The industry owes its troubles to Congress, regulators -- and ...
By NATHANIEL C. NASHWASHINGTON
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Who to Thank for the Thrift Crisis

1979
Fed begins to push interest rates to record levels to stop inflation.

1980
Thrift units sell assets to meet deposit withdrawals, but begin to suffer heavy losses. Congress responds by deregulating interest rates. Bank Board drops minimum capital requirements to 4 percent from 5 percent.

1981
Bank Board permits thrift units to make variable-rate mortgages.

1982
Congress and some states permit thrift institutions to enter new businesses, such as direct lending to commercial real estate. Bank Board eases accounting and capital requirements further. More than 250 institutions fail.

1983
As interest rates fall, thrift institutions pour billions into risky Texas, Florida and California real estate development.

1984
Bank Board studies show hundreds of insolvent thrift institutions nationwide. The board's examination force is cut. Oil prices and Texas economy begin to collapse.

1985
Regulators, realizing there are hundreds of insolvent thrift units, start passing regulations that inhibit risky lending, excessive growth and lenient accounting practices. Bank Board begins talk of recapitalization.

1986
Texas economy badly depressed. Thrift units' losses mount nationwide, led by Texas. At year end, F.S.L.I.C. liabilities exceed assets by $6 billion.

1987
Congress permits F.S.L.I.C. to borrow $10.8 billion to shut insolvent thrift institutions, but F.S.L.I.C. losses reach $13.7 billion.

1988
Spring: Bank Board acknowledges it has 515 insolvent thrift units. Total losses estimated at $20 billion to $70 billion. First official talk of taxpayer bailout.

Net Worth
Negative net worth of insolvent F.S.L.I.C.-insured savings and loans, based on generally accepted accounting principles. In billions of dollars. 1988 is N.Y. Times first quarter estimate.

The industry owes its troubles to Congress, regulators – and itself.

By NATHANIEL C. NASH

WASHINGTON

HOWEVER you look at them, the numbers are staggering. Last week, the Federal Home Loan Bank Board said it would pay $1.35 billion to liquidate two California savings and loan associations that had gone bankrupt, producing the most expensive liquidations on record. It will devour more than 40 percent of the cash on hand at the Government's deposit insurance fund, whose paper losses already total almost $14 billion, according to the General Accounting Office.

The bleeding does not stop there.

Almost one-third of the nation's 3,120 savings and loan institutions lost money last year — a staggering total of $13.4 billion — and analysts expect losses to be just as big this year. More than 500 savings and loans are bankrupt and another 300 to 500 are nearly insolvent. In all, experts estimate that it will cost anywhere from $20 billion to $70 billion — and maybe more — to shut institutions that have already been found insolvent and to cover their losses.

This is shaping up to be the biggest financial disaster of the post-war era. It is a crisis that could produce the largest Government bailout in history and the possibility that the thrift industry, born in the Depression to bolster home ownership, will not survive the turbulent, deregulated 1980's as an independent industry.

As the scope of the disaster becomes increasingly clear, so does a picture of how the situation managed to get so out of control.

Fingers point in different directions, and many take aim straight at the depressed Texas economy, whose plummeting oil prices brought down the real estate industry to which savings and loans had lent heavily. But there was not just one culprit, nor a single big mistake. Rather, from the late 1970's on, there was a confluence of error and ineptitude, at times compounded by fraud. Congress, regulators and the industry, all failed. Together, they produced a maelstrom of legislation, regulatory measures and lending practices that were too lenient, shortsighted, poorly conceived, politically compromised or inadequate.

"There's an awful lot of blame to go around," said M. Danny Wall, chairman of the Federal Home Loan Bank Board.

"No one can really escape culpability here," said R. Dan Brumbaugh Jr., a former economist at the Bank Board. "Just about everything has gone wrong that could go wrong."

Federal legislators, who frequently bowed to political pressure from an industry known for its powerful grass-roots lobbying, have come under fire for deregulating the thrift industry piecemeal and granting too much leeway in accounting practices. The Bank Board, the industry's primary regulator, is criticized for being too close to the thrift units it regulated, and for responding with inadequate resources and ill-trained examiners when the situation began to unravel.

And the industry, for its part, was unable to cope with the high interest rates that sprang from the late 1970's and spurred deregulation. Many executives lacked expertise to compete in the new world of finance. More troubling were the aggressive entrepreneurs, wheeler-dealers and gamblers who saw an opportunity to make a bundle at the expense of the Federal Government.

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Who to Thank for the Crisis in the Thrift Industry

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Now, in sorting through the rubble, several questions emerge. One is the scope of the problem; how many billions of dollars will be needed to resolve it depends partly on how much the government can salvage from real estate loans gone bad . Another is whether the policies pursued by the Federal Home Loan Bank Board will be enough to halt the industry's deterioration. But what worries people most is this: In the last five and a half years, despite troubles in Texas, the United States economy has experienced a record economic boom. If the thrift industry bleeds profusely in good times, what will happen in the bad — when, say, interest rates spike up or the next recession hits?

"Over the next two or three years, the industry is going to face either a high-interest-rate problem or another credit problem brought on by a recession, and it could face them both in sequence," said Henry J. Gailliot, chief economist for the Federated Research Corporation, a mutual fund investment company in Pittsburgh.

How Congress Failed

Senator William Proxmire minces no words when he speaks of how Congress handled industry problems in the last 10 years.

"Repeatedly, Congress moved too late or failed to produce legislation" to halt the industry's demise, said the Wisconsin Democrat who is chairman of the Senate Banking Committee. "We created a whole new ball game in 1980," he said, referring to Congressional deregulation of interest rates. But, he added, the Federal Government was unwilling "to appropriate funds to adequately police the new systems."

Although some candid lawmakers blame themselves for insufficient action in the late 1970's and 80's, some analysts believe the roots of the crisis lie deep in the structure of the industry, established by Congress in 1932. The savings and loans — or building and loans, as others were called — were intended to take short-term deposits and use them to make 15-, 20- and 30-year mortgages.

"The whole thrift financial structure was fundamentally flawed from the beginning," said Bert Ely, a banking and thrift consultant based in Alexandria, Va. "It is borrowing short to lend long. Sooner or later you are going to have a disaster."

While interest rates held steady over the next few decades, the system worked. Congress had established an interest-rate ceiling for deposits and the business developed essentially risk-free. But when the Federal Reserve Board, to tame inflation, dramatically pushed up interest rates in the late 1970's and early 1980's, the system's fatal flaw was revealed: savings and loans were forced to pay more for deposits than their mortgage portfolios were yielding.

The interest-rate ceiling that had long provided the industry with handsome profits began to suffocate it. Depositors, knowing that they could earn higher rates from money-market mutual funds, began massive withdrawals of their money. To finance that, the industry began selling assets at a loss. The result: Almost 500 institutions failed between 1980 and 1983, and the underlying net worth — the capital cushion used in times of stress to absorb losses — plummeted from

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$32.4 billion in 1980 to $20.3 billion by 1982.

As losses mounted, Congress was urged to rescue the system it had created. But the steps it took had the unanticipated effect of making matters worse.

"I don't think that most of us really understood just how serious the problem was," said Senator Jake Garn, Republican of Utah. "When we began to realize how big it was, we did not have the resources to handle it."

First, in 1980, Congress deregulated interest rates that depository institutions could pay on deposits. It also allowed the industry to offer adjustable-rate mortgages to help protect itself from interest-rate fluctuations. Then, in 1982, Congress passed the Depository Institutions Act, permitting the industry to enter new businesses, such as commercial loans like those from banks. The idea was to let the industry to diversify its asset portfolio and to shore up its finances.

Deregulation was not confined to Washington. Several states — particularly Florida, Texas and California, trying to protect the interests of their state-chartered savings and loans — passed their own, even more sweeping, deregulatory provisions. Those measures essentially enabled institutions to engage in any lending practice they wanted.

The new powers allowed institutions with skilled managers to benefit. But Congress and the state legislatures failed to take into account the existence of more than 1,000 severely weakened institutions. With diminishing resources, they began commiting funds to new, risky ventures: horse and fish farms, racetracks and building projects that made no economic sense. Many of these projects carried no proper documentation and had no valid appraisals. And state regulators proved particularly lax in supervising such transactions.

"Texas and California had laws that said you could do anything you want with essentially no supervision," said Richard Pratt, then chairman of the Federal Home Loan Bank Board and now chairman of Merrill Lynch Mortgage Assets Inc. "And the results are obvious. I know of only two or three Federally chartered institutions that are in trouble; 95 precent are all state-charters."

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A disaster was in the works because the industry's deposits were insured by the full faith and credit of the United States Government. In 1980, when Congress deregulated interest rates, it increased deposit insurance for thrift institutions, banks and credit unions to $100,000 per account, from $40,000. But the mechanism, intended to protect depositors, enabled thrift executives to attract funds, even while they took big risks with large amounts of money. If they lost, the Government would pay the tab.

Congress then made matters worse by inaction, Senator Proxmire said. It ignored pleas from some regulators to come down hard on thrift units in California and Texas, which were taking particularly large risks.

In 1984, it failed to support the Bank Board and the Federal Deposit Insurance Corporation in attempts to stop money brokers from placing large sums of insured deposits at risk-taking thrifts and banks. It initially opposed a Bank Board bid to limit savings and loans from placing more than 10 percent of their assets in risky real estates ventures.

In general, Congress failed to support policies — other than those that provided regulatory leniency, or forbearance — for an industry taking greater and greater lending risks at the Government's expense.

"The theory of forbearance is all right," Mr. Proxmire said. "But it allowed poorly managed institutions to dig themselves into deeper difficulty at an ultimately higher cost to the Government."

Congress's continued insistence on forbearance is developing into an ethical issue that Republicans are raising in the Presidential campaign. The Democratic Speaker of the House, Jim Wright, is under fire for trying to intervene with Bank Board enforcement actions against two insolvent Texas thrifts, whose owners were later charged with lending irregularities and fraud. In an almost unprecedented action, he called Edwin J. Gray, the Bank Board chairman, to get him to reconsider legal actions taken against the institutions.

Other Congressional actions are under scrutiny, too. Last year, Congress was still pushing policies aimed at keeping sick thrifts open. Senator Garn noted that it took Congress almost two years to approve legislation to permit the F.S.L.I.C. to borrow up to $10.8 billion over the next three years to close down thrifts, at a time when losses were mounting. "Quicker action would not have totally solved the problem, but would have made it less," he said.

Lenient Regulators

While Congress carries its share of responsibility for the industry's crisis, experts place almost equal blame on Federal and state regulators who were overwhelmed by the disaster and did not move fast enough to contain it.

As the Bank Board tried, in the 1980's, to give sick institutions enough time to recover, it approved new regulations that most experts, in hindsight, call accounting gimmickry. Those measures hid real losses, delayed big write-downs on bad loans and permitted thrift institutions to lend at levels that far exceeded prudent lending practices.

"In retrospect, the relaxation of controls caused, or at least facilitated, the current crisis," stated R. Dan Brumbaugh Jr., a former economist at the Bank Board, and Andrew S. Carron, an analyst for the First Boston Corporation, in a report for the Brookings Institution last year.

In 1980, for example, the Bank Board lowered the minimum capital requirements for thrifts to 4 percent of total assets, from 5 percent. Then in 1982, they were lowered again, to 3 percent. This was done to permit savings and loans to operate in a time of stress without disciplinary intervention, but lower capital ratios permitted institutions to lend at riskier levels. Instead of having a safety cushion of capital equal to $1 for every $20 of loans, they could make $33 in loans for every dollar in capital.

But the Bank Board then decided that was not enough to keep weakened institutions above water until a general economic recovery. Starting in 1982, it began liberalizing the industry's accounting rules, among other things permitting savings and loans to delay, sometimes for years, the reporting of losses from bad loans, and enabling them to overstate the value of their assets.

The rationale, once again, was to enable scores of savings and loans, at least on paper, to keep their net worths up so that the Bank Board would not have to shut them down.

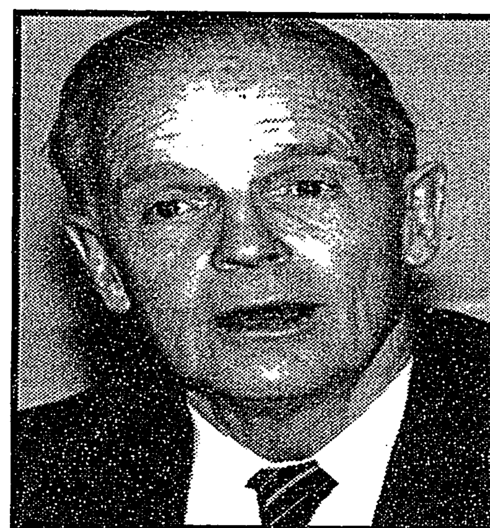
But as Mr. Brumbaugh noted in his most recent book, "Thrifts Under Seige," the accounting techniques merely papered over weaknesses in the real market value of the industry.

Finally, the Bank Board refused to halt the most egregious accounting practice of all, a system by which an institution's minimum capital requirement could be calculated as 3 percent of the five-year average of its assets. This had been a common practice during the 1950's and 60's, when the growth of thrift institutions was incremental. But by the 1980's, as asset growth exploded, five-year averaging meant that an institution could maintain capital levels at only a fraction of the 3 percent minimum.

Eric I. Hemel, former chief economist for the Bank Board and now an analyst at First Boston, said the five-year average permitted savings and loans to leverage their capital at a 150-to-1 rate. He also said longstanding practices allowed savings and loans to record large origination fees when they made risky loans and show very healthy profits, despite having almost no net worth.

The New York Times/Marty Katz

M. Danny Wall



Reuters

Senator William Proxmire

"Of the 25 thrifts showing the largest accounting profits in 1984, a majority were bankrupt by 1987," Mr. Hemel said.

Once the industry discovered the magic of growth in the early 1980's, it solicited high-priced deposits, and then poured them into the booming Texas economy. The American Diversified Savings Bank of Costa Mesa, Calif., which was shut down last week by the Bank Board, was a prime example. Begun in June 1983 by Ranbir S. Sahni, a former Indian Air Force and commercial pilot, the institution grew to $1 billion in two years, investing depositor funds in such high-risk ventures as wind-mill farms, ethanol plants, restaurants and a venture that collected manure for a cogeneration plant in Chino, Calif.

Almost no one argues that the Federal and state regulators failed in duties to oversee the industry's explosive and permissive growth. Moreover, regulators failed to recognize a crucial lesson about deregulation: When an industry is permitted new powers and less Government control over its activities, the Government must step up its policing mechanism.

Facing explosive growth in lending, thrift examiners — from the Bank Board and the state agencies — were underpaid and undertrained; there were also not enough of them. The annual starting pay of Bank Board examiners in the early 1980's averaged about $14,000. And Reagan Adminstration budget cuts trimmed the staff just when the Bank Board needed skilled personnel the most.

"When the Bank Board went to the Office of Management and Budget for additional personnel, or to the Office of Personnel Management for permission to increase salary scales, they ran into strenuous opposition," said William B. O'Connell, president of the United States League of Savings Institutions, the industry's largest trade group.

By 1984, the Bank Board began to realize how large the problem was. But by then, the assets of the Federal Savings and Loan Insurance Corporation, used to shut thrifts and pay depositors, had begun to dwindle to finance the closures of almost 500 institutions in the previous five years.

Beginning in 1985, the Bank Board — finally recognizing that leniency would only deepen the problem — began trying to institute regulatory changes to reverse the loose accounting measures and to restore credibility to the industry's balance sheets. It approved regulations that limited the amount of direct investment that savings and loans could make in building projects; limited the amount that they could grow each year; phased in increases in minimum capital requirements to 6 percent, and phased out regulatory accounting principles and ushered in a return to generally accepted accounting practices.

But many argue that the measures were too few — and too late. Failure to recognize the problems sooner meant the insolvent institutions were piling losses higher.

"The losses in Texas are averaging $500 million a month, and they get bigger with time until you finally do something about it," said William K. Black, senior associate general counsel at the Federal Home Loan Bank of San Francisco. "That is the magic of compound interest, and the blood letting will continue. You get very scary numbers."

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The Industry's Role

In Jimmy Stewart's movie, "It's a Wonderful Life," the local building and loan society brought joy and prosperity to the middle-class town of Bedford Falls. Residents were prudent savers, homes were built — and the ending couldn't have been happier.

Hollywood would be hard-pressed to make such a movie today. Instead it would have to show a crippled industry whose members include thrift owners wooing members of Congress, building huge, high-risk projects and, not infrequently, engaging in kickbacks, land-flips and other fraudulent acts.

Unlike bankers, executives in the thrift industry are permitted to run their institutions as funding operations for their personal businesses and investments. Banking regulators place severe restrictions on the extent that a bank can lend to its executives. But such stringent rules have not traditionally existed for savings and loan associations.

In the case of the North American Savings and Loan Association of Costa Mesa, Calif., closed last week, the Bank Board has filed a lawsuit against the estate of its late owner, Duayne D. Christensen, who died last year in a car accident, and his business associate and companion, Janet F. McKinzie, charging them with funneling $40 million out of the institution for their personal use.

Bank Board officials say that 75 percent of the thrift insolvencies include fraud or criminal conduct. "That does not mean 75 percent of the failures are caused by fraud, but in 75 percent, fraud is a contributing factor," said Mr. Black.

Fraud has cropped up all over the country, but Bank Board officials say it has been most apparent in Texas, California and Florida, which have the most liberal investment regulations for their state-charterd thrifts, and the weakest state regulators.

In Texas, although obtaining permission to open a new thrift institution was next to impossible, it was "particularly easy" to buy an existing one, with little interference from regulators, Mr. Wall said. Kenneth Littlefield, the state's banking commissioner, said this created a hot market for insolvent thrifts among speculators, "who could buy them for a song, and immediately use brokered deposits and high rates to raise a lot of money that they would the loan to their buddies."

Critics say that some industry executives urged Congress and regulators to go easy on the entire industry, and thus jeopardized the industry's safety and soundness. "This industry has been constantly fighting for weakness in regulation and supervision," said Mr. Black. "They got it and now they are finding that the sins of the crazies are visited on the strong."

"At each and every step along the process, the industry argued for forbearance," added Mr. Brumbaugh, now an independent consultant. "It's been steadfast in opposing acknowledgement of how deep the problem is and that a large part of the problem will have to be remedied by closing many institutions."

Since 1985, the industry frequently opposed Bank Board policies it considered too punative or costly. That conflict came to a head last year, in the debate over the rescue of the F.S.L.I.C. The Bank Board and the Treasury Department supported a $15 billion rescue package for the F.S.L.I.C., while the industry — which would pay for the borrowing authority — sought a $5 billion rescue. In the end, a compromise $10.8 billion was reached. "A lot of pressure came from the industry and in many instances the Congress went along," said Sen. Proxmire. "The industry makes big contributions and they know how to concentrate on the right people of the right committee."

During the 1940's, 50's and 60's, the interests of the regulators and the industry were essentially identical. Since the Bank Board's mandate was to promote homebuilding, whatever promoted it was considered good regulatory policy. But many analysts say the close relationship that developed between regulators and the industry ultimately proved too close — and expensive.

In the early 1980's, as hundreds of savings and loans neared disaster, it was hard for the industry to endorse policies that would have closed many weak institutions. "Remember that the U.S. League represents the strongest and the weakest, and they have to try to be everything to everybody," said Mr. Wall of the Bank Board.

It proved to be a recipe for disaster. ■

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