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Statement No. 43
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Statement of the Shadow Financial Regulatory Committee on the Financial Institutions Reform, Recovery, and Enforcement Act of 1989

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General Position

After years of procrastination the Administration and the Congress have finally come to grips with the insolvency of the FSLIC, and have proposed spending some $90 billion to resolve the deficit. Three years ago, the Shadow Financial Regulatory Committee called public attention to the depth of this problem, and recommended an expeditious recapitalization of the FSLIC, along with merger or closing of hopelessly insolvent ("zombie") thrifts. At the beginning of 1987 we estimated that the cost of resolving the thrift problem was at least $30 billion, and we stressed the need for Treasury funding and for early takeover of deteriorating and insolvent institutions. (See Statement No. 16, February 9, 1987). Recent actions by the Administration and Congress make it clear that the full faith and credit of the United States stands behind the deposit insurance system, even if the cost turns out to exceed today's estimate.

Unfortunately, the commitment to raise the necessary funds is one of the few constructive provisions contained in the lengthy bills now before the Congress. In the past, the Shadow Financial Regulatory Committee has expressed the need for fundamental reform of the deposit insurance system, and articulated the key issues that such reform should address. The Committee urged that such reform would be coupled with any bailout of FSLIC. None of the pending bills effectively deals with the incentive and other structural defects of the present system. Instead, they contain a number of provisions that could worsen the situation.

The Committee has concluded, reluctantly, that given the need for prompt action, <u>the best action would be legislation restricted to raising the funds needed to take over insolvent and hopelessly deteriorating thrift institutions</u>. While the Committee is disappointed that significant regulatory reform does not seem politically feasible at this time, we urge the

Administration and the Congress to consider carefully serious structural reform.

This statement lists a number of issues on which we believe that the legislation does mischief or represents a facile "solution" to a complicated problem. This listing is not exhaustive.

Financing:

We strongly oppose the complex financing scheme provided for in the bills that passed the Senate and the House Banking Committee. There seems to be no purpose to this arrangement other than the desire to keep the cost off-budget. All agree that this will increase the ultimate cost of resolving the problem, and there is no public benefit from the money wasted in this manner. Keeping the funding off-budget necessitates the creation of the Resolution Funding Corporation and the Resolution Trust Corporation, with resulting additional inefficiencies and costs. We commend the House Ways and Means Committee for its tentative vote that all spending be handled on-budget, with all borrowing being done by the U.S. Treasury. The Shadow Financial Regulatory Committee has issued a separate Policy Statement (No. 42) dealing with this issue.

Capital Standards:

The aspect of the legislation that has generated the most controversy is the level and structure of the capital requirement to be imposed on S&Ls. This Committee has been a strong supporter of high and rigorous capital requirements, but specification of capital requirements requires careful action. We do not believe that Congress can develop an effective system on the short time schedule necessary for this legislation. If Congress is to include provisions on capital in this legislation, we believe that it should be to express: (1) a general objective--that no depository institution should be allowed to continue to operate without capital that is positive when calculated in accordance with generally accepted accounting principles (and eventually on a market value basis); (2) a definition of capital as all claims junior to the claims of depositors and other general creditors--obviously this includes subordinated debt; and (3) an implementing principle--that thrifts should be required to meet commercial bank capital standards by a date certain.

Related to the capital controversy is the debate over accounting treatment of goodwill and other intangibles. Congress is not the place to debate technical accounting matters, such as which intangibles have more economic value than others, or whether purchased rights to mortgage servicing deserve more favorable treatment than purchase accounting goodwill, or whether goodwill acquired as a result of supervisory mergers is better than goodwill acquired in other ways.

Qualified Thrift Lender Test:

Portfolio diversification is fundamental for the prudent management of interest rate and credit risk. Tightening of the "qualified thrift lender" (QTL) test, as the legislation provides, will produce perverse results. It also is not a reasoned response to irresponsible risk-taking by some thrift managers.

Deposit Insurance Funds:

The legislation perpetuates the idea that it is necessary to maintain two separately reserved deposit insurance funds, even though explicitly recognizing that deposit insurance is backed by the full faith and credit of the U.S. The funds would serve as accounting devices rather than as a constraint on spending for deposit insurance purposes. With the funds under common management (the FDIC), separate accounting may focus attention on differences in risk exposure to thrift and commercial bank operations.

It is important is that Congress not allow the implication that one fund is stronger or safer than the other. Clearly, both are backed by the U.S. government. As a result, there is no logic to separate deposit insurance names or logos. If any artificial distinction in the quality of deposit insurance is perceived by depositors, thrifts will be forced to pay higher rates on deposits. Much of this increased cost will be borne by taxpayers, through the operation of existing conservatorships and yield maintenance agreements. Both House and Senate versions of the bill provide for different insurance names and logos.

Organizational Structure:

The legislation makes a number of changes in the organization structure of thrift regulation that address the perceived regulatory failures of the FHLBB. The thrift industry, with the aid of the Congress, historically exerted undue influence over its regulator. But we find it hard to believe that thrift regulation can be more effective as part of the Treasury Department than as an independent agency. Nor is it clear that such a structure would keep this function freer of Congressional pressure. The legislation does provide for exemption from the appropriation process for the thrift regulator, and that may indeed be helpful.

Enforcement Powers:

There are a number of provisions in the legislation that increase the regulatory agencies' enforcement powers. The agencies were granted substantial enforcement powers in 1966, which were significantly enhanced in 1978. We have seen no evidence that lack of the powers included in the proposed legislation was responsible for the losses incurred. It is clear that there was a lack of will to use existing powers effectively. Far worse, some of these additional powers raise substantial issues of regulatory overkill. We find it hard to justify, for example, the power to levy fines as high as $1 million per day. If any such additional powers are granted, there should be clear provisions for accountability by the agencies and an attempt to see that rights to procedural fairness are protected.

Cross Guarantees

The legislation provides that bank subsidiaries of a multibank holding company be required to indemnify the FDIC against losses due to failure of their affiliated banks. The FDIC has a valid concern that its potential exposure is now affected arbitrarily by the way in which a bank holding company chooses to organize its operations. On the other hand, the proposed change would have far reaching implications for the position of creditors and minority stockholders of the subsidiary banks. If any such change is made, it should only become effective after a substantial phase-in period. In addition, affected institutions should have the option to operate their banking operations as branches, rather than subsidiaries, regardless of state or federal restrictions on branching.

Acquisition of Healthy Thrifts:

The Senate bill delays for two years the authority of commercial banks or bank holding companies to acquire healthy thrifts. There should be no delay, and this authority should be granted immediately, as the House bill provides.

CPA Audits:

We support the provision in the legislation that requires independent CPA audits of all commercial banks. Savings and loans are already subject to such a requirement. We endorsed this concept earlier in our Policy Statement No. 32, May 16, 1988.