

Statement No. 8

Recapitalizing FSLIC and Zombie S&Ls

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According to estimates reported by the U.S. General Accounting Office, as of mid-1985 461 S&Ls with \$113 billion of assets were operating with negative net worth, as defined by generally accepted accounting principles (GAAP). For the industry as a whole, the deficit aggregated \$3½ billion. The number of economically or market-value insolvent S&L associations is underestimated by GAAP, since GAAP includes as assets goodwill and other intangibles carried at "book" value. In essence, economically insolvent S&Ls are de facto nationalized; in practice, they are appropriately described as "zombies".

The zombie development has reached its present stage for several reasons. Supervisory, monitoring, and information development systems for S&Ls have been inadequate. The Federal Home Loan Bank System chose to defer oversight problems; operating and valuation losses were concealed by novel and irregular regulatory accounting principles (RAP) and the use of a liquidity criterion to differentiate between the viable and zombie institutions. The availability to insolvent institutions of FSLIC guarantees of deposits has enabled most of these institutions to pass the liquidity test and continue in operation.

The presence of S&L zombies raises three issues of public policy. First, S&L zombies must be kept from absorbing additional FSLIC resources by the contamination of healthy institutions and through future operating losses. This suggests the need for expeditious recapitalization, public conservatorship, interindustry takeover, or closure of these entities, since existing regulations have been ineffective in curbing the zombie practice of bidding up deposit rates. Healthy institutions are also weakened by agency-imposed, across-the-board increases in deposit insurance premiums.

The second problem is to distribute the economic losses already imposed on the FSLIC. A 1982 resolution expressed the sense of Congress that the full faith and credit of the United States might be available to potential claimants against FSLIC reserves. If these potential claims were now to come due, the FSLIC would be unable to meet them from its present resources. An injection of substantial new capital into the FSLIC would be required. Although the largest possible part of this capital injection should come in some way from the thrift industry, recent proposals for new infusions to FSLIC from advances by the Federal Home Loan Banks do not fully resolve the problem.

The third policy requirement is to prevent a repetition of this development in the future. A central element of reform must be an early elimination of well-known weaknesses. This applies to banks as well as to S&Ls. A threshold for the "windup" of an institution's position should be established at some level of net worth above zero. Ideally, such net worth should be defined in market terms—that is, balance sheet and off-balance sheet positions should be marked to market at frequent intervals to provide an estimate of economic net worth. Recent proposals by the Federal Home Loan Bank Board to increase capital and liquidity requirements, to move away from RAP accounting, and to strengthen oversight of credit quality represent steps in the right direction.