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SUMMARY OF THE NADER REPORT ON THE S&L CRISIS

The Ralph Nader study, Report To U.S. Taxpayers On The Savings & Loan Crisis, February 1989, presents a comprehensive plan to address the savings and loan crisis. Key recommendations of the Nader report are as follows:

** A set of reforms to deter unsound banking practices and fraud in future years -- tough new standards for civil and criminal liability on the part of bank officers for negligence, fraud, and self-dealing; prohibition of investments in real estate equity; deposit growth ceilings for weak institutions.

** A federal policy that does not force S&Ls to invest a high percentage of their assets in mortgage loans

** Equalization of deposit insurance premiums paid by S&Ls and commercial banks.

** A new mandate for the 12 Federal Home Loan Banks to use their resources to support neighborhood revitalization and local community development -- 30% of cash advances earmarked for community development purposes; commercial bank and credit union access to the cash advance facility; and divorce of the 12 Banks from S&L supervision.

** Four options for raising $10 billion per year to help cover the cost of the FSLIC bailout -- without new federal revenues of this magnitude two-thirds or more of the bailout cost will be borne by individual taxpayers at large.

I. Safety and Soundness Reform

Restrict investment powers. Investment in real estate equity, which is risky in and of itself and also undermines objectivity in credit judgments, has been a principal cause of S&L failure. A 1987 FHLBB study of the condition of 33 California S&Ls that had made extensive real estate equity investments in the early 1980's found that by 1986 5 of these institutions had failed, 1 had merged, and the remaining 27 had an average net worth of 0.3% and an average return on assets of negative 3.3%.

A number of states, including Texas and California, have granted state chartered S&Ls broad authority to invest in real estate equity and other kinds of direct investments. The imprudence of this policy is manifest in the massive losses that state chartered S&Ls have imposed on FSLIC. In October 1988 the FHLBB calculated that state chartered S&Ls, which represent only 36% of the total assets of all

FSLIC insured institutions, are responsible for 81% of FSLIC's current losses.

Federally insured S&Ls, both state chartered and federally chartered, should be prohibited from making real estate equity or other direct investments. Also, S&L holding companies should not exercise real estate equity investment powers broader than those available to bank holding companies.

Officer and director liability for misconduct. A recent GAO review of 26 S&L failures and 184 commercial bank failures found in virtually every case "a breach of [management's] fiduciary duty to operate a financial institution in a safe and sound manner." In particular, GAO found management fraud or insider abuse in 100% of S&L failures and 64& of commercial bank failures.

Greater officer and director liability for misconduct in operating federally insured deposit institutions is vitally needed in order to instill greater fiduciary discipline in bank managements. Uninsured depositors and individual shareholders should be given standing to bring direct suits (as opposed to derivative suits) against officers and directors for bank misconduct that leads to failure. A cause of action for bank misconduct should arise whenever fraud, negligence, or self-dealing have contributed to the failure of a federally insured institution. Once a civil or criminal suit for bank misconduct has been filed, the court should have clear authority to issue a pre-trial freeze order to prevent the dissipation of assets by the defendants. Both private plaintiffs and the government should be authorized to recover treble damages in bank misconduct suits.

II. Future Role of S&Ls

Requiring or encouraging S&Ls to hold a high percentage of their assets in residential mortgage loans should no longer be a goal of federal financial regulatory policy. Concentration of residential mortgage loans in the portfolios of S&Ls creates an inherently unstable situation. If the mortgage loans are fixed rate, then S&Ls are playing interest rate roulette and whenever interest rates escalate the deposit insurance funds and ultimately taxpayers will have to cover their losses. On the other hand, if the mortgage loans are adjustable rate mortgages (ARMs), then they become interest rate time bombs in the hands of individual home owners.

Adjustable rate mortgages. In fact, many S&Ls with a portfolio concentration in residential mortgages have become very aggressive in shifting interest rate risk to home owners in the form of ARMs that allow rapid rate increases. S&Ls using "teaser" rates and other hard sell tactics have pushed so many ARMs on home buyers in recent years that by year-end 1987 54% of the 1-4 family mortgage loans held by FSLIC insured institutions were ARMs. Home owners with ARMs will get a taste of interest rate shock this spring and summer when the interest rate on their ARMs is scheduled for a sharp upward jump. On a typical ARM -- whose rate is often tied to the interest rate on 1 year Treasury securities -- the interest rate is likely to jump 2 full percentage points from 9 3/8 % to 11 3/8%. While ARMs may be useful for affluent and upwardly mobile home buyers, they are not a suitable mortgage instrument for persons with moderate incomes or limited upward mobility.

Overall supply of mortgage credit. The restructuring of the mortgage market during the last 15 years has greatly expanded the number of mortgage originators and mortgage investors. For example, during 1987 54.8% of the 1-4 family mortgage loan originations were converted into mortgage-related securities, many of which were purchased by pension funds, insurance companies, and other capital market investors that seek long-term fixed rate investments. Thus, even though the share of the nation's stock of residential mortgage loans held by S&Ls has declined from 44.6% in 1977 to 26.9% in 1987, there has been no shortage in the overall supply of mortgage credit.

Moreover, the new risk-based capital rules recently adopted by the Federal Reserve Board, Comptroller of the Currency, and the FDIC will provide an incentive for commercial banks to increase their holdings of mortgage loans and mortgage-related securities. Under these rules the risk-adjusted capital requirement for residential mortgage loans is only 4%, compared to a capital requirement of 8% for commercial loans.

Many S&Ls will undoubtedly continue to specialize in mortgage lending, especially the origination of 1-4 family mortgage loans; but, the restructuring of the mortgage market eliminates the need to require S&Ls to hold a large share of their assets in residential mortgages in order to assure an adequate supply of mortgage credit; while the spectre of interest rate risk now renders such forced specialization unsafe and unsound for both the deposit insurance funds and individual home owners. Consequently, S&Ls should be allowed to diversify within the boundaries of traditional commercial bank lending authority. The inevitable conclusion is that there is no public purpose in maintaining separate charters for commercial banks and S&Ls.

Equal deposit insurance premiums for S&Ls and commercial banks. S&Ls presently pay deposit insurance premiums to FSLIC at a rate that is more than two and one-half times greater than the premium rate that FDIC charges commercial banks. If S&Ls are required to pay a substantially higher premium rate than commercial banks for an extended period of time, this will force them to operate at a significant competitive advantage, weaken their ability to rebuild their capital base, and ultimately drive more toward insolvency. Such a policy would be shortsighted and counterproductive. It might earn FSLIC additional revenues up front, but in the long-run FSLIC's costs would be higher and taxpayers are likely to have to pay more. Clearly, the appropriate policy is to equalize deposit insurance premiums for S&Ls and commercial banks.

Equalization of deposit insurance premiums implies that commercial banks may be required to contribute to the FSLIC bailout -- unless S&L and commercial bank premiums are both set so low that there is no effective contribution from either source. The notion of commercial bank contribution, although evoking shrill protests from the commercial banking lobby, is not inequitable. Federal deposit insurance, like other forms of insurance, is a risk pooling system under which healthy members pay to cover the costs of sick members. Under the circumstances, it is reasonable for Congress to view both FSLIC and FDIC insured institutions as comprising the underlying risk pool and to adopt a premium equalization strategy.

III. Reform of the Federal Home Loan Banks

Pressing credit needs. While the overall supply of mortgage credit is adequate, there are many specific unmet or underserved credit needs. These run the gamut from credit for low and moderate income housing, housing rehab loans, credit and capital for non-profit housing developers and local community development entities, to intermediate term credit for small business. These gaps in credit availability are caused by various factors: patterns of disinvestment in older urban neighborhoods; racial discrimination; standardization of mortgage loans; and lender reluctance to extend fixed-rate financing. In particular, many depository institutions are limiting their lending activities to loans that can be resold in the secondary market or securitized. Yet, the non-standardized credits that are the lifeblood of housing rehabilitation and community development cannot be sold into secondary markets or securitized. Moreover, in the case of credit and capital for low income housing, substantial subsidies are needed to surmount the affordability barrier.

The Federal Home Loan Banks: public instrumentalities diverted to private use. The Federal Home Loan Bank Act of 1932 authorized the establishment of the 12 Federal Home Loan Banks as "instrumentalities of the federal government." The purpose of the Banks was to stabilize and enhance the flow of residential mortgage credit by raising funds in the capital market and lending "cash advances" to S&Ls. The Banks have prospered and today their financial resources are enormous. On a consolidated basis, the 12 Banks have a $14 billion capital base; $130 billion in debt securities outstanding; $145 billion in cash advances (loans) outstanding to S&Ls; and in 1987 they had a robust net income of $1.3 billion.

However, as presently operated the cash advance system is not supporting the mortgage market in a manner that provides discernible public benefit, but rather is being used by S&Ls to balloon their balance sheets. The FHLBB and the Federal Home Loan Banks allow S&Ls to use cash advances to fund any kind of lending or investment activity. In fact, a 1988 GAO study of the cash advance system could not identify any way in which this massive funding mechanism was serving housing credit needs. Moreover, the cash advance function envisioned by Congress in 1932 -- providing S&Ls with access to the capital market and liquidity -- has in large measure been rendered obsolete by the growing ability of S&Ls to access the capital market directly through mortgage securitization and to use the secondary market as a source of liquidity.

<u>A new mandate for the Federal Home Loan Banks to focus on unmet and underserved credit needs</u>. The statutory mandate of the Federal Home Loan Banks should be reformed to resurrect the Banks as public instrumentalities and to focus their credit activities on today's most pressing credit needs. To accomplish this goal the Federal Home Loan Bank Act should be amended as follows.

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.

3. All federally insured depository institutions should be permitted to borrow cash advances from the Federal Home Loan Banks (i.e., commercial banks and credit unions, as well as S&Ls).

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.

There is strong precedent for a major community development cash advance program, the centerpiece in the proposed resurrection of the Federal Home Loan Banks. At the urging of President Carter, the 12 Federal Home Loan Banks in 1978 implemented a special cash advance program, known as the Community Investment Fund (CIF). Under the CIF Program cash advances were extended at preferential interest rates to S&Ls that had developed a specific plan for community development lending. From 1978 to 1983 $7.9 billion in cash advances were extended under the CIF Program. However, under the Reagan Administration the FHLBB, which oversees the 12 Federal Home Loan Banks, lost interest in the CIF Program and today it survives on a greatly reduced, caretaker basis.

Divorcing the Federal Home Loan Banks from S&L supervision. The 12 Federal Home Loan Banks play a major role in the safety and soundness supervision of S&Ls. Given that S&Ls elect a clear majority of the directors of the Banks, assigning supervisory functions to the Banks creates a severe conflict of interest and has been a major factor in the lax supervision of S&Ls.

Further, resurrection of the Federal Home Loan Banks under a new credit needs mandate will provide further reason for divorcing the Banks from supervisory functions. As the S&L debacle has painfully demonstrated, the promotion of housing credit does not mix well with safety and soundness supervision. supervision do not mix well.

IV. Funding the FSLIC Bailout Cost

Over the next few years the federal government will need to raise at minimum $100 billion in cash to fund the FSLIC bailout -- $50 billion in new funds under the Bush plan, $38 billion to refinance FSLIC's high cost outstanding liabilities, and a $10 billion FSLIC contingency fund for additional S&L failures. At current interest rates, just servicing the interest cost on the $100 billion bailout debt will require a federal payment of $9 billion per year. Moreover, above and beyond the interest cost is the need for additional revenue streams to recapitalize FSLIC, strengthen FDIC, and pay the principal on the $100 billion bailout debt at maturity.

Even under the heroic assumption that a combination of deposit insurance premiums, recovery from S&L asset liquidations, and other FSLIC revenues will be sufficient to fully recapitalize the insurance funds and pay off the $100 billion bailout debt at maturity, the $9 billion annual interest payment will inevitably be a charge against federal revenues. If a new federal revenue stream of at least $9 billion per year is not created by Congress, then this annual interest charge will exacerbate the federal deficit and force more cutbacks in social spending or increased taxes born by taxpayers at large.

The correct approach to funding the FSLIC bailout is to impose the cost of generating new federal revenues on individuals or sectors that have benefited from inequities in the tax code or are engaged in speculative financial activities that should be dampened. Four reasonable options are presented below for raising the federal revenues needed to fund the annual interest cost on the bailout debt in an equitable and productive manner. Each of these options would raise approximately $10 billion per year in new federal revenues.

a. An increase in the marginal federal individual income tax rate from 28% to 33% for persons in the highest income tax bracket.

b. A one-half percent transaction tax on the sale of equity securities.

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

d. A 10% surtax on the corporate income tax.