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Title
Avoiding Future Losses

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Publication Date
1989-03-01

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WORKING PAPER NO. 89-158

AVOIDING FUTURE LOSSES

BY

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AVOIDING FUTURE LOSSES

Testimony Before the U.S. House of Representatives
Committee on Ways and Means
Washington, D.C.
February 22, 1989

by

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WORKING PAPER NO. 89-158
March, 1989

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University of California, Berkeley

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Committee on Ways and Means
February 22, 1989

Mr. Chairman and Members of the Committee:

It is a pleasure to be able to discuss with you problems in cleaning up the savings and loan situation, together with its tax and budget implications.

Most critical is the assurance of federal financing to allow for the orderly liquidation of the insolvent and non-viable thrifts, together with the adoption of a sound plan for the future. Large sums have already been wasted in attempts to avoid facing up to this problem. If we lose this opportunity to rationalize the industry, even larger sums will be lost in times to come.

President Bush's proposals are a good starting point for Congressional consideration. However, many details must be worked out. Among the most important are decisions as to what the future thrift industry--if one is to exist--should look like, which of past mistakes can be avoided, and who should pay for the losses that already exist.

I believe that:

--- We should attempt to maintain a separate thrift industry, with its firms primarily limited to lending on homes and other consumer needs similar to traditional savings banks. A critical mistake leading to the huge losses was allowing thrifts to enter into joint ventures and to make commercial and development loans

for purposes unrelated to residential structures.

--- The thrift industry should be restricted to adequately capitalized firms. Money spent to keep insolvent or marginally solvent firms open beyond the time required to liquidate them most efficiently will be wasted. Depositors, borrowers, and taxpayers will all suffer if excess capacity is retained.

--- The current problems arose primarily because of (1) inadequate capital requirements, (2) deregulation, allowing firms to make loans about which they had inadequate knowledge and experience, and (3) a lack of control over firms' rate of growth, capital, and risks. Most losses were caused by ignorant, greedy speculation.

--- It will be costly to delay dealing with the problem. So will the use of off-budget techniques, such as tax expenditures or unconventional financing. While most economic losses occurred when the loans went bad, they have been magnified by a lack of funds to close firms down and to liquidate them in a logical manner. It would be best if losses for the remaining insolvent firms could be shown as a charge against this year's budget.

--- Clearly, costs will be high because of past failures to charge enough for the insurance to cover the risks. Ideally, most of the funds needed to pay for the deficits in FSLIC funds should come from the institutions, depositors, and borrowers who did not pay adequately for the insurance in the past. This argues for an increase in deposit insurance rates, augmented perhaps by a return to prior higher reserve requirements. Since funds from these sources will be inadequate to cover all losses,

taxpayers will have to share the burden. Still, a primary aim should be to have users of financial services pay as much as possible and taxpayers the least.

<u>Adequate Funds for a Sound Liquidation and Future Operations</u>

The key need at the moment is for sensible legislation that will allow the consequences of past errors to be dealt with while insuring efficient future operations. This means both finding adequate funds to liquidate insolvent and marginal firms efficiently and, more important, devising a regulatory structure that will guard against a replay of past errors.

The reason that action is needed is not, as some have argued, because the costs of delay run at one-half to one billion dollars a month. Closing down the insolvent institutions now is not going to save anywhere near these amounts. Most of the so-called operating losses are merely the costs of carrying non-earning or barely-earning assets. Whether or not past actions that caused lost values are entered on the books of institutions and the insurance fund, interest must be paid to cover the gap between liabilities and assets. In the same way, interest will have to be paid by the receiver when firms whose liabilities far exceed their real assets are taken over. A saving occurs only to the extent that the government borrows at lower rates than the insolvent institutions. If the government borrows off-budget and for 30 years, instead of the Treasury's borrowing along the full yield curve, rates for the new corporation--and, therefore, the government's costs--will probably be higher than they are now.

A failure to liquidate raises real costs because it retains

excess capacity in the industry. Equally important monies are lost because of the difficulty of controlling lending policies of insolvent institutions continuing to operate with old management and stockholders. Without any capital at risk, it pays them to make speculative loans. The need is to wind down these firms now. They should not be authorized to make new loans.

Perhaps more important is the lack of a national policy as to what assets to sell, when to sell them, and when to hold them. Just as we have had a fire sale of institutions, a danger exists that the receivers will take too narrow a view of their market impact and will liquidate too rapidly. Liquidation should be gradual, taking into account the difficulty of accurately valuing real poperty and the need to market it cautiously, without too rapid an increase in the supply.

The Industry Structure for the Future

Liquidation without a sound future structure for financial institutions, the insurance funds, and the regulatory agencies will invite similar errors and losses down the road.

Doing Away with Thrifts. There is some validity to the arguments of those who say that it would be a mistake to try to maintain a separate thrift industry but that, instead, all sound survivors should be allowed to become commercial banks. They point out that since savings and loans are only part of the mortgage market, interest rates and terms are set at the market price needed to attract other lenders to mortgages. Savings and loans merely meet the prices of these others; they need not and do not offer lower terms. In fact, in most markets, S & Ls

charge more than mortgage bankers. They believe that most federal aid has gone either into wasted excess capacity or higher profits. Neither borrowers nor depositors have gained.

The critics say that the government would never have appropriated the 80 or 90 billions of dollars--now being requested--as subsidies to the industry, and that the amount lost far exceeds the public gain from having separate thrifts. Yet past policies committed these amounts through back-door financing. Wouldn't it be better policy to decide how much aid should go to housing and to appropriate it directly, rather than trying to use indirect methods with unknown and unmeasurable results?

Finally, they claim that the current crisis resulted from the fact that the past structure was illogical. Combining regulation and promotion in one industry subject to extreme political pressure was never sensible.

Maintaining the Thrifts. While these arguments are strong, I believe that good reasons exist for maintaining a separate thrift industry--provided that it has a clear mission and that it meets the test of good management and adequate return on capital. However, if savings banks are to have most of the powers and act like commercial banks, a separate industry is not logical. What Congress has wanted in the past, and what makes sense, are institutions specializing in residential lending together with other minor consumer functions.

Why do home and consumer financing banks make sense? While residential financing agencies such as GNMA, the FHLMC, and FNMA and the growth of the secondary market have greatly improved lending on housing, holes in the market remain. A need exists

for major portfolio lenders who primarily make variable-rate residential mortgages. Thrifts are the primary force in this critical market.

Thrifts serve to channel a share of newly created money and credit into the housing market. As a result, national savings and investment are higher. Most recognize that the level of saving and investment is too low. Removing institutions that specialize in saving and mortgages might reduce it still further.

The market for insured savings will remain more competitive if specialized thrifts continue. They have paid slightly higher deposit rates in the past and can continue to do so. Parenthetically, I believe that the suggestions made by some in the Administration that removing or reducing deposit insurance would improve operations is wrong. We know from experience that insiders, auditors, and regulators have great difficulty in measuring inadequate capital or insolvency. The chances that this function could be performed by the average depositor are slight. We would return to deposit runs and much greater instability.

An Industry Equipped to Meet National Goals

New legislation should aim at maintaining only those financial institutions that are efficient, whose capital is fully adequate to absorb lending risks, and that can give their customers the highest deposit rates and charge the lowest mortgage interest. Since capital requirements should be--and, hopefully, are to be--related to risk, thrift institutions specializing in residential mortgages would not need as much

capital as those institutions making commercial loans and having large off-balance-sheet commitments.

Some observers have expressed concern because marginal firms with inadequate capital may have to leave the industry. Such departures should be welcomed. If a firm cannot raise adequate capital to handle its risks, it should not be open. Some of the biggest errors of the past were to reduce capital requirements and allow special regulatory accounting. Even general accounting procedures for financial institutions have been inadequate because they do not require the recognition of losses caused by changes in market interest rates and collateral values. The use of regulatory accounting compounded the problems.

Major costs to borrowers, depositors, and taxpayers resulted from excess capacity that developed because firms were not required to have capital sufficient to cover their risks. They were subsidized by the insurance fund. The elimination of non-viable firms will be helpful, not harmful, to the economy. If they are not efficient enough to survive, they are being subsidized either by their customers or by the government, and neither makes sense. If they are closed as soon as they become insolvent, their closing will not increase the government's losses.

If only efficient firms remained, there might be far fewer than the current number, but the public would be better off. There is no magic in large numbers of institutions. If a pattern of financial institutions equivalent to that which now exists in California were adopted by the country as a whole, we would have

less than 5,000 banks and thrifts rather than over 16,000. Most would agree that California has more than enough institutions to assure competition and good service. Efforts to keep existing insolvent and marginal firms open, even with new management, are costly.

Except for requiring thrifts to pay part of the costs arising from past errors in the industry, it does not seem logical to keep two separate funds under one management. Costs and the amount of reserves required, as well as deposit interest rates, would be reduced if the FDIC and FSLIC funds were merged. The FDIC now insures some savings banks and other thrift institutions. Maintaining separate housing and consumer institutions depends on capital, lending, and tax regulations, not separate insurance funds.

<u>What Went Wrong?</u>

Past errors contain valuable lessons as to what not to do in the future. What did go wrong? Only a small share of the losses are due to fraud and high living. Most arose from mismanagement, taking of excess risks, ignorance, and poor regulation.

The losses developed because the country has buildings without tenants, half-finished projects, and the after-effects of a speculative credit bubble that inflated land and building prices. Results were similar to those following the Florida Land Boom and the South Sea Bubble.

The ability to lose so much money was made possible by deregulation between 1980 and 1983 at both federal and state levels. Particularly at fault was the attempt to keep alive

failing institutions with little or no capital through actions of the regulators and the Depository Institutions Act of 1982. In effect, the government assumed all the risks for hundreds of insolvent institutions. It was like staking poker players with piles of chips while allowing them to keep any winnings, even as the government agreed to pay all the losses.

With the ability to get all the funds they wanted through money desks or brokered deposits, S & Ls expanded too fast. Neither they nor the regulators had adequate staffs. Neither realized how many risks were being taken. All the new credit, together with large tax benefits, greatly inflated land and building prices. When inflation subsided and interest rates rose, the inflated values were squeezed out. Regional problems exacerbated some of the difficulties, but these were far less significant than the fact that capital was inadequate for the risks assumed.

How Should the Losses be Paid For?

We must recognize that the FSLIC losses have already occurred. The time at which they are entered on FSLIC's books and are included in the government deficit is a matter of bookkeeping. Whether or not they are recorded, interest has to be paid on the amount by which FSLIC's actual liabilities exceed the depreciated assets. The Executive and Congress must ask how much, if at all, the government's real costs should be raised in order to postpone the budgetary reckoning. The costs have already been inflated because FSLIC did not have the funds to liquidate its problems. To what extent should they be increased

now?

The ruling decision as to when to close or sell institutions should be based on the least cost to the government. This rule was not followed last year. In selling off major institutions, FSLIC considered only the expenditure of the insurance fund. It failed to take into account the costs to the government through the tax expenditures used to entice the purchasers.

Such tax expenditures are high. In some cases, savings in taxes will surpass the new capital invested. Buyers were again handed free chips to gamble with the government's money. In other cases, however, buyers received only minor tax benefits. This, of course, is the problem with using tax forgiveness as a policy. How much the government pays depends on the tax position and bracket of those given the benefit. By giving a premium to those with the largest potential tax benefit, such policies run counter to tax reform.

These deals had the additional disadvantage of failing to remove excess capacity. Instead, they restructured weak and under-capitalized institutions. What we need now is to recognize the potential expense of such temporary fixes. The use of further tax expenditures should be avoided. So should non-treasury borrowing or funding primarily with long-term bonds. These techniques also are almost certain to raise total costs.

Paying the Piper

Another critical issue is how to divide the costs engendered by the losses among users of financial services, financial institutions, and taxpayers in general.

I would prefer that most of the funds be raised through increased deposit insurance rates, since these were too low in the past. We should recognize that most of the sums collected will be paid for by the users of financial services--those who benefit from the insurance.

Provided that increased insurance rates apply to all deposit institutions, only a small share of any increased collections will be paid by the firms in the industry. They act primarily as collectors. No one knows better than the members of this committee how difficult it is to trace the true incidence of any charge. However, it is clear in economic theory that the charges will be passed on to the users of financial services. Furthermore, the deposit market is sufficiently differentiated so that they will be passed on rapidly.

The differential to be paid by institutions should be maintained, but gradually eliminated over time. The situation is analogous to taxes. The differentials have already been built into the capital structure. Removing them results in a windfall gain. On the other hand, firms willing to make a single advance payment to the insurance fund to move from a higher to a lower annual rate should be allowed to do so. Even if separate regulatory systems are maintained, firms should be permitted to transfer any time they want, provided that they pay their fair share of the costs that have been accumulated in the past.

I believe also that Congress and the Administration should consider carefully the time at which the losses are recognized for budgetary purposes. It is clear that the losses have already occurred. Their economic consequences were inflated asset values

and large unrecorded liabilities of FSLIC, which the Treasury guaranteed through actions of the Executive and Congress.

The federal deficits for the past eight years have been understated. If such losses were discovered in a private firm, it would restate its past revenues and expenses. While I recognize the problems raised by arcane federal budgetary procedures, it seems logical to attempt to recognize the existing losses now. Why should the recognition be limited to the $12 billion or so proposed in the budget? Couldn't the money be appropriated to pay off the difference between the real asset values and the amounts owed depositors in the remaining 200 to 300 institutions that are insolvent? Wouldn't we be better off making the 1989 deficit reflect actuality rather than expending time, energy, and real costs in an effort to fudge future deficits?

The increased collections from deposit insurance could be used to pay the obligations FSLIC has already entered into plus paying the Treasury for some of the interest on newly issued bonds. Any difference between the new book values for assets held by the receiver and liquidation receipts could also be used to reduce the debt.

In conclusion, we should reemphasize the need to arrive at logical procedures for the future. The mess we are in makes clear the need for a more rational structure for the financial services industry. Attempts to retain insolvent or marginally solvent institutions are likely to add to our previous losses. So will efforts to use tax expenditures or other off-budget procedures to reduce the reported budgetary costs.