Thrift Deregulation and Federal Deposit Insurance

JAMES R. BARTH  
MICHAEL G. BRADLEY  
The Office of Policy and Economic Research,  
Federal Home Loan Bank Board,  
1700 G Street, N.W.,  
Washington, D.C. 20552

Abstract

The federal insurance funds were designed to cover all insured deposits but lacked a rule specifying how these deposits would be covered if a crisis occurred that swamped either insurance fund. The Congress apparently accepted the argument that strict enforcement and regulation could be used to reduce the probability of failure and thereby avoid large losses to the insurance fund. This flaw in the federal deposit insurance system has permitted insolvent institutions to remain open. The very poor performance of these institutions has skewed aggregate thrift performance in recent years, masking the performance of solvent institutions. A protracted debate has ensued centering on the cost of resolving troubled thrifts and whether healthy thrifts can pay these costs. This debate has drawn attention away from the potential value of the thrift charter.

1. Introduction

There are hundreds of insolvent thrift institutions that will impose significant costs upon the Federal Savings and Loan Insurance Corporation (FSLIC). Estimates of these costs currently range from $50 billion to $100 billion or more, and who will bear them has become a controversial issue. Since its establishment, the FSLIC has covered all costs through premiums levied on thrift industry deposits. Regardless of the costs that must be incurred, this is the only effective way the FSLIC can currently fulfill its obligations.

Although the exact cost of resolving troubled institutions and whether healthy thrift institutions can bear this cost have dominated the public debate, there is a more fundamental problem: the federal deposit insurance itself. At present, deposit insurance is not insurance in the normal sense of the word. It is a guarantee that all insured depositors will be fully

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protected against any loss. Yet, there is no rule in place by which one can predictably
determine how the insured deposit commitment will be honored when extraordinary costs
are imposed upon the insurer. This surprising omission in the federal deposit insurance
system goes beyond the problem of estimating how much it will cost to resolve troubled
institutions and, instead, focuses on the guarantee aspect of federal deposit insurance itself.

2. Deregulation and thrift performance

2.1. Deregulation reviewed

For years there has been a maturity imbalance in thrift balance sheets. Greater asset
diversification for thrift institutions was viewed as a way to reduce this imbalance and
thereby allow for the removal of deposit-rate ceilings. Such a view was expressed as far back
as the 1971 Hunt Commission Report, which argued that the long-run viability of thrift
institutions depended on an expansion of their asset and liability powers.

Legislation enacted in the early 1980s did indeed broaden the range of services thrift
institutions could offer as well as the types of funds that could be attracted. The intent was
to enable thrift institutions to diversify their portfolios and to shorten the effective maturity,
or repricing period, of their assets relative to their liabilities. New asset powers included:
the ability to make consumer and commercial loans and to conduct leasing activities; greater
commercial mortgage lending authority; expanded authority to make acquisition, develop-
ment, and construction loans; increased service corporation powers; and the ability to
provide credit card, trust, and fiduciary services. The major legislation affecting thrift
institutions is presented in table 1. This legislation—notably the Depository Institutions
Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Garn-St Germain
Depository Institutions Act (DIA) of 1982—also expanded the liability powers of thrift
institutions. Federally chartered institutions—accounting for 57 percent of thrift institutions
and 66 percent of assets in June 1988—were permitted to offer a wider range of products,
including transaction accounts, to a wider range of customers. In addition, this legislation
gave the Depository Institutions Deregulation Committee the authority to create money-
market deposit accounts—which would compete more effectively with money-market
mutual funds—and to give thrift institutions and other depository institutions greater
flexibility to determine the interest rates offered on deposit accounts. Rates were deregulated
gradually until they were completely deregulated in March of 1986.¹

The Federal Home Loan Bank Board (Bank Board) granted relatively few additional
powers beyond those legislated by the Congress. The more important regulations approved
by the Bank Board in the 1980s, excluding regulations mandated by legislation, are
presented in table 2. These regulations can be divided into two periods: 1980 through 1983
and 1984 to the present. During the early period, the Bank Board was primarily concerned
with interest-rate risk. The earlier regulations were, therefore, designed to help thrift
institutions adjust to interest-spread problems and to help ensure that a similar situation
would not recur. Federally chartered thrift institutions were permitted to: make, purchase,
and participate in adjustable-rate mortgages; make greater use of futures and options; expand