. Horvitz and Pettit mention the Bank System's targeted advances program (TAP) designed to provide low interest rate advances to member institutions with low net worth ratios that are operating at a loss. Perhaps it is only inadvertent that they fail to mention that this program has not been in operation since the end of 1980 for reasons that are justifiable.

There is an interesting discussion of a capital infusion program at zero interest cost which it is argued should be offered by insuring agencies to a limited number of institutions that meet certain conditions. As the authors correctly note, zero interest rate is a very substantial subsidy given the present very high level of interest rates in the economy. The conditions they set, however, for implementing the program contain a certain degree of fuzziness. They argue that the thrift that gets a capital infusion must have prospects for long-run profitability. But, as noted above, this is not easy to ascertain. The condition of zero, or close to zero, net worth needs elucidation since the authors have previously rejected any book value rules. Does this imply that they are speaking about zero market net worth?

As many of you may know, the FSLIC has already used capital infusion through what it terms an income capital certificate that it purchases from the troubled thrift and for which, in turn, it gives a promissory note to the thrift that can count toward liquidity requirements. Both the income capital certificate and the promissory note carry an interest rate, although the rates differ, and the income capital certificate contains a provision that permits the thrift to defer payment of interest on the certificate under certain conditions.

Capital infusion is not, however, any more of a "free lunch" solution than others utilized by the insuring agencies for troubled financial institutions. It minimizes the drain on the insurance funds in the short run—an important consideration if insurance reserves are limited—but might lead to larger drains on the insurance fund over the long run if interest rates don't come down significantly. Nonetheless, capital infusion is a useful addition to the tools available to the FSLIC.

It needs to be emphasized that the FSLIC is clearly in a much more flexible position than is the FDIC as recent problem mergers illustrate, especially given the ability of the Bank Board to merge federal S&Ls across state lines. There is no McFadden Act applicable to federal S&Ls as there is with respect to national banks.

The more interesting question now is whether the Bank Board will look favorably upon any action of the Federal Reserve Board to permit bank holding companies to acquire S&Ls. Chairman Volcker has stated that he believes that, if the Federal Reserve Board does permit such acquisitions, it cannot restrict them solely to failing thrifts. Thus, the acquisition of thrifts generally by bank holding companies would be opened up by any

FRB action in this area. An alternative would be that provided in pending legislation that would permit acquisition of failing S&Ls by bank holding companies.

Whether even this circumscribed type of legislative action can be enacted into law soon enough to provide an additional tool to the Bank Board and the FSLIC remains to be seen. This is the most interesting policy issue as we peer into the future with respect to further steps that may be taken to help troubled thrifts.

While the Horvitz-Pettit paper is supposed to examine only short-run solutions, it looks as if short-run solutions for troubled thrifts are turning out to be an entering wedge for revolutionary changes in the financial system that could broaden thrift powers, accelerate interstate banking, and bring about cross-industry acquisitions among different types of financial institutions. It would be ironic if future economic financial history books pay less attention to the problems of thrifts *per se* during the current period and emphasize rather that such problems accelerated far-ranging changes in the financial system.

Discussion

Harry V. Keefe, Jr.*

Back in 1947 when I was a young and struggling bond salesman, I called on Pop Tirrell, who was then the chairman of the $30 million Norwich Savings Society in Norwich, Connecticut. Pop was an honors graduate of MIT and the former headmaster of the local high school, so I prepared my sales presentation very thoroughly. It was my suggestion that the bank sell its position of $500,000 American Telephone 2¾s yielding 2.7 percent and replace them with an equal amount of 15-year telephone convertibles 2¾s yielding 2.65 percent. My point was that for a modest 5 basis point sacrifice in yield the bank could reap a 30 percent profit if telephone's common stock yield dropped to 6 percent any time during the 15-year life of the debentures. Pop accepted my thesis enthusiastically and went to his board meeting to recommend the switch. An hour and a half later he returned and apologized that the board had literally spent an hour and 29 minutes discussing a $10,000 mortgage and only one minute discussing a $1 million dollar bond transaction. "Let that be a lesson to you, young man," he said, "the average savings banker is incapable of considering any investment except a home mortgage." He went on to explain, in his best schoolteacher manner, that he believed this was the result of the immense sense of power a banker got from granting or denying monies for what we all cherish most: our homes.

Many years later, I was asked to address a savings bank group at a convention held in Bermuda. In my talk I castigated the bankers for persisting in making mortgages for an 8¼ percent gross yield, when it was possible to buy double A bonds at a 9 percent net yield. My point was that they should be doing everything in their power to bolster earnings against what I considered at the time the sure demise of Regulation Q. At that time the best rate being paid by a thrift was 5.47 percent, and inflation was 7½ percent, and I accused the thrifts of *stealing* from the savers to subsidize the home buyer. The next day the savings bankers brought in Saul Klaman, who informed the audience that Keefe should learn that the basic responsibility of a savings bank was "to provide low-cost mortgages to home buyers." So they took Klaman's advice and now look at the mess they're in. It did not surprise me, therefore, that Kopcke noted in his talk yesterday that in studying New England mutuals, the most profitable had been the ones who had the lowest mortgage-to-asset ratio.

In the summer of 1978 after the Fed had granted the financial intermediaries the right to issue six-month money market certificates at a rate tied to Treasury bills, I received a call from Leo Stanley, chairman of the

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$742 million New Haven Savings Bank. "Harry," he said, "the Fed has just signed the death papers of the thrifts." "Those jerks in the thrifts," said the outspoken Stanley, "are going to do the only thing they know how, and that is to make 25- and 30-year mortgages with six-month monies." How right he was! For the last 10 years, Stanley has adamantly refused to buy a bond with a maturity over 10 years, and he laid off his money market certificate money in matched-maturity CDs of the New York commercial banks. The result: New Haven has been consistently profitable, and indeed this year should earn 30 to 40 basis points on its assets, while the rest of the thrift industry is bleeding to death.

Two years ago my associates wrote a paper in which they questioned the viability of the New York City mutual savings banks. In a speech in April 1980, I predicted that if rates held at the then-pertaining levels, which was 20 percent on the prime, two of the New York City banks could lose as much as $100 million each. Their reaction: Keefe has been smoking pot. Well, this year, the same banks are going to lose *over* $100 million each.

My basic quarrel with the paper presented by Professors Horvitz and Pettit, and indeed with all the papers to this conference, is that no one raises the point of the functional failure of the thrifts. Mr. Kopcke said in his paper that $80 to $120 billion dollar bailout is required to raise the thrift industry CVR net worth to 6 percent. In other words, the present value of the subsidy that covers the thrifts' current prospective losses will be $80 to $120 billion. Wait till Henry Kaufman reads those figures and see what it does to his interest rate forecast!

I don't question that massive assistance will be needed, but I do question how these monies will be spent. I vehemently object to using taxpayers' monies to bail out and perpetuate incompetent thrift management.

I read the financial press rather thoroughly, and cannot remember a case of a CEO of a mutual thrift being fired for incompetence. I say the time is here right now. The evidence is becoming too patently clear that the thrift *and* banking industries are too fragmented to exist under current economic conditions, where the cost of liabilities will float with the money market. The Federal Home Loan Bank Board suggests that broadening lending powers is the solution in the so-called "Pratt" bill. I submit that in most cases that won't work. At this very moment my firm is counseling a number of commercial banks, whose assets and liabilities are configured like thrifts. They have always had the power to make interest-sensitive commercial and industrial loans, yet they have not had the skill or the manpower to do so.

I'm a stockbroker and a member of all the major stock exchanges, yet neither I nor any of my associates know anything about making margin loans or dealing in commodities or options. Shearson/American Express, despite the enormous financial backing behind them, are not competitors of my firm, and we certainly could never match their skills in most areas of the brokerage business. Making a loan on a single family home does not require a large amount of lending skill. I submit that an officer who has spent

his career making mortgages is not competent to make accounts-receivable loans, nor indeed to grant unsecured credit to a business. If the Federal Home Loan Bank Board's proposal for broadening lending powers is granted, I anticipate enormous loan losses at the thrifts.

A few years back, the SEC instituted freely competitive commission rates. The result: hundreds of brokerage firms, heretofore sheltered by fixed rates, went out of business, and only the most efficient survived. Memberships in the Securities Industry Association dropped from 800 to 400, and the survivors are making more money than ever before, and investors have benefited from drastically reduced transaction costs.

The Fed, however, has had a maniacal obsession with market concentration and potential competition. But the plain hard fact is that with liability costs floating at uncontrolled levels, just as in the brokerage industry, there are too many banks and too many thrifts.

When Reg Q which has sheltered the inefficient thrift and community banks goes, so must many, many banks and thrifts be consolidated to be more efficient. Professors Horvitz and Pettit used a symbol P_c to indicate the present value of expected future long-run profits in continuance. My question is, who determines P_c? Certainly not the FDIC and the FSLIC. They have neither the skills nor the manpower to make such an important judgment on hundreds and perhaps thousands of thrifts. I have an abhorrence of turning over such an important decision involving billions of dollars to the bureaucrats. They'll never get the job done.

We recently represented the $100 million Maplewood Bank and Trust in a merger with the Summit Bank Corp. of Summit, New Jersey. Clearly, neither bank held a very large share of the New Jersey market. Maplewood was without a CEO and served a mature residential community where there was no C&I loan demand. Summit, on the other hand, had a strong, young management, was well capitalized, and consistently earned over 1 percent on its assets, and indeed in 1980 earned 1.36 percent. It was a merger made in heaven, yet the Fed took over three months to render an approval that could have been given in six minutes.

I see the solution to the problems of the troubled thrifts to be, as in the brokerage business, in the private sector. Mergers, preferably with other thrifts, are a solution, in the absence of mergers with commercial banks. I also see this is the time for, and should be the catalyst for, getting rid of the interstate nonsense. As we see it, the most severe problems face the thrifts beginning with the giant New York City mutuals, whose performance borders on disaster. Now is the time for Bill Isaacs at the FDIC to say to Sam Armacost at the Bank of America, "How would you like some branches in New York City? Make me a bid." I warrant that that assisted takeover would cost less than giving a couple of these basket cases a capital infusion to continue to do what they have done so poorly to date.

Am I being uncharitable? I think not. In my home state of Connecticut, a number of savings banks are doing just fine, thank you. I mentioned earlier that the New Haven Savings Bank will earn 30 to 40 basis points on assets. The Chelsea Savings Bank in Norwich, Connecticut will earn 1.05 percent on its assets for the 12 months ending September 30, 1981, and the

New Milford Savings Bank earned 1.03 percent for the six months ending June 1981. Why did these thrifts and People's Savings Bank in Bridgeport which earned 29 basis points for six months all do so well? Because they utilized their authority to invest in common stocks whose profits helped offset losses on fixed rate assets. Rather than change thrifts into pseudo-commercial banks, which I submit could lead to disastrous loan losses, give the thrifts expanded equity buying authority. We have clear evidence that this worked in New England.

Horvitz and Pettit suggest making deposit insurance an explicit guarantee of the United States. There is no advantage, they say, or government purpose, served by having bank deposits a risky asset. I heartily concur with those sentiments, but cannot concur with their suggestion that the institutions and supervisory agencies should make use of whatever creative accounting techniques are available to defer losses. In this respect, the recent decision, they say, of the Federal Home Loan Bank Board to allow deferral on losses on the sale of mortgages is a correct one. Creative accounting merely papers over the functional failure of the thrifts, and, I might add, many community banks, to be able to operate in the vastly changed cost-of-money atmosphere. I also disagree that aid should be withheld until surplus reaches zero. This is too short a time if one wants to bring in a purchaser, and I have had some experience with this because we worked on the Farmers Bank case in Delaware and worked on Hamilton Bancshares, and it takes a long time to get people to come up with money to study whether they want to put something in the situation. I think if it has come down to the 23rd hour and 59th minute, you can't get the best available assistance from outside the community.

I agree with Eisenmenger's position that there is a need for standardized designs for adjustable rate mortgages. Indeed, two years ago in 1979, I was asked to address the annual meeting of the BAI held in Los Angeles. At that time I recommended that those bankers go home and put an end to fixed rate mortgages. My observation is that few took my advice. While I was, therefore, an early proponent of adjustable rate mortgages, I have now come to the conclusion they do not fit, and are not appropriate for all borrowers who warrant and need a term loan at a fixed rate. How to fund such loans? Our answer is jumbo CDs, which my firm has been marketing for regional banks since January. There are investors who used to buy long-term corporate bonds, who are now very attracted to the safety of principal inherent in a five-, six-, or seven-year term CD, which would match what has historically been the average maturity on a mortgage. The trouble is that these investors have large sums of money to put out, and are, therefore, not interested in the $500,000 CD of a $100 million bank that they never heard of.

It is my opinion that this simple, practical consideration, more than anything else, is going to force a contraction of a number of banks and thrifts into larger units whose paper would thus be more suitable for the large investors who control the bulk of the money seeking such investments.

One assistance method not mentioned by Horvitz and Pettit was reported by Alan Sloan, writing in the October 26 issue of *Forbes*. He says,

> Major S&Ls, whose problems can't be solved by portfolio sales, may be attractive takeovers, thanks to section 244 of the 1981 Tax Act. That clause pushed through by the FSLIC when no one was looking, enabled the FSLIC to unload two of its biggest problems: The $2.6 billion West Side Federal S&L, and the $1.3 billion Washington S&L of Miami on to National Steel. The FSLIC will probably shell out $10 to $12 million a month to National this year to cover the two S&L's losses. Heaven knows what the cost will ultimately be. But had the FSLIC chosen to close West Side and Washington, it would have had to lay out 20 to 25 percent of its insurance fund. That might have gotten people into worrying about the safety of deposit insurance—the last thing the FSLIC needs.

And he goes on:

> Section 244, the FSLIC's goody in the Tax Act, allows owners of money-losing S&Ls, receiving FSLIC subsidy payments, to deduct the S&L's operating losses for tax purposes, but does not require them to count FSLIC payments as income. If you can buy an S&L losing $100 million a year with a guarantee that the FSLIC will cover the $100 million, you can't lose. You shell out the $100 million loss, get a $46 million refund from the IRS and then get the $100 million from the FSLIC. Net cash flow: $46 million.
>
> With deals like that available, people are going to be banging down the door trying to acquire some of the troubled S&Ls. The FSLIC would rather pay hefty annual subsidies from its insurance fund, than shell out hundreds of millions of dollars all at once to pay off the depositors for failed S&Ls.
>
> When the FSLIC is finished, there will be far fewer S&Ls than the 4600 there are today, and in that I concur heartily. Merging S&Ls into each other will be a growth business, at least for a few years, while the thrifts sort themselves out.
>
> But at some point after muddling through, the thrift industry will have to become profitable if it is to get off the regulators heart-lung machine. Doing that will require capital, interest-free money.
>
> The obvious way to get it once the crisis is passed, may be to convert mutual S&Ls and savings banks into stockholder institutions, by selling new shares in them. That may be tomorrow's problem, but the time to start worrying about it is today.

The fact that borrowers have been subsidized at the expense of savers, perhaps since the late thirties, has been well documented, and therefore established. Lest one suppose that this is a recent deduction, the following quotation was taken from a report from the Connecticut Bank Commissioner Walter Perry, to Governor Baldwin, for the year ended September 30, 1939. Commissioner Perry said in his letter, "It is perhaps inevitable that a great deal of public interest has been lately focused upon dividend rates of savings banks at present when compared with rates prevailing up to 1932, and upon the reasons for such rates. It is unfortunate, however, that such interest is not more informed, particularly when it seeks, as it did in the past two sessions of our general assembly, to cure an economic condition by legislation, and to set up by some arbitrary, mathematical formula,

a fixed differential between dividend rates, and the rates charged by savings banks on mortgage loans. Those earnest persons, who have made themselves heard on this latter point, must bear in mind that Connecticut statutes and court decisions sustain the theory that the management of savings banks has a trustee relationship to its depositors, who are the beneficial owners of the bank."

"Savings bank management," Perry said, "has a definite obligation to serve depositors only, and has no obligation whatsoever to serve the borrowing public with mortgage money. Furnishing such money to the public is only incidental to providing a prudent investment for the depositor's funds. Whenever this principle is lost sight of, and management, out of local pride or what it considers to be public interest becomes too generous in making mortgage loans to help a local industry or build a hotel or finance home building, depositors are apt to suffer losses. There is ample evidence of this in the files of the banking department." So wrote Commissioner Perry in September 1939!