

# The New Thrift Act: Mending the Safety Net

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When the Federal Reserve Banks opened their doors on November 16, 1914, the nation's financial system was on the threshold of historic change. Seventy-five years later, it faces dramatic change again. The new Financial Institutions Reform, Recovery, and Enforce-

ment Act, designed to mend the federal safety net for depositors, will not only restructure the thrift industry, but alter the banking industry as well.

## **Weaving the Safety Net**

Just as the new legislation is intended to stem a crisis in the financial industry, the Federal Reserve Act was a response to the financial panics of the late 19th and early 20th centuries. Wanting banks to be able to meet liquidity crises, Congress created the Federal Reserve System in 1913. The 12 Federal Reserve Banks,

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which opened less than a year later, were authorized to hold reserves for member banks in their districts and to lend to them for short periods. For member banks experiencing short-term liquidity problems, the Federal Reserve was to be the lender of last resort—the first piece of the “federal safety net.”

With the Great Depression and the numerous bank failures of the early 1930s, Congress’s attention turned to two issues: deposit insur-

ance and bank powers. Many legislators believed that the 1929 stock market crash, the widespread bank failures that followed, and the onset of the Depression were all tied to abuses of the connections permitted between investment banking and commercial banking. Congress passed the Banking Act of 1933 to 1) separate commercial banking from securities underwriting and 2) insure deposits. Popularly known as the Glass-Steagall Act (named

## Old Regulatory Structure

### *Treasury Department*

Office of the Comptroller of the Currency

- Charters national banks
- Supervises and regulates national banks

### *FDIC*

- Insures deposits at commercial and savings banks
- Manages assets and liabilities of insolvent banks
- Supervises and regulates state-chartered banks that are not members of the Federal Reserve System

### *Federal Home Loan Bank Board*

- Charters federal S&Ls
- Regulates and supervises federal S&Ls
- Oversees the FSLIC
- Oversees the 12 regional Federal Home Loan Banks

### *FSLIC*

- Insures deposits at S&Ls
- Manages assets and liabilities of insolvent S&Ls

### *Federal Home Loan Banks*

- Lend (make advances) to member S&Ls
- Examine S&Ls

### *Federal Reserve*

- Supervises and regulates state-chartered member banks, bank holding companies and their nonbank subsidiaries, the international activities of banks and bank holding companies, and the U.S. banking and nonbanking operations of foreign banks
- Sets reserve requirements for all banks, S&Ls, and credit unions
- Through the 12 regional Federal Reserve Banks, provides discount-window loans to depository institutions

## **New Regulatory Structure**

### ***Treasury Department***

Office of the Comptroller of the Currency

- No major change in duties

Office of Thrift Supervision

- Charters federal S&Ls
- Establishes S&L regulations
- Supervises both federal and state-chartered S&Ls, and S&L holding companies

### ***FDIC***

- FDIC's Board of Directors expanded from 3 to 5 members and will include the Director of the Office of Thrift Supervision

Bank Insurance Fund (BIF — same as original FDIC fund)

- Insures deposits of commercial and savings banks
- Manages assets and liabilities of insolvent banks

Savings Association Insurance Fund (SAIF — replaces FSLIC)

- Insures deposits of S&Ls
- Manages assets and liabilities of insolvent S&Ls *after 1992*

FSLIC Resolution Fund

- Manages the remaining assets and liabilities of some 200 S&Ls taken over by the FSLIC prior to 1989

### ***Resolution Trust Oversight Board***

- Oversees the Resolution Trust Corporation
- Chaired by the Secretary of the Treasury. Includes the Federal Reserve Board Chairman, the Secretary of Housing and Urban Development, and two others appointed by the President

Resolution Trust Corporation (managed by the FDIC)

- Manages the assets and liabilities of S&Ls that become insolvent between 1989 and August 1992
- Can use \$50 billion that will be raised by the Treasury and the Resolution Funding Corporation to resolve S&L problems
- Ceases to operate after 1996, when its responsibilities are shifted to the FDIC's Savings Association Insurance Fund

Resolution Funding Corporation

- Issues up to \$30 billion of long-term bonds to finance the activities of the Resolution Trust Corporation

### ***Federal Housing Finance Board***

- Oversees the 12 regional Federal Home Loan Banks

Federal Home Loan Banks

- Lend (make advances) to member institutions, which may include banks and credit unions as well as S&Ls

### ***Federal Reserve***

- No major change in duties

after its sponsors), the new law banned securities underwriting by national banks and deposit-taking by securities underwriters.

Concern about the losses incurred by depositors led Congress to include in this law a section establishing the Federal Deposit Insurance Corporation. The FDIC insured bank deposits up to \$5,000, with initial funds provided by the Treasury and the Federal Reserve Banks. The law provided for ongoing funding of the FDIC by assessing each bank a premium based on the amount of its insured deposits. By 1935, about 98 percent of all commercial bank deposits in the country were insured.

Savings and loan associations were not left out of the safety net. The Federal Home Loan Bank Act of 1932 established a regional system of Home Loan Banks to issue bonds and use the proceeds to supply liquidity to S&Ls by making loans (advances) to them. Congress followed with deposit insurance for S&Ls that were members of the FHLB System, creating the Federal Savings and Loan Insurance Corporation in 1934. Like the FDIC, both the Federal Home Loan Banks and the FSLIC initially received funds from the Treasury, but eventually became self-financing.

### Extending the Safety Net

Deposit insurance for both banks and thrifts was raised to \$20,000 per depositor in 1969, and failures were rare. Indeed, Rep. Wright Patman, then Chairman of the House Banking Committee, wondered publicly whether the low incidence of failures indicated that regulators were preserving banks by preventing competition.

The FDIC did try to keep most banking offices open—not to prevent competition, but to protect depositors and reduce costs to the insurance fund. Under the purchase-and-assumption method of dealing with failing banks, the FDIC provided financial assistance to a healthy bank that purchased the assets and assumed the liabilities of a failing bank. In-

stead of closing the bank and paying off only insured depositors, the FDIC effectively protected all depositors. The FSLIC took a similar approach.

Over time, the limit on deposit-insurance coverage was increased—to \$40,000 in 1974 and to its current level of \$100,000 by the Depository Institutions Deregulation and Monetary Control Act of 1980. This Act also made the Fed's discount-window lending available to all banks, S&Ls, and credit unions having transactions accounts or nonpersonal time deposits, and levied reserve requirements on these same institutions.

### Mending the Safety Net

During the 1980s the number of bank failures and insolvent thrifts increased sharply. Earnings problems for S&Ls had begun in the late 1970s, when inflation drove short-term interest rates and S&Ls' cost of funds above the interest rates these institutions were earning on their portfolios of mortgages. These problems continued in the 1980s, even after inflation and interest rates subsided, because S&Ls' cost of funds still remained high compared to their low-yielding, long-term mortgages. The deregulation of deposit interest rates and the expansion of S&Ls' powers into such areas as direct real estate investments, commercial lending, and high-yield junk bonds did not reverse the deteriorating trend for S&L losses as some had hoped. Also, problems with agricultural and energy loans caused losses for both banks and thrifts in several regions of the country. And as the energy sector continued to deteriorate in the Southwest, real estate values in the area plunged, adding to loan losses.

Because deposit-insurance premiums are assessed at a flat rate based only on the level of an institution's deposits, not on the riskiness of the bank or S&L, the deposit-insurance system did not provide an incentive for a troubled institution to avoid risk. In fact, since regulators followed a policy of "forbearance" in the

early 1980s by not enforcing strict capital requirements on many troubled S&Ls, there was actually an incentive for these institutions to take on more risk. A risky venture might pay off and bolster earnings. If it didn't, the deposit-insurance fund would be the one taking the loss.

Estimated losses at the insolvent thrifts eventually outstripped the size of the FSLIC's resources. The FSLIC's inability to meet its liabilities, as well as the first-ever operating loss for the FDIC in 1988, challenged the viability of the deposit-insurance system. In 1987, Congress passed a \$10.8 billion recapitalization of the FSLIC, but this amount proved inadequate to handle mounting thrift insolvencies. In February 1989 the Administration proposed major legislation to deal with the S&L problem, and President Bush signed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in August. The new Act:

1. *Provides funding for the regulatory authorities to sell or close insolvent S&Ls.* Managed by the FDIC, the Resolution Trust Corporation (RTC) will receive \$50 billion to close or sell ailing S&Ls: \$20 billion borrowed by the Treasury and \$30 billion borrowed by the Resolution Funding Corporation, the financing arm of the RTC. The total cost over 10 years for closing or selling all insolvent S&Ls (including interest on borrowed funds) is estimated by several analysts to be over \$160 billion, with the majority of the cost being paid by the government.
2. *Restructures and strengthens the deposit-insurance funds for both S&Ls and banks.* The FSLIC is replaced by the Savings Association Insurance Fund (SAIF), now under the FDIC's control. The banks' insurance fund is renamed the Bank Insurance Fund (BIF), separate from the SAIF. Deposit-insurance premiums for both S&Ls and banks are raised from their current levels, with S&Ls' premiums higher than banks' until 1998. These increases are expected to replenish the two insurance funds over the next 10 years.
3. *Restructures the regulatory framework of the financial system.* The Act abolishes the Federal Home Loan Bank Board. Its job of setting regulations and chartering federal S&Ls will be performed by the new Office of Thrift Supervision (OTS), which will be part of the Treasury. The regional Federal Home Loan Banks will be managed by a new agency, the Federal Housing Finance Board, whose members will include the Secretary of Housing and Urban Development. S&L examinations will be handled by the OTS rather than the FHLBs. As with banks, S&Ls' chartering and deposit insurance now will be regulated by separate agencies.
4. *Tightens restrictions on S&Ls' activities and raises their capital standards to increase the thrift industry's safety and soundness.* Capital standards for S&Ls will be raised to levels no less stringent than those for national banks. The Act also tightens restrictions on S&Ls' lending and investments—including investments in junk bonds, the size of loans made to one borrower, the extent of transactions with affiliates, the equity investments that can be made by state-chartered S&Ls, and the use of brokered deposits by S&Ls not meeting the new capital standards.
5. *Encourages S&Ls to focus on their more traditional role as mortgage lenders.* In addition to tightening the restrictions on S&Ls' activities, the Act redefines "qualified thrift lender" as one holding 70 percent or more of its portfolio in housing-related assets. These assets include mortgage loans, home-equity loans, and mortgage-backed securities. This QTL provision takes effect on July 1, 1991; until then, the current 60 percent QTL test ap-

plies. If an S&L fails to meet the QTL test, it will be ineligible for further advances from FHL Banks and will be subject to bank-like restrictions. If it then fails to meet the QTL test within three years, it must repay its FHLB advances.

6. *Reduces the differences in regulatory treatment of S&Ls and banks.* The structure of their regulatory agencies is now similar, and eventually so will be their insurance premiums, capital standards, and supervisory treatment. S&Ls now may take demand deposits from any commercial business, just as banks do. Banks and credit unions can become members of the Federal Home Loan Bank System and obtain advances from the FHL Banks if they have invested 10 percent of their assets in residential mortgage loans, although FHLBs must give preference to members meeting the QTL test. The Federal Reserve is directed to permit bank holding companies to acquire healthy S&Ls. And an S&L may convert to a bank charter or be merged with a bank subsidiary of a holding company, although there are exit and entry fees that must be paid to switch deposit insurance from SAIF to BIF.
7. *Increases the enforcement powers of the regulatory agencies and the penalties for banking-law violations.* For its costs of closing a failed or failing insured institution, the FDIC can obtain reimbursements from other insured institutions owned by the same parent company; it also is empowered to act more swiftly in suspending or revoking an institution's deposit insurance. Regulators are given more leeway in issuing cease-and-desist orders to banks and S&Ls. Civil and criminal penalties for violating banking laws are increased and may be applied to a broader range of individuals involved with depository institutions.
8. *Encourages the development of low-income housing and strengthens the Community Reinvestment Act's role in the banking and S&L industries.* Regulatory agencies' evaluations of CRA performance by banks and S&Ls must be made public. The Home Mortgage Disclosure Act now covers all mortgage lenders with assets of more than \$10 million and requires expanded reporting of completed applications by income, race, and sex. Each FHL Bank must establish a program to provide funding to member institutions for CRA-type activities, and subsidized funding for low-income housing. In two years, FHLB advances will be made only if borrowing institutions meet certain community investment standards established by the Federal Housing Finance Board.

The new Act will mean dramatic changes for the financial industry, affecting S&Ls and banks alike. As the Resolution Trust Corporation sells or closes sick thrifts, more consolidation of firms will occur, reinforcing a trend for S&Ls and banks already begun by increased competition and expanded interstate banking.

While the FIRREA makes major changes in the safety net, Congress still plans to examine the net more closely. In particular, Congress held initial hearings in September on one of the major unresolved issues in the pricing of deposit insurance: whether the current system of flat-rate deposit-insurance premiums should be changed to one that takes into account the different levels of risk each bank or thrift imposes on the deposit-insurance funds. The FIRREA also requires the FDIC and the Treasury to study the feasibility of risk-based premiums and to report back to Congress within 18 months of FIRREA's enactment. If the practical difficulties of designing risk-based deposit-insurance premiums can be overcome, such premiums would be one way in which the safety net could be reinforced further.