FRBSF WEEKLY LETTER

December 1, 1989

FIRREA and Deposit Insurance Reform

In August 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was passed to protect the federal deposit insurance funds from the escalating claims of insolvent thrift institutions. To achieve this goal, the bill enhances the powers of thrift regulators to restrict risky activities and close insolvent institutions promptly. The new law also strengthens supervisory and regulatory oversight and imposes more stringent capital requirements on thrift institutions. These measures are features of a number of proposals for permanent reform of deposit insurance.

This *Letter* analyzes key provisions of FIRREA and finds that although the law takes a number of positive steps to deal with the current thrift crisis, it contains elements of forbearance that risk further growth in claims on the deposit insurance funds. Perhaps more important, FIRREA does not address the flawed incentive structure of the deposit insurance system. Additional reforms, therefore, will be necessary if future problems are to be avoided.

Objectives of FIRREA

The crisis in the savings and loan industry is the result of serious deterioration in the net worth of insured institutions. As of August this year, insured liabilities at insolvent institutions exceeded the value of assets by an estimated $100 billion or more. Moreover, the potential liabilities of the insurance fund were increasing at a rapid rate. Lacking even a tenth of the resources to cover this enormous shortfall, the Federal Savings and Loan Insurance Corporation ultimately was declared insolvent.

There is much debate over the proximate causes of this deterioration, but it is widely agreed that the deposit insurance system itself is fundamentally at fault. With fixed-rate premiums unrelated to the riskiness of insured institutions' portfolios, there exists an incentive, or "moral hazard," for excessive risk taking. This perverse incentive for risk taking increases, moreover, as the net worth of insured institutions approaches zero.

The legislative response to the S&L crisis was passage of FIRREA. The bill has a number of stated objectives. Among these are: 1) to strengthen the enforcement powers of thrift regulators, enabling them to deal promptly with insolvent and weak thrifts; 2) to protect the integrity of the deposit insurance funds by curtailing activities at insured institutions that pose unacceptable risks; 3) to strengthen the financial condition of the industry by imposing more stringent capital and other supervisory standards; and 4) to promote through regulatory reform a safe and stable system of affordable housing finance.

Strengthening supervision and regulation

Since the incentive for excessive risk taking rises as the net worth of an institution approaches zero, currently insolvent institutions pose the greatest risks to the deposit insurance fund and must be closed immediately. Previous regulatory forbearance enabled these insolvent thrifts to continue to operate, thereby increasing risk taking and the potential liabilities of the insurer.

Many have suggested that the Federal Home Loan Bank Board's dual roles as thrift chartering agent and overseer of the deposit insurance fund created conflicts of interest that led to this forbearance policy and increased the size of the insurance crisis. In response to these concerns, FIRREA includes a number of organizational reforms of thrift industry regulators. It consolidates management of the bank and thrift deposit insurance funds under the Federal Deposit Insurance Corporation (FDIC) and creates a new thrift regulatory agency, the Office of Thrift Supervision (OTS). FDIC and OTS are endowed with enhanced powers to enforce bank and thrift regulations.

FIRREA facilitates the closure process by broadening the powers of the FDIC to close insolvent thrift institutions as well as insolvent banks in a prompt manner. The bill authorizes the FDIC to step in as conservator or receiver for any insured bank or S&L chartered under federal or state law.

(As conservator, the FDIC operates or disposes of an institution as a going concern, while a receiver has the power to terminate activities and liquidate assets.)

The Act also gives FDIC authority to suspend or terminate deposit insurance coverage more expeditiously. Prior to FIRREA, the minimum legal period required to terminate coverage was significantly more than two years. Under the new bill, this process has been "accelerated" to as little as six to seven months. Since most weak or insolvent institutions cannot survive without deposit insurance, the power to terminate coverage promptly is, in effect, a prompt closure policy.

FIRREA also gives OTS greater authority to restrict activities at undercapitalized thrifts, the ones that face the strongest incentives to exploit the deposit insurance guarantee by pursuing high-risk activities. For example, OTS can prohibit undercapitalized thrifts from accepting brokered deposits and it can restrict the growth rate of assets at such thrifts. These restrictions limit the extent to which an ailing institution can add to the potential liability of the deposit insurance fund.

Enhancing capital

Another objective of FIRREA is to reinforce the financial position of thrifts and ensure a safe and sound housing finance industry. The primary tool is stricter capital requirements. In the past, regulatory accounting techniques and other means of capital forbearance enabled zero or negative-net-worth institutions to continue to operate. In contrast, FIRREA sets new capital standards that are to be strictly applied to all institutions.

Thus, thrifts must hold core capital equal to three percent of their assets and tangible capital equal to 1½ percent of assets. Core capital is the sum of common equity, noncumulative preferred stock, minority interests in consolidated subsidiaries, and supervisory goodwill, less most intangible assets. Tangible capital is core capital minus all intangibles (except mortgage servicing rights) and supervisory goodwill.

FIRREA's more stringent capital regulations should give thrift owners and managers greater incentives to control risk-taking. With more of their own money at stake, thrift owners will be less likely to exploit the deposit insurance guarantee by pursuing high-risk strategies.

In an additional effort to limit the risk and enhance the financial stability of thrifts, FIRREA contains some new restrictions for all savings and loan institutions, including those that are not federally chartered. For example, the new legislation prohibits thrifts from investing in less-than-investment grade debt instruments, that is, junk bonds. Thus, it supercedes certain states' laws that have granted thrift institutions considerable latitude in investment powers.

FIRREA also raises the proportion of assets that depositories must hold in residential mortgage-related assets in order to be considered thrifts. The "Qualified Thrift Lender" (QTL) test requires an insured institution to hold at least 70 percent of its assets in so-called "qualified thrift investments." S&Ls that satisfy the QTL test benefit from low interest rate advances from the Federal Home Loan Banks. Those that do not meet the new QTL guidelines must convert to a bank charter.

Where FIRREA falls short

Although FIRREA enhances closure powers, strengthens capital standards, and limits forbearance, it does not go far enough to provide for lasting reform of the deposit insurance system. One important problem is that the new capital requirements are based on book-value ratios. Although a book-value standard has the advantage that it is relatively easy to administer, in a liquidation or reorganization, book accounting values are irrelevant. The cost to the insurance fund in a liquidation is the difference between the prices the institution's assets and liabilities can be sold for on the open market. The incentive to take on risk, moreover, relates to the *market* value of capital. Thus, emphasis on book values raises the likelihood that thrift portfolios may look good on paper while concealing weak market-value net worth and large potential claims on the deposit insurance fund.

The failure to incorporate market-value accounting in FIRREA also presents problems for the closure of insolvent institutions. Although the new law makes it easier for the OTS and FDIC to

close *book-value* insolvent institutions, clever accounting at troubled thrifts may make it possible for *market-value* insolvent institutions to continue to operate under the new law, pursuing high-risk strategies that entail growing liabilities for the deposit insurer. In addition, the growth limits, asset restrictions, and other sanctions contained in the bill are all based on book value measures of capital deficiency and thus suffer the same weakness as the closure rules.

Also, it is difficult under FIRREA's capital provisions to distinguish risky from relatively safe institutions. The bill calls for risk-based capital standards that are "no less stringent" than those applied to national banks. Even the bank standards, however, do not employ market valuations and focus primarily on credit risk. These measures thus do not provide an accurate valuation of institutions' risk-adjusted market-value net worth, particularly as regards interest rate risk. Thus, two S&Ls could maintain the same book-value capital ratio, but pose very different risks to the insurance fund.

These problems with book valuation implicitly allow capital forbearance to continue. Another problem with FIRREA is that it still *explicitly* allows room for forbearance that would permit even *book-value* insolvent institutions to continue to operate. At the discretion of the Director of OTS, an institution that violates the new capital standards can be granted an exemption from FIRREA's asset growth and activity restrictions by filing an acceptable "capital plan." Although this plan must address the need for additional capital at the institution and describe the methods that the insured thrift will use to raise the new funds, this provision leaves the door open to continued capital forbearance.

There is also an implicit form of forbearance in the relatively long delays required to terminate insurance coverage (though these delays are shorter than in the past). Claims against the deposit insurance fund could grow significantly while the FDIC moves to terminate coverage.

Another potential problem with FIRREA is that it requires thrifts to concentrate a large majority of their portfolios on residential mortgage assets. These QTL restrictions prevent thrifts from employing diversification strategies that actually might reduce the risk of their portfolios. In fact, it can be argued that a lack of diversification contributed to the problems at many failed thrift institutions. The wisdom of these restrictions is thus questionable.

Long-term reform

FIRREA was intended primarily as a short-term reorganization and recapitalization of the thrift industry and its deposit insurance fund. The bill, however, comes surprisingly close to true, long-term reform of the deposit insurance system. Long-term reform requires that the perverse incentives for risk taking embedded in the existing insurance system be eliminated.

FIRREA falls short of this standard by continuing to emphasize book-value net worth. It is possible under the new law for a book-value solvent, but market-value insolvent, institution to manipulate the recorded value of its net worth and continue to operate in a high-risk fashion. The deposit insurance fund will thus continue to be in danger until long-term reform eliminates the incentives for such behavior.

Two provisions of FIRREA, namely, enhanced capital requirements and prompt closure could be sufficient to eliminate the perverse incentives if these provisions were geared to market values. In fact, risk-based capital standards and a policy of closing depository institutions that fail to meet these standards on a market-value basis effectively would eliminate the need for deposit insurance.

FIRREA recognizes the importance of more fundamental deposit insurance reform. It commissions a number of special studies on long-term issues, including market-value accounting and a risk-based insurance premium system. True reform likely will have to wait for the findings of these studies in 1991.

Jonathan A. Neuberger
Economist

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Research Department

Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120