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**Statement of the Shadow Financial Regulatory Committee**

on

**The Southwest Plan for Ailing Thrift Institutions**

February 8, 1988

The development of the Southwest Plan by the Federal Home Loan Bank Board (FHLBB) is an important step toward a comprehensive, coherent approach to dealing with problem savings and loan associations in Texas. There are clear benefits to setting and announcing criteria for decisions on troubled institutions and this should help the Federal Savings and Loan Insurance Corporation (FSLIC) use its limited resources more effectively.

Unfortunately, FSLIC resources appear woefully inadequate for a full solution to the problem. While we applaud the FHLBB's efforts to make creative use of FSLIC's limited resources, we believe it is equally important that sufficient resources be devoted to the problem now. Experience indicates that delay in case resolution is costly to FSLIC and ultimately to the

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taxpayer. As we have indicated in previous statements, it seems inevitable that the taxpayer will end up bearing the burden of S&L failures.

The Southwest Plan contemplates merging insolvent institutions into existing well-managed (though not necessarily solvent) institutions. This will facilitate the closing of branches without a loss of convenience to customers.

While reduction of non-interest operating expenses would constitute an important saving to the industry and to FSLIC, interest costs are much more important. The FHLBB's statement on the Southwest Plan contemplates a reduction of interest costs through an expected reduction in the "Texas premium" (the higher rates paid by Texas S&Ls). We fail to see the basis for this hope. If a number of institutions, each seeking funds from the market, are replaced by one large S&L needing the same level of funding to finance its asset holdings, there is no reason to expect interest rates to decline. The demand for funds will decline only if assets are liquidated, and it is not clear whether such shrinkage is contemplated by the Southwest Plan. The Texas premium reflects a market risk assessment that will not disappear without an improvement in the market's confidence in FSLIC. We question whether the Plan will inspire that confidence.

In view of the limited resources provided by last year's recapitalization legislation, FSLIC is attempting to maximize the impact of the new funds by "leveraging" them. The FHLBB indicates that case resolution will be handled largely through use of notes rather than cash. "Leveraging" means borrowing, and borrowing implies repayment. It is important to distinguish borrowing or issuance of notes by FSLIC from the bonds being sold by the Financing Corporation (FICO) under the Competitive Equality Banking Act (CEBA) recapitalization legislation. Repayment of principal on the FICO bonds is assured through purchase of zero-coupon Treasury bonds, and interest on the FICO bonds is provided by a first claim on FSLIC income. Under plausible assumptions about S&L growth and continuation of membership in FSLIC, debt service is reasonably assured.

The Committee's reservations go to the ability of FSLIC to handle its own obligations with the income it will have available after the FICO debt service is paid. The implications of any such weakness for future FSLIC case resolution are ominous. We note that the Congressional resolution contained in CEBA promised support for deposits insured by FSLIC, but is silent with respect to other FSLIC liabilities. As long as the financial soundness of FSLIC is in doubt, those institutions that are attracting deposits primarily on

the basis of FSLIC insurance will be forced to pay higher rates than FDIC-insured institutions or sound FSLIC-insured institutions. In view of the difficulty of distinguishing sound from weak institutions, it is not irrational for depositors to demand higher rates from all Texas thrifts.

We support the use of a variety of means to reduce the dependence of weak institutions on high-cost funds. For example, the "As Agent" and "DalNote" programs developed by the Federal Home Loan Bank of Dallas can be helpful, as can the willingness of the Home Loan Banks to make advances on the basis of FSLIC guarantees. Nevertheless, we believe that FSLIC-assisted mergers under the Southwest Plan should generally be conditioned on a plan for asset shrinkage by the resulting institution.

The FHLBB policy of issuing notes in case resolutions is made necessary by its lack of cash. The alternative, to handle many fewer cases, is not desirable. As we have argued previously, Congress must provide resources sufficient to solve the problem. The Administration must face up to the problem and prepare an adequate proposal. The FHLBB must make the Administration and the Congress aware of the magnitude of the problem and of the fact that delay will increase the ultimate cost.