

**Shadow Financial
Regulatory Committee**

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Statement of the Shadow Financial Regulatory Committee
on the
FSLIC's Handling of Failed Thrifts

May 16, 1988

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In previous Statements we noted that the resources available to the Federal Savings and Loan Insurance Corporation (FSLIC) are inadequate to meet its insurance responsibilities for insolvent savings and loan associations. The shortfall was estimated to be less than \$15 billion in 1985, less than \$30 billion in 1987, and now it appears that \$50 to \$60 billion would be required to protect depositors at insolvent institutions. We are concerned that this shortage of funds has led the FSLIC to prefer solutions in specific cases that minimize immediate outlays, but which are likely to have great long-run costs which will have to be paid by the taxpayers or depositors. This problem is particularly acute as the FSLIC attempts to deal with the large number of insolvent institutions in the economically troubled Southwest.

We recommend that priority be given to case resolutions that bring new private capital into the S&L industry. Well-capitalized parties are willing to invest in thrifts, but they usually want to earn returns commensurate with their alternatives. Therefore, they will not take over an insolvent institution unless the value of its assets is at least equal to the amount of its liabilities, which requires the FSLIC to provide the shortfall. Rather than deal with these investors and put up the required resources, the FSLIC prefers to buy time and impose higher costs on taxpayers in the future by selling failed institutions to weak or insolvent S&Ls. Unlike well-capitalized investors, these S&Ls are willing to take over the failed institutions so that they can buy time and expand risk-taking. Most of the risk-taking results in higher future losses to the FSLIC, which will add to the FSLIC shortfall.

Dealing with economically (market value) insolvent or weak S&Ls allows the FSLIC to maintain the charade that it is not massively insolvent. These S&Ls often are willing

to acquire a failed institution with a smaller amount of financial assistance than is needed to restore economic solvency. They often ask only that the book value negative net worth hole be filled, and are willing to accept notes from the FSLIC that are worth less than face value. Since the book value of their net worth often depends on including overvalued assets on their balance sheets, they cannot argue that the assets of the acquired institution are misstated. Since these potential buyers often operate with inadequate net worth themselves, they put considerable value on FSLIC forbearance which gives them the time either to take gambles that might pay off or to wait for a favorable change in economic conditions.

If auctions are conducted under the FSLIC's current procedures, successful bidders for failing institutions will tend to be relatively weak themselves. Well-capitalized investors have learned the FSLIC's preferences and are becoming less willing to go through the costly, time-consuming bidding process when they believe they have little chance of winning.

Having weak and insolvent S&Ls take over failed S&Ls is costly to the taxpayers, since many of the successful bidders are likely to require FSLIC assistance themselves in the future. Some weak and insolvent S&Ls believe that, if they become large enough, they can become "too large to fail."

The FSLIC must recognize that weak S&L's have an incentive to submit uneconomic bids. In the long-run, acceptance of such bids is not in the FSLIC's or the taxpayers' interest. Therefore, we urge the FSLIC to reject bids from institutions that will not be able to comply with capital requirements. This requires it to look through accounting rules to the underlying economic values.

It is the Committee's policy that members abstain from voting on policy statements in instances in which they have a direct or professional involvement in the matter that is the subject of the statement. Accordingly, Lawrence Connell abstains from voting on this statement.