The 1989 reform legislation and its impact on savings institutions in the US

By Michael Wilson

Last year, the US Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) with astonishing speed for this august body. Signed into law by President George Bush in August — just six months after he submitted the draft version to Capitol Hill — FIRREA has drastically altered the landscape in which savings associations operate.

FIRREA was passed in reaction to the very real problems resulting from the ill-timed and ill-managed deregulation of savings associations in the early 1980s. The combination of broad investment powers, inadequate capital standards, lax government supervision and unlimited availability of federally insured deposits was a recipe for disaster. A débâcle was all but guaranteed by an economic downturn in the energy and primary commodity producing regions of the United States.

Today, the US government faces the unenviable task of making good on deposit insurance by taking control of hundreds of failed savings associations. Eventually, it must dispose of the billions of dollars of distressed assets they hold.

FIRREA created a mechanism to handle these problems. It also aimed to prevent an occurrence of similar problems in the future. However, some of these alterations may have sown the seeds for future failures.

Mechanism to solve the problem

To manage the situation, FIRREA demolished one set of bureaucratic structures in favour of another. The Federal Home Loan Bank Board (FHLBB), which had been the key regulator of thrifts, was abolished. Its functions, which included acting as the policy-making board of the Federal Savings and Loan Insurance Fund (FSLIC) and the Federal Home Loan Bank System, were parcelled out to two new entities and one existing entity.

This break-up of the FHLBB was considered necessary because Congress felt the centralised system represented by the FHLBB lacked the proper checks and balances to ensure simultaneously the soundness of the business it regulated and the deposit insurance fund it managed.

The Office of Thrift Supervision (OTS) was created to take over the regulatory functions of the defunct FHLBB. The OTS is a division within the Treasury Department, similar to that of the Office of the Controller of the Currency (OCC), which regulates national commercial banks.

The Federal Housing Finance Board (FHFB) was created to regulate and monitor the activities of the Bank System. The 12 banks in this system supply funds and provide other banking-type services to member savings associations. The FHLBs are wholly owned and capitalised by their members. In the pre-FIRREA environment, these regional banks were an integral part of the examination and supervision function. As a result of FIRREA, they have been stripped of these responsibilities; these duties now reside completely within the OTS.

The insurance of accounts function for savings associations, which had been handled by the FSLIC, was passed on to the Federal Deposit Insurance Corporation (FDIC), the insurer of commercial bank deposits. Technically, the FDIC now manages two insurance funds: the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). By law, however, both banks and savings associations are considered insured by the FDIC.

A temporary workout agency, the Resolution Trust Corporation (RTC), was created to resolve failed savings associations. An Oversight Board was also established to determine general policies for the RTC to follow.

With the $50 billion given to it by Congress to absorb losses, the RTC has the day-to-day responsibility of managing and selling or liquidating associations that fail between January 1989 and August 1992. (After August 1992, that burden is supposed to fall to the SAIF.)

The funds the RTC needs to resolve failed operations are raised by the Resolution Funding Corporation (REFCORP). The repayment of principal on REFCORP obligations is guaranteed via the purchase of zero-coupon US Treasury bonds. The Treasury provides a back-up for payment of interest.

The funds needed to purchase the

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zero-coupon bonds have been extracted from the FHLBs. Including earlier attempts to address the problem in 1987, the FHLBs have given up $3 billion of their retained earnings to fund the resolution of failed associations. In addition, under FIRREA, the FHLBs are committed to providing $300 million annually to help pay interest costs until the REFCORP bonds are completely retired.

It is important to recognise that the funds taken from the FHLBs are, in fact, being taken from the savings associations themselves.

The RTC has a tremendous job to perform. From its inception in August 1989 through the middle of March 1990, it took over 402 associations with liabilities in excess of $200 billion (Table 1). It has closed or sold only 52 of these operations.

But this is not the full extent of the RTC's caseload. The OTS has reported that at least another 120 associations are slated for transfer to the RTC. The RTC will eventually control in excess of 520 associations, a group representing about 20% of the savings associations business.

It will be many years before the RTC wraps up its affairs. Indeed, given the slow pace of case resolutions and the large amount of troubled and other difficult-to-sell assets under its domain, it is becoming increasingly doubtful whether the RTC will finish its business within its statutory seven-year life.

Furthermore, from analysis provided by the RTC, the Congressional Budget Office and US Accounting Office, it is doubtful whether the $50 billion Congress provided to clean up the affair will be sufficient. All indications are that FIRREA Version 2 is likely to be a major topic of debate in 1991 or soon thereafter.

Table 1
Savings Associations Closed by or Operating Under Control of the Resolution Trust Corporation

Based on associations placed into the RTC through March 16, 1990. Data is as of December 31, 1989, unless noted. Dollars in billions.

	Closed by the RTC[1]	*Operating under RTC control*	*Total handled by the RTC*
Number of associations	52	350	402
Total assets	$16.91	$163.51	$180.42
Total liabilities	$23.43	$188.09	$211.52
Total deposits	$18.09	$141.09	$159.18
Troubled assets:			
Delinquent loans	$2.18	$12.69	$14.87
Foreclosed real estate	2.38	11.76	14.14
Total	$4.56	$24.45	$29.01
As a % of assets	26.97%	14.95%	16.08%
Difficult-to-sell assets:			
Commercial real estate loans[2]	$2.00	$17.46	$19.46
Construction & land loans[3]	0.89	5.99	6.88
Service corporation investments	0.32	3.95	4.27
High-yielding bonds	0.00	3.63	3.63
Direct real estate investments	1.06	1.75	2.81
Fixed assets	0.25	1.99	2.24
Total	$4.52	$34.77	$39.29
As a % of assets	26.73%	21.26%	21.78%
Tangible capital	($6.91)	($27.45)	($34.36)
As a % of assets	−40.86%	−16.79%	−19.04%

1. Includes June 30, 1989 data for 24 associations closed by the RTC prior to September 30, 1989 and September 30, 1989 data for 13 associations closed prior to December 31, 1989.
2. Current loans only; includes loans on multi-family properties.
3. Current loans only.
Source: US League of Savings Institutions using data supplied by the Office of Thrift Supervision

Future of savings associations

FIRREA also changed the operating environment for tangible solvent associations, henceforth referred to as the "business". These number 2,398 with assets of $976.08 billion. These associations can be divided into three groups based on their level of compliance with the new capital requirements (Table 2).

These requirements were imposed on the business through FIRREA. By the time these standards are fully phased in at the end of 1994, associations must have at a minimum, tangible capital equal to 3% of their total assets. They must also pass an 8% risk-based capital requirement.

The risk-based capital standard is modelled after the international accords developed by the Basle Committee on Banking Regulation and Supervision Practices in 1987. Apparently, only in the US are savings associations required to meet capital guidelines meant for internationally operating commercial banks.

Currently, 1,506 associations meet the fully phased-in capital requirements. While these institutions hold 44.1% of the business' assets, they account for 69.4% of its tangible capital. These institutions have the best chance of long-term survival.

Another 301 institutions meet existing capital requirements (1.5% tangible capital and 6.4% risk-based capital), but fall short of the fully phased-in requirements. These institutions face a period of capital building and asset restructuring, but their survival prospects are also good.

The remaining 591 associations with assets of $331.64 billion are out of capital compliance. They must submit a business plan to the OTS detailing how they will achieve capital compliance. If the business plan is rejected — and many have been rejected to date — their future

becomes very uncertain. A takeover by the RTC looms as a distinct possibility.

Maintaining or building capital levels will be a preoccupation for all savings associations. Indeed, if there is one point on which all parties are in agreement, it is that capital requirements were too low for too many years. The problems the government confronts today would be substantially smaller, if not absent altogether, had higher levels of capital been required.

FIRREA, however, has raised many obstacles that make success in this regard highly dubious. The reform legislation imposes costs on associations that threaten to reduce already weak profit levels. Furthermore, the changes thrust upon the business have made investors reluctant to invest new capital in associations.

These burdens include:

- Deposit insurance premium rates that, on average, are 40% higher than those for commercial banks for the same coverage;
- A more restrictive qualified thrift lender test that severely limits the ability of associations to diversify against risk;
- Sharply reduced dividends from the FHLBs (because of the expropriation of the system's retained earnings);
- A business-supported examination and supervision system with costs double those of the commercial bank's system.

In its zeal to prevent a recurrence of problems, the US Congress may have actually accomplished the opposite. No fundamental market forces prevent a well-managed association from surviving as a specialised housing portfolio lender. The operational changes wrought by FIRREA, however, have eroded the value of the savings association charter and call into question the very survival of a distinct business dedicated to housing finance.

The end result is that, unless these issues are addressed in FIRREA Version 2, the savings association business in the United States will continue to consolidate. The chances of reopening FIRREA in 1990 are slim. This is an election year, after all. In 1991, however, new banking legislation will be introduced. It will probably focus on an overhaul of the deposit insurance system. That will be the first opportunity for comprehensive corrective legislation related to FIRREA. Hopefully, it will not be too late for the business. ■

Table 2
Condition of the Savings Associations Business in the United States
Data is as of December 31, 1989. Dollars in billions unless noted.

	Fails minimum capital levels	*Passes minimum capital levels*	*Passes fully phased-in capital levels*	*Total all associations*	*Memo: Associations w/negative tangible capital*[1]
Number of associations	591	301	1,506	2,398	115
% of total	24.6%	12.6%	62.8%	100.0%	—
Total assets	$331.64	$213.88	$430.56	$976.08	$104.28
% of total	34.0%	21.9%	44.1%	100.0%	—
Average asset size ($ millions)	$561.1	$710.6	$285.9	$407.0	$906.8
Tangible capital	$4.92	$7.58	$28.32	$40.82	($2.96)
% of total	12.1%	18.6%	69.4%	100.0%	—
Average ratio of tangible capital to total assets	1.48%	3.54%	6.58%	4.18%	−2.84%
% of associations profitable in the 4th qtr 1989	54.5%	72.1%	83.0%	74.6%	7.0%
Annualised 4th qtr 1989 after-tax net income to:					
Total assets	−0.41%	0.35%	0.39%	0.11%	−2.13%
Tangible capital	−27.86%	9.92%	5.87%	2.55%	—
Troubled assets:					
Delinquent loans	$12.47	$3.80	$5.93	$22.21	$4.80
Foreclosed real estate	10.14	2.28	2.31	14.74	5.46
Total	$22.62	$6.09	$8.25	$36.95	$10.26
As a % of assets	6.82%	2.85%	1.91%	3.79%	9.84%
As a % of total assets:					
Single-family loans	35.71%	42.99%	53.82%	45.29%	29.80%
Multi-family loans	7.23%	9.36%	5.47%	6.92%	4.40%
Mortgage-backed securities	12.62%	12.10%	13.58%	12.93%	19.73%
Consumer loans[2]	4.19%	4.95%	4.00%	4.27%	4.92%
Total household assets	59.75%	69.39%	76.86%	69.41%	58.84%

1. These institutions were insolvent as of December 31, 1989 and were losing money at the operating level. Many will probably end up under RTC management. For this reason, they have been excluded from the "business". Fifty-one tangible insolvents earning operation profits have been included in the column headed "Fails minimum capital levels". These institutions had total assets of $32.4 billion.
2. Non real estate loans to individuals.

Definition of capital compliance groups:
Fails minimum capital levels: Tangible capital positive but under 1.5% of assets.
Passes minimum capital levels: Tangible capital over 1.5% but under 3% of assets; risk-based capital ratio over 6.4% but under 8% of risk-weighted assets.
Passes fully phased-in capital levels: Tangible capital over 3% of assets and risk-based capital ratio over 8% of risk-weighted assets.
Source: US League using OTS-supplied data.

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