SHADOW
FINANCIAL
REGULATORY
COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
(312) 915-7075
Fax (312) 915-6118

Statement No. 80

For information contact:
Edward J. Kane
614-292-8708

Statement of the Shadow Financial Regulatory Committee on the FDIC's Program for "Hospitalizing Sick Banks"

February 17, 1992

This Shadow Financial Regulatory Committee has noted repeatedly that taxpayers are apt to lose when regulators gamble that the government can efficiently nurse an insolvent enterprise back to health. This policy affords a pretext for refusing to impose losses on uninsured depositors in failing institutions. Experience with thrift institutions insured by the FSLIC has shown that programs of capital forbearance and government management increase rather than reduce taxpayer losses.

Despite this unfavorable experience, in late January the FDIC rejected private bids for CrossLand Savings FSB, choosing instead to nationalize this firm "temporarily." FDIC Chairman William Taylor euphemistically characterized this action as the beginnings of a federal "hospitalization program" for failing depository institutions. This approach undermines the major reforms achieved by the FDIC Improvement Act that Congress passed less than three months ago.

It is possible that temporary nationalization might, in some cases, be the least-cost method for resolving an individual bank failure. But taxpayers have good reason to doubt that their interests are being well represented when "hospitalization" decisions are made. As amply demonstrated in the FSLIC fiasco, public managers are seldom as efficient as private ones, and regulatory authorities face serious conflicts of interest that can bias them against promptly reprivatizing a failed bank or thrift.

Prior to implementation, FDIC officials should have issued a public notice that fully articulated the tests and criteria by which they proposed to govern their nationalization program. The FDIC Improvement Act of 1991 favors imposing losses on uninsured creditors and undertaking a prompt privatization of risks. Given this intent of Congress, FDIC officials should have set up a reporting framework that would expose their decisions to informed outside examination. This entails releasing to the public a detailed and reproducible analysis of the costs and benefits the FDIC Board found and upon which it based its decision. General Accounting Office review of these findings as required by the 1991 Act is also essential for establishing the integrity of the Board's conclusions.

Complete accountability requires further that a timetable be established for reexamining every quarter the costs and benefits of each deposit-institution nationalization. Each nationalization should be kept to the shortest term feasible, with repeated public review. The process might usefully be modeled as an expedited bankruptcy action. This would mean establishing a receivership at the start of the process, and then, as quickly as possible, proceeding with a corporate reorganization or a liquidation. Either alternative would imply pro rata losses to uninsured creditors.

Rejecting private bids for an insolvent institution is dangerous from the standpoint of taxpayers because it has the effect of avoiding a writedown of assets to the market values that informed bidder valuations clearly imply. Taking a lesser writedown enables the agency to report a stronger balance sheet and higher operating income than it would otherwise have to reveal.

In the CrossLand case, the FDIC staff projected that the nationalization approach would cost $763 million in present value as against an estimated $1.3 billion cost for accepting the top private bid received. However, perhaps to insulate itself from outside criticism of the doubtful assumptions on which the staff's estimate of nationalization costs is based, the FDIC Board stopped short of endorsing its staff analysis by noting: "The Board did not adopt every detail of this analysis -- finding that the overall cost of both alternatives could be greater, and the differences between the two could be smaller."

It is easy to understand why Board members might be uncomfortable with the numerical assumptions its staff employed. These assumptions are grossly disparate from the market valuation of CrossLand's balance sheet offered by the high bidder. Under these circumstances, it was incumbent on the FDIC to document a compelling supporting analysis for its projections. The Committee believes that a proper analysis would not support the decision the FDIC made. Specifically, such analysis would not:

1. Treat $437 million as the present value of CrossLand's realizable future franchise value, based largely on an excessively optimistic 1.5 multiplier of the book value of the equity to be injected by the FDIC.

2. Assume $440 million for the present value of an incrementally better recovery on $4.4 billion in "difficult" assets by government agents compared to returns from liquidating these assets straightforwardly. In contrast, by declining to bid for these assets, the top private bidder treated this workout as at best a breakeven opportunity.

3. Make the deeply troubling -- and totally undocumented -- assumption that there is a net gain to the insurance fund from protecting a failing firm's uninsured depositors from loss. The Committee believes that this assumption is rooted in the perpetuation of deposit-insurance subsidies associated with the "too big to fail" policy. In this case, uninsured depositors were granted an estimated $18 million in immediate relief, and protection also against short-falls in the FDIC's assumed recovery rate on troubled assets. But the cost of protecting these depositors cannot be calculated on the basis of the isolated individual insolvency, because it extends to uninsured depositors at all institutions.

The FDIC action in the CrossLand case is based on unconvincing evidence and violates the Congressional intent expressed in the FDIC Improvement Act of 1991. It is poor public policy to implement major changes in insolvency resolution in an episodic fashion, without adequate disclosure and prior comment.