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Statement of the

Shadow Financial Regulatory Committee

on

FSLIC Recapitalization

February 9, 1987

Congress is considering proposals to recapitalize FSLIC. FSLIC's net reserves have declined to about $2 billion, while the present value of its expected losses has been estimated at $30 billion or more.

The current Administration proposal, however, entails raising only $10-15 billion, through issuance of long-term debt. This debt would be serviced by contributions from the Federal Home Loan Banks, a pledging of FSLIC's future income, and a continuation for many years of the special assessment on FSLIC-insured institutions.

The Shadow Committee believes that the problem of insolvency of FSLIC is critical, demanding prompt governmental decisions. Delays in resolving this insolvency have already added substantially to the ultimate bill that must be paid. Moreover, FSLIC reports that currently insolvent institutions are incurring losses of over $6 million per day.

Congress must now decide who will pay for these mounting losses. The are four broad alternatives:

1. FSLIC could be allowed to fail when it runs out of cash. Losses would be suffered by insured depositors in failed institutions. This policy assigns the loss to depositors and raises the problem of runs on other institutions.

   Deposit insurance was established with limited resources and without an explicit U.S. government guarantee. However, the public has been led to believe that the federal government stands behind the deposit insurnce system. A March 1982 resolution stated the United States Treasury stands behind FSLIC. While this resolution would not seem to have legal force, savings and loans have used this statement widely in their advertising, with no objection from the federal government. We do not believe that substantial losses should be imposed on depositors who have relied on this implicit guarantee.

2. The funds needed to restore FSLIC to health could be drawn mainly from the savings and loan industry, as the Administration's proposed legislation would do.

   This approach assumes implicity that it is most equitable that the savings and loan industry bear the largest part of the burden of recapitalizing FSLIC. These institutions have benefited over the years from the operation of the federal deposit insurance system. While the Committee agrees with assessing savings and loan associations, it believes that the funding contemplated by the Administrations's proposed legislation is inadequate. Moreover, funding at an adequate level (i.e., $30 billion) would exhaust the industry's present net worth.

3. Commerical banks could be tapped, in addition to savings and loan associations, to make up the FSLIC losses.

   Since commercial banks have also benefited from the existence of federal deposit insurance, it has been argued that they should share in the burden of recapitalizing FSLIC. On the other hand, commercial banks have not caused FSLIC problems. One way of indirectly assessing commercial banks would be by merging FSLIC with FDIC. However, the combined insurance funds cannot cover the present expected losses of all banks and savings and loans.

4. We think it inevitable, therefore, that the general taxpayer will have to bear some of the cost.

   The current Administration proposal provided significant resources to be financed by the industry to deal with the immediate problem, and we support that approach. We believe, however, that FSLIC needs more funds -- which must come from the taxpayer.

   Although recognizing and distribution FSLIC losses is necessary, that is only the most obvious part of the solution to the problems insolvent institutions pose. An explicit commitment must be made to the taxpayers to assure them that their money will be used efficiently. A system that uses market values must be established for making FSLIC officials more accountable to Congress and the taxpayers. Economic principles for selecting institutions for reorganization need to be enunciated explicitly. While forbearance may be useful in some cases, opportunities for corrupt or wasteful management of the assets of weak institutions must be curtailed.

Fundamental redesign of federal deposit insurance, to the end that current problems will not again be incountered, remains
9 project of the highest priority.