

The Honorable Lee Daniels
Majority Leader
National Conference of State Legislators

Dear Mr. Daniels:

This is in response to your request for information regarding the origin of the savings and loan crisis.

This is a question which the Administration, academicians, economists, and the Congress have been exploring for some time. The Treasury Department is pleased to share our information with you because we believe it is important that as many people as possible have a thorough understanding of the events which began long ago and led to the current crisis.

The savings and loan industry was created in the early 1930's through charters which restricted their activities to fixed-rate, long-term mortgage loans and the acceptance of short-term deposits. Without a diversified portfolio, thrifts were, from their very inception, particularly vulnerable to the "ups and downs" of the real estate market and any substantial increases in interest rates. Because the interest rates these savings and loan institutions charged were primarily locked into long-term residential mortgage loans, significant increases in market rates meant thrift institutions would likely be paying out more in interest to depositors than they were receiving in interest payments from loans.

In 1966, Congress attempted to address the industry's particular vulnerability to increasing interest rates by creating "Regulation Q." This regulation imposed ceilings on the amount of interest that S&Ls could pay on deposits. But as market interest rates increased, depositors who had their money in low-rate S&L accounts began to take their money out of S&Ls and put their savings in other financial instruments, which were paying market interest rates (higher than S&L rates). S&Ls were then faced with massive deposit outflows, while their assets were primarily tied up in long-term, fixed-rate, low-interest mortgage loans.

In the late 1970's, inflation and interest rates soared, and eventually the prime interest rate skyrocketed as high as 21 percent. The combination of high inflation and high interest rates, along with Regulation Q, put extreme financial pressure on the thrift industry. During the period 1978-80, thrifts suffered significant declines in deposits, and their capital positions deteriorated to the point where a substantial part of the industry was bankrupt on a mark-to-market basis.

In 1979, President Carter formed a special Task Force to study the problem. The Task Force recommended deregulation. In 1980, President Carter proposed, and the Congress passed, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA). The principal features of that Act included:

- Providing for the phased elimination of Regulation Q, allowing thrifts to attract more deposits with higher interest rates.
- Raising deposit insurance from \$40,000 to \$100,000 per account, an increase of 150 percent, which increased the government's liability should an institution fail.
- Expanding the ability of federally-chartered thrifts to engage in commercial lending, including commercial real estate loans.
- Lowering capital requirements for thrift institutions.

From 1980-82, the regulators of the S&Ls, the Federal Home Loan Bank Board (FHLBB), were also attempting to find ways to loosen restrictions on thrift industry operations. The hope was that thrifts could "grow" their way out of their current crisis. For example, in 1981, the FHLBB, an independent regulatory agency, loosened restrictions on the ability of S&Ls to use brokered deposits. Taking advantage of the huge increase in deposit insurance coverage and this new ability to aggregate deposits, S&Ls gained access to large pools of money.

In 1984, the FHLBB reversed itself and proposed regulations limiting the use of brokered deposits. However, the courts overturned the FHLBB regulations, and Congress refused to provide the authority needed for FHLBB to proceed with the regulations.

Higher interest rates continued to cause more thrifts to become unprofitable and seriously depleted their capital, but they were allowed to stay in business. Thrifts with low capital had a perverse incentive to make riskier investments in order to gain higher returns. Any profits from the riskier investments could be used to shore up their capital, while any losses from these same investments would be absorbed by the taxpayer because of the higher insurance coverage. The huge pools of money-- made available through brokered deposits and deposit insurance-- added to the motivation for thrift operators to expand their risk of loss.

However, even with interest rate deregulation, increased deposit insurance, and brokered deposits, thrifts continued to struggle because the bulk of their assets were still held in low-interest mortgage loans.

In response, Congress passed the Garn-St Germain bill in 1982. The bill allowed federally-chartered thrifts to become more like banks and further expanded authority granted in the 1980 act to make commercial loans. It also continued the 1980 practice of lessening capital requirements. Many believed these actions were necessary in order for thrifts to make higher returns on investments to offset lower returns on mortgage loans. Prior to the passage of Garn-St Germain, states began to greatly broaden the powers of state-chartered, but federally-insured,

thrifts to make direct equity investments in speculative ventures, from windmill farms to precarious real estate developments.

As early as 1984, the FHLBB attempted to curb abuses by state-chartered savings associations. The FHLBB was opposed by many in Congress, and in particular by the House of Representatives. For example, in 1985, a resolution calling on the FHLBB to delay its tighter regulation of direct real estate and equity investment by state-chartered institutions was co-sponsored by over one-half of the House of Representatives. In 1987, amendments in the House Banking Committee to regulate these aggressive real estate practices of state-chartered institutions were defeated by overwhelming margins.

In 1982, the FHLBB was losing examiners because their pay rate was low compared to other financial examiners, and there was a feeling that more examiners were needed to watch over the loosened restrictions. The FHLBB was frustrated in its efforts to increase the number of examiners and their salaries due to budget constraints. In 1985, the FHLBB was finally successful in adding additional, higher-salaried examiners by funding them out of the Federal Home Loan Bank system, which was not under the budgetary control of either the Congress or the Office of Management and Budget (OMB).

Now S&Ls could attract more deposits because they could pay higher interest rates on those deposits, offer higher insurance levels, and attract depositors from across the country. And thrift institutions, particularly state-chartered thrifts, could invest those deposits in highly risky ventures, particularly commercial real estate ventures. And all the time, the U.S. Government's promise to insure every depositor's savings up to \$100,000 kept looming as a larger and larger potential liability.

In 1984, then-Vice President Bush led an Administration task force on regulation of financial services. The task force recommended comprehensive reform of the regulatory system:

- Higher capital and accounting standards for S&Ls making riskier loans and elimination of phony accounting standards. (The task force report noted that low capital levels encouraged insured institutions to engage in high-risk speculative activities.)
- More effective regulation through the elimination of archaic and overlapping regulatory structures.
- Strengthened ability for the FDIC to oversee deposit insurance, and authorization for FDIC to institute risk-based insurance premiums. (The task force report noted that the current flat-rate premium system forced prudently managed institutions to subsidize high risk institutions.)

The task force recommendations were endorsed by the Reagan Administration's Cabinet Council on Economic Policy in 1985 and forwarded to the Congress.

Meanwhile, sharp declines in oil prices and weakness in the agricultural sector contributed to devastating economic declines in certain regions, particularly the southwest. Real estate values plunged. Large numbers of thrifts that had invested in commercial real estate and other ventures became insolvent, requiring deposit insurance protection from the federal insurance (FSLIC) fund. When the FSLIC insurance fund ran low, the Reagan Administration requested \$15 billion to recapitalize FSLIC in the spring of 1986.

The request encountered strong opposition on Capitol Hill. Some Members of Congress feared that providing \$15 billion in deposit insurance funding would encourage S&L regulators to close down more unsafe institutions. The savings and loan industry forcefully lobbied the Congress in opposition to this legislation, and it was killed at the end of 1986.

Finally, in 1987, Congress passed a bill which provided \$10 billion to recapitalize the insolvent FSLIC fund -- a year and a half after the Administration requested \$15 billion. The final amount authorized was only two-thirds of the amount requested by the Administration. In addition, Congress added forbearance provisions making it harder for regulators to close down high-flying S&Ls. Specifically, those provisions permitted additional questionable accounting techniques which allowed thrifts in trouble to make their levels of capital look better than they were. They also allowed thrifts to count "goodwill" toward meeting capital requirements.

The delay in funding the FSLIC prevented regulators from closing insolvent institutions when the cost of protecting depositors would have been much less. Instead, the problem continued to grow, and so did the U.S. Government's liability to make good on its promise of insurance coverage for deposits.

In February 1989, just 18 days after taking office, President Bush proposed a comprehensive and permanent solution to the savings and loan industry crisis -- The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Four principles have guided the Administration in developing and implementing the savings and loan cleanup effort:

- Protecting the savings of Americans who made deposits in thrift accounts, relying on the U.S. Government's promise of deposit insurance.
- Restoring safety and soundness to the thrift industry, especially through tougher capital requirements.
- Aggressively prosecuting the crooks who stole the taxpayers' money through fraud and mismanagement.
- Cleaning up the S&L mess as expeditiously and responsibly as possible.

After seven months of debate, Congress passed FIRREA, and President Bush signed the bill into law on August 9, 1989.

FIRREA provided not only the initial funds for remedying the current crisis in the industry and protecting depositors' savings, but the legislation also put into place the

mechanisms needed to prevent similar occurrences in the future. Of those mechanisms, we consider the most important to be those which provide a buffer between the deposit insurance fund and possible risky practices of individual institutions.

Tougher capital requirements which mandate that savings and loans must meet the same capital requirements as banks will require thrift operators to put their own money at risk ahead of the taxpayers. New authority for the federal government to deny federal insurance coverage to state-chartered S&Ls allows the federal government to protect taxpayer dollars from riskier ventures which may be allowable under individual state regulations. In addition, a study of deposit insurance, required by the legislation and currently being drafted by the Treasury, will provide additional proposals to deal with one of the critical causes of the current crisis.

With these protections in place, as well as provisions proposed by the Administration to enhance the Government's ability to prosecute those guilty of financial fraud and mismanagement, we believe we have the basic framework necessary to clean up the savings and loan crisis in an expeditious and responsible manner.

In the year since FIRREA was enacted, the government has paid out \$62.5 billion in deposit insurance obligations, representing 5.8 million accounts -- about \$10,000 per account. The RTC has seized 463 insolvent thrifts -- more than one per day; closed or sold 211 bankrupt thrifts -- one every 48 hours; and sold or liquidated more than \$65 billion of assets -- \$178 million per day. By moving expeditiously and responsibly to quarantine sick thrifts, the Administration has stemmed the losses and given the healthy segment of the industry an opportunity to succeed.

Since October 1988, the Justice Department has obtained more than 200 convictions for savings and loan fraud. Settlements and judgements from civil cases during the first half of 1990 will produce recoveries in excess of \$200 million.

Let me reiterate that the purpose of the cleanup effort is not to bail out financially unsound S&Ls or S&L executives responsible for the crisis. The sole purpose is to protect the savings of those Americans who have insured deposits in savings and loan institutions. The U.S. Government made a promise to insure those deposits, and the Government is now living up to that promise.

We hope this is useful in tracing the causes of the thrift crisis and describing the considerable progress made under FIRREA to address the problem and prevent its recurrence.

Sincerely,

John E. Robson