Report to U.S. Taxpayers on the Savings & Loan Crisis

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Introduction

President Bush has finally recognized that there is a $100 billion deficit in the Federal Savings and Loan Insurance Corporation (FSLIC) that must be filled in order to protect insured depositors and place our system of federally insured depository institutions on a sound footing. A federal bailout of this magnitude is unprecedented, and must be subjected to rigorous scrutiny by the nation's citizens.

The FSLIC bailout should be guided by three broad principles. First, the bailout must be funded in an open, fair and efficient manner that does not hide costs, needlessly raise costs, or shift costs to persons who can least afford to pay. Second, the bailout must be accompanied by a fundamental reform of the regulation of federally insured depository institutions, otherwise the costly scenario of bank mismanagement and fraud and regulatory breakdown will repeat itself. Third, the 12 Federal Home Loan Banks, which were chartered by Congress in 1932 as public instrumentalities to serve housing credit needs, must be removed from the grasp of the S&L industry and given a new mandate to serve today's housing credit needs, especially those relating to housing for persons of modest means and local community development.

President Bush has proposed a plan for bailing out FSLIC, disposing of insolvent S&Ls, and revising the administrative structure of federal banking regulation. The President's plan is a step forward because it clearly recognizes the magnitude of the problem. However, the plan has a number of major flaws and crucial details are still unknown.

The Bush plan does not provide for sufficient new federal revenues to meet the cost of the bailout. This means that the bailout will exacerbate the federal deficit, crowd out important social spending, and ultimately be borne by taxpayers at large.

Whether the Bush plan will strengthen banking regulation depends on the precise nature of the reforms, but these have not yet been drafted. Prohibition of risky investment powers and tough new liability standards for misconduct by S&L and bank officers are essential. Merely shunting S&L regulation from one agency to another will not by itself accomplish reform.

The Bush plan fails to separate the Federal Home Loan Banks from the S&L supervision function and also fails to end S&L industry control over these vital housing finance vehicles. Giving the Treasury Department oversight authority over the Federal Home Loan Banks without revising their mandate and control structure will do little to serve the housing credit needs of local neighborhoods.

I. Stronger Regulation of Insured Depository Institutions.

a. Limit Expanded Powers

A major cause of S&L insolvency and the collapse of FSLIC has been the expansion of S&Ls in recent years into new investment activities, especially investment in real estate equity. Real estate equity investment is not only an inherently risky activity -- and thus inappropriate for federally insured depository institutions -- but, it also undermines a S&L's credit judgement in extending mortgage loans on properties where the S&L has a equity position and provides a potent incentive for real estate interests to take over S&Ls for purposes of self-dealing.

As early as January, 1987 FHLBB Chairman Edwin Gray warned Congress about the damage that the real estate equity investment power was wreaking in the S&L industry. Mr. Gray pointed to the performance of 33 California S&Ls which had made large real estate equity investments in the early 1980's. By 1986, five of these institutions had failed, one had merged, while the remaining 27 had an average net worth of 0.3% and an average return on assets of negative 3.3%.

One of the most vitally needed reforms is to prohibit S&Ls from engaging in real estate equity investment and other forms of direct investment. These investment powers, which even lie outside those available to commercial banks, should not be exercised by any type of federally insured depository institution. In short, S&Ls should not exercise lending and investment powers beyond those traditionally available to commercial banks. On the other hand, there is no reason to confine S&Ls to home mortgage lending. S&L diversification within traditional bank lending powers is useful to achieve portfolio balance and to manage interest rate risk.

Another flaw in the S&L regulatory structure has been the authority of state legislatures to grant broad investment powers to state chartered, but federally insured, S&Ls. The most expansive investment powers, especially in regard to real estate equity, have been granted to state chartered S&Ls by various state legislators, including those of Texas and California. The consequences for FSLIC and ultimately U.S. taxpayers of the permissive approach to S&L powers at the state level are quite shocking.

State chartered S&Ls represent 36% of the assets of FSLIC insured institutions, while federally chartered S&Ls contain the remaining 64% of such assets. Yet, looking at FSLIC insured institutions that are insolvent under generally accepted acounting principles (GAAP), state chartered S&Ls represent 58% of the assets of these insolvent institutions, while federally chartered S&Ls represent only 42% of such assets. More dramatically, the FHLBB calculated in October 1988 that state chartered S&Ls account for 81% of the collective negative net worth of GAAP-insolvent S&Ls, while federally chartered S&Ls account for 19% of this net worth deficit. Overall, the data indicate that state chartered S&Ls, which only represent slightly more than one-third of S&L industry assets, are responsible for about 80% of FSLIC's losses.

Clearly, Congress must prohibit state chartered S&Ls as well as federally chartered S&Ls from undertaking real estate equity and other non-banking investments. A regulatory structure under which the federal government insures the deposits of state chartered S&Ls while state legislatures have carte blanch to grant broad investment powers to these institution is not a creative exercise in federalism but a license to steal from U.S. taxpayers.

The failure to limit the activities of unitary S&L holding companies poses another major threat to the safety of the federal deposit insurance system. The Savings and Loan Holding Company Act is a legislative sieve that imposes virtually no limits on the acquisition of unitary S&Ls by non-financial firms. Corporations engaged in a broad range of economic activities -- real estate development and brokerage, manufacturing, retailing, as well as investment banking and insurance -- can and have taken over S&Ls and manipulated them for various corporate purposes. William Black, Deputy Director of FSLIC, graphically described this danger in testimony prepared for House Banking Committee Hearings on June 9, 1987:

> The change of control often brought a real estate developer into control of the thrift. For the unscrupulous developer, owning a thrift was a dream come true -- a virtual printing press to provide money to develop his real estate.

At the eleventh hour, Mr. Black's testimony was quashed by House Banking Committee Chairman Fernand St Germain and never presented to the committee.

In sharp contrast to the Savings and Loan Holding Company Act, the Bank Holding Company Act imposes important limitations on the ownership of commercial banks by non-financial corporations. Any reform legislation should extend the Bank Holding Company Act to cover S&Ls and jettison the S&L Holding Company Act as a relic of an over indulgent S&L regulatory structure that can no longer be tolerated.

b. Greater officer and director liability for misconduct

The GAO has been conducting an extensive investigation into the causes of S&L and bank failures. Although FSLIC's $100 billion insolvency is the paramount issue of the today, concern about commercial bank failures is warranted. Over the 1987-1988 period 424 commercial banks failed, and the FDIC anticipates that its insurance fund will show a $3 billion to $4 billion loss for 1988. The most striking finding of the GAO investigation, which was reported to the House Banking Committee in January of this year, is the critical role of management misconduct -- fraud, insider abuse, and violations of law -- in recent S&L and commercial bank failures.

Much attention has been focused on the historic mismatch between long-term assets and short-term funds in S&Ls and the downturn of the Southwest economy as the principal causes of recent S&L and bank failures. Yet, GAO reports that well-managed banking institutions have remained viable despite downturns in their local economies. More dramatically, after reviewing 26 S&L failures and 184 commercial bank failures, GAO found in virtually every case a failure by management to establish and maintain adequate controls or as GAO phrased it "a breach of [management's] fiduciary duty to operate a financial institution in a safe and sound manner."

Specifically, GAO found management fraud or insider abuse in 100% of S&L failures and 64% of commercial bank failures. The S&L failures were characterized by extensive and repeated violations of law. At 77% of failed S&Ls, there were conflict of interest problems, while allegations of criminal misconduct were found at 73% of failed S&Ls.

Moreover, GAO also determined that the managements of the failed financial institutions had not been responsive to the recommendations and directives of the regulators. At failed commercial banks the responses were often delayed or inadequate, while some S&L managements were "astoundingly egregious in ignoring or circumventing regulators."

GAO's findings on the central role of bank management misconduct are similar to those of the banking agencies and the Congress. For example, a 1988 review by the House Government Operations Committee of FHLBB data for 210 S&Ls that failed during the January 1984-June 1987 period revealed that the FHLBB had identified misconduct at 80% of these institutions. A 1988 study by the Comptroller of the Currency of 171 national banks that failed during the 1979-1987 period found that insider abuse was a significant factor in 35% of the failures.

These government investigations evidence a shocking pattern of greed and lawless behavior by officers of banking institutions that rivals the financial misconduct of the late 1920's as revealed in the 1933 Pecora Hearings, such as the misdeeds of National City Bank's Charles E. Mitchell and Chase National Bank's Albert H Wiggin. The crux of reforming banking regulation is to instill a greater discipline in bank management and the most effective means to this end is to expand the scope of their civil and criminal liability for misconduct.

Senior officers and directors of a federally insured depository institution should be held liable for misconduct that leads to institution failure under a more rigorous set of civil and criminal liability provisions. In the event of failure, individual shareholders in the S&L or bank and uninsured depositors should have standing to bring direct suit against bank officials. The existing private remedy of derivative stockholder suits is cumbersome and often ineffective, and the banking regulators often fail to pursue available civil and criminal remedies.

Once a civil or criminal suit for misconduct has been filed, the court should have clear authority to issue a pre-trial freeze order to prevent dissipation of assets by the defendants. Misconduct should be defined to include fraud, negligence, or self-dealing that contributes to the failure of the bank. Such strict liability for self-dealing is appropriate, given that self-dealing has been found to be an important cause of bank failure and is <u>ab initio</u> suspect under fiduciary concepts. Finally, private plaintiffs and the government should be authorized to recover treble damages in bank misconduct suits.

Prohibiting S&Ls from making speculative investments (real estate equity and other direct investment in non-banking activities) and expanding management liability for bank misconduct are vital tandem reforms. Evidence from recent S&L failures indicates that the authority to engage in speculative investments interacts with the proclivity toward misconduct to produce management decisions that are lethal to bank safety. In 1987 FSLIC testified before the House Government Operations Committee that "Combined, these two causes of losses [insider abuse and fraud and risky investment strategies] are overwhelmingly responsible for virtually all recent failures, FSLIC's growing insolvency, and the huge coming losses that we have already identified."

c. More regulatory discipline

1. Early closure

An additional set of regulatory reforms are necessary to stiffen the will of the banking regulators to take timely action against problem banking institutions and to provide better information to the public on the condition of federally insured banking institution. The regulators should be required to operate under an early closure rule that would direct them to close or merge a failing institution before not after it reaches the point of insolvency. If FDIC or FSLIC "resolves" a failing institution before it becomes insolvent on a market-value basis, then there will be no loss to the insurance fund.

Yet, when banking institutions begin to slide towards failure, they are often able to exert enough political pressure on their regulator to obtain forbearance. In fact, a 1986 study by FHLBB economists found that during the 1980's FSLIC had been following a closure rule that on average delayed agency action until one full year after GAAP insolvency, an approach that guarantees that FSLIC will incur large losses.

To safeguard the deposit insurance funds, Congress should require an early closure rule based on an institution's market-value or GAAP value, not the lax regulatory accounting rules (RAP) that banking regulators have devised. To the extent feasible, the market-value test should be used in preference to the GAAP value test, because GAAP itself is book value accounting that does not measure the current market value of assets.

2. Runaway deposit growth

A frequent scenario leading to deposit institution failure is a pattern of explosive deposit and asset growth by thinly capitalized institutions pursuing high risk investment strategies. This runaway institution phenomenon -- which is possible only because of deposit insurance and, at least for larger institutions, the implicit promise of full bailout -- has proved exceedingly costly to FSLIC. Given the mounting severity of capital inadequacy in the S&L industry during the 1980s, it was inexcusable for the FHLBB to permit deposits at S&Ls to escalate from $499 billion at year-end 1980 to $933 billion by year-end 1987, a 7 year growth rate of 187%. Congress should explicitly empower and direct the banking agencies to impose deposit growth ceilings on insured institutions that do not meet GAAP-based or market-value capital requirements.

3. Accounting practices

More generally, accounting legerdemain in the form of RAP accounting has been one of the principal mechanisms used by the FHLBB to mask S&L insolvency and postpone FSLIC's day of reckoning. This refusal to recognize losses has caused the FSLIC deficit to escalate from perhaps $15 billion in the early 1980's to $100 billion today. To prevent a repeat performance in future years and more generally in the interest of honest accounting procedures Congress should require the banking agencies to reform their accounting rules for banking institutions. Specifically, the agencies should be directed to apply market-value accounting rules to the maximum extent feasible or GAAP rules. RAP rules should be assigned to the growing trash bin for regulatory indulgences that will no longer be tolerated by taxpayers who stand behind the federal deposit insurance funds.

The banking agencies collect extensive balance sheet and income statement data on a quarterly basis for each federally insured depository institution. These quarterly reports, known as condition reports, contain important information concerning an institution's portfolio composition, interest rate risk, and operating costs. Unfortunately, only portions of these condition reports are made available to the public. For example, the condition report that the FHLBB requires from S&Ls contains 610 data items, but the FHLBB releases only 231 of these items to the public. Full public disclosure of condition report data should be an automatic -- and hardly controversial -- condition of access to federal deposit insurance. To overcome the agency inclination to shield banking institutions from public disclosure, Congress should mandate full disclosure of condition reports.

d. Problems inherent in a rollback of deposit insurance

Some proponents of financial deregulation have called for a rollback in the scope of federal deposit insurance with its current ceiling of $100,000 per deposit account in order to impose more market discipline on the activities of insured banking institutions. At year-end 1987, 34% of total deposits in FDIC insured banks were uninsured (accounts over $100,000), while less than 10% of the deposits in FSLIC insured institutions were uninsured.

Although plausible at first blush, this approach to reforming banking regulation has a number of troublesome aspects. The root causes of banking failure -- management misconduct and excessive risk on certain (usually non-standardized) loans and investments -- are not readily discernible in bank financial statements and can deeply erode an institution's capital well before the situation is discernible to even sophisticated public investors. Thus, a rollback in federal deposit insurance -- especially one coupled with greater willingness on the part of the federal regulators to leave uninsured depositors fully exposed when institutions fail -- could lead to situations in which the rumor of potential problems could trigger rapid deposit outflows at a bank. This could destabilize problem banks, thereby compounding the supervisory task of the regulators, and might even injure some perfectly healthy banks.

More generally, any pronounced rollback in federal deposit insurance or effort to "privatize" deposit insurance could have significant adverse impacts on the availability of credit for local community development and small business. If depositors or private insurers must evaluate bank or S&L portfolios in order to safeguard their funds or control their insurance liability, they will want to deal with banking institutions that hold only very standardized loans. Non-standardized credits, which are the lifeblood of small business, housing rehabilitation, and other small-scale local community development endeavors, are costly on a per dollar of assets basis for third parties to evaluate. In fact, this information obstacle already prevents banking institutions from originating such non-standardized loans and then "securitizing" or reselling them into secondary markets.

Moreover, "privatization" of deposit insurance would most likely merely transform the problems of banking regulation into problems of insurance regulation, rather than obviate the need for government regulation. In essence, the state-level insurance guarantee funds would become the new deposit insurance agencies. Depositors, local community borrowers, and ultimately taxpayers who want strong banking regulation are better off seeking banking reform from Congress than becoming trapped in the quagmire of state insurance regulation.

What is needed far more than market discipline is a strong dose of structural discipline, fiduciary discipline, and regulatory discipline. Structural discipline will place excessively risky powers, such as real estate equity investment, off-limits to S&Ls and other banking institutions. Fiduciary discipline will internalize in managements of financial institutions a much greater awareness of the need for honesty, prudence, and restraint in self-dealing. Regulatory discipline -- a stronger mandate for action on the part of the regulators -- will work to protect the government deposit insurance funds by curbing losses before they begin to escalate.

II. Greater Public Accountability for Banking Regulators

a. Financial consumers' associations

A clear lesson of the FSLIC debacle is the great potential for regulatory failure at agencies charged with regulating depository institutions -- not just regulatory mismanagement, but also misrepresentation to the public of the real condition of financial institutions. S&L depositors in Maryland and Ohio felt the full sting of such regulatory failure in 1986 when the state insured S&Ls in those states collapsed. As for FSLIC, not until the very end of 1988 -- after Vice President George Bush had successfully completed his campaign for the Presidency -- did FHLBB Chairman Danny Wall publicly admit that FSLIC required additional public funds. Furthermore, such regulatory obfuscation and outright misrepresentation provides a convenient pretext for legislative inattention.

In the long run the only effective antidote to regulatory failure and legislative inaction is a more vigorous watchdog role by consumer organizations with enhanced expertise in financial service regulation. To this end, Congress should enact legislation that would facilitate the establishment in each state of a consumer controlled, self-funded, but publicly chartered financial consumers' association. The legislation would direct federally insured depository institutions to insert in their deposit account statement mailings to consumers a statutory notice informing the consumer of his or her right to join the association. In December 1988 the Senate Banking Committee held hearings that produced a strong record of support by consumer groups for the financial consumers' association concept.

b. Congressional access to banking agency documents

The House Banking Committee has encountered strong resistance and extended delays in obtaining from the FSLIC assistance agreements and other documents concerning failing S&Ls. Given the massive taxpayer liability that underlies these transactions, the inability of Committees of Congress to obtain prompt access to these documents is inexcusable. Reform legislation should give Congress direct access to all FSLIC and FDIC assistance agreements and all supervisory documents concerning federally insured institutions that fail to meet regulatory net worth requirements.

III. Revamping the Federal Agency Structure of S&L Regulation

GAO stated in January 1989 testimony before the House Banking Committee that there is a "basic structural flaw" in the Federal Home Loan Bank System: its "dual and conflicting responsibilities for promoting the thrift industry while at the same time supervising and regulating it."

The inherent conflict of interest that has undermined the Federal Home Loan Bank System has two aspects. First, the 12 Federal Home Loan Banks, which play a major role in examination and supervision activities, are controlled by the S&Ls that they are supposed to regulate. Second, the S&L industry has exercised inordinate influence over the FHLBB in large measure because the FHLBB has a mandate to promote housing -- easily construed to mean the interests of the S&L industry -- as well as a mandate to supervise federally insured S&Ls for safety and soundness purposes.

Dan Brumbaugh, who served as the FHLBB's deputy chief economist from 1983 to 1986, has aptly described the consequences of this structural flaw in his recent book, Thrifts Under Siege:

> It is difficult not to conclude that, by a combination of direct and indirect avenues, primarily through the Federal Home Loan Banks and trade associations, the thrift industry has heavily influenced the regulatory policy since the 1930s. Without doubt, the degree of this influence has exceeded what is necessary to assure that relevant industry expertise finds its way into regulatory deliberations. To those steeped in the capture theory of regulation, however, it is not surprising to find that what appears to be the most regulated industry also appears to have the greatest influence over its regulators. The result in the 1980s has been the selection of regulatory approaches that have favored the short-term interests of existing thrift institutions at the expense of consumers of financial services, society in general, and even the long-term interests of stockholders and employees of those thrift institutions that will ultimately survive.

a. Conflicts of interest at the Federal Home Loan Banks

The Federal Home Loan Bank System is comprised of (1) the Federal Home Loan Bank Board (FHLBB), (2) the FHLBB's two operating subsidiaries, FSLIC and the Federal Home Loan Mortgage Corporation (FHLMC), and (3) the 12 Federal Home Loan Banks. The Federal Home Loan Banks embody the most serious structural conflict of interest in the system. Under the Federal Home Loan Bank Act of 1932 the S&Ls from each Bank District elect a clear majority of the directors of their Federal Home Loan Bank. Most Federal Home Loan Banks have 14 directors, and S&Ls elect 8 of these directors. Under this statutory scheme, the directors of a Bank employ, set the salary of, and dismiss at pleasure the president of the Bank and its senior officers. Although the FHLBB has collateral authority to remove a Bank officer, the senior management of a Federal Home Loan Bank is nonetheless a creature of the Bank's board of directors and, indirectly, of the S&Ls within the Bank's District.

Moreover, S&Ls have a proprietary interest in the Federal Home Loan Banks which reinforces their control via election of Bank directors. All of the stock of a Federal Home Loan Bank -- which for all 12 Banks had a consolidated book value of

$13.7 billion at year-end 1987 -- is owned by the S&Ls within the Bank's District.

The Federal Home Loan Banks exercise a range of supervisory activities over S&Ls and conduct other operations that have a direct bearing on S&L safety and soundness. Most important, the president of each Bank serves as the FHLBB's "Principal Supervisory Agent", the chief S&L supervisor for S&Ls within the Bank's District. Assigning such a key supervisory function to an official who holds office at the pleasure of the S&Ls that he or she is suppose to regulate is obviously a fundamental conflict of interest. An extensive examination of the S&L industry and S&L regulation commissioned by the FHLBB, Study of the Savings and Loan Industry (1969), forewarned of this conflict in its conclusion that: "Because the supervisory agent is an officer of the Bank, and therefore elected by a board dominated by industry members, there appears to be some feeling that his judgment is not entirely objective."

The supervisory activities of the officers of the Federal Home Loan Banks are critical from a number of perspectives. Most important, they involve taking action -- or failing to do so -- when examiners have uncovered unsafe conditions or violations of law at an S&L. Bank officers play a key role in monitoring problem S&Ls and providing advice to FSLIC on the negotiation of assisted mergers. Beginning with a 1980 report and continuing through its present investigations, GAO has observed systemic weakness in the supervisory actions of the Federal Home Loan Bank System: timidity in initiating supervisory action; failure by S&Ls to act on supervisory recommendations; and reluctance to take formal action in the face of S&L foot-dragging or blatant disregard of supervisory recommendations. Without doubt, the close relationship between the Banks and the S&Ls they regulate has been a primary factor underlying what GAO has described as a breakdown of the supervisory and regulatory system.

Moreover, the officers of Federal Home Loan Banks have other important policy roles that impact on S&L safety and soundness, and thus entail further conflicts of interest. Under the FHLBB's rules governing S&L direct investment powers, they exercise important discretion in determining the scope of permissible activities. They have been delegated authority by the FHLBB to act on various types of expansion applications. They also have a major role in determining whether real estate appraisals are adequate. Further, they directly control activities of the Banks -- in particular, cash advance lending to S&Ls and interest rate swap programs operated for the benefit of S&Ls -- that can have a vital impact on the financial condition of individual S&Ls.

Finally, the institutionalization of conflict of interest in the structure of the Federal Home Loan Banks has signaled the S&L industry that self-dealing is permissible and created a regulatory culture that is tolerant of self-dealing. Yet, all studies of S&L failures have identified self-dealing as a key cause of failure in the S&L industry.

The structural conflict of interest inherent in assigning supervisory responsibilities to Federal Home Loan Bank officers was exacerbated in 1986 when the FHLBB placed the Bank officers in direct control of S&L examiners and transformed the examiners into employees of the Banks. FHLBB Chairman Edwin Gray in testimony before the House Banking Committee in June, 1986 somewhat euphemistically referred to this delegation of the examination function to the Federal Home Loan Banks as allowing "maximum responsiveness to the needs of the industry we regulate."

FSLIC's recent attempts to deal with insolvent S&Ls in Texas provide a classic illustration of the conflict of interest inherent in allowing S&L officials to serve as directors of the Federal Home Loan Banks. In May, 1988 FSLIC provided a record $2 billion in assistance to Southwest Savings Association, Dallas to acquire four insolvent S&Ls. Southwest's top executive, C. Todd Miller, was the vice chairman of the Federal Home Loan Bank of Dallas. At the time that FSLIC extended the $2 billion package to Southwest Savings, FHLBB member Roger Martin stated that Southwest "provides good management" for the insolvent institutions. Yet, only four months later Martin stated publicly that the FHLBB was "very disappointed with the progress [Southwest's officers] have made" and complained that Southwest "hasn't been aggressive" in acting on FHLBB directives to cut overhead, streamline operations, and put a lid on deposit interest rates.

In 1988 S&Ls from the Dallas District nominated as candidates for election to the board of directors of the Federal Home Loan Bank of Dallas 3 officers from 3 problem Texas S&Ls. In recent years a number of Federal Home Loan Bank directors have been top officers of S&Ls that have either collapsed or been seriously weakened by unsound lending practices.

S&L industry control over the Federal Home Loan Banks creates conflicts of interest in regard to the use of Bank resources, as well as in the supervisory area. For example, in December 1988 the Federal Home Loan Bank of Indianapolis sent a letter to S&Ls in its District calling attention to the opportunity to borrow from the Bank's cash advance facility in order to dress-up their balance sheets. Unabashedly, the letter stated, "As in years past, we anticipate that many institutions will want to fine-tune their statements by using short-term advances as 'window-dressing.'"

b. Conflict of interest inherent in the FHLBB's housing promotion mandate

Marriner Eccles, Chairman of the Federal Reserve Board from 1934-1948, has described in his book Beckoning Frontiers (1951) the difficulties he encountered in keeping Morton Bodfish, chief lobbyist for the powerful Building and Loan League (predecessor to the U.S. League of Savings Institutions), out of the drafting sessions of Roosevelt Administration officials that led to the National Housing Act of 1934. In addition to creating the Federal Housing Authority (FHA), that Act established FSLIC, thereby extending the system of federal deposit to savings and loans. Moreover, with remarkable prescience Eccles observed:

> ... in later years all the protective provisions that were agreed to for the purpose of creating adequate reserve funds in the insured institutions as well as adequate reserve funds in the new insurance corporation were either weakened or eliminated under the lobbying pressure that Bodfish effectively directed.

In 1986, as the savings and loan system began to unravel and FSLIC slid into insolvency, former FSLIC director Peter Stearns noted the same pattern of inordinate S&L industry influence over the FHLBB. According to Stearns, "The Bank Board doesn't regulate anything unless the U.S. League and the top S&Ls agree."

The unique power of the S&L industry to influence the policies of the FHLBB and indirectly the decisions of Congress is rooted in the FHLBB's dual mandate to promote housing and regulate insured S&Ls. The S&L industry doesn't employ a more skilled cadre of lobbyists or operate with a larger war chest of PAC funds than other financial sectors, such as the commercial banking industry or the insurance industry. What the U.S. League has done skillfully is to wrap itself in the mantle of housing and exploited the political appeal of housing to obtain a continuing series of special exemptions, privileges, waivers, and indulgences that have loosened S&Ls from the regulatory constraints generally imposed on federally insured depository institutions. The authority of S&Ls to engage in risky investment activities, such as real estate equity investment, through service corporations or directly in the case of some state chartered S&Ls is a prime example of this phenomenon. Another is the authority for non-financial firms, such as real estate developers or insurance companies, to acquire S&Ls under the S&L Holding Company Act.

Moreover, the housing mantle has definitely been a factor contributing to the failure of Congress to direct FSLIC to close down insolvent S&Ls before their losses escalated to the point of creating a $100 billion taxpayer liability. The Garn-St Germain Act of 1982, which sought to disguise the loss of capital at many S&L with paper net worth certificates, reflected a desire to keep as many struggling housing lenders afloat as possible, as well as federal budget constraints that weighed against authorizing real funds to dispose of these institutions. In fact, the Act even went so far as to prohibit the FHLBB from requiring problem S&Ls as a condition for receiving net worth certificates to agree to make management changes or to merge with a healthy institution.

In 1987 many members of Congress, including House Speaker Jim Wright, vigorously opposed the Treasury Department's proposal to provide $15 billion to FSLIC to resolve insolvent S&Ls. The driving force behind this effort to minimize FSLIC's resources was once again the desire to buy more time for failing S&Ls. The FSLIC Recapitalization Act of 1987 authorized only $10.8 billion for FSLIC and these funds could only be drawn down over a three year period. The legislation also contained an explicit waiver from certain GAAP accounting rules for S&Ls.

c. A new structure for S&L regulation

A number of agency structure reforms are needed to establish adequate safety and soundness regulation of S&Ls and minimize future liability on the part of U.S. taxpayers for regulatory mismanagement.

First, all activities relating to the examination and supervision of S&Ls should be completely divorced from the 12 Federal Home Loan Banks. The mandate of these institutions is to serve housing credit needs, not to engage in safety and soundness regulation; and, further, it is foolhardy to give then even a tangential role in safety and soundness matters in view of their domination by S&Ls.

Second, FSLIC should be incorporated within the Federal Deposit Insurance Corporation, as President Bush and the GAO have proposed. This consolidation makes sense from the point of view of administrative efficiency, agency resources, and minimization of conflicts of interest.

Third, the FDIC should be given authority to set general safety and soundness standards (capital requirements, accounting rules) for all federally insured S&Ls. This transfer of authority should take place regardless of what happens to the FHLBB's other functions. Again, both President Bush and the GAO have recommended this course of action.

Fourth, a major policy question arises as to where the authority to charter federal S&Ls and to examine and supervise all federally insured S&Ls should be lodged. A good case can be made that all examination and supervisory activities should be assigned along with the deposit insurance function to the FDIC. All too often bank examiners from the FHLBB and OCC -- agencies with the promotional chartering mission -- have uncovered unsound banking practices, but their immediate supervisors have failed to act vigorously on the examiners' recommendations. In fact, much of the weakness in both S&L and commercial bank regulation reflects a lack of agency will to use their existing supervisory powers, rather than failure on the part of examiners to uncover unsafe and unsound banking conditions.

Thus, one approach would be to assign all S&L examination and supervision functions to the FDIC and downgrade the FHLBB to the status of a promotional and chartering Office of Savings and Loans within the Treasury Department. A second approach would be to leave the FHLBB with chartering, examination and supervision powers over federally chartered S&Ls in a manner that parallels the authority of the Comptroller of the Currency (OCC) over national banks. In this case, the FHLBB could either remain as an independent agency or be incorporated within Treasury. A third approach would be to leave the authority to examine and supervise state chartered S&Ls, as well as federally chartered S&Ls, within the FHLBB, either as an independent agency or as a Treasury office.

A fourth and preferred approach would be to leave the authority to examine and supervise S&Ls within the FHLBB, but to require the automatic transfer of this authority to FDIC whenever an S&L falls below the regulatory capital standard or is found to be operating in an unsafe or unsound condition. Moreover, this principle of transferring full authority over problem institutions to the FDIC should also be extended to the regulation of national banks.

Finally, the question of whether FHLBB should retain independent agency status or be subsumed within the Treasury Department should be determined by the future role envisioned for S&Ls. As discussed below, S&Ls should be given the same lending powers as commercial banks and allowed to decide individually the extent to which they will specialize in mortgage lending. Thus, the best course would be to establish within the Treasury Department a banking office that would issue an all-purpose federal bank charter that would replace the separate charters currently issued for national banks, federal S&Ls, and federal savings banks.

IV. The Changing Structure of the Mortgage Market and the Future Role of Savings and Loans

a. Restructuring the mortgage market

Throughout most of the post-War era S&Ls have served as the nation's predominant residential mortgage lenders. By 1977, S&Ls held in their portfolios 44.6% of the nation's outstanding stock of residential mortgage loans, and during that year accounted for 52.4% of all residential mortgage loan originations. Yet, over the last decade the role of S&Ls in the mortgage market, both as originators and as portfolio investors, has declined dramatically. At year-end 1987 S&Ls held in their portfolios only 26.9% of the nation's stock of residential mortgage loans, and S&Ls accounted for only 38.8% of residential mortgage loan originations.

At the same time that S&Ls have declined, the mortgage market has been dramatically transformed by the introduction of financing techniques that convert mortgage loans into securities. In 1977 only 14.6% of 1-4 family mortgage loan originations were "securitized", but this figure had grown to 54.8% by 1987. Mortgage securitization, by directly linking the mortgage market and the capital market, has encouraged major capital market investors, such as pension funds and insurance companies, to expand their investment in mortgage credit.

Moreover, the strong demand in the capital market for mortgage-backed securities has encouraged many lenders who are unable or unwilling to hold mortgages on a permanent basis in their portfolios to become more active as mortgage loan originators. For example, the share of residential mortgage loans originated by mortgage companies and commercial banks rose from 37.5% in 1977 to 49.5% in 1987. By enlarging both the number of originators and the number of ultimate investors, the restructuring of the mortgage market has provided, in general, an adequate supply of mortgage credit, notwithstanding the declining role of the S&L industry.

Of course, the traditional problems of discrimination in mortgage lending and redlining still remain: and there has been an unconscionable failure by our society to provide an adequate supply of housing for lower income persons; and today serious affordability obstacles are encountered even by middle income first-time home buyers. However, these housing problems are the product of continuing lender prejudice and the distorted budget priorities and manifest fiscal irresponsibility of the Reagan era, not a consequence of mortgage market restructuring or the decline of S&Ls. For the affluent, the mortgage market has been booming: and as housing prices continue to escalate, a serious question exists as to whether too much of the savings of our nation's families is being funneled into luxury housing equity instead of being invested in education and industry to improve the productivity and competitiveness of our economy.

b. The future of S&Ls

Reliance on S&Ls as mortgage specialists is not only unnecessary in light of the restructuring of the mortgage market, but also an unsound policy from the perspective of maintaining the safety and soundness of insured depository institutions. Charter requirements that forced S&Ls to specialize in holding mortgage assets resulted in the negative spreads and large-scale losses that weakened many S&Ls in the early 1980's. Given the potential for interest rate instability that characterizes our financial markets, S&Ls can prudently hold a high proportion of their assets in residential mortgage loans only if the loans are adjustable rate mortgages that permit rapid rate increases. In fact, so many S&Ls have limited their portfolio acquisitions to exclusively adjustable rate mortgages in recent years that by year-end 1987 54% of the 1-4 family mortgage loans held by FSLIC insured S&Ls were adjustable rate mortgages.

However, a national policy encouraging the use of adjustable rate mortgages is both undesirable and unnecessary. It is undesirable because it shifts interest rate risk to home buyers. Although adjustable rate mortgage may be useful in some circumstances, for the majority of home buyers they are a time bomb waiting to detonate whenever there is a sharp and prolonged escalation of interests rates. Moreover, primary reliance on adjustable rate mortgages is unnecessary because many capital market investors, such as pension funds and insurance companies, seek long-term, fixed rate investments and thus are in a good position to purchase securities collateralized by pools of long-term, fixed rate mortgages. Thus, from several perspectives -- bank safety, home buyer interest, and financial efficiency -- national mortgage market policies should encourage the linking of the mortgage origination process to the capital market via securitization, rather than forcing S&Ls to hold a high percentage of their assets in residential mortgage loans.

S&Ls should be permitted -- with vigorous oversight to prevent future debacles in commercial mortgage lending -- to diversify their assets within the boundaries of traditional commercial bank lending authority. In fact, the diversification process has already begun at many S&Ls. As recently as year-end 1977, S&Ls collectively held 74.4% of their total assets in residential mortgage loans. By year-end 1987 this percentage had fallen dramatically to 45.9%. On the other hand, during the same 10 year period the share of S&L assets invested in mortgage-related securities rose from 2.8% to 16.1%. Thus, the increase in mortgage-related securities offset less than one-half of the decline in mortgage loan holdings.

From year-end 1980 to year-end 1987 the total assets of the S&L industry grew from $615.3 billion to $1,250.9 billion. Only 20.2% of this massive $635.6 increase in S&L assets was invested in residential mortgage loans, and another 27.5% was invested in mortgage-related securities.

The degree of specialization in mortgage lending should be a decision left to managements of individual S&Ls. Undoubtedly, given their expertise in the mortgage area, many will choose to continue to emphasize mortgage lending. Their charter authority, however, should be no less than -- but, also no greater than -- the charter authority of commercial banks. The unmistakable conclusion is that there is no underlying public purpose in maintaining separate charters for commercial banks and S&Ls.

V. A New Mandate for the Federal Home Loan Banks to Address Today's Housing Finance Needs

a. The Federal Home Loan Banks: Public Purpose Institutions

The Federal Home Loan Bank Act of 1932 authorized the establishment of the 12 Federal Home Loan Banks. The underlying purpose of the Banks was to enhance and stabilize the flow of residential mortgage credit by lending cash advances to S&Ls. The Banks are federally chartered corporations and by federal statute they have a $4 billion line of credit from the Treasury Department. The fact that the federal government stands behind these Banks has enabled them to borrow massive sums at preferred interest rates, lend the funds as cash advances to S&Ls, generate robust income, and build a substantial capital base.

At year-end 1987, the Federal Home Loan Banks had raised $116 billion (outstandings) in the capital market by issuing consolidated bonds and notes and had lent $133 billion (outstandings) in cash advances to S&Ls. The combined equity capital of the Banks was $13.7 billion at year-end 1987 and their combined net income for 1987 was $1.328 billion.

Even though S&Ls elect a majority of the Federal Home Loan Bank directors and hold the capital stock of the Banks, the Banks are clearly public purpose instrumentalities. As the U.S. Court of Appeals for the Ninth Circuit held in Fahey v. O'Melveny 200 F.2d 420 (1952), "the Federal Home Loan Banks are not 'private property' of their member-stockholders but are banking agencies and instrumentalities of the federal government."

b. Diversion of the Federal Home Loan Banks from public purpose to private use

The direct control exercised by S&Ls over the Federal Home Loan Banks not only has resulted in serious conflicts of interest in regard to the supervision of S&Ls but also has diverted the Banks from their intended role as public institutions serving housing credit needs identified by public policy. The current operation of the cash advance program is the most compelling evidence of how far the Banks have slipped from their intended purpose of serving mortgage credit needs.

Cash advances can provide a useful tool to stimulate housing loans and other community development lending because they provide S&Ls with longer term, stable rate funds and also because the preferred rate at which the Banks raise funds can to some extent be passed along to S&Ls borrowing cash advances. Yet, a 1988 GAO study of the cash advance system could not identify any significant way in which this massive funding system was serving housing credit needs. The FHLBB and the Banks allow S&Ls to use cash advances to fund any kind of lending or investment activity. GAO found that as of year-end 1986 for the 54.8% of S&Ls that had cash advances outstanding, mortgage loans on 1-4 family homes represented 47.40% of their combined assets; while for S&Ls without cash advances outstanding, 1-4 family mortgage loans comprised 48.22% of their total assets -- a statistically insignificant difference. Moreover, S&Ls with cash advances tended to use new lending and investment powers more aggressively than S&Ls without cash advances.

One plausible public rationale for the cash advance system is that it can provide smaller S&Ls, who may lack the ability to issue their own debt securities, access to longer term funds. Yet, GAO found that cash advances were used predominantly by large, aggressive S&Ls, not smaller institutions. For example, at year-end 1986 only 35% of S&Ls with assets less than $100 million held cash advances, while 95% of the 207 S&Ls with assets over $1 billion held cash advances. In fact, 45 S&Ls with assets over $1 billion from the Federal Home Loan Bank of San Francisco District held $32 billion in cash advances -- 30% of the entire volume of cash advances outstanding.

GAO also found a clear correlation between use of cash advances and the financial condition of S&Ls. At year-end 1986 S&Ls with cash advances had an average net worth of only 3.4%, compared to 4.8% for S&Ls without cash advances. In the Federal Home Loan Bank of Dallas District, cash advance users had an average net worth of -0.1%, compared to 3.2% for non-users. The GAO study suggests that the cash advance system has been administered by the Banks in a manner that not only fails to serve current mortgage credit needs, but also has weakened safety and soundness discipline at many S&Ls.

While the Federal Home Loan Banks seem to have had little positive impact in serving mortgage credit needs, they have been a very efficient cash generating machine for the S&L industry. For example, over the three year period from 1985 through 1987 the Banks had a cumulative net income of $3.9 billion and paid out $2.8 billion of this income to S&Ls in the form of cash and dividends. Nor have the presidents of the Banks been bashful in voting themselves hefty salaries. In 1988 the average salary of Federal Home Loan Bank presidents was $198,175, compared to an average salary of $157,217 for Federal Reserve Bank presidents.

c. Strengthening the mandate of the Federal Home Loan Banks to serve housing credit and community development needs

The statutory mandate of the Federal Home Loan Banks should be reformed to resurrect the Banks' mission as public instrumentalities and to better focus their credit activities on today's most pressing credit needs -- credit for low and moderate income housing, credit for neighborhood revitalization, and capital for community development corporations. In view of the "securitization" of mortgages, which has linked the mortgage market directly to the capital market, there is no general shortage in the supply of funds for standardized mortgages. However, the many non-standardized credits that are the lifeblood of housing rehabilitation and community development cannot readily be converted into securities. As more and more lending institutions limit their lending activities to loans that can be sold in the secondary market or securitized, the supply of funds for "non-standardized" credits is threatened.

Legislation that bails-out FSLIC should include the following amendments to the Federal Home Loan Bank Act.

1. The Department of Housing and Community Development (HUD) should appoint all directors of the 12 Federal Home Loan Banks. In selecting Bank directors HUD should place special emphasis on persons and representatives of organizations engaged in low and moderate income housing, neighborhood revitalization, and local community development activities.

2. At least 30% of the total volume of cash advances outstanding at each Federal Home Loan Bank should be community development cash advances. A community development

cash advance would be extended to an S&L (or other institution) pursuant to a plan submitted by the S&L indicating that the funds would be used for a community development purpose. A community development purpose could encompass a broad range of lending activities related to low and moderate income housing, neighborhood revitalization, and small business development. Cash advances, which can be provided on a longer-term, stable-rate basis, represent an excellent source of funds for community development lending.

In 1978 FHLBB Chairman Robert Mckinney with the support of President Carter authorized a $10 billion Community Investment Fund (CIF) program under the cash advance system. During the five-year period from June 1978 through June 1983 the cumulative volume of cash advances extended under the CIF program was $7.9 billion. However, under the Reagan Administration the FHLBB lost interest in the CIF program and delegated full authority to the individual Federal Home Loan Banks to abandon or continue the program as suited their interests. Consequently, the program now operates on a vastly reduced scale. For example, during the three year period from 1986 through 1988 the cumulative volume of CIF cash advances was only $720 million.

3. All federally insured depository institutions should be permitted to borrow cash advances from the Federal Home Loan Banks. If a primary purpose of the cash advance system is to support community development lending, then it is important that commercial banks and credit unions have access to the cash advance facility. In particular, commercial banks have far more resources to bring to community development activities than a seriously depleted S&L industry.

4. The Federal Home Loan Banks should invest 20% of their capital in community development corporations (CDCs) and other non-profit entities that focus on low and moderate income housing and neighborhood revitalization efforts. CDCs provide a critical infrastructure for local community development activities, especially housing rehabilitation, and facilitate neighborhood lending by financial institutions. A recent study commissioned by the Ford Foundation entitled Corrective Capitalism (1987) has found that:

> In a decade of contracting federal domestic activity, CDCs along with their allies in churches and other nonprofit organizations, have become the principal suppliers of low-income housing in the United States. ... CDCs in their quiet way, have become a major component of corrective capitalism; in this free-enterprise nation they are finding ways to open doors to classes and individuals otherwise excluded from the American dream.

Yet, lack of capital has severely constrained the growth and role played by CDCs and other non-profit community development entities. As the Ford Foundation's Corrective Capitalism has observed:

> ...the surface has barely been scratched - in neighborhoods covered, in investments made, in financial and corporate assistance mobilized, in public recognition of the central role community development could play in bringing the opportunities of the American economic system to peoples and neighborhoods long excluded.

VI. Full, Fair, and Efficient Funding of the FSLIC Bailout

a. On-budget financing

The approximately $100 billion needed to meet FSLIC's liabilities should be raised by issuing long-term bonds that are the direct obligations of the U.S. Treasury. Resort to off-budget bond financing -- such as the $10.8 billion of Financing Corporation (FICO) bonds authorized by the FSLIC Recapitalization Act of 1987 -- raises the interest cost on the bond issue. For example, the yield on the $700 million of 30-year FICO bonds issued in December 1988 was 9.64% -- 70 basis points above the rate on comparable direct Treasury bonds. Such a premium for off-budget financing, applied to a 30-year $100 billion bond issue, would raise the total financing cost by $21 billion. It would be irresponsible for the President and Congress in the name of budget gimmickry to impose such a needless cost on those who must ultimately foot the bill for the FSLIC bailout, whether they be individual taxpayers, corporate taxpayers, financial institutions, or consumers.

b. Renegotiate FSLIC's recent assistance agreements

The assistance agreements that FSLIC reached in 1988 must be renegotiated in order to reduce the ultimate cost of the FSLIC bailout. During 1988 FSLIC resolved 217 insolvent savings and loans by issuing $38 billion in liabilities to acquiring firms: approximately $20 billion in 7 to 10 year FSLIC notes and an estimated $18 billion of asset yield maintenance and asset value guarantees. The $20 billion in FSLIC notes issued to S&L acquirors represents a high cost source of bailout funding. The interest that FSLIC pays on these notes is tax exempt and thus they are a hidden drain on Treasury tax revenues. Notwithstanding their tax-exempt status, these notes bear interest rates that are quite high -- often set at the cost of funds for Texas S&Ls plus a mark-up, such as 50 basis points. Long-term Treasury bonds should be issued and substituted for these FSLIC notes. President Bush in proposing to issue $50 billion in long term bonds overlooked the need to refinance the $20 billion in outstanding FSLIC notes. Substitution of lower cost Treasury bonds for the high cost FSLIC notes will require renegotiation of the agreements.

Moreover, the President did not indicate a reliable source of funding for FSLIC's anticipated cost of $18 billion on yield maintenance and asset guarantee commitments.

The FSLIC assistance agreements often fail to provide adequate incentives for the prudent management of the acquired institutions. Many acquirors have invested little of their own cash or equity in the acquired institutions. In many cases the cash injected by the acquiror is less than 1% of the institution's total deposit liabilities, so the acquiror has the same incentive to gamble with the institution as have managements of near-insolvent institutions.

In negotiating these agreements, FSLIC often granted the acquirors exemptions from important safety and soundness rules, such as capital requirements, accounting requirements, and limits on speculative investments. Probably, the most notorious of these safety and soundness waivers is the provision allowing Robert Bass to invest $1 billion of the deposits of American Savings Bank of Stockton, California in investment banking activities, such as financing corporate take-overs and leveraged buy-outs.

Moreover, a number of the agreements appear to authorize the acquiror to assign certain insured deposits to a phantom bank -- known as an "air bank" in the parlance of S&L lawyers -- in the event that FSLIC defaults on any FSLIC notes held by the acquiror. These provisions seem to be designed to allow the acquirors to dump insured depositors out on the street in retaliation against a FSLIC note default.

Some observers contend that the contract clause of the Constitution prevents renegotiation of these high cost, unsound assistance agreements. Yet, careful review of this issue suggests that Congress could enact FSLIC bailout legislation containing renegotiation requirements that would pass constitutional muster. First, it is questionable whether FSLIC had authority to negotiate assistance agreements that resulted in the issuance of $38 billion in FSLIC liabilities to acquirors. The FSLIC Recapitalization Act of 1987 placed a cap of $10.8 on the issuance of FICO bonds, and it is clear that Congress intended that FSLIC return to Congress for additional resources rather than issuing $38 billion in unfunded liabilities. Second, provisions allowing acquirors to shift insured deposits to phantom banks are a breach of FSLIC's fiduciary duty to protect insured depositors. Third, and most important, Congress retains broad authority to set the terms and conditions of access to federal deposit insurance, and this includes the power to modify the terms of any agreement involving a federally insured depository institution. These agreement are not isolated contracts, but undertakings within a constantly evolving scheme of deposit insurance regulation.

c. Using deposit insurance premiums to fund the bailout cost

Most of the cost of the FSLIC bailout will be borne by those who have to pay the interest on the $100 billion of bailout debt. Given current rates on Treasury bonds, the annual interest cost of a $100 billion FSLIC bailout will be approximately $9 billion per year or a 30 year total interest cost of $270 billion. Given the huge size of this annual interest requirement, it is essential that a new revenue stream be established to fund it. If this is not done, then the cost will exacerbate the federal deficit and squeeze out vitally needed expenditures, such as those for low income housing and education.

It is not realistic to look to the savings and loan industry to fund a large share of the interest payment on the FSLIC bailout debt. Savings and loans, by themselves, clearly lack the resources needed to bear this cost. Moreover, imposing even a large share of the cost on S&Ls would be counterproductive, since it would place them at a major competitive disadvantage and drive more toward insolvency. For the same reason, the deposit insurance premium rate for S&Ls and commercial banks should be equalized. In the long run, it is likely to cost taxpayers even more money if the premium rate structure forces S&Ls to operate at a competitive disadvantage vis-a-vis commercial banks.

Allocating the entire bailout cost collectively to both commercial banks and S&Ls would require a large increase in federal deposit insurance premiums. The premium rate would have to jump to about 40 cents per $100 from its current level of 8 cents per $100 at FDIC and 21 cents per $100 at FSLIC. Banking institutions would tend to pass a major cost increase of this nature along to depositors and borrowers who have the least bargaining power -- small depositors who cannot shift their deposits into money market mutual funds and small businesses that are dependent on local banks for loans. The upshot would in all likelihood be a major new round of fee and service charge hikes on small balance deposit accounts, higher rates on small business loans, and a spate of branch closings in inner city neighborhoods. Thus, without some safeguard mechanism, any major increase in deposit insurance premiums would tend to be passed on in this fashion to the less affluent segments of society.

The only way that deposit insurance premiums can be used to fund a major share of the FSLIC bailout without having the cost shifted to bank customers in an extremely regressive manner is to accompany the premium increase with safeguards to protect the less affluent bank customers. The necessary safeguards are lifeline banking requirements, strengthening the Community Reinvestment Act, and branch closing limitations. In fact, such legislation was passed by the House Banking Committee in 1988 -- so, there is already good reason for Congress to enact such measures. However, reliance on deposit insurance premiums as a major source for FSLIC bailout funding will elevate the need for such safeguards to a critical level.

Moreover, if an increase in deposit insurance premiums is going to be used to cover a substantial share of the FSLIC bailout cost, then a comparable assessment should be imposed on money market mutual funds. These funds, which currently total about $300 billion, provide a close substitute for transaction and savings balances at depository institutions. A major increase in deposit insurance premiums coupled with rules to prevent cost-shifting to less affluent bank customers would give banking institutions few options other than to lower interest rates paid on all deposits. This would tend to encourage disintermediation -- the shifting of consumer funds from bank deposits to money market mutual funds. Since money market mutual funds invest only in high quality money market instruments and have no capacity to engage in local community and small business lending, it is unwise to unleash incentives for disintermediation. Thus, an assessment should be imposed on money market mutual funds to neutralize the disintermediation effect of any major increase in deposit insurance premiums.

Moreover, such as assessment is appropriate as a matter of equity, since money market mutual funds are in essence free-riders on the banking system. Money market mutual funds are able to offer transaction account services because they maintain clearing balances with banking institutions; yet, the cost of operating the banking system -- which performs the underlying deposit and payment functions -- is assessed to banking institutions, not money market mutual funds.

d. Realistic and fair options for funding the FSLIC bailout

Four options for creating a new federal revenue stream of approximately $10 billion per year that can be earmarked for the FSLIC bailout are presented below. A long-term revenue stream of this magnitude is needed to service the annual interest payments on the $100 billion FSLIC bailout debt. Should the FSLIC deficit turn out to be $200 billion instead of $100 billion, then combining two options would generate the necessary annual revenue stream of $20 billion per year.

Funds to repay the $100 billion principal of the bailout debt upon maturity can be generated by having the federal deposit insurance funds purchase $10 to $15 billion of long-term, zero-coupon Treasury securities during the early years of the bailout process.

1. Increase the marginal individual federal income tax rate from 28% to 33% for persons in the highest income tax bracket

The existing marginal rate structure of the federal individual income tax law is grossly inequitable. Persons in the next to highest income tax bracket pay a marginal rate of 33%, while persons in the highest income tax bracket -- about the top 1% of income recipients -- pay a marginal rate of only 28%. This change in the tax code would subject persons in the highest income bracket to the same marginal rate as persons in the next to highest income tax bracket. This would be a correction of a wholly insupportable drafting "accident" in the 1986 tax law. This change, which is warranted on equity grounds alone, would generate approximately $10 billion in new tax revenues per year.

2. A one-half percent transaction tax on the sales of equity securities

In 1987 the aggregate dollar volume of registered stock transfers in the U.S. was $2.284 trillion. A one-half percent tax on stock sales could be expected to generate approximately $10 billion in new annual federal revenues. Moreover, it would tend to dampen stock speculation and encourage longer-term investment strategies, a goal endorsed by the Bush Administration.

3. Increased deposit insurance premiums and new excise taxes on mutual funds, junk bonds, LBO financings, and mortgages on luxury homes

This combination of financial assets and liabilities provides a sufficient tax base to generate $10 billion per year in new federal revenues. Additionally, an excise tax should be imposed on investment banking fees associated with hostile take-overs and LBOs. The recent RJR Nabisco buy-out resulted in almost $1 billion in fees.

4. A 10% surtax on the corporate income tax

Revenues from the federal corporate income tax are estimated to be $107 billion for FY 1989. Thus, a 10% surtax would generate approximately $10 billion in new revenues.

Conclusion

In conclusion, it does not follow that the Bush government has to place the burden of the FSLIC bailout on the backs of those taxpayers who are the least able to pay or who labor productively far removed from the gyrations of the financial sector. Instead, the burden for this massive financial debacle should fall primarily on those entities and taxpayers most able to pay or engaged in financial activities providing only limited or arguable productive benefit to society.

This bailout should also provide the occasion for regulatory and structural reform that provides both public and organized consumer checks against future repetitions of this speculative and sordid situation from early alerts to later accountability. Finally, these reforms can redirect depositors funds into more housing credits to enhance the homeownership that S&Ls were suppose to be facilitating.