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Statement of the Shadow Financial Regulatory Committee on The Administration's Plan to Resolve the Thrift Crisis

February 13, 1989.

The Bush Administration's proposal for resolving the thrift crisis recognizes that the problem is much larger than has previously been officially acknowledged. The proposal forthrightly admits that losses have mounted during many years of procrastination and that public funds must now be employed to support the government's deposit insurance obligations. The Administration envisions raising an additional $50 billion over the next three years to recapitalize or liquidate insolvent thrifts. These funds will give FSLIC/FDIC flexibility that could be used to resolve efficiently the many insolvent institutions it will have to deal with.

While the President's statement correctly notes that economic conditions, excessive risk taking and fraud have played major roles in the development of the current problem, it does not recognize the critical role that the perverse incentive structure that underpins the existing deposit insurance system has played in bringing about this crisis. A critical part of any Administration proposal must be to restructure the deposit insurance system to correct the present adverse incentive structure facing institutions and regulators. In particular, once an institution approaches insolvency, it is unreasonable to expect that regulation and supervision can overcome the incentives that managers of failing institutions have to take excessive risk. Allowing undercapitalized and insolvent institutions to remain in business through regulatory forbearance encourages risk taking that ultimately leads to huge losses.

To improve bank managers' incentives, it is essential that the increased capital requirements recommended by the Administration be accompanied by an improved monitoring system (including market value reporting and enhanced supervision), and by an obligation on the part of the insurance agency to intervene when capital is still positive and before insolvency is a strong possibility. The Committee's views on the necessary reforms are set out in its February 13, 1989 Policy Statement No. 41, "An Outline of A Program for Deposit Insurance and Regulatory Reform."

To improve incentives for regulators, the Administration's plan should include an accountability mechanism to assure that decisions are made objectively and efficiently during the insolvency resolution process. At a minimum, this requires a coherent program for distinguishing between institutions that can and cannot survive, for acquiring the assets of insolvent thrifts, for reprivatizing the assets and institutions acquired, and for regular and comprehensive public reporting of the determinations made.

At least two other issues must be considered in evaluating the Administration's plan. First, we are concerned that the magnitude of the problem is potentially greater than the $90 billion that the plan recognizes. There is a strong possibility that additional thrifts which are now marginally solvent will become insolvent in the near future. Increases in interest rates may also lead to financial difficulties for many more thrift institutions.

Second, whatever the size of the required government financing, it is important that the funds be raised in the lowest cost way possible. By funding off-budget (albeit with Treasury guarantees of interest) as the plan proposes, it is likely that the cost will be greater than if the Treasury financed the cash requirements directly.

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