

WHAT HAVE WE LEARNED FROM THE THRIFT AND BANKING CRISES OF THE 1980's?

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I. Introduction

Let me skip right to the bottom line conclusion. What have we learned from the thrift and banking crisis of the 1980's? (For reviews of the 1980s crises see Barth, 1991; Barth and Litan, 1998; Kane, 1989, and Kaufman, 1995.) The academics, I think, have learned a great deal.¹ The regulators, have also learned a great deal, but primarily in theory. In practice, the jury is still out. But, as I will argue below, it does not look promising. Do the widescale failures and resolutions of the savings and loan associations (S&Ls) and commercial banks in the 1980s provide useful perspectives for today? The answer is definitely yes.

How have I come to this conclusion? Since 1995, which sort of represents the end of the cleanup of the S&L and commercial banking mess, few banks and thrifts have failed, that is put into receivership or conservatorship by the regulators. As can be seen from Table 1, less than ten banks and thrifts failed per year, and even fewer institutions of any size failed. As of mid-2002, only three institutions with total assets of \$1 billion or more have failed and none with assets of more than \$2.5 billion at the date of failure. The First National Bank of

¹ The numerous published recommendations by academics on how to deal with the recent banking crises in Japan, East Asia, and other countries clearly reflect the experiences of the United States with the crisis of the 1980s.

Keystone (West Virginia) failed in 1999 with about \$1 billion in assets. Superior Federal Savings Bank, a thrift in Chicago failed in 2001 with assets of \$2.3 billion. Hamilton National Bank (Miami, Florida) failed in early 2002 with some \$1.3 billion in assets. I will add a fourth bank to this list that is a lot smaller, but of interest for purposes of this analysis. The Best Bank (Boulder, Colorado) with \$300 million in assets failed in 1998.

So far, so good. But, although very few banks failed, things change dramatically if one looks at the cost of the failures to the Federal Deposit Insurance Corporation (FDIC) and uninsured depositors and creditors at the bank. Estimates of this loss or negative net worth of the institutions on the date of resolution are frequently made by the FDIC and reported in the press release announcing the failure. In cases where the FDIC does not report this estimate, estimates are often reported in the press based on information provided by bank analysts. The estimates are periodically updated until the resolution of the bank is completed. Relying on the most recently available credible estimates, the loss on Keystone is estimated at near \$800 million or 75 percent of its assets; on Superior, \$500 million to \$800 million (before a payment to the FDIC by the Pritzker family, the primary owner) or 20 to 40 percent of its assets; on Hamilton \$400 million (even though the Comptroller of the Currency proudly announced he had closed the bank before its risk-based capital ratio declined below 8 percent), or 30 percent of its assets; and on Best Bank, \$170 million or more than 50 percent of assets.² These large losses focus attention on two areas of concern where the lessons of the 1980s do not appear to have been fully learned by the regulators - - 1) effective regulatory intervention to minimize losses from failure through, among other powers, application of prompt corrective action (PCA) and least cost resolution (LCR) and 2) design of a government-sponsored deposit insurance structure that minimizes poor behavior by both

² What is in a name? Instead of being named First, Superior, Hamilton, and Best, these failed banks might more correctly have been named Last, Inferior, Burr and Worst.

banks and bank regulatory agencies. The remainder of this paper examines each of these two areas.

II. Effective Regulatory Intervention

The large losses associated with a number of the bank and thrift institution failures in recent years do not seem to be what most people had in mind when Congress enacted prompt corrective action and least cost resolution in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. There appears to be no reduction in the average cost of bank failures after the enactment of FDICIA from before and the costs of some of the individual failures are considerably greater. The recent costly failures are spread over all federal regulators. The Comptroller (OCC) had two, the FDIC had one, and the Office of Thrift Supervision (OTS) had one. But this does not clear the Federal Reserve, because the Hamilton's parent holding company was also in trouble, and the Fed has authority over bank holding companies. One could also go back to the problems at the Daiwa Bank in the mid-90's. It was under Fed supervision.

What went wrong? Are these four banks outliers or mainstream? Are there many more such banks waiting in the wings to be discovered?

One could make a case that they are outliers. Each one of these involved massive fraud and legal maneuvers by the bank to delay responding to the enforcement actions by the regulators. In some cases, there was even physical interference with and intimidation of the supervisors and the examiners. These banks concentrated on very risky loans. Keystone and Superior securitized sub-prime loans, which are risky to begin with, and increased their risk exposure further by holding on to the first dollar loss tranche, which is widely referred to as the "toxic waste." tranche. Hamilton, a bank in Miami of less than \$1.5 billion in assets, was heavily involved in loans to distant Ecuador. But, on the other hand, these institutions

had many of the same red flags flying high that were flying during the S&L crisis in the 1980s. There was rapid growth. Superior doubled in size in the three years from 1996 to 1999. Keystone grew even faster. There was a rapid runoff of uninsured deposits that were replaced by insured deposit. In addition to the risky lending, these institutions did very complex lending and some engaged significantly in derivatives activities. While these later activities might make sense and be appropriate for larger institutions, one can wonder whether a small institution has both the skill - set and the management capabilities required to engage in these activities successfully. Moreover, there were frequent misclassifications and misreporting of activities on the call reports that were provided to the regulators and the public, substantial underreserving for loan losses, and very high off-balance sheet recourse exposures relative to the size of the institution.

What happened? Were the regulators caught unaware with their pants down? I do not think so. They knew for many years that there were serious problems in each of these banks, and they filed enforcement actions and even cease and desist actions. But they were often stalled. And when the regulators were stalled, they did not follow through aggressively. There appears to have been no sense of urgency. While one may not necessarily be in favor of regulatory bullying of institutions and unwarranted intervention, as sometimes happened in the 1980s, in these four cases, there was effectively regulatory “chickening-out.” The Inspector General of the Department of the Treasury’s report on Keystone was highly critical of the lack of aggressiveness by the Comptroller and failure to respond clearly to visible red flags and to harassment of his staff on site (Office of Inspector General, 2000).³

³ FDICIA requires the Inspector General of the Federal regulatory agencies involved to prepare a public report whenever a bank resolution results in a material loss to the FDIC, subject to review and verification by the U.S. General Accounting Office.

But, the lessons from this failure were not learned. Almost exactly the same things happened in both Superior and Hamilton. If anything, the Inspector Generals of the FDIC and the Treasury Department were even more scathing in the Superior Bank debacle. Yogi Berra is alive and doing well in Washington! The new game of regulatory chickening-out leads to the same old-time forbearance practices that have been criticized widely and correctly so. What is the result? To some people, the moral is that prompt corrective action is not working and should be repealed. But, as I see it, it is not the fault of prompt corrective action, but of the regulators. PCA was neither applied in a timely fashion nor with enthusiasm and gusto. The numerical values of the capital trip-wires for supervisory sanctions are set by the regulators, not in legislation. Only the value of the minimum capital-ratio for resolution is specified in FDICIA. If the regulators believe that the trip wires are set too low – which I have argued for many years now – the regulators have it within their authority to raise the values of the capital ratios to where they could get at the banks even sooner and start corrective action more promptly. How capital is measured is also determined by the regulators. Book value capital is correctly criticized as being a lagging indicator of the condition of an institution, particularly for troubled banks that tend to underreserve and delay recognizing other losses in order to prop up reported earnings and capital. FDICIA encourages the regulators to give serious thought to make greater use of market value accounting and reporting to supplement book value accounting and reporting. But, to date, the regulators have rejected this. In all four of the bank failures noted above, reported capital was vastly overstated and had to be revised sharply downward shortly before or at failure. But this did not imply that the regulators did not know better on a timely basis. They had additional information.

Moreover, the capital-asset ratios available to supervisors are not the only criterion for downgrading a bank in FDICIA. The regulators have a great deal of discretion. The specified capital-asset ratio is just the final trigger. The regulators can also downgrade banks on the basis of regular or special examinations and even put them in receivership when in the regulators' opinion the banks have insufficient assets to meet their obligations, are experiencing losses that will deplete their capital, or are engaging in unsafe and unsound practices (12 U.S.C. 1821 (c) (5)). If the regulators do not do anything else earlier, then the capital ratio forces them into action. The mandatory sanctions specified in FDICIA are the last line of defense for the regulators, not the first. Better late than never.

If one does not favor the use of prompt corrective action, what does one favor? Does one return to the bad old days of greater regulatory discretion? That is, a return to non-prompt, non-corrective, non-action, which was equivalent to excessive forbearance? That did not serve the banking industry nor the country well.

III. Deposit Insurance Design

In addition to failing to learn some of the important lessons of the 1980s with respect to PCA and LCR, the regulators also appear to have failed to learn the lessons with respect to the potential adverse effects of a poorly designed and structured government – sponsored deposit insurance system on the number and cost of depository institution failures. As has been discussed in the academic and professional literature ad infinitum, poorly designed insurance deposit systems encourage both excessive moral hazard risk-taking by insured institutions and poor agency behavior by bank regulators of the form of excessive forbearance. (Kane,_____). The increased risk-taking by banks occurs because of the reduced incentives of de-jure or perceived insured depositors to monitor and discipline their institutions for such behavior. The reduction in the incentive for these depositors to

discipline their banks by withdrawing funds or running on troubled institutions, in turn, maintains their funding and reduces the likelihood of potential liquidity problems. This permits them to remain in operation and lessens the pressure on regulators to close the institutions on a timely basis when they are unable to meet their depositor claims in full and on time. Before the introduction of deposit insurance, regulators did not have this option. The inability to meet depositor claims forced immediate voluntary or regulatory suspension of operations. Evidence clearly shows that the longer insolvent institutions are permitted to continue in operation, the larger on average are the losses ultimately associated with failure likely to be.

Both bank moral hazard and regulator poor agency problems can be reduced, although probably not eliminated altogether, by properly structuring the deposit insurance system. FDICIA introduced a number of important improvements to reform deposit insurance and achieve such results. Among other changes, the FDIC is required to increase insurance premiums on insured institutions whenever its reserves decline below 1.25 percent of aggregate insured deposits to regain this minimum ratio value within one year. (Kaufman, 2001a and 2002). If this is not achieved, the FDIC is required to impose an average high premium of 23 basis points on total domestic deposits at insured institutions until it is. Before 1989, the FDIC was effectively unable to raise premiums above a maximum of 8.33 basis points, regardless of its losses. Thus, losses greater than the ability to be financed by these premiums were shifted to and paid by the federal government.

Moreover, if the FDIC suffers a loss in protecting an insolvent large bank's de-jure uninsured depositors or other creditors, whom it is otherwise explicitly prohibited from protecting, by invoking the systemic risk exemption, which permits it to do so and has replaced the previous "too big to fail" policy, it is required to recoup the loss expeditiously

by imposing a special assessment on all the other banks. In addition, invoking this exemption was made considerably more difficult. It now requires a written recommendation by two-thirds of both the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System to the Secretary of the Treasury to make a determination, after consultation with the President, that not assisting these claimants “would have serious adverse effects on economic conditions or financial stability” and that “any action or assistance...would avoid or mitigate such adverse effects.” Thus, since 1992, deposit insurance in the United States has effectively been a privately funded system. Contrary to popular belief, the government becomes liable for losses only if the capital of the banking system is depleted to the point where the remaining solvent banks cannot afford to pay the required increases in insurance premiums. This condition would not have occurred at the height of the 1980s bank and thrift crisis and not either even in the 1930s crisis. As a result, deposit insurance is now of considerably less public policy importance.

But some bank regulators are working to change this structure through legislation to increase the probability of returning to the “bad old days” that put the federal government at greater risk. All regulators are supporting legislation currently pending in Congress that would increase the flexibility of the FDIC to extend the maximum time period for it to recoup its losses without imposing the 23 basis point “cliff-rate” premium. This increases the likelihood that the FDIC will delay the painful increases in rates and in the process run out of funds to pay the losses and need to tap the Treasury for what may turn out to be permanent funding. The primary reason provided for this proposed change is to avoid increasing insurance premiums on the banks when they are in weak financial shape and least likely to afford the increases. That is, to avoid “hitting the banks when they are down.” But private insurance firms tend to price along these lines. Hurricane insurance premiums rise after

major hurricanes and flood insurance premiums rise after widespread floods, when the insurers have to recoup some or all of their unexpected losses. There is little, if any, reason to treat banks differently.

The FDIC, although not the other agencies, is also supporting legislation to increase the account coverage ceiling above the basic \$100,000 adopted in 1980. The public policy implications of such an increase in coverage depend on how confident one is that the insurance system is now effectively privately funded by the insured banks as described above. If confidence is high, then the issue of coverage is primarily a private policy concern for the paying banks rather than public policy concern for the taxpayers. But if confidence in the lasting nature of the current arrangement is low, then the issue is of important public policy concern. Many analysts have attributed a considerable part of both the cause and severity of the thrift crisis in the 1980s to the jump in insurance coverage from \$40,000 to \$100,000 that was enacted by Congress in 1980. This reduced depositor concerns about the financial health of their insured depositories and made it considerably easier for depositors to divide larger accounts into smaller accounts at multiple banks that qualify for full insurance coverage. These analysts fear that another increase would produce similar adverse effects and may again prove costly to the taxpayer.

IV Conclusion

I ended my testimony in the U.S. Senate on Superior's failure (which started on September 11, 2001, was rudely interrupted, and was completed on October 16, the day they found anthrax in the adjoining Senate office building) with a call for greater commitment by the regulators to the concept of prompt corrective action and recommended sensitivity training to raise their awareness levels (Kaufman, 2001b). The basic problem is not with the quality of the regulators, but with their incentive structure. To date, there is little penalty to

the regulators for permitting high-cost failures and little credit for achieving low-cost failures or permitting orderly exit through failures. Attempts to prevent or delay failures frequently result in higher cost failures. While, entry into banking has been pretty well deregulated, exit apparently has not. Top regulators continue to be rewarded by being recycled to other sectors that are related to banking through a revolving door after their term of office is completed.⁴

In addition to increased regulatory sensitivity to PCA, laws should be strengthened to give the regulators both greater authority and greater incentive to move faster and stronger in obvious problem cases. The recent tardy actions by the regulators send a message to these troubled institutions and their lawyers to stall and delay the regulators even longer. If the regulators cannot deal efficiently and effectively with the current few failures of reasonably small banks, what will they do and how will they act if we ever have a larger number of failures again and particularly of larger banks?

Bank regulators still, at times, appear to let parochial concerns over the short-run well-being of the banking industry color their recommendations on public policy. This will only lead to poorer performance and higher costs for both industry and the economy at-large in the long-run. That is, regulators have failed to sufficiently take to heart two of the more important lessons of the 1970s – prompter intervention in troubled institutions and reduced government incentives for banks to increase risk-taking and for regulators to forbear.

The American philosopher George Santayana admonished us that “those who cannot remember the past are condemned to repeat it.” To me, this is not as interesting a question to ask as “what happens to those who do remember the past?” Unfortunately, all too often it appears that they agonize first and then repeat it again. The behavior of the bank regulators

⁴ For example, Ellen Siedman, who was Chairperson of the OTS during the Superior Bank problem, now serves on the Democratic staff of the House Banking Committee.

in the last ten years with respect to prompt corrective action and deposit insurance structure suggests that my modification of Santayana's admonition holds true, at least in their case.

Table 1
**Number and Cost of Bank and Thrift Failures
 1995 – 2002***

<u>Year</u>	<u>Number</u>	<u>Total Assets (\$Bill)</u>	<u>Estimated Loss</u>		
			<u>Average**</u>	<u>Low (Percent)</u>	<u>High</u>
1995	6	0.8	14	10	28
1996	6	0.2	26	11	40
1997	1	***	14	14	14
1998	3	0.4	48	6	54
1999	8	1.5	56	0	74
2000	7	0.4	10	4	17
2001	4	2.4	24	1	24
2002	8	2.2	NA	NA	NA

* Through June

** Weighted by total assets

*** Less than \$100 million

Source: Federal Deposit Insurance Corporation and press reports

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