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When Regulation Was Too Successful—The Sixth Decade of Deposit Insurance

A History of the Troubles of the U.S. Banking Industry in the 1980s and Early 1990s

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Contents

Finally, a disclaimer During the preparation of this book, I was on the staff of the Federal Deposit Insurance Corporation (FDIC) The interpretations, opinions, and views herein, however, were developed in my capacity as a mere taxpayer and should most certainly not be construed as those of the FDIC or any of its divisions or offices

Introduction

In 1983, the Federal Deposit Insurance Corporation proudly celebrated its 50th birthday The occasion was marked by the publication of a history of the deposit insurer's first half-century *The Federal Deposit Insurance Corporation The First Fifty Years* Although low-key, the work was largely laudatory, leaving the reader with an impression of an agency characterized by quiet competence and possessed of the confidence that comes from successfully meeting difficult challenges over a long period of time

Concerning the future, the FDIC acknowledged growing risk and instability in the banking system but predicted that the adequacy of the insurance fund and its historical relationship to the level of deposits would continue The net worth of the insurance fund was then in excess of $15 billion, and the ratio of the fund to insured deposits was 1 22 percent The ratio had never been below 1 percent

Eight years later, at year-end 1991, the bank insurance fund stood at a red-ink nadir of a negative $7 billion From year-end 1983 to year-end 1992, 1,394 banks failed, more than twice the 673 banks that had failed in the first 50 years of the FDIC's existence Also between 1983 and 1992, the number of commercial banks fell more than 20 percent, from 14,469 institutions at year-end 1983 to 11,462 institutions at year-end 1992 The decline has continued at year-end 1997, the number of commercial banks was 9,143, a decline of 37 percent since 1983

What happened?

This work attempts to answer that question The study is an examination of the banking industry's troubles of the 1980s and early 1990s, troubles that at times approached the level of a crisis Unlike the more infamous savings and loan crisis, however, the banking troubles did not result in the decimation of an industry or a massive taxpayer bailout The banking industry survived, and indeed today seems healthy and very much a central, fundamental component of the U S financial system Nevertheless, some of the lessons that a study of the troubles could provide may not have been fully accepted The initial government responses to the shakeout were dominated by those who believed that detailed control, regulation and supervision are the answer. Yet the underlying causes of the banking difficulties of the 1980s and early 1990s may well have been many decades of too much control, regulation, and supervision, and not enough reliance on market forces. If this contention is correct but is not the basis for legislative and regulatory oversight of the industry, banking's apparent recovery from the difficulties may not be as complete as it appears to have been, or long-lasting. Continued unwise public policies regarding the banking industry could produce, at some point in the years or decades ahead, another period of turmoil and another flirtation with the federal treasury.

Government policies and actions are the primary focus of this look at the banking troubles of the 1980s and early 1990s. The banking industry is a private sector industry and responds to many of the dynamics of the free market. But the industry was and is one of the most regulated segments of the economy. Government plays a role that is much more activist and central than is the case with the vast majority of other industries. A private sector focus for a history of the period is not impossible, but this present effort will concentrate on public policies—the activities of the Congress and government agencies.

The FDIC, the federal deposit insurance agency created in the depths of the Great Depression, was at the center of the efforts to deal with the banking troubles of the 1980s and early 1990s. Thus this study of those troubles is also a review of the FDIC's sixth, and most turbulent, decade of existence. A focus on the FDIC is further appropriate because deposit insurance, the agency's reason for being, had a causal role in the banking troubles. Deposit insurance was a major contributor to banking industry stability from the mid–1930s to the late 1970s. But as described in Chapter 1, the deposit insurance system also slowly germinated the seeds from which sprouted the difficulties of the 1980s.

Because what happened to and with the banking industry and the New Deal deposit insurer were reflections of trends and events in larger arenas, the study begins with an extended look at banking industry history and at the changing environment within which the FDIC and the other federal regulators operated. Although the banking industry is the primary focus of attention, pertinent matters concerning the remainder of the depository institutions industry, and concerning the financial industry in general, are also covered. The background material is presented in two chapters. In Chapter 1, an excess capacity interpretation of banking industry history is advanced. The argument is that what happened in the FDIC's sixth decade was in large part a consequence of a shakeout of industry excess capacity built up over a period stretching back to the nation's earliest days. Chapter 2 is an overview of the financially turbulent 1980s and the buildup to the decade.

After this look at the big picture, the focus turns to the banking industry's troubles. Chapter 3 broadly summarizes those troubles and their more notorious companion, the savings and loan (S&L) crisis. The subsequent chapters consider the banking troubles in greater detail, concentrating on several topics: too big to fail, the Texas experience, Congress's eventual acceptance that a crisis indeed existed in the S&L industry and the effects this acceptance had on banking and its regulation, the peaking of the banking problems in 1990 and 1991, and the industry's extraordinary recovery.

Finally, the government's actions during the banking troubles are assessed, and several observations on the future are offered. The government record contains both successes and failures. Unfortunately, the characterization of "successes" and "failures" is not a value-free effort, and the values or standards that one brings to the determination are not the subject of universal agreement. The basic question of how to view the survival of the banking industry and its recovery in the 1990s provides an example of the interpretation problem. Were the industry's survival and recovery a vindication of the existing regulatory structure, or did they amount to a near miss for a seriously flawed system? That question and subsidiary matters will be addressed, although definitive answers remain elusive.

The FDIC has published its own, official study of its decade of testing. As a detailed review of the decade, the study is commendable. The detail, however, can obscure several points. First, the study gives only passing attention to the deficiencies in banking industry structure that had developed as a result of many decades of close government control. These deficiencies provided the fertile ground from which sprang the troubles of depository institutions. Second, the FDIC's study acknowledges only obliquely the political battles that the troubles generated as Congress, the administration of the moment, independent agencies, and the many interested parties attempted to come to grips with what was occurring. Legislative solutions were not the products of a logical, rational process in which consensus was reached after the enlightened give-and-take of informed debate. Perhaps the FDIC's status as a government agency prevented it from describing in depth the reality of vehement disagreements, unmitigated self-interest, messy compromises, and sometimes ineffectual and sometimes excessive outcomes that constitute the legislative process. Finally, the FDIC's study spends considerable time on the techniques of bank supervision. Although important at one level, this topic can easily be accorded too much responsibility for the troubles of the decade. Would near-perfect supervision have prevented what transpired? No more than the near-perfect sand castle can withstand the ocean's waves.

THE COMPLEXITY OF REGULATION

The banking industry is not only one of the most pervasively regulated sectors of the economy, it is also subject to one of government's more complex regulatory schemes. A reader unfamiliar with that scheme might benefit from a brief—very brief—primer.

Banks are one of two types of institutions commonly referred to as depository institutions. The second type of depository institution is today called the savings association. Prior to legislation enacted in 1989—the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)—the term most often applied to this second type of depository institution was "savings and loan association." Savings associations are also called thrifts. The use of "thrift" can sometimes be confusing, however, because the term can also encompass savings banks, one of two sub-categories of banks, the other and far larger subcategory being commercial banks In many ways, credit unions—another type of institution—resemble banks and more especially savings associations, but credit unions are usually not included within the definition of depository institutions

Three federal regulators share responsibility for banks The Office of the Comptroller of the Currency (OCC), established in 1864, regulates national banks, which are generally the larger banks The OCC is an agency in the Department of the Treasury The independent Federal Reserve Board, established in 1913, regulates state-chartered banks that are members of the Federal Reserve System The Federal Reserve also regulates companies that own banks These companies are called bank holding companies Bank and bank holding company regulation is not the principal function of the Federal Reserve Board The principal function is the formulation and implementation of monetary policy The independent Federal Deposit Insurance Corporation, established in 1933, insures deposits, currently for up to $100,000, in practically all banks and savings associations The FDIC also regulates state-chartered banks that are not members of the Federal Reserve System Because a banking organization organized in a holding company structure is regulated at both the bank level and the holding company level, it may have direct contact with more than one of the federal banking regulators The holding company is under the supervision of the Federal Reserve, but the subsidiary bank or banks may be regulated by the OCC, the Federal Reserve, or the FDIC

Savings associations are regulated by the Office of Thrift Supervision (OTS), which like the OCC is an agency in the Treasury Department Prior to the enactment of FIRREA in 1989, the federal regulator of the S&L industry was the independent Federal Home Loan Bank Board, and the federal insurer for S&L deposits was its subsidiary, the Federal Savings and Loan Insurance Corporation

Further complicating this regulatory structure is the fact that state-chartered banks and thrifts are also regulated by state regulators

1

Excess Capacity

The troubles of the banking industry and the FDIC in the 1980s did not emerge from a void The foundations had been laid over many decades Indeed, what happened to the bank and thrift industries during the 1980s was a consequence of events, decisions, and developments that reached back to the nation's founding The events, decisions, and developments produced a depository institutions industry that was, as the 1970s ended, ripe for extensive consolidation In the language of economists, the depository institutions industry had become burdened with excess capacity In the language of common folk, there were just too darn many banks and thrifts

Three topics summarize the events, decisions, and developments that over the almost two centuries of the nation's existence led to excess capacity in the depository institutions industry geographic restraints, product limitations, and deposit insurance

GEOGRAPHIC RESTRAINTS

The geographic restraints had the longest lineage They arose from the federal nature of the United States Under a federal system, power is divided between the national and state governments One of the motivations that led to the Constitutional Convention in 1787 was dissatisfaction with the impediments the newly independent states were able to impose to interstate and foreign commerce under the Articles of Confederation Although the Constitution created a relatively strong national government and eliminated many of the state impediments to commerce, the states retained much power over economic activity

One source of state power was the ability to license or charter business enterprises With the exceptions of the first, 1791–1811, and second, 1816–1836, Bank of the United States, banks were among those business enterprises that required state permission to function And again with the exceptions of the two

15 Federal Reserve Bank of New York, *Studies on Excess Capacity in the Financial Sector* (June 1993)

16 The relationship between a reduction in the proportion of household assets entrusted to the banking industry and excess capacity may not be readily apparent Would not a reduction in the raw material of banking—deposits—automatically produce a shrinkage in the industry? Probably so over the long term For the short term, however, the infrastructure—personnel and facilities—to support the intermediation of a certain proportion of household assets is perhaps not so easily shed

2

A Turbulent Time

What social and cultural turbulence were to the 1960s, financial turbulence was to the 1980s In the world of money, the decade was a volatile, exuberant period, and depository institutions—banks and savings and loans—partook of their fair share of the good life and suffered their fair share of the upheavals This chapter details the buildup to the 1980s and suggests several broad themes that characterize the decade In the next chapter, the focus is narrowed to depository institutions in the 1980s

THE BUILDUP

A snapshot at any point in time is really a picture of the cumulative results of all that has gone before The connections between some present conditions and past situations are readily discernable In other instances, the cause and effect relationships are much less clear But in all cases, the present cannot properly be considered in isolation from the past Regarding depository institutions, one important legacy of the past was discussed in the first chapter—excess capacity In this section of Chapter 2, the years leading up to the 1980s are considered in more detail Trends and events of those years helped produce the turmoil that followed

World War II is often a starting point for histories of the recent past, including the recent financial and economic past The war ended with a well-defined situation an economically supreme United States, the remainder of the industrial world *in extremis*, and the potential of the nonindustrialized world apparent to only a few Although it was not the intent, the Bretton Woods Conference of 1944 had implicitly anointed the U S dollar as the lynchpin of the international financial order, an anointment that worked because it comported with economic reality

The world has never been static, however, and the balance of financial and economic power was bound to undergo movement as the years passed These changes in the international environment both brought about and were effected by changes in the U.S. domestic economy. Parenthetically, it is worth noting that the existence of the relationships between the international economic environment and the U.S. domestic economy was not accepted by many Americans. Indeed, a fair number of the citizens of the United States still refuse today to accept the fact that the U.S. economy is a part of the larger world economy.

One significant change was the inevitable economic recovery of Western Europe—particularly Germany—and Japan. With educated, trained, productive populations, at least a modicum of belief in the decisions of the marketplace, access to raw materials, and the jumpstart of U.S. financial aid, the prewar industrialized nations had nowhere to go but up. And because so much of their infrastructure had been destroyed, the upward journey was also a modernization voyage. A result was that by the 1960s the U.S. hegemony was being challenged. International flows of goods, services, and funds were taking new paths, creating consternation and causing disruptions among those accustomed to the old routes.

The paramount position of the U.S. dollar was one victim of the changing economic relationships. As the economies of other countries surged relative to the economy of the United States, the belief in the dollar as the stable foundation of the international financial system faded. Overseas holders of dollars worried about potential losses in the value of their holdings. Ups and downs in the U.S. economy caused ripples in the international money markets. Periodic crises of confidence in the dollar led to much jetting across the oceans and numerous international conferences and meetings, which occasionally produced agreements purporting to solve the perceived problem of the moment. The solutions, however, turned out to be no more than temporary.

One set of contributors to the dollar's problems was loose monetary and fiscal policies in the United States during the mid- and late-1960s as the nation tried to fund both the Vietnam War and a massive growth in social welfare programs without incurring any financial hardships, such as increased taxes. The loose monetary and fiscal policies started an inflationary spiral that was to be an important precipitant of the depository institution problems of the 1980s.

In the early 1970s, the declining fortunes of the dollar finally produced the demise of the dollar-based fixed-exchange rate system that had evolved from the Bretton Woods Conference of 1944. The fixed-exchange rate system was replaced by a modified floating exchange rate system in which the major currencies were allowed to fluctuate against one another. One consequence was an enormous growth in currency trading and related activities in the banking industry. This growth in turn helped foster a general environment of change and innovation.

Another consequence was the removal of a possible restraint on the inflationary spiral that was getting under way. Inflation under a fixed-rate regime often quickly leads to pressure on a currency that in turn spurs the government to adopt non-inflationary policies. Under a flexible-rate regime, on the other hand, depreciation of the currency can preclude, or at least postpone, the need to bite the bullet with tight monetary and fiscal policies. A government is often willing to tolerate currency depreciation as the lesser of two evils.

In 1973, the incipient inflationary spiral received a king-size boost. The oil-exporting countries, operating through their cartel the Organization of Petroleum Exporting Countries (OPEC), imposed a fourfold increase in the price of oil. Additional increases followed as the decade progressed. The increase in the price of a basic commodity caused an upward ratcheting of prices throughout the economy. Inflation and interest rates reflected the climb.

For example, the largest annual increase in the consumer price index (CPI) in the 1960s had been 5.5 percent in 1969. During 1974, the first full year after the initial oil-price boost, the CPI rose 11 percent. The annual increase fell to 5.8 percent in 1976 but returned to double digits by the end of the decade. For 1979, 1980, and 1981, the CPI increases were 11.3 percent, 13.5 percent, and 10.3 percent, respectively.[1]

Regarding interest rates, the annual rate on new issues of three-month U.S. Treasury securities reached 10.0 percent in 1979, its first ever foray into double digits. The yield on new-home mortgages went from 7.7 percent in 1971 to 10.8 percent in 1979, 14.7 percent in 1981, and 15.1 percent in 1982. The prime rate charged by banks hit 18.9 percent in 1981; in 1971 it had been 5.7 percent.[2]

In October 1979, the increasing inflation and interest rates spurred Paul Volcker's Federal Reserve Board to abandon the direct targeting of interest rates. The new primary target was the money supply. The theory was that over the long term a slow steady growth in the money supply would result in only modest levels of inflation. The long term, however, would take time to arrive. Meanwhile, interest and inflation rates continued climbing.

As the economic environment was undergoing these profound changes, technology was adding its bit of uncertainty to the financial arena. Computers and computerized communications were making credit, market, and product information more accessible. The delivery of financial services was becoming less dependent on customer or institution location. Technology was contributing to the assault on the competitive barriers—the geographic and product restraints discussed in Chapter 1—that had long protected the franchises of banks and S&Ls.

Thus the 1970s were years of increasing volatility in the banking world. The international financial order was rapidly changing. Interest rates, at the time the major determinant of revenues and expenses for depository institutions—and still a principal factor today—were entering uncharted territory. The onrush of the information age was altering how financial products and services were developed and delivered. Those comfortable with the way banking had been done for decades were becoming uneasy, at least those prescient enough to realize that the foundations of their world were crumbling. Those with an entrepreneurial bent were eagerly analyzing the changing landscape for potentially profitable opportunities.

By the end of the decade, the changing world had produced significant inroads in the traditional franchises of depository institutions. On the asset side—the lending side—of the balance sheet, banks encountered increased competition from finance companies, the commercial paper market, and foreign sources of funds. The statistics do not fully reflect the extent of the competition. For example, between 1970 and 1980, bank loans as a percentage of the total liabilities of corporate businesses declined only a little over two percentage points, from 18.8 percent to 16.7 percent.

The finance company share of the corporate business market increased from 1 98 percent to 3 22 percent, the commercial paper market share from 1 30 percent to 2 04 percent, and the foreign direct investment share from 2 02 percent to 8 01 percent[3]

What the relatively small decline in the bank share of the corporate lending market masks is that the banking industry's competitors were making a good proportion of their gains in the quality end of the market Only the soundest corporations could issue commercial paper, for example Thus the increased competition encountered by banks during the decade was very noticeable because it was for their best customers

On the liabilities side—the deposit-taking side—of the balance sheet, the interplay between the high interest rates and the interest rate ceilings on banks and S&Ls produced a new competitor almost from scratch That competitor was the money market mutual fund industry

Interest rate ceilings were a legacy of the Great Depression In the early 1930s, one popular explanation—since substantially discredited—for the troubles was the payment of excessive interest on deposits As a result, the authority to promulgate interest rate ceilings for time and savings deposits for banks was contained in the Banking Acts of 1933 and 1935[4] It was three decades, however, before market interest rates began bumping up against the ceilings In 1957, in response to increased business loan demand, increased competition for funds, and rising rates, the interest rate ceilings were raised for the first time Four more increases came in the early 1960s

In 1966, the ceilings were expanded to include S&Ls, which were having trouble competing with banks for funds in the gradually more volatile interest rate environment Because the essence of their business was the funding of long-range assets with short term liabilities, S&Ls were not as able as banks to move quickly to higher rates Indeed, higher rates were a real threat to S&L profitability The interest income from the long-range assets rose much more slowly than the interest expense on the short term deposits Congress instructed the banking agencies and the S&L regulator, the Federal Home Loan Bank Board, to coordinate their decisions on ceilings In implementing the expanded ceilings structure, the regulators established a differential for S&Ls The S&L ceilings were higher than the bank ceilings, which was hoped would aid in keeping an adequate supply of funds flowing to the housing markets

Market interest rates continued to increase in volatility and to reach new heights In 1966, 1969–70, 1973–74, and 1978–80, the ceilings prevented depository institutions from fully meeting the rates available elsewhere One of those "elsewheres" was a new animal, the money market mutual fund

Money market mutual funds, or money market funds (MMFs) for short, are mutual funds that limit their investments to short term money market instruments Originated by securities firms and mutual fund groups, MMFs were beyond the reach of much banking industry legislation, including the laws and regulations on deposit interest rate ceilings Many MMFs could be redeemed by drafts, thus giving them the appearance of interest-bearing checking accounts The first MMF appeared in 1972, and 50 were in existence by the end of 1977, but net assets were less than $4 billion[5] The period of exponential growth commenced with the interest rate upsurge that began in 1978 At the end of February 1980, 79 MMFs with total assets in excess of $60 billion were in existence

By the late 1970s, competition from the MMFs was posing a significant threat to the banking and S&L industries High interest rates seemed to have become firmly entrenched The interest rate ceilings prevented banks and S&Ls from meeting the interest rates of the marketplace With much reluctance, Congress responded to the situation by providing for the phasing out of the interest rate ceilings The law was the Depository Institutions Deregulation and Monetary Control Act of 1980. Although myopically opposed by a sizeable number of bank and, especially, S&L industry executives, the interest rate ceiling phaseout was almost a necessity for the industries' continued existence The nitty-gritty of the matter was that depository institutions were subject to cost controls while their growing number of competitors were not, an untenable state of affairs for long term survival

Nevertheless, although almost a necessity, the phasing out of interest rate ceilings was a traumatic move The previously slow wrenching of the depository institutions industry from its sedate past was significantly accelerated Bank and S&L executives who had long abided by the 9–3–3 rule—into the office at 9 in the morning, three hours for lunch, on the golf course by 3 in the afternoon—were finding themselves more and more challenged Product and service decisions that had in years gone by been made by government decree were becoming the responsibility of private sector individuals Some of them did not want the increased uncertainty Others did not mind the uncertainty but, as events of the decade were to show, lacked the judgment and restraint to make wise choices on a consistent basis

The Depository Institutions Deregulation and Monetary Control Act of 1980 contained other provisions in addition to those phasing out interest rate ceilings One of the most intriguing, as least as much for its symbolic value as for its provable direct consequences, was the raising of the deposit insurance limit from $40,000 to $100,000.

Regarding direct consequences, probably the most notable was the impetus the action gave to the growth of brokered deposits These are deposits that are gathered for or directed to banks or S&Ls by middlemen, or deposit-brokers Brokered deposits became a big business in the 1980s, a business that had some detrimental results A number of banks and S&Ls desirous of fast growth turned to brokered deposits to provide funds for their lending activities The brokered deposits were often attracted by higher-than-average interest rates, a condition that the gradual elimination of the interest rate ceilings eventually made possible but that was jump-started by the raising of the deposit insurance limit More than a few institutions that pursued the brokered deposits route to glory became casualties in the years ahead

The connection between the raising of the insurance limit to $100,000 and the growth of brokered deposits lay principally in the fact that the interest rate ceilings did not apply to deposits of $100,000 or larger The ceilings on deposits of $100,000 and above had been removed in 1970 to help stem the outflow of funds from large banks at the time of the Penn Central railroad crisis Thus the raising of the insurance limit to $100,000 meant that the government guarantee of deposits had been expanded to a group of deposits not subject to interest rate ceilings Almost immediately, entrepreneurs began bringing together packages of insurable deposits not subject to interest rate ceilings and institutions seeking funds [6]

Also a factor, although a difficult one to quantify, in the connection between the raising of the insurance limit and the growth of brokered deposits was the handy nature of the $100,000 figure A certificate of deposit of $100,000 had an easy marketability Moreover, larger blocks of funds could be readily broken down into $100,000 blocks Even the most mathematically impaired financial industry gnome could work with the nice round amount of $100,000

But it is as a symbol, as evidence of a pervasive attitude, that the raising of the insurance limit is probably most instructive The action was taken with very little debate and in part as a sop to those S&L industry executives who were opposed to the removal of interest rate ceilings The nonanalytical manner in which the legal responsibility of the federal deposit insurance funds was more than doubled shows how cavalierly deposit insurance had come to be viewed Forty years of practically no problems had lulled Congress, the regulators, and the industry into accepting deposit insurance as a free lunch The benefits of deposit insurance seemed obvious, the principal one being a seemingly stable banking system The costs, particularly a stagnating industry burdened with excess capacity and reluctant to change, were not so apparent

Thus the bank and S&L industries entered the 1980s open to trouble The world economic order had been changing The volatility of economic life had long been on the increase As a result of geographic and product limitations, the U S depository institutions industry was, in comparison to the industry in other nations, unconcentrated and segmented Thousands of institutions existed in semiprotected geographic markets, enjoying only minimal competition from institutions with similar charters The activities restrictions hindered innovation regarding products and services Meanwhile, nondepository institutions not constrained by the pervasive geographical and product limitations were impinging more and more on the traditional businesses of banks and S&Ls In short, the stability of the New Deal–era financial system was eroding, perceptibly in some ways, imperceptibly in others Interest rate ceilings, a major support of the depository institutions industry, had become no longer tenable and had been ordered eliminated The fun was about to begin

THE 1980s

The economic and financial history of the 1980s defies easy characterization For one thing, the decade abounded in contradictions Amid widespread prosperity, sectors of the economy suffered significant downturns Amid six-figure salaries on Wall Street for newly minted masters of business administration (MBAs), homelessness became a national issue Amid a pervasive fear of inflation, financial strategies based on high and volatile interest rates produced enormous profits Amid much concern about the detrimental effects of negative trade balances and federal budget deficits, gross domestic product enjoyed one of the longest continuous recorded rises in the nation's history Amid cries of American economic stagnation, a period of almost unparalleled corporate restructuring took place

Chronologically, the decade began with a slide into recession, which stretched 16 months from July 1981 to November 1982 Then followed the aforementioned lengthy, sustained economic expansion, an expansion so impressive that articles suggesting the demise of the business cycle began appearing The business cycle, however, proved to be merely dormant, and the decade closed in a slide toward another recession, which arrived in July 1990 and lasted to March 1991

Ideologically, the decade saw a resurgence of free market capitalism Ronald Reagan was elected president in 1980 on a platform that in the domestic arena pledged to get the government off the peoples' collective back Many of the economic and social programs descended from Franklin Roosevelt's New Deal and Lyndon Johnson's Great Society were perceived as unnecessary, indeed as hindrances to progress The tax structure was viewed as onerous, a discourager of initiative and a zapper of the entrepreneurial spirit The Reagan administration was remarkably successful in the degree to which it carried out its program Under the rubric of "Deregulation," considerable reduction and simplification took place in many areas of federal regulation, including the banking area And taxes were reduced, particularly for upper income taxpayers As the decade proceeded, both deregulation and tax reduction were to have numerous and varied consequences, some foreseen, some unforeseen

Morally, ethically, the decade certainly did not see a resurgence of much that was exemplary Indeed, some would argue that the period was a nadir of sorts Greed and ostentatious consumption were the order of the day for a sizeable segment of the population Wall Street experienced a series of highly publicized insider trading scandals and securities laws violations The tenor of the times was captured in Tom Wolfe's novel, *Bonfire of the Vanities*, in which the protagonist, a Wall Street trader, considers himself to be a "master of the universe" Main street was not immune to the stampede in search of wealth In fact, a goodly proportion of the problems in the thrift and banking industries during the decade could be traced in the first instance to a certain moral laxity in the hinterlands Bank and thrift directors and officers in a number of institutions were guilty of a variety of conflict of interest and self-dealing transgressions, some amounting to illegalities, some just unseemly No better example of the prevailing attitudes can be found than that provided by the president, who was elected in 1992, and his spouse The favoritism that they received in their real estate transactions and that she received in her commodities trading may not have amounted to violations of the law, but it did indicate a rather cavalier attitude regarding the ethics of associating public position with activities for private gain

A central feature of the 1980s was debt Between the mid–1950s and 1982, the ratio of domestic nonfinancial debt to nominal gross domestic product (GDP) had stayed within a relatively narrow band, averaging about 135 percent In 1983, however, the ratio commenced a rapid rise, reaching almost 200 percent by the end of the decade [7] Government, businesses, and households all participated in the debt binge In the decade ending in 1992, federal government debt held by the public more than tripled, reaching $3 1 trillion For the corporate sector, the debt-to-assets ratio reached a post–World War II record in 1990 of 32 percent [8] The primary reasons for the increase in corporate sector debt were debt-financed acquisitions and stock repurchases A term, "junk bonds," came into common usage to describe less-than-investment-grade debt instruments whose purpose was largely to finance corporate acquisitions and restructurings For households, total debt of the household sector as a percentage of disposable personal income increased from 71 percent to 90 percent between 1980 and 1990.[9] Much of the increase was due to a rise in residential mortgages—during the period 1981–89, the ratio of mortgage debt to home values rose from 36 percent to 50 percent [10]

The debt binge led to a general increase in the burden of servicing debts For example, the ratio of interest cost to cash flow for nonfinancial corporations reached a post-World War II high of 25 percent in 1991 [11] The greater servicing burden contributed in turn to more downgradings of corporate debt, higher default rates on corporate bonds, and increases in business failures It also depressed corporate profits Whether measured relative to gross domestic product or corporate net worth, corporate profits in the 1980s were below the levels of the 1970s [12] In the household sector, the ratio of debt service to disposable personal income rose from less than 15 percent in 1982 to over 19 percent in 1989 [13] Delinquency rates on mortgage loans and on consumer credit categories such as auto and credit card loans spiraled upward Mortgage foreclosures rose steadily over the decade, and personal bankruptcies shot up after 1985 [14]

What caused the increase in debt? The tax deductibility of interest expense was certainly a factor As inflation pulled interest rates higher in the 1970s and early 1980s, the fact that interest could be deducted in calculating taxes seemed actually to engender a sense of wealth on the part of some debtors Theoreticians in finance gave respectability to the phenomenon by purporting to be able to calculate what a firm's optimum level of debt was Debt has always been recognized as an ingredient of growth, but in the 1980s, debt's importance to growth came to be considered overriding Indeed, individuals and businesses that shunned debt were looked upon with condescending pity

The credit strains produced by the higher levels of debt and the greater debt servicing burdens found their way back to the providers of funds, including banks and S&Ls The effects of debt were not the sole immediate cause of the difficulties depository institutions encountered in the 1980s, but they were certainly a major contributor to those difficulties

NOTES

1 *Economic Report of the President, February 1994* (Washington, DC US Government Printing Office, February 1994), Table B–62, p 339

2 Ibid, Table B–72, p 352

3 Board of Governors of the Federal Reserve System, *Guide to the Flow of Funds Accounts* (1993)

4 The summary of the history of interest rate ceilings is based on Edward F McKelvey, "Interest Rate Ceilings and Disintermediation," *Staff Economic Studies*, No 99, Board of Governors of the Federal Reserve System (April, 1978)

5 Constance Dunham, "The Growth of Money Market Funds," *New England Economic Review*, Federal Reserve Bank of Boston (September—October 1980), pp 20–34

6 See Irving Sprague, "Unrelated Series of Events Led to S&L Crisis," *American Banker*, May 3, 1989, p 4, for a description of events and consequences concerning interest rate ceilings and the raising of the deposit insurance limit

7 Board of Governors of the Federal Reserve System, *Flow of Funds*, p 22

8 Edward J Frydl, "Overhangs and Hangovers Coping with the Imbalances of the 1980s," *Annual Report 1991*, Federal Reserve Bank of New York, p 16

9 Board of Governors of the Federal Reserve System, *Flow of Funds*

10 Frydl, p 16

11 Ibid, p 19

12 Ibid, p 22

13 Ibid, p 20

14 Ibid, p 19

3

A Crisis and a Shakeout: An Overview

As the 1970s gave way to the 1980s, the banking industry was ripe for change Discerned by only a few, excess capacity provided the background Interest rates—both the cost of the industry's major raw material and the price of its major products—were behaving in unaccustomed fashion New aggressive competitors, aided and in some cases created by the computer-based revolution in communications and information processing, were appearing on the scene Financial experimentation and risk-taking were coming to be held in high regard

For the banking industry, the result of this volatile mix was a shakeout of sizeable proportions Banks' partners in the depository institutions industry—savings and loan associations—were subject to the same structural and environmental factors The impact on the S&L industry was more than a shakeout, however it was a full-blown crisis This chapter is an overview of the S&L crisis and banking troubles Subsequent chapters examine the banking troubles, or shakeout, in greater detail

The highlights of the S&L crisis and the banking troubles are as follows

- Due to decades of geographic restraints, product limitations, and an overly protective deposit insurance system, the banking and S&L industries, and the financial industry of which they were a part entered the 1980s burdened with excess capacity
- The high and volatile interest rates in the late 1970s and early 1980s undermined the long-existing approach to profitability in savings and loans associations, which was borrow for short terms at low rates, lend for longer terms at higher rates
- In the 1970s and into the 1980s, both banks and S&Ls experienced increasing levels of competition from other sectors of the financial world Because of the long-standing geographic and product restrictions, banks and S&Ls were constrained in their ability to respond
- To aid the S&L industry, Congress and federal and state regulatory authorities in the early

1980s relaxed restrictions on activities S&Ls' enthusiastic embrace of the new powers was not constrained by adequate supervisory oversight

- The S&L industry suffered massive losses and eventually required a huge taxpayer bailout The federal regulator and the federal insurer of S&Ls—the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC)—were legislated out of existence The FHLBB was replaced by the Office of Thrift Supervision The insurance function was given to the FDIC
- As the S&L industry was experiencing its explosive expansion and implosive contraction, the banking industry and its regulators were hit by a rolling series of difficulties Troubles in less-developed countries and in the energy, agriculture, and real estate sectors of the U S economy all had negative impacts on the health and profitability of banks
- The real estate–related difficulties were the most widespread The difficulties began in Texas and the Southwest and spread to the Northeast, the Southeast, and finally the West Coast
- The banking industry's difficulties severely tested the FDIC and the bank deposit insurance system Congress responded by significantly buttressing the bank supervisory system and by providing taxpayer backing for the Bank Insurance Fund.
- Largely in response to marketplace changes and until 1994 largely at the state level, interstate banking restrictions were relaxed This relaxation contributed to a consolidation trend in which the numbers of bank and thrift organizations declined
- Congress's efforts between 1980 and 1991 to deal with the turmoil in the depository institutions industry resulted in five major laws, each a reaction to the perceived difficulties of the moment and each pushing the regulation of depository institutions in significant new directions The five laws were the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), the Garn-St Germain Act of 1982, the Competitive Equality Banking Act of 1987 (CEBA), the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

The remainder of the chapter expands upon this summary The S&L crisis is considered first Then an overview of the banking troubles is presented

THE THRIFT INDUSTRY

The crisis of the S&L industry in the 1980s was a two-step affair The first step was relatively straightforward, its immediate cause relatively easy to pinpoint That cause was high interest rates The second step was significantly more complex and eventually much more severe It concerned the sometimes contradictory responses of the industry, the industry's regulators, and Congress to those high interest rates and the various difficulties that ensued

As institutions whose principal mode of operation was to fund long term loans with short term deposits, savings and loans were detrimentally affected by the prolonged period of high interest rates that occurred in the late 1970s and early 1980s S&Ls sustained losses by having to pay higher rates on the short term deposits than they were earning on the long term loans And the interest rate caps then in existence made keeping old deposits and acquiring new ones exceedingly difficult In 1981, for example, the profits for the S&L industry were a negative \$4 6 billion,[1] and FSLIC-insured institutions suffered net deposit withdrawals of \$25 4 billion [2]

Congress's initial answer to the problems created by the high interest rates was

to provide for the phasing out of interest rate controls As noted in the preceding chapter, this was done in the Depository Institutions Deregulation and Monetary Control Act of 1980 The relaxation and eventual elimination of the controls enabled both S&Ls and banks to stem the loss of deposits due to the inability to pay market rates of interest Paying market rates of interest, however, only exacerbated the major difficulty facing a large proportion of S&Ls supporting low-rate long term loans with high-rate short term liabilities

Removal of interest rate ceilings was only the first of a number of steps Congress and the Federal Home Loan Bank Board—the federal regulator of S&Ls—took to aid the S&L industry in overcoming the interest rate–caused threat to its viability and in meeting other difficulties rising from changes in the financial marketplace In total, the actions came to be referred to as the "deregulation" of the S&L industry To generalize, the deregulatory steps beyond the removal of interest rate ceilings consisted of (1) the relaxation of capital and accounting standards and (2) the expansion of lending and investment powers [3] Of great significance, the increased flexibility and freedom granted to S&Ls were not matched by increased supervisory efforts or resources Indeed, a major cause of the subsequent troubles was inadequate supervision

The relaxation of capital and accounting standards occurred in a variety of ways One of the first major steps was the FHLBB's reduction in 1980 of the statutory reserve requirement—one of several measures of S&L capital—from 5 percent to 4 percent of insured deposits The requirement was further reduced in 1982 to 3 percent In 1981, the FHLBB authorized S&Ls to defer and amortize losses on the sale or other disposition of mortgage loans, mortgage-related securities, and debt securities Previously, such losses had to be recognized immediately Also in 1981, the FHLBB permitted troubled institutions to issue income capital certificates to bolster their capital positions The certificates were purchased by the FSLIC with either cash or interest-bearing notes In the Garn-St Germain Act of 1982, Congress appropriated the income capital certificate concept by authorizing a net worth certificate program for both banks and S&Ls The program improved the financial appearance of banks and S&Ls with low net worth by permitting the institutions to count promissory notes from the appropriate federal regulator as capital Among the FHLBB's actions in 1982 was an increase from 10 to 40 years in the period during which goodwill in merger transactions could be amortized The effect was to significantly increase the reported, but not the real, income and capital of the S&L industry

A retreat from the trend of standards relaxation began the following year, 1983, but several major capital-diluting steps still lay ahead In 1985, the FSLIC began a Management Consignment Program to reorganize and recapitalize troubled institutions The recapitalizations were largely paper transactions, being accomplished through the issuance of capital certificates And in the Competitive Equality Banking Act of 1987, Congress instituted supervisory forbearance for "well-managed" under capitalized S&Ls

Regarding the expansion of S&L lending and investment powers, the DIDMCA in 1980 was an important early step Among its other deregulatory measures, that act (1) removed a geographic limit on S&L lending, (2) allowed S&Ls to buy corporate debt and commercial paper up to 20 percent of assets and to invest up to 3 percent of assets in service corporations, and (3) expanded S&L authority to make acquisition, development, and construction (ADC) loans. Meanwhile, several states, notably California, Texas, and Florida, were aggressively broadening the powers of state-chartered institutions. In 1980 and 1981, the FHLBB allowed S&Ls to lend with loan-to-value ratios greater than 90 percent, to accept less than a first lien on mortgage loans, and to hedge with financial futures. In addition, S&L service corporation powers were expanded. In 1982, and on the liabilities side of the ledger, the FHLBB removed restrictions on brokered deposits. Congress also made significant liberalizing contributions in 1982, in the Garn-St Germain Act. Prohibitions or limitations on nonresidential real estate lending, consumer lending, commercial lending, and personal property leasing activities were relaxed. These many steps to expand the powers of S&Ls were not in themselves, and considered individually, necessarily "bad." Indeed, in view of the changes taking place in the financial marketplace, some of them may have been unavoidable, even desirable. The liberalizing steps, however, were not accompanied by adequate oversight. Many S&L executives reacted to the freer environment like small children turned loose without parental oversight in the Halloween candy. The unrestrained gorging was unsurprising, and the unpleasant consequences were not unforeseeable.

The resources and efforts of government supervisors were insufficient to halt a rapid growth in imprudent lending and investing. Moreover, fraud and insider abuse began surfacing with unsettling frequency. Attempts by supervisors to handle troubled institutions with a minimum initial outlay of government funds compounded the difficulties. Acquisitions of institutions were permitted in which acquirers put little or no capital at risk. Unhindered by either government supervision or fear of losing their investments, more than a few such acquirers treated their acquisitions as spigots on the pipelines of the nation's financial flows.

One further major ingredient interacted with the loosened capital and accounting standards, expanded lending and investment powers, and inadequate supervision to produce the S&L debacle of the latter half of the 1980s. That ingredient was an exaggerated swing of the real estate cycle. Real estate markets expanded rapidly in the early- and mid-1980s and contracted precipitously as the decade neared its end. A portion of the expansion and contraction was undoubtedly the natural workings of the marketplace. The pent-up demand that the high interest rates of the early 1980s had produced led to overbuilding, which in turn caused retrenchment. Just as important in the swing, however, were government actions and policies that first encouraged and then discouraged flows of funds to real estate.

For some time, the semigovernment mortgage agencies—the Federal National Mortgage Association, the Government National Mortgage Association, and the Federal Home Loan Mortgage Corporation—had been bringing forth, in conjunction with private sector participants in the capital markets, a variety of innovative mortgage packaging techniques and products. The innovations widened the circle of potential real estate investors.

Congress contributed to the upswing in the real estate cycle by tax cuts in 1981 and through the Secondary Mortgage Market Enhancement Act in 1984. The 1981 tax cuts contained accelerated depreciation provisions and investment tax credits that made real estate investments extremely attractive. The 1984 law reduced state barriers to investment in mortgage-related securities.

But then, as many real estate sectors were probably getting ready to cool of their own accord, Congress inadvertently accelerated the downturns with the Tax Reform Act of 1986. That law reduced depreciation benefits, restricted passive loss deductions, and eliminated favorable treatment for capital gains. The reduction in the attractiveness of real estate as an investment was both substantial and abrupt. Over the next few years, real estate values in many areas declined significantly. Commercial properties were particularly hard hit. S&Ls that had helped fuel the speculative binges of the early 1980s found themselves burdened with defaulting borrowers and falling collateral values. Although many of the post-1986 S&L failures were undoubtedly already foreordained, the Tax Reform Act of 1986, by suddenly altering the real estate investment climate, did the industry no favors.

By the middle of the decade, S&L executives were making extensive use of the increased powers they had been given by Congress, state legislatures, and the regulators. Between 1982 and 1985, industry assets grew 56 percent, from $686 billion to $1,070 billion.[4] The share of the nonresidential mortgage loan market controlled by S&Ls in 1980 was 11 percent. By 1985, the S&L proportion had risen to 30 percent.[5] Home mortgage loans—the traditional mainstay of S&Ls—fell from 67 percent of S&L assets in 1980 to 42 percent in 1985.[6] Newcomers rushed to the industry: 133 new S&L charters were issued in 1984, 173 the following year.[7]

Also by mid-decade, signs of the coming disaster were surfacing rapidly. In 1978, the mortgage delinquency rate for Federal Savings and Loan Insurance Corporation (FSLIC)-insured institutions had been under 1.5 percent. In 1986, it was 5 percent.[8] S&L industry profits for 1986 were an anemic $131 million. The previous year they had been $3.7 billion.[9] By one count, 46 FSLIC-insured institutions with assets totaling $12 billion failed in 1986.[10] At an estimated cost of $3.1 billion, these failures rendered the FSLIC fund insolvent.[11] In 1987, the S&L industry suffered a loss of $7.8 billion.[12] Forty-seven institutions with assets of $11 billion failed, at an estimated cost of $3.7 billion.[13]

Reaction to the developing crisis was increasing, but the taking of effective corrective steps was severely hindered by a number of factors. A general disbelief that the problems were really as bad as they seemed was widespread. The complexity and esoteric nature of the difficulties discouraged examination by the media. A politically powerful S&L industry lobby vehemently fought any reexamination of the liberalizing moves of the early 1980s and even the smallest attempt at increased supervision. Involvement of both political parties in industry problems—at the policy as well as individual levels—discouraged congressional and Executive Branch action, particularly during the 1986 and 1988 election years.

Congress's first effort to deal with the snowballing situation was tentative. The Competitive Equality Banking Act of 1987 authorized a $10.8 billion recapitalization of the FSLIC and called for supervisory forbearance for "well-managed" undercapitalized institutions. The act did little to staunch the hemorrhaging that was taking place in the S&L industry, and the $10.8 billion was quickly perceived as inadequate. In 1988, 205 S&Ls with assets of $100 billion failed. The estimated cost of the failures was $31.2 billion.[14] The FSLIC reported a deficit of $75 billion.[15]

Tentative was not how the next congressional effort could be characterized. Shortly after taking office in 1989, President George Bush sent a massive, complex S&L industry restructuring bill to Capitol Hill. The resulting legislation was the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). The FHLBB and the FSLIC were abolished. S&L industry oversight was moved to a newly created agency in the Department of the Treasury, the Office of Thrift Supervision (OTS). The FSLIC's insurance functions were transferred to the FDIC. Responsibility for dealing with failed S&Ls was given to another newly created organization, the Resolution Trust Corporation (RTC), which was to accomplish its task and go out of existence at year-end 1996.[16]

A few of FIRREA's provisions—probably more than a few—went too far, thus compounding the difficulties. For example, S&Ls were required to dispose quickly of their junk bond inventories. In complying, some S&Ls sustained what might have been unnecessary losses, and the already weakened junk bond market may have received an additional unnecessary jolt.

Time, the exit from the industry of the worst performers, declining interest rates, and human effort eventually alleviated the S&L crisis, at a total estimated cost of $160 billion, excluding interest. From 1989 to June 30, 1995, when its authority to close failed thrifts expired, the RTC resolved 747 institutions with aggregated assets of $402 billion.[17] Most of the institutions were taken over in the first years of the RTC's existence.[18] What remained of the S&L industry—1,215 OTS-supervised institutions with assets of $777 billion at year-end 1997, down from 2,949 FSLIC-insured institutions with assets of $1,351 billion at year-end 1988—slowly returned to profitability. In 1988, the profitability nadir, the S&L industry lost $13.4 billion. The losses decreased in 1989 and 1990 to $6.2 billion and $2.9 billion, respectively. The industry finally posted a positive net income of $1.8 billion in 1991. The black ink continued in the years that followed. Industry net income for 1997 was $6.5 billion.[19]

Over a period of little more than a decade, the thrift industry first was severely threatened, then enjoyed enormous growth, then was virtually decimated, and finally emerged shrunken but profitable. Notwithstanding the recovery, the future of the industry as a separate, distinct industry is difficult to predict. The return to profitability has not stopped the slide in industry size. The number of thrifts has declined each year since the OTS's establishment in 1989. Aggregate assets declined initially, reaching $775 billion in 1993; at year-end 1997, assets were $777 billion. In the Deposit Insurance Funds Act of 1996, Congress mandated a merger of the deposit insurance funds for the bank and thrift industries—the Bank Insurance Fund and the Savings Association Insurance Fund—if no savings associations exist on the date specified for the merger, January 1, 1999. The assumption is that the savings association charter can be merged into the bank charter by that time. The thrift industry still has a fair amount of political power, however. In addition, the

industry has a defender in a government agency, the OTS, that would go out of business if its constituency ceased to exist. Thus the legislated demise of the thrift industry appears to be no sure thing.

THE BANKING INDUSTRY

The difficulties that beset the banking industry in the 1980s and very early 1990s differed in several important respects from the problems of the S&L industry. First and foremost, the rise in interest rates in the late 1970s and early 1980s was much less a problem for banks—at least commercial banks—than it was for S&Ls. Although commercial banks were subject to the interest rate caps on deposits and consequently experienced some outflow of funds, they were not burdened with large proportions of long term fixed-rate assets. Commercial bank assets generally had much shorter maturities than did the mortgage loans of the S&Ls. Consequently, commercial banks could adjust upward the price of loans and other assets as the cost of funds—the rates paid on deposits—rose in response to market forces.

An exception to the generalization of the effects of interest rate rises on banks concerned a subset of the species—mutual savings banks. Like S&Ls, with which they shared the rubric "thrifts," mutual savings banks, found largely in the Northeast, were primarily in the business of real estate lending. As interest rates rose, their large inventories of fixed-rate mortgage loans declined in value, and they were unable to match increases in the cost of funds with increases in revenues. Their troubles, however, were not as broadly devastating as those of the S&L industry. For one thing, mutual savings banks constituted a relatively small proportion of the total banking industry. For another, the regulator of most savings banks, the FDIC, was much less indulgent than the S&L regulator, the FHLBB. Savings banks received a limited degree of temporary forbearance, but nothing comparable to the extent of the official kindness shown S&Ls. Problems were not compounded by a wholesale relaxation of accounting rules and product restrictions, and supervision was not curtailed.

Indeed, as a general matter, the supervisory system for banks was superior to the system for S&Ls. The primary federal S&L regulator, the FHLBB, was charged with being both a supervisor of S&Ls and a promoter of the home-financing industry. This dual focus probably increased the S&L supervisory system's susceptibility to the badgering and entreaties of what was at the time one of Washington's most powerful, and myopic, lobbies.

Another way in which banking industry problems differed from S&L industry problems was that the banking problems were for the most part regional in scope. Thus the entire industry was not hit by difficulties at once. The industry and its regulators were able to deal with troubles in more manageable portions than were the S&L industry and its regulators.

Four major sets of difficulties challenged the banking industry and its regulators in the 1980s and early 1990s. These four sets of difficulties concerned less-developed countries, agriculture, energy, and real estate lending, with the last being the most damaging. The four problem areas have a similarity. Bank involvement in each was characterized by an exuberance fueled in part by the enthusiasm of other banks—the bandwagon effect. The exuberance and enthusiasm clouded the reality that too much of a good thing is possible. After the initial burst of bank lending in each area, further funds were chasing fewer viable projects and were advanced with inadequate attention to changing macroeconomic conditions.

The less-developed country (LDC) debt crisis was the outcome of massive flows of funds to the LDCs in the 1970s. Fueled in large measure by the "petrodollars" that the oil-exporting countries placed in international banks following the oil price rises during the decade, the lending was based on increasingly tenuous assumptions about LDC growth. The LDCs simply could not make bona fide economic use of the financial largess coming their way. The lending resulted in large increases in LDC external debt.

Mexico's announcement in August 1982 that it would be unable to meet its debt payments to foreign creditors brought an abrupt end to unrestrained lending and an abrupt start to the LDC debt crisis. Within the U.S. banking industry, the largest banks were the ones with the greatest LDC exposure and consequently the most affected. As a percentage of equity capital and reserves, the nontrade exposure of the average U.S. money-center bank to LDCs was 227 percent in 1982.[20] The announcement by Mexico began a multiyear work-out effort involving banks, governments in both debtor and creditor countries, and international organizations during which much of the LDC debt was restructured. The crisis's impact on U.S. banks was slow to be acknowledged in financial statements. Eventually, however, the piper had to be paid. In 1987 and again in 1989, U.S. money-center banks added substantially to reserves to provide for LDC debt losses. The effect in 1987 was especially noticeable, the increase in reserves being largely responsible for a decline in the return on assets for the banking industry from 0.61 percent in 1986 to 0.09 percent in 1987.[21]

By the end of the decade, concern about LDC debt had largely abated. The external debt burden for a number of the LDCs had been eased through various forms of debt restructurings. Many countries were enjoying sustained periods of growth. As for banks, their exposure to LDC debt problems had been significantly reduced. For example, the ratio of LDC nontrade exposure to equity capital and reserves for the average U.S. money-center bank had fallen from 227 percent in 1982 to 91 percent in 1989.[22]

Regarding agricultural lending, difficulties had surfaced by 1984 and were to be a concern for the next several years. The difficulties had their immediate origins in the previous decade. Led by export growth and rising commodity prices, in the 1970s, the farming sector of the economy enjoyed one of its more expansive periods. The boom had a substantial effect on the price of farm land, causing it to rise significantly. Expecting the good times to continue, many farmers borrowed heavily to expand operations, using the inflating real estate values to support the increases in debt.

As booms are wont to do, however, the agriculture boom of the 1970s came to an end. The particular macroeconomic forces that had helped produce it—strong growth in demand in the industrial economies, a cheap dollar, high inflation, and low real interest rates—suffered reversals as the new decade began. The value of farmers' main asset, land, plunged.[23] Farmers who had used rising real estate values to finance operations were forced to rely on cash flow from operations. In many instances, the cash flow, which was reduced because of the general fall in demand, was not sufficient to enable debt service obligations to be met. In consequence, farm lenders experienced large loan losses, and many of them failed. Agricultural banks, defined as banks in which agricultural loans amount to 25 percent or more of total loans, accounted for 32 percent of bank failures in 1984 (25 of 79), 54 percent in 1985 (65 of 120), 41 percent in 1986 (57 of 138), 30 percent in 1987 (56 of 184), and 14 percent in 1988 (28 of 200).[24] Fortunately from the standpoint of the banking system and its regulators, most of the failed agricultural banks were relatively small. Thus considered in isolation, the problems in agricultural lending, though significant, were not system-threatening.

Energy lending difficulties, centered in the Southwest but reverberating nationwide, were to pose a more formidable challenge to banking and its overseers. As was the case with agriculture, the energy-related lending difficulties of the 1980s had their origins in boom conditions in the 1970s. The boom was due to the huge increase in energy prices. For example, the price of domestic crude oil rose more than 700 percent between 1973 and 1981, from $4.17 to $34.33 per barrel.[25] Assuming that the power of the OPEC to control world oil prices would continue, many forecasters envisioned a barrel's cost at $50 or more before too long.

Such projections colored the lending decisions at many Southwest banks and S&Ls. The oil-price outlook implied strong economic growth and in-migration for the region. Banking institutions responded by lending aggressively to businesses that stood to benefit from these trends, principally oil and gas producers, construction firms, and real estate developers. A sizeable oil-price hike in 1981, from $24 to $34 per barrel, appeared to confirm the prevailing outlook for ever-increasing energy prices.[26]

But 1981 was the oil-price apogee. Prices began falling in the latter half of the year and did not find a bottom until past mid-decade. The 1986 price per barrel was just under $15.[27] The prognosticators had failed to foresee the increase in supply from non-OPEC producers and the significant reduction in demand due to conservation measures. They had also failed to discern the fragility of OPEC's own production agreements. As oil prices began falling, OPEC members sought to maintain their revenues by ignoring production quotas and raising output. This further increased supply and accelerated the downward movement of prices.

Economic growth in the Southwest slowed, stopped, and turned negative. Real estate values collapsed, and lenders of all types began feeling the effects. From 1980 through 1989, 535 banks failed in Texas, Oklahoma, and Louisiana, a total that was 50 percent of all U.S. bank failures during the period.[28] Some of the failures were of agricultural banks, but the majority succumbed to energy-related difficulties. By the end of the decade, 9 of the 10 largest banking organizations in Texas had been recapitalized with FDIC or other outside assistance.[29] Factors that combined with the energy boom-bust to produce the Southwest banking debacle included inadequate portfolio diversification, poor underwriting standards, weak internal controls on lending decisions, infrequent supervisory examinations, and unrealistic real estate valuations.

The effects of the energy-related lending difficulties were not confined to the

Southwest Indeed, the largest U S bank failure, that of Continental Illinois National Bank and Trust Company in 1984, with assets of $33 6 billion, can be traced to troubles in the Oil Patch Continental had purchased hundreds of millions of dollars of energy loans from Penn Square Bank, N A , Oklahoma City, which failed in 1982 The large losses on these loans started a sequence of events that culminated in May 1984 in a massive run on Continental The immediate spark was withdrawals of several billion dollars in deposits by European and Japanese depositors Quick action by the FDIC and the other bank regulators stanched the run A permanent reorganization and recapitalization, involving significant monetary assistance by the FDIC, was accomplished later in the year [30] Although the regulators' actions alleviated the immediate crisis, the appropriateness was questioned by a number of critics, a topic covered in the next chapter

Energy-related lending and the difficulties it encountered also contributed to the most significant assault of the period on the banking industry's well-being—the collapse of a nationwide real estate boom An important part of the Southwest's energy euphoria in the early years of the decade was a surge in construction and real estate development That surge outlived the energy boom itself and spread to much of the rest of the nation The surge continued long after economic indicators should have persuaded perceptive real estate lenders and investors that a degree of caution was in order For example, the vacancy rate for office buildings in 31 major markets rose from 4 9 percent in 1980 to 13 5 percent in 1983 to 16 5 percent in 1985 Yet the funds continued to flow By 1991, the vacancy rate was 18 8 percent [31]

Banks and S&Ls were important providers of funds for the real estate boom S&L involvement was discussed earlier in this chapter For banks, real estate loans rose from 14 5 percent of their assets in 1980 to 24 5 percent a decade later [32] And as was the case with S&L real estate activity, the composition of bank real estate lending shifted toward riskier endeavors The safer home mortgage lending became relatively less important, displaced by more volatile construction and commercial real estate lending Furthermore, the underwriting standards for construction and commercial real estate lending were relaxed High loan-to-value ratios, no take-out commitments, and reduced recourse to corporate strength became common

In hindsight, discerning what happened in the real estate boom-bust of the 1980s —as well as the boom-busts regarding LDC, agricultural, and energy lending—is relatively easy Determining why it happened is more difficult and not susceptible to much in the way of quantifiable answers The ultimate "why" raises issues of human psychology, specifically the mind-sets that produce economic booms and busts Charles Kindleberger discussed the human propensity for economic folly in his classic *Manias, Panics, and Crashes A History of Financial Crises* [33] More recently, James Grant described the 1980s in his book, *Money of the Mind*, in terms that give rise to visions of credit run amuck [34] Whatever the causes, the financial world of the 1980s saw a reduction in caution and an increase in risk-taking Being part of the financial world, banks were infected by these attitudes Banks were also influenced by the changing nature of their business For example, many corporate customers found cheaper financing elsewhere, such as in the commercial paper market As they lost customers and saw more competition in some of their traditional areas of activity, banks turned to other fields, such as the risky world of real estate development

Bank troubles grew throughout the decade Insured bank failures from 1934 through 1981 totaled 586, an average of 12 a year On a decade basis, 358 banks failed from 1934 through 1940, 61 banks in the 1940s, 28 in the 1950s, 50 in the 1960s, and 79 in the 1970s The 1980s started normally enough, with 10 banks failing in 1981 In 1982, however, the figure jumped to 42 From 1982 through 1992, 1,484 banks failed, an average of over 130 a year and more than two and a half times the number of failures in the previous 48 years [35] In 1984, FDIC insurance assessments on banks were, for the first time since the agency's founding, less than insurance outlays [36]

Still, the banking system, including the industry's deposit insurance fund, appeared to be in reasonably good shape through the end of the decade, particularly when compared to the S&L industry and its defunct insurance fund Despite insurance assessments not keeping pace with insurance costs after 1984, the bank insurance fund continued to increase, reaching its then apogee, $18 3 billion, in 1987 The increases were due to interest on the fund's investments in U S Treasury securities In 1988 the fund declined to $14 1 billion, and in 1989 to $13 2 billion, but attention at the time was focused on the thrift industry and its problems The FDIC was still respected enough in Congress to be given responsibility for overseeing the organization and operation of the RTC, the S&L cleanup agency That mandate came in FIRREA [37]

Within a very short time, however, the possibility of an S&L-type disaster in the banking industry moved to center stage The reason for the concern was increasing awareness of the enormity of the real estate problems The Southwest's difficulties had been known for some time But as the 1990s dawned, the abysmal state of New England real estate markets became apparent And it soon became obvious that conditions in the Southeast and on the West Coast were also poor Lenders, including banks, suffered heavy losses The FDIC bank fund fell to $4 0 billion in 1990, and expectations of further massive declines rapidly became widespread

Fears that the banking industry was going the way of the S&L industry quickly grew Also attracting adherents was a belief that the performance of the bank regulatory agencies in controlling bank risk-taking had been inadequate This belief was reflected in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) A general thrust of that law was to curtail supervisory discretion One important way this was done was to require that certain corrective actions be taken as an institution's capital ratios decline The act also, among other things, (1) provided a Treasury line of credit for the deposit insurance system, (2) mandated annual examinations for banks and savings associations, (3) established a least-cost standard to be followed by the FDIC in resolving failing institutions,[38] (4) required the adoption of a risk-based deposit insurance assessment system, and (5) restricted the activities of state banks

For 1991, the FDIC reported a balance for the bank deposit insurance fund of a negative $7 0 billion, which included a large reserve mandated by the General Accounting Office for future failures The negative result confirmed for a number of observers the severity of the situation Predictions of continued troubles and further declines in the fund were heard throughout 1992 and even surfaced prominently as a issue in the presidential election campaign in the fall.

The low-point was 1991, however. Due in part to low interest rates, 1992 turned out to be a year of record profits for the industry. The number of bank failures—122—though large, was considerably less than what had been expected. The bank deposit insurance fund recovered to essentially a break-even position: a negative $100 million. The good news continued in the succeeding years and was still underway in 1998. Each year has seen the profitability record of the previous year broken. In 1994, the balance of the Bank Insurance Fund passed the prior peak of $18.3 billion, reached in 1987, and finished the year at $21.8 billion. At year-end 1997, the balance was $28.3 billion.

As the bank and S&L industries and individual institutions were on their roller-coaster rides during the 1980s and early 1990s, they were also on a consolidation path. From year-end 1983 to year-end 1992, the number of commercial banks fell more than 20 percent, from 14,469 to 11,462. At year-end 1997, the number of commercial banks was 9,143, a decline of 37 percent since 1983.[39] From year-end 1988 to year-end 1997, the number of thrifts declined 59 percent, from 2,949 FSLIC-insured institutions to 1,215 OTS-supervised institutions.[40] From year-end 1984 to year-end 1997, the number of independent banking organizations—bank holding companies plus unaffiliated banks and thrifts—declined 40 percent, from 14,888 to 8,967.[41] By the mid-1990s, the excess capacity that had burdened the industries at the beginning of the 1980s and that was a cause of the subsequent problems had been at least somewhat alleviated.

An important reason for the consolidation was the growth of interstate operations. In 1980, interstate bank and S&L organizations were largely prohibited by law. The various marketplace changes and crises, however, prompted efforts to overcome or reduce the legal hurdles. Many of these efforts were at the state level and consisted of measures permitting holding companies to acquire subsidiary depository institutions in more than one state. A number of the federally encouraged acquisitions of failed or failing banks and S&Ls involved interstate transactions. Indeed, without the existence of interstate acquirers, the bank and S&L cleanups might have been even more costly.

Overemphasizing the significance in U.S. financial history of the growth of interstate banking operations would be difficult. The move to reduce and remove state barriers marked a radical reversal of a two-century-old approach to supervising and regulating banking. For the future, the increased competition should help to control the tendency toward industry excess capacity that can be an undesirable by-product of government oversight and supervision. In addition, by making institutions less vulnerable to economic declines in a single state or region, interstate operations should enhance industry stability. In 1994, the federal government with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act finally became a firm supporter of the interstate movement. The act authorized bank holding companies to acquire banks located in any state. Equally as important, it also authorized, beginning June 1, 1997, and unless a state affirmatively opted out of the provision's coverage before then, interstate branching through bank mergers across state borders. States can go further than the

federal requirement by authorizing the establishment of new interstate branches.

The bank troubles and S&L crisis of the 1980s and early 1990s sorely tested the federal oversight system for depository institutions. The S&L crisis was the much more serious. The S&L industry was decimated, and the federal structure for regulating and supervising the industry was revamped. The banking troubles were milder. Both the banking industry and the federal banking agencies survived largely intact. But the survival has a downside. Some attribute banking's survival and remarkable recovery to the fundamental correctness of the regulatory system and to government actions to alleviate the troubles. The industry, however, might have survived not because of but in spite of the system and official actions. If this is the case, failure to grasp the true lessons of what transpired could raise the next banking crisis to the level of the 1980s' thrift debacle, resulting in a decimated industry and a disgraced regulatory structure.

NOTES

1. Office of Thrift Supervision, *Supervising Today's Thrift Industry* (December 1992), p. 1.
2. Federal Home Loan Bank Board, *Annual Report, 1986*, p. 6.
3. National Commission on Financial Reform, Recovery and Enforcement (NCFRRE), *Origins and Causes of the S&L Debacle: A Blueprint for Reform* (Washington, D.C., July 1993), contains a detailed description of the deregulatory steps taken by Congress and FHLBB regarding the S&L industry.
4. NCFRRE, p. 44.
5. Prudential-Bache Capital Funding, *Financial Strategies Group, A 1980s Retrospective of the Savings and Loan Crisis* (Prudential-Bache Capital Funding, 1990).
6. James R. Barth, *The Great Savings and Loan Debacle* (Washington, D.C.: The AEI Press, 1991), p. 25.
7. Prudential-Bache.
8. Ibid.
9. Barth, p. 25.
10. Ibid., p. 32.
11. Federal Home Loan Bank Board, *Annual Report, 1986*, p. 25.
12. Federal Home Loan Bank Board, *Annual Report, 1987*, p. 5.
13. Barth, p. 32.
14. Ibid.
15. Federal Home Loan Bank Board, *Annual Report, 1988*, p. 36.
16. The Resolution Trust Corporation Completion Act of 1993 changed the RTC's termination date from December 31, 1996, to December 31, 1995.
17. General Accounting Office, *Resolution Trust Corporation's 1995 and 1994 Financial Statements* (GAO/AIMD-96-123, July 1996).
18. The numbers of institutions taken over by the RTC by year were: 1989, 318; 1990, 213; 1991, 144; 1992, 59; 1993, 9; 1994, 2; and 1995, 2. Resolution Trust Corporation, *Statistical Abstract, August 1989/September 1995*, p. 9.
19. See Office of Thrift Supervision, *Savings & Home Financing Source Book, 1988*; *Supervising Today's Thrift Industry* (December 1992); *Quarterly Financial Results & Condition of the Thrift Industry, 4th Quarter, 1997*. See also, Jonathan L. Fiechter, *Testimony Concerning the Condition of the Thrift Industry Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, September 22, 1994. Net income for OTS-supervised institutions for 1992 to 1997 was: 1992, $5.1 billion; 1993, $4.9 billion; 1994, $4.3 billion; 1995, $5.4 billion; 1996, $4.8 billion; and 1997, $6.5 billion. But for a special assessment to

capitalize the Savings Association Insurance Fund, 1996 net income would have been an estimated record $6 9 billion

20 Gary S Fissel, "The Anatomy of the LDC Debt Crisis," *FDIC Banking Review* (Spring–Summer 1991, Vol 4, No 1) p 10

21 Calculated from Federal Deposit Insurance Corporation, *Historical Statistics on Bank-ing, 1934–1991,* Tables CB–7, CB–12

22 Fissel

23 See John Rosine and Nicholas Walraven, "Drought, Agriculture, and the Economy," *Federal Reserve Bulletin* (January 1989), p 7

24 Total bank failures for each year are from FDIC *Annual Report, 1991*, Table A, p 127 Agricultural bank failures are from the following FDIC *Annual Reports* 1986, p 8, 1987, p xvi, 1988, p xvi

25 John O'Keefe, "The Texas Banking Crisis Causes and Consequences, 1980–1989," *FDIC Banking Review* (Winter 1990, Vol 3, No 2), Table 5, p 17

26 Ibid The price is the domestic crude oil refiner acquisition cost

27 Ibid

28 Gregory K Gibbs, "Distribution of Failed Banks by State and by Type of Transaction," Unpublished paper prepared in the Banking Statistics Section, Division of Research & Statistics, Federal Deposit Insurance Corporation, March 16, 1990

29 O'Keefe, p 1

30 See Federal Deposit Insurance Corporation, *Annual Report, 1984*

31 CB Commercial/Toro Wheaton Research Vacancy rates are reprinted in various issues of *The Real Estate Report*, Division of Research and Statistics, Federal Deposit Insurance Corporation

32 Calculated from Federal Deposit Insurance Corporation, *Historical Statistics on Banking, 1934–1991,* Tables CB–12 and CB–14

33 Charles P Kindleberger, *Manias, Panics, and Crashes A History of Financial Crises* (New York Basic Books, 1978)

34 James Grant, *Money of the Mind* (New York Farrar Straus Giroux, 1992)

35 Federal Deposit Insurance Corporation, *Annual Reports*

36 Ibid Data in the subsequent paragraphs on bank failures and on balances of the deposit insurance fund are also from the FDIC's *Annual Reports*

37 The FDIC's oversight of the RTC was removed by the Federal Deposit Insurance Corporation Improvement Act of 1991

38 Section 141 of FDICIA, 12 U S C §1823(c)(4), requires the FDIC to use the "least costly" method of resolving failed or failing banks A systemic risk exception exists for large institutions The least-cost standard replaced the cost test that the FDIC had been using since 1951 and that had been codified in the 1982 Garn-St Germain Act Under the cost test, financial assistance provided by the FDIC to aid in the acquisition of a troubled bank by another institution could not exceed the cost of liquidating the bank and paying off only its insured deposits

39 FDIC, *Annual Reports*, individual years, *Historical Statistics on Banking, 1934–1992, Statistics on Banking*, individual years

40 Office of Thrift Supervision, *Savings & Home Financing Source Book, 1988, Quarterly Financial Results & Condition of the Thrift Industry* (4th Quarter, 1996)

41 FDIC, *Quarterly Banking Profile, Graph Book* (4th quarter, 1997)

4

Too Big To Fail: Sound Bite in Search of a Policy

When Chairman Bill Isaac left the FDIC in 1985, he departed with the admiration and respect of the agency's staff Within a few years, however, more than a few members of that staff regarded Mr Isaac as the Benedict Arnold of bank regulation His sin? He publicly questioned the FDIC's actions concerning the largest bank failure in U S history, actions that he himself helped shape, and that he oversaw and approved[1] One cannot fully appreciate the enormity of Mr Isaac's sin unless one remembers that questioning its own past is not one of a bureaucracy's strong points, and the FDIC is nothing if not a bureaucracy

The bank in question was Continental Illinois National Bank and Trust Company It was the biggest victim of the energy lending spree of the early 1980s It was rescued by the federal banking regulators, with the FDIC playing a crucial role The rescue precipitated a debate on the handling of bank failures that lasted for the rest of the decade Moreover, at its heart the debate was about much more than bank failures It was about the structure of banking in the United States and was a continuation of the small bank-big bank arguments that had been ongoing since the nation's founding It encompassed elements of states' rights and populism In the years following the Continental rescue, this two-centuries old debate became focused on the concept of "too big to fail "

CONTINENTAL ILLINOIS

The rescue of Continental Illinois National Bank and Trust Company (NB&TC) in 1984 was, and remains to this day, the largest bank resolution in U S history The bank's parent holding company was Continental Illinois Corporation The size of the transaction attracted considerable public attention, which contributed to issues concerning bank resolutions receiving a degree of public scrutiny

not previously experienced One particular issue was whether large banking organizations in trouble received preferential treatment from government regulators

At year-end 1983 less than six months before its troubles surfaced, Continental Illinois NB&TC with assets of $33 billion, was the seventh largest bank in the United States The holding company was the eighth largest holding company The immediate cause of Continental's troubles was a traditional bank run with a high-tech cachet rather than physically lining up at the doors, withdrawing depositors made their attack through electronic transfers The longer term causes of the difficulties involved declines in lending standards and too great an emphasis on growth

Continental had grown rapidly in the late 1970s Between 1976 and 1982, its loan portfolio increased almost 200 percent, from $11 6 billion to $34 billion For the same period, the assets of the U S banking industry as a whole increased just 80 percent Energy lending was a significant contributor to Continental's growth In particular, by 1982 the Chicago-based institution held approximately $1 billion in oil and gas loans originated by Penn Square Bank, N A , of Oklahoma [2] Penn Square, with assets of approximately $500 million, considerably less than the total assets it had originated but sold to others such as Continental, failed in July of 1982, a victim of lending practices that were little more than speculation Its resolution was handled by closing the bank and paying off insured depositors to the extent of their insured deposits It was the largest bank payoff, a subcategory of bank resolution methods, in the history of the FDIC The Penn Square failure was the flame that lit the fuse of Continental's implosion

Awareness of the relationship between Continental and Penn Square caused the investing community deep concern Continental Illinois Corporation's stock dropped from $25 a share in June 1982 to $16 a share in mid-August The stock recovered before the end of the year and reached $26 in the first quarter of 1983, but earnings for 1982 were only a third of what they had been in 1981 Exacerbating Continental's difficulties were its loan exposures in a number of bankruptcies in 1982 and in the international debt crisis that burst on the scene in August of the year when Mexico announced it would be unable to meet debt payments to foreign creditors

Continental's earnings for 1983 were an improvement over 1982, but much of the improvement was attributable to asset sales and extraordinary items rather than to continuing operations Domestic funding sources became more difficult to tap, and Continental turned increasingly to the Eurodollar market, which was more expensive

Exactly what set off the run on Continental in May of 1994 was never isolated The sale of a profitable credit card operation in March, anemic first quarter earnings, an allusion to troubles by television commentator Robert Novak, and a perhaps overly emphatic denial of difficulties by Continental itself have all been cited [3] What is clear is that the run occurred In the ten days preceding the announcement of FDIC assistance on May 17, over $6 billion was withdrawn from Continental practically all of it through wire transfers In the assistance package announced on May 17—a package worked out by the FDIC, the Federal Reserve

System, the Comptroller of the Currency, and private bankers—the FDIC made a $2 billion subordinated loan to Continental The bankers participated in $500 million of the loan In the announcement following the loan, the FDIC, the Federal Reserve, and the OCC stated that the assistance was temporary and designed to ensure the bank's liquidity until a permanent resolution could be arranged The temporary package also included assurances that the bank would have access to the Federal Reserve System to meet any extraordinary liquidity requirements

In late July 1984, after more than two months of exhaustive efforts by, and some degree of acrimony among, the federal banking regulators and the Department of the Treasury, a plan for a permanent resolution of Continental's difficulties was agreed upon The FDIC took $4 5 billion in bad loans from Continental The FDIC paid for the loans by assuming $3 5 billion in loans to Continental from the Federal Reserve Bank of Chicago The result of this portion of the transaction was that Continental immediately wrote off a $1 billion loss The loss was replaced by the injection by the FDIC of $1 billion into the parent holding company In return, the FDIC received preferred stock in the holding company The $1 billion was down streamed by the holding company into the bank in the form of equity capital

Among the issues the banking regulators and the Department of the Treasury grappled with regarding the resolution of Continental Illinois was the threshold one of deposit payoff versus continued existence Why not simply close the bank and pay off the insured deposits?

From almost the beginning of its existence in 1933, the FDIC has had two basic options regarding a failed or failing bank (1) close the bank permanently and pay off the insured deposits[4] or (2) keep the bank itself or its remnants in existence The second alternative is most often accomplished by having another bank acquire the failed or failing bank [5] Since 1950, however, the FDIC has had the power to keep a failing bank in existence by infusing funds directly, as was done in the Continental case [6]

Until the 1990s, a crucial distinction between closing a bank and paying off depositors, on one hand, and keeping the bank or its remnants in existence—either through an acquisition or by a direct infusion of FDIC funds—on the other, was that only with the first method did uninsured depositors suffer losses Any of the variants in the second category practically always resulted in all depositors—insured and uninsured—receiving full protection, although a point often overlooked was that management and shareholders were not protected top management was usually replaced and shareholders usually suffered losses

Today, as a result of Section 141 of the Federal Deposit Insurance Corporation Improvement Act of 1991, the FDIC is required to use the "least costly" method of resolving failed or failing banks [7] In implementing the provision, the FDIC developed a new method for merging a failed or failing bank into a healthy one Under the new method, only the insured deposits of a failed or failing bank are assumed by the acquiring institution Uninsured deposits are not assumed or otherwise protected The FDIC calls these transactions "purchase and assumption-insured deposits only" transactions In 1992, the year after FDICIA's enactment and even before Section 141 went into effect, they accounted for 42, or 34 percent, of the

122 failed or failing bank cases resolved by the FDIC

The FDIC did make one attempt prior to FDICIA to reduce the protection afforded uninsured depositors In 1983–84, the agency, under Chairman Isaac, experimented with a "modified payout" procedure Under this procedure, the FDIC advanced to uninsured depositors and other creditors an amount based on the anticipated recoveries of the failed bank's assets Normally, liquidation recoveries were paid out to uninsured depositors and creditors only when received The ultimate intent of the modified payout experiment was to increase market discipline by placing uninsured depositors and creditors at a greater risk of loss More apprehension on the part of depositors and creditors supposedly would result in more marketplace restraints on management If the modified payout procedure had proved successful, the acquisition method of handling failed banks—in which uninsured depositors and other creditors were invariably fully protected—would have given way in many instances to liquidations and the accompanying payoffs of insured depositors only The immediate partial payments provided under the modified payoff procedure were apparently viewed as making the shift from acquisitions to deposit payoffs more palatable The modified payoff experiment, however, fell victim to the Continental crisis, although in hindsight, the aban-donment of the experiment does not appear to have been absolutely necessary Perhaps the controversy surrounding the Continental crisis temporarily curtailed the FDIC's appetite for experimentation In addition, at least some in the agency apparently did not view the concept of increased depositor discipline as practical [8]

In any case, the modified payout experience of 1983-84 was an aberration for the pre–FDICIA period Prior to FDICIA, two distinct alternatives existed for handling a failed or failing bank (1) closing the bank and paying off insured deposits or (2) keeping the bank in existence through an acquisition or the provision of assistance Uninsured depositors and other creditors suffered under the first alternative, not so under the variants of the second

One of the considerations in the choice between the two alternatives, and one only occasionally acknowledged explicitly, was ease of administration [9] The larger the bank, the more administratively and logistically difficult it was to close the doors, pay off the depositors, and liquidate the assets This ease-of-administration consideration could combine with concerns about the effect on a community of shutting down a large institution, and with other factors, such as a perceived higher franchise value for larger institutions, to create a correlation between the size of a troubled institution and the way that regulators preferred to handle it The larger the bank, the greater the subtle pressure bank regulators felt to find an alternative to closing the doors and paying off depositors

And indeed an actual correlation between bank size and resolution method did exist, although the relationship was not as clear-cut as many discussants of the issue would have one believe For example for banks that failed during the period 1986–1992 the average assets of the 224 institutions that were liquidated, with only the insured deposits fully paid off was $60 million [10] This was considerably below the average assets of $207 million for the 928 institutions that were resolved through some form of acquisition or open bank assistance both of which resulted in uninsured deposits being fully protected For two of the years, however, the average assets of the liquidated and uninsured-deposits-unprotected banks exceeded the average assets of the uninsured-deposits-protected banks In 1987, the average assets of the 51 uninsured-unprotected resolutions was $48 million, while the average assets of the 152 uninsured-protected resolutions was $45 million And in 1990, the average assets of the 20 uninsured-unprotected resolutions was $125 million, while the average assets of the 149 uninsured-protected resolutions was $89 million

But as a generalization, the statement was accurate that troubled large banks were more likely than troubled small banks to be handled in a manner resulting in full protection for uninsured depositors This being the case, the potential existed for the development of a perception of unequal treatment between depositors and other creditors of troubled large banks and those of troubled small banks Prior to 1984, the perception was largely uncrystallized, due most likely to the small number of bank failures and their generally unspectacular nature Uneasiness existed about the differing effects on uninsured depositors of the liquidation-and-payoff alternative versus the keep-the-bank-or-its-remnants-in-existence alternative, but the debate focused as much on the supposed lack of depositor or marketplace discipline as on bank size [11]

Continental Illinois, however, changed the focus of the debate, and considerably broadened the interested audience The ingredient added by Continental Illinois was a factor that had been present in only one or two troubled bank cases over the preceding half-century That ingredient was the stability of the banking system itself

As the seventh largest bank in the nation, Continental was difficult for the banking regulators to view in isolation It had a large correspondent business [12] Almost 2,300 small banks had a total of nearly $6 billion at risk in the Chicago institution The exposures of 66 of them were greater than their capital, and the exposures of another 113 were in excess of 50 percent of their capital If Continental were closed and only insured deposits made whole—insured deposits amounted to little more than $3 billion of Continental's more than $33 billion in liabilities—at least some of these U S banking customers would have their own existences threatened In addition, the international banking community was closely watching the actions of the U S banking regulators Losses by uninsured depositors would have significantly reduced foreign faith in the U S banking system The consequences of such a loss of trust on the part of foreign depositors and investors were, of course, unknowable beforehand but not pleasant for those responsible for the health of the U S banking system to contemplate

Thus the alternative of closing Continental and paying off only insured depositors was not an attractive option for U S banking regulators In their view, the potential impact of this alternative on the stability of the U S banking system made preserving Continental as an ongoing institution, either by arranging an assisted acquisition or by propping up Continental itself, an imperative An appropriate acquirer could not be found, so the FDIC resorted to its authority to prop up an existing institution

Appendix B

The Thrift Industry in Crisis

Year	Number of Institutions	Industry Assets	Industry Net Income	Failures	Insurance Fund
1980	4,005	$620 6	$0 8	11	$6 5
1981	3,785	658 5	(4 6)	28	6 2
1982	3,349	699 5	(4 1)	63	6 3
1983	3,183	819 2	1 9	36	6 4
1984	3,136	977 5	1 0	22	5 6
1985	3,256	1,070 1	3 7	31	4 6
1986	3,220	1,163 9	0 1	46	(6 3)
1987	3,147	1,250 9	(7 8)	47	(13 7)
1988	2,949	1,350 5	(13 4)	305	(75 0)
1989	2 878	1,251 6	(6 2)	318	0 0
1990	2,521	1,084 8	(2 9)	213	0 0
1991	2,119	882 1	1 8	144	0 1
1992	1,871	806 7	5 1	59	0 3
1993	1,669	774 8	4 9	9	1 2
1994	1,543	774 1	4 3	2	1 9
1995	1,437	771 0	5 4	2	3 4
1996	1,334	769 2	4 8	1	8 9
1997	1,215	776 6	6 5	0	9 4

Notes (1) Dollar figures in billions (2) Institutions, assets, and net income through 1989, FSLIC-insured institutions—U S League of Savings Institutions, *Savings Institutions Sourcebook*; 1990–91, number of institutions and assets—*Statistical Abstract of the United States, 1992*, FDIC, *Statistics on Banking 1991*, 1990–91, net income, OTS-regulated institutions—OTS *Supervising Today's Thrift Industry* (December 1992), 1992-97, OTS-regulated institutions—OTS, *Quarterly Financial Results* (3) Failures 1980–1988—James R Barth *The Great Savings and Loan Debacle* (The AEI Press, 1991), p 32, 1989–1995—RTC, *Statistical Abstract* (8/89–9/95), 1996-97—OTS (4) Insurance Fund FSLIC through 1988, SAIF thereafter

Appendix C

The Banking Industry in Trouble

Year	Number of Institutions	Industry Assets	Industry Net Income	Failures	Insurance Fund
1980	14,435	$1,855 7	$14 0	11	$11 0
1981	14,415	2,029 1	14 7	10	12 2
1982	14,451	2,193 9	14 8	42	13 8
1983	14,469	2,342 0	14 9	48	15 4
1984	14,483	2,508 9	15 5	80	16 5
1985	14,407	2 730 7	18 9	120	18 0
1986	14,199	2,940 7	17 4	145	18 3
1987	13,703	2,999 9	2 8	203	18 3
1988	13,123	3,130 8	24 8	221	14 1
1989	12,709	3,299 4	15 6	207	13 2
1990	12,343	3,389 4	16 0	169	4 0
1991	11,921	3,430 6	17 9	127	(7 0)
1992	11,462	3,506 0	32 1	122	0 0
1993	10,958	3,706 2	43 4	41	13 1
1994	10,451	4,010 5	44 7	13	21 8
1995	9,940	4,312 7	48 8	6	25 5
1996	9,528	4,578 3	52 4	5	26 9
1997	9,143	5,014 9	59 2	1	28 3

Notes (1) Dollar figures in billions (2) FDIC *Historical Statistics on Banking, 1934–1992, Quarterly Bank Profile*, various issues, *Annual Report*, various issues

Appendix D

Interest Rates and Inflation (%)

Year	Federal Funds Rate	Change in Consumer Price Index
1970	7 18	5 7
1971	4 66	4 4
1972	4 43	3 2
1973	8 73	6 2
1974	10 50	11 0
1975	5 82	9 1
1976	5 04	5 8
1977	5 54	6 5
1978	7 93	7 6
1979	11 19	11 3
1980	13 36	13 5
1981	16 38	10 3
1982	12 26	6 2
1983	9 09	3 2
1984	10 23	4 3
1985	8 10	3 6
1986	6 81	1 9
1987	6 66	3 6
1988	7 57	4 1
1989	9 21	4 8
1990	8 10	5 4
1991	5 69	4 2
1992	3 52	3 0
1993	3 02	3 0
1994	4 21	2 6
1995	5 83	2 8
1996	5 30	3 0
1997	5 46	2 3

Source Economic Report of the President, February 1998, Tables B-63 and B-73

Appendix E

Major Banking Laws, 1980–1996

1980 Depository Institutions Deregulation and Monetary Control Act (DIDMCA) Established the Depository Institutions Deregulation Committee and provided for the phasing out of interest rate ceilings Extended nationwide the authority of depository institutions to issue NOW accounts or their equivalent Required all depository institutions offering transaction accounts to maintain reserves with the Federal Reserve System Expanded the powers of federal S&Ls Raised the federal deposit insurance limit from $40,000 to $100,000 Pub L 96–221

1982 Garn-St Germain Depository Institutions Act Its most notable provisions authorized interstate emergency mergers and acquisitions and expanded the powers of federal S&Ls and savings banks Pub L 97–320

Title I, the Deposit Insurance Flexibility Act, expanded the FDIC's power to assist troubled banks, authorized certain acquisitions on an interstate or cross-industry basis, allowed the FHLBB to charter savings banks that retained their FDIC insurance and permitted the FDIC to convert a state mutual savings bank into a federal stock savings bank under certain circumstances

Title II, the Net Worth Certificate Act, authorized the FDIC and the FHLBB to provide capital assistance through the purchase, with promissory notes, of net worth certificates

Title III expanded the powers of federal S&Ls and savings banks

Title IV increased the lending limit for national banks and made a number of changes regarding insider transactions

Title V restricted the insurance activities of bank holding companies

Title VI made a number of changes in the Federal Credit Union Act to give credit unions greater flexibility and authority in daily operations

Title VII allowed financial institutions to offer NOW accounts and share draft accounts to state and local governments, directed certain studies be made regarding deposit insurance, and expanded the powers of bank service corporations

1983 International Lending Supervision Act Imposed controls over the international lending activities of U S banking organizations Directed the federal banking agencies to establish minimum capital levels Pub L 98–181, Title IX 12 U S C §§3901–3912

1987 Competitive Equality Banking Act (CEBA) A 12–title law that, among other things, addressed certain inequities among depository institutions and attempted to deal with the escalating S&L crisis Pub L 100–86

Title I, the Competitive Equality Amendments of 1987, prohibited the establishment of new "nonbank banks," imposed certain restrictions on existing "nonbank banks" and their parent organizations, and created the concept of a "qualified thrift lender" a definition that had to be met if an organization wanted to enjoy certain benefits of being a thrift

Title II imposed a temporary moratorium on Federal agency approvals of certain securities, insurance, and real estate activities by banks, bank holding companies, and foreign banks

Title III was a plan to recapitalize the FSLIC in the amount of $10 8 billion

Title IV, the Thrift Industry Recovery Act, mandated the adoption by the FHLBB and the FSLIC of regulations concerning accounting, appraisal, reserve, and capital standards A forbearance program for certain weak thrifts was also to be instituted.

Title V extended, with modifications, the emergency interstate acquisition provisions of the Garn-St Germain Act of 1982, authorized the FDIC to establish "bridge banks" to aid in arranging mergers or other disposition transactions for failing banks, and extended Garn-St Germain's new worth certificate program for five years

Title VI, the Expedited Funds Availability Act, limited the number of days a depository institution could restrict the availability of funds deposited in any transaction account

Title VII made a number of changes in the Federal Credit Union Act

Title VIII authorized agriculturally oriented banks to amortize loan losses over an extended period of time

Title IX provided that federally insured deposits were backed by the full faith and credit of the government

Titles X–XII concerned certain miscellaneous matters and mandated various studies

1989 Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) A 14-title law that established the Resolution Trust Corporation to manage and resolve failed savings institutions, abolished the FHLBB and the FSLIC, created the Office of Thrift Supervision within the Treasury Department to replace the FHLBB, and created the Savings Association Insurance Fund under the control of the FDIC to replace the FSLIC Pub L 101–73

Title I set forth the act's purposes

Title II renamed the FDIC's existing fund as the Bank Insurance Fund (BIF), created a second fund—the Savings Association Insurance Fund (SAIF)—under the FDIC's jurisdiction, set forth assessment and funding instructions for the funds, gave the FDIC resolution powers concerning failed or failing SAIF–insured thrifts, established cross–guarantee liability for commonly controlled depository institutions, gave the FDIC the power to restrict the acquisition of brokered deposits by troubled institutions, imposed certain limitations on the powers of state–chartered thrifts, and prohibited investments by thrifts in junk bonds

Title III created the OTS, mandated that thrift capital standards be at least as stringent as capital standards for national banks, strengthened the qualified thrift lender test, added an additional restriction on thrift commercial real estate loans of 400 percent of capital, and required thrifts to adhere to national bank standards regarding limits on loans to one borrower and transactions with affiliates

Title IV abolished the FHLBB and the FSLIC and provided for the transfer of their functions

Title V created the RTC and authorized $50 billion for the S&L cleanup The RTC was to resolve all formerly FSLIC-insured institutions failing between January 1, 1989, and August 9, 1992 The RTC was to cease to exist on December 31, 1996

Title VI amended the Bank Holding Company Act, giving the Federal Reserve Board the specific authority to permit bank holding companies to acquire thrifts

Title VII made a number of changes in the organization and operation of the Federal Home Loan Bank System, including the creation of the Federal Housing Finance Board to oversee the Federal Home Loan Banks

Title VIII granted to the Comptroller of the Currency clearer powers to appoint conservators for national banks

Title IX expanded and strengthened enforcement powers

Title X mandated several studies, including a Treasury Department–coordinated study of the deposit insurance system

Title XI provided for regulation of the real estate appraisal industry

Titles XII–XIV dealt with a number of topics, including taxes and additional studies

1990 Assessment Rates—the Omnibus Budget Reconciliation Act removed caps on assessment rate increases and allowed for semiannual rate increases 12 U S C §1817(b) It also permitted the FDIC, on behalf of the BIF and the SAIF, to borrow from the Federal Financing Bank (FFB) on terms and conditions determined by the FFB 12 U S C §1824(b) Pub L 101–508

Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act—Title XXV of the Crime Control Act of 1990 Contained a variety of provisions designed to assist the FDIC and the RTC in preventing and punishing fraud in the banking and thrift industries Gave the FDIC and the RTC the authority to ask a court to freeze the assets of persons who defraud depository institutions Prevents individuals who defraud financial institutions from using the federal bankruptcy code to discharge debts or shield assets Authorized the FDIC to prohibit excessive bonuses, benefits, and "golden parachute" severance packages for departing officers, directors, and employees of troubled institutions For codification, see 12 U S C §1001 note Pub L 101–647

Subtitle F established a National Commission on Financial Institution Reform, Recovery, and Enforcement to examine the origin and causes of the thrift crisis and to make recommendations on preventing recurrences

Subtitle H, the Financial Institutions Anti-Fraud Enforcement Act of 1990, encouraged private persons to inform the government of violations that could give rise to civil penalties and of specific assets that could be recovered in satisfaction of judgments 12 U S C §§4201–4247

1991 Resolution Trust Corporation Funding Act Provided an additional $30 billion for the S&L cleanup Pub L 102–18

Resolution Trust Corporation Refinancing, Restructuring and Improvement Act

Provided an additional $25 billion for the S&L cleanup, extended the ending date for the period during which failed thrifts became the responsibility of the RTC from August 9, 1992, to September 30, 1993, made changes in the control structure of the RTC, and relaxed the real estate appraisal requirements of the FIRREA Pub L 102–233

Title III, the Resolution Trust Corporation Thrift Depositor Protection Reform Act, replaced the RTC Oversight Board with the less powerful and intrusive Thrift Depositor Protection Oversight Board, abolished the RTC Board of Directors (which had been the FDIC Board of Directors wearing a different hat), and replaced the FDIC as manager of the RTC with the chief executive officer of the RTC

Federal Deposit Insurance Corporation Improvement Act (FDICIA) Provided for recapitalization of the FDIC's Bank Insurance Fund, and tightened regulation and supervision of banks and thrifts in a number of areas The regulatory and supervisory changes included (1) creation of five capital-to-assets ratio categories and articulation of detailed actions to be taken by bank supervisors if an institution's capital declines (prompt corrective action), (2) requirement that banks and thrifts be examined and audited annually, (3) establishment of a least-cost standard to be followed by the FDIC in resolving failing institutions, (4) prohibition on use of brokered deposits by low capitalized institutions, (5) requirement that the FDIC institute a risk-based assessment system for deposit insurance assessments, (6) restrictions on the activities of state banks, and (7) requirement that the banking agencies promulgate standards concerning real estate lending, operational and managerial matters, asset quality, earnings, stock valuation, and compensation Pub L 102–242

Title II, Subtitle A, the Foreign Bank Supervision Enhancement Act, strengthened the regulation and supervision of foreign banks

Title II, Subtitle C, the Bank Enterprise Act, provided for reduced insurance assessment rates for lifeline accounts and assessment credits for lending and other activities in distressed areas

Title II, Subtitle F, the Truth in Savings Act required adequate disclosure of terms and conditions about interest on savings vehicles

Title IV, Subtitle G, the Qualified Thrift Lender Reform Act, relaxed the qualified thrift lender test for thrifts

1992 Regulatory Burden—The Housing and Community Development Act contained a number of provisions relaxing statutory requirements on depository institutions Among other things, the act prohibited the FDIC from setting a specific range of compensation for officers, directors, and employees of insured financial institutions 12 U S C §1831p–1(d) Pub L 102–550

1993 Depositor Preference Title III, §3001, of the Omnibus Budget Reconciliation Act amended the FDI Act to give depositors a preference over general creditors and shareholders when a receiver distributes assets from failed banks and thrifts Because the FDIC is subrogated to the claims of insured depositors, the amendment increased the FDIC's share of the recoveries of the assets of failed institutions Pub L 103–66 12 U S C §1821(d)(11)

Resolution Trust Corporation Completion Act Released to the RTC up to $18 1 billion in previously authorized funding that had lapsed April 1, 1992 Changed the date on which the RTC was scheduled to terminate from December 31, 1996, to December 31, 1995 Extended the RTC's authority to be appointed conservator or receiver of failed thrifts from September 30, 1993, to a date between January 1, 1995, and July 1, 1995, the exact date to be selected by the chairperson of the Thrift Depositor Protection Oversight Board Established transitional procedures for the folding of the RTC back into the FDIC Established a new SAIF funding schedule, reducing the maximum authorization of appropriations from the FIRREA's $32 billion to $8 billion Specified certain management and operational reforms for the FDIC and the RTC Pub L 103–204

1994 Riegle Community Development and Regulatory Improvement Act A five-title law that, among other things, authorized financial assistance for community development financial institutions and scaled back the regulatory burden on federally regulated banks and thrifts Pub L 103–325

Title I, Subtitle A, the Community Development Banking and Financial Institutions Act, created a community development fund and authorized it to provide financial and technical assistance to Community Development Financial Institutions (CDFIs) Any entity, including an insured depository institution, may seek qualification as a CDFI

Title I, Subtitle B, the Home Ownership and Equity Protection Act, established disclosure requirements and standards concerning home equity lending

Title II, Subtitle A, the Small Business Loan Securitization and Secondary Market Enhancement Act, built on the framework for securitization established by the Secondary Mortgage Market Enhancement Act of 1984 by creating a similar framework for small business-related securities.

Title II, Subtitle B, established a Small Business Capital Enhancement Program to assist in providing access to debt capital for small business concerns

Title III contained a number of provisions designed to reduce regulatory burden

Title IV, the Money Laundering Suppression Act, imposed requirements on the Secretary of the Treasury and the banking agencies designed to better control money laundering

Title V, the National Flood Insurance Reform Act, expanded flood insurance purchase requirements and mandated that the banking agencies and the National Credit Union Administration ensure compliance on the part of depository institutions

Riegle–Neal Interstate Banking and Branching Efficiency Act Authorized banks, beginning June 1, 1997, to branch across state lines through merger States could accelerate the effective date and can allow de novo branching States could also opt out of interstate branching altogether if they did so by June 1, 1997 Authorized bank holding companies beginning one year after enactment to acquire banks located in any state Pub L 103–328

1996 Small Business Job Protection Act Section 1616 repealed the provision of the IRC, Section 593, authorizing the reserve method of accounting for bad debts by thrift institutions The section also forgave the recapture of bad debt reserves for taxable years before 1988, thus removing a financial barrier to the conversion of thrifts to banks Pub L 104–188

Economic Growth and Regulatory Paperwork Reduction Act Contained a number of regulatory relief measures, including imposition of a 60-day time period for the FDIC's consideration of a state bank application to engage in an activity not permissible for a national bank, removal of ATMs from branch closure notification requirements, and exemption of certain other branch closures from notification requirements Mandated that one of the public members of the FDIC board have state bank supervisory experience Excluded retirement certificates of deposit from the definition of "deposit," thus making them ineligible for deposit insurance coverage Pub L 104-208

Subtitle G, the Deposit Insurance Funds Act, provided for capitalization of the Savings Association Insurance Fund and for the spreading of the FICO (Financing Corporation) obligation to include banks The SAIF was to be capitalized at the designated reserve ratio of 1 25 percent of insured deposits through a special assessment on SAIF members Full pro rata responsibility of banks for FICO assessments was to be in place by December 31, 1999, or the date on which the last savings association ceased to exist if earlier Prior to that time, banks were to make FICO payments at one-fifth the rate imposed on SAIF-insured institutions The BIF and the SAIF were to be merged on January 1, 1999, if no savings association existed on that date The Treasury was to study the development of a common charter and report to Congress by March 31, 1997

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