NBER WORKING PAPER SERIES

HOW INCENTIVE-INCOMPATIBLE DEPOSIT-INSURANCE FUNDS FAIL

Edward J. Kane

Working Paper No. 2836

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
February 1989

The author is Everett D. Reese Professor of Banking and Monetary Economics at Ohio State University and Research Associate, National Bureau of Economic Research. He wishes to thank Richard C. Aspinwall, Stephen Buser, Ronald Bolton, Charles Calomiris, W. Arthur Cullman, Myron Dale, Susan Faller, Benjamin Friedman, Benson Hart, J. Huston McCulloch, Anna Prochnow Educational Foundation for financial support. This paper extends Kane (1987a). Opinions expressed are the author's alone and should not be construed to represent those of the Prochnow Foundation or the National Bureau of Economic Research.

NBER Working Paper #2836
February 1989

HOW INCENTIVE-INCOMPATIBLE DEPOSIT-INSURANCE FUNDS FAIL

ABSTRACT

An incentive-incompatible deposit-insurance fund (IIDIF) is a scheme for guaranteeing deposits at client institutions that deploys defective systems of information collection, client monitoring, and risk management. These defective systems encourage voluntary risk-taking by clients and by managers and politicians responsible for administering the fund.

The paper focuses on how principal-agent conflicts and asymmetries in the distribution of information lead to myopic behavior by IIDIF managers and by politicians who appoint and constrain them. Drawing on data developed in legislative hearings and investigations and in sworn depositions, the paper documents that managers of IISIFs in Ohio and Maryland knew well in advance of their funds' 1985 failures that important clients were both economically insolvent and engaging in inappropriate forms of risk-taking. It also establishes that staff proposals for publicizing and bringing these clients' risk-taking under administrative control were repeatedly rejected.

The analysis has a forward-looking purpose. Congress and federal regulators have managed the massively undercapitalized Federal Savings and Loan Insurance Corporation (FSLIC) in much the same way Ohio and Maryland officials did. Unless and until incentives supporting political, bureaucratic and private risk-taking are reformed, the possibility of a FSLIC meltdown cannot be dismissed. To encourage timely intervention into insolvencies developing in a deposit-insurance fund's client base, the most meaningful reforms would be to force the development and release of estimates of the market value of the insurance enterprise and to require fund managers to use the threat of takeover to force decapitalized clients to recapitalize well before they approach insolvency.

Edward J. Kane
Center for Financial System Research
Arizona State University
College of Business
Tempe, AZ 85282

HOW INCENTIVE-INCOMPATIBLE DEPOSIT-INSURANCE FUNDS FAIL

Edward J. Kane

In late 1984, eleven state-based guarantee funds underwrote deposit insurance for about 650 state-chartered thrift institutions. Since then, as Table 1 indicates, state-based funds have shrunk greatly in importance. Four have been declared insolvent, one no longer has any thrift clients, and three others are winding down their operations. The remaining three have decided to limit sharply the business they underwrite. This paper argues that these funds' problems and prior insolvencies of deposit-insurance funds in Mississippi (1976) and Nebraska (1983) illustrate the virtual impossibility of preventing incentive-incompatible insurance schemes that are not reformed from being overrun eventually by client insolvencies.

Incentive incompatibility exists when an insurer's pricing, client-monitoring, and risk-management procedures lead contracting parties to pursue risks that undermine fund reserves. Incentives supporting innovative forms of risk-taking are particularly defective. The aggregate size of these incentives increases with the volatility of the financial environment, with opportunities for degrading the flow of information to regulators or taxpayers, and with the extent to which regulators count on exacting implicit post-government compensation (i.e., an ex post settling up) for their term of regulatory service (Kane, 1988).

The analysis begins with the hypothesis that information asymmetries and other principal-agent problems make government-based deposit insurers slow to see the extent to which clients' reliance on innovative financial instruments and activities threatens the solvency of the funds they administer or protect. Even when fund administrators finally see the dangers inherent in client innovations, absence of takeover discipline makes them slow to control their funds' exposure to these risks. These two lags permit aggressive clients to extract unintended subsidies to risk-taking. If and when risks taken by these clients produce hidden losses that loom large relative to fund size, the political pressure and short horizons under which the administrators operate make it advantageous for officials to temporize and to tolerate endgame gambles by failing clients. Opportunities for effecting a reputationally clean getaway to a better job encourage regulators to provide relief from capital requirements precisely when the continued solvency of associated insurance funds most strongly demands that such requirements be enforced.

The paper draws on a variety of court and legislative documents to slow empirically that this model of recognition and action lags and joint regulator-client gambling accounts for the 1985 demise of both the Ohio Deposit Guarantee Fund (ODGF) and the Maryland Savings-Share Insurance Corporation (MSSIC). The analysis has a forward-looking purpose. Congress and federal regulators have taken the massively undercapitalized Federal Savings and Loan Insurance Corporation (FSLIC) far down a parallel road. Unless and until incentives supporting incompatible bureaucratic, political, and private risk-taking are reformed, the specter of a parallel meltdown by FSLIC cannot be dismissed. However, the successful adjustments made by state-based funds in Pennsylvania and North Carolina indicate that FSLIC's affairs could be put in order without crisis if the political will could be developed to acknowledge and allocate hidden losses.

The fundamental issue in financial reform is the need to restructure government regulators' and politicians' incentives. These officials are engaged in a complex game of rescue. In this game, officials are rewarded for solving "problems" that they first exacerbate by implicit subsidies that are long-lived and addictive and for helping persons and institutions that they or their predecessors first victimize.

The recurrence of regulatory scandals and crises testifies to the ability of both private and governmental regulators to conceal for long periods relevant information on the effects and quality of their performance. This experience suggests that, once a substantial amount of adverse information is being covered up, regulators become more concerned with avoiding a bad press than with delivering their best-efforts regulatory performance. Given officials' sensitivity to criticism, the most meaningful regulatory reforms promise to be those that would either improve the flow of timely information on regulator performance or otherwise restrain the production of hidden regulatory subsidies and attendant losses by regulatory bureaus.

I. An Overview of the ODGF and MSSIC Crises

In March 1985, the partial banking holiday associated with the failure of ODGF sent shock waves reverberating through the world financial system. These shock waves contributed to the May 1985 failure of MSSIC two months later. However, as it became clear that Ohio, Maryland, and federal taxpayers were going to pick up the bill for these failures, the system settled down again.

This paper portrays both ODGF and MSSIC as small-scale versions of the massively undercapitalized Federal Savings and Loan Insurance Corporation (FSLIC). We study the pathology of the ODGF and MSSIC failures and bailouts to learn how ODGF's and MSSIC's longstanding economic insolvency degenerated into a crisis of confidence. Given FSLIC's continuing economic insolvency, this knowledge may help us to avoid a replay of ODGF and MSSIC experience on the federal level. Observers need to understand that the ODGF, MSSIC, and FSLIC became insolvent because incentive-incompatible deposit-insurance contracts induce undesirable political, bureaucratic, and private risk-taking behaviors. Incentive defects make the occurrence of de facto insolvencies in unreformed insurance funds inevitable.

A lesser theme of the paper is that the ODGF failure occasioned a worldwide financial disturbance, not because of the size of the insolvency, but because State and federal politicians made a surprising (albeit short-lived) attempt to duck out of what the market conjectured to be their responsibility for backing up ODGF resources. The temporary unwillingness of State authorities to make good the losses suffered by ODGF amounted to their calling the equivalent of a timeout to assess the relative willingness of State taxpayers and federal authorities to bear the costs of keeping ODGF-insured depositors whole. In calling a prolonged banking holiday for ODGF institutions instead of promptly promising to recapitalize the guarantee fund, Ohio's Democratic governor challenged the Republican-controlled State legislature and federal regulators and politicians to a multisided game of chicken. Playing out this game confirmed market participants' long-standing presumption that in a political showdown the concentrated interests of depositors in troubled institutions tend eventually to overcome the diffuse interests of the various taxpayers that the U.S. financial system makes into risk-bearers of last resort.

The spectacular and corrupt failure of a securities firm (E.S.M. Securities in the case of ODGF and Bevil, Bresler, & Schulman for MSSIC) and the imprudently large exposure of one or more large client thrifts to this single credit were the proximate causes of both ODGF's and MSSIC's demise. However, the ultimate cause was the false security that extensive ODGF and MSSIC guarantees gave to depositors in insolvent clients and to other insured firms. The insurers' official seals and corporate names were widely mistaken as evidence of formal state backing. As unrealized losses at ODGF and MSSIC institutions grew increasingly larger than fund reserves, this security became more and more illusory because it placed a correspondingly greater burden on state regulators to oversee insured institutions ever more skillfully.

Common sense holds that it is not sensible to depend on others (particularly politicians and bureaucrats) always to act sensibly. In driving one's car, for example, depending on other drivers to behave optimally is a sure formula for eventual disaster. Using this perspective, the paper maintains, not that the colorful individuals involved in these funds' demise were blameless, but that deposit-insurance incentives sorely and perversely test the limits of participants' moral and financial integrity. No guarantee scheme could endure forever whose information, monitoring, and regulatory-response subsystems put the interests of so many politicians, regulators, and S&L executives so deeply into conflict as ODGF's and MSSIC's did. The analysis develops the premise that only by refusing to let the search for individual scapegoats serve as a political palliative can we make progress on the vital task of building a more durable system of federal deposit insurance.

Adam Smith notes man's natural propensity to truck, barter, and exchange. Kane (1988) develops a model of incentive cross-over points for regulators that implies a parallel natural propensity for otherwise-honorable politicians and bureaucrats to deny and cover-up massive insolvencies at government-insured financial institutions and to bailout affected parties once a shortage is incontrovertably revealed. Congress' repeated resistance to adequately recapitalizing FSLIC exemplifies this propensity. This proclivity toward deception and myopia is rooted in officials' desire to project a favorable image of their capacity to control the events that fall within their administrative purview, their interest in developing and sharing regulatory rents, and their belief that current taxpayers are relatively insensitive to the deferred costs of following cover-up and bailout policies. Presuming that regulators engage in self-interested, career-enhancing conduct rather than purely altruistic behavior makes it unreasonable for taxpayers to expect public servants charged with managing deposit-institution insolvencies to give them voluntarily either an honest count or an honest deal. If taxpayers truly want an honest count and an honest deal, they are going to have to demand laws that apply meaningful sanctions to public servants that do not promptly disclose information indicative of poor performance.

II. Preliminary Concepts: Insolvency, Insolvency Resolution, Runs, and Information Suppression

Insolvency. Insolvency exists *de facto* when an institution loses the autonomous capacity to discharge its liabilities. To an economist, this condition is synonymous with an institution's net worth becoming negative. Economic insolvency occurs when the market value of an organization's nonequity liabilities exceeds the market value of its assets. This definition proceeds in terms of the firm's expanded balance sheet, recognizing all explicit and implicit sources of value to the firm and all explicit and implicit nonequity claims against it. To the economist, the idea of an "off-balance-sheet item" is an oxymoron (i.e., a contradiction in terms).

Accountants employ different concepts of insolvency and net worth. For many items, accountants substitute book values (which often embody adjusted or unadjusted historical costs) for market values and typically neglect potentially important categories of assets and liabilities. Rules which dictate permissible substitutions and omissions are embodied in what accountants call "generally accepted accounting principles."

U.S. deposit-institution regulators' closure rules turn on an inherently more discretionary concept of *de jure* or legal insolvency. This concept is even more amorphous than accounting insolvency. If regulators choose, they may selectively and asymmetrically recognize sources of income or capital gains and defer losses or capitalized costs that generally accepted accounting principles would treat more conservatively. In practice, regulators tend to focus primarily on a troubled institution's liquidity: its capacity to cover its debts as they come due or accrue. Since (except in the most extreme cases of economic insolvency) collateralized last-resort lending from an institution's Federal Reserve or Federal Home Loan Bank can maintain this capacity, using a liquidity criterion puts the legal solvency of deeply troubled firms squarely into the hands of federal officials.

Methods of Insolvency Resolution. When a firm becomes economically insolvent, the downside risk from its continuing operations accrues predominantly to its creditors or (when the debt is guaranteed) to its guarantors. Given their exposure to moral hazard in an undercapitalized firm, creditors and guarantors typically insist on covenants that effectively give them the right either to accelerate their claims or to take over an insolvent borrower unless its stockholders promptly inject new capital into its balance sheet.

Because it is politically awkward to permit a deposit institution to operate in an officially insolvent condition, until recently a de jure insolvency generally impelled regulators to close its doors. An institution's formal failure may be resolved in either of three ways: by a liquidation and payoff (in which the proceeds from disposing of the firm's assets are divided among creditors and guarantors), by a private acquirer's undertaking a comprehensive or selective asset-purchase and deposit-assumption transaction, or by a government takeover (which is invariably conceived to be temporary). However, instead of declaring an official insolvency, authorities may demand that stockholders go to private capital markets to recapitalize the firm or act to bailout the firm by providing it or its acquirer explicit or implicit financial assistance on below-market terms. While the concept of explicit financial assistance is a straightforward one, implicit assistance can take many and subtle forms. The subtlest and quantitatively most important form of assistance a guarantor can give consists of turning a blind or nearly blind eye to a debtor's economic insolvency. A guaranteed, but insolvent debtor faces strong incentives to make risky financial plays. It is uneconomic for a guarantor not to protect itself against these incentives by exercising takeover options established by the guarantee contract when they are "in the money" or by at least negotiating a quid pro quo for its forbearance, such as by taking an explicit warrant position. Neglecting a client's insolvency implicitly transfers capital funds from the guarantor (in these cases, the Ohio and Maryland taxpayer, including other ODGF and MSSIC members) to managers, stockholders, and unguaranteed (or imperfectly guaranteed) creditors of the insolvent firm. Moreover, such neglect sets up incentives for managers of the decapitalized firm to engage in risky endgame plays that tend to increase the value of the implicit transfer the longer and more completely the guarantor forbears from intervening to control its exposure to losses from the firm's continuing operations. Forbearance occurs primarily because agents that are supposed to act on behalf of the guarantor find it in their own career interest to try to deny, cover up, or use taxpayer resources to buy their way out of recognizing particular classes of insolvency.

In Ohio, Home State Savings Bank was destroyed primarily by $145 million in losses incurred through inappropriately heavy and apparently corrupt securities lending to E.S.M. Securities, Inc. (ESM). Examiners for the State first discovered this problem in 1980 when losses were still small and went on to recommend strong and immediate action. However, in ostrich-like fashion successive state superintendents of the Ohio Division of Savings and Loans (ODSL) chose to forbear. Table 2 shows that, for several years before its 1985 failure, Home State Savings was economically insolvent. Moreover, the addendum documents ODSL examiners' concerns about the firm's exposure to losses in ESM. The not-insubstantial contemporaraneous value of Home State stock traced to its managers' ability to keep ODGF and State officials from closing the firm. Although Home State's *de facto* insolvency and its exposure to further losses in ESM were recognized by ODSL examiners, the State's regulatory braintrust chose not to enforce in full the economic interests of other ODGF members and Ohio taxpayers. It settled for negotiating a series of nonbinding supervisory agreements that, until March 1985, Home State's management abrogated with virtual impunity. Instead of getting tough with Home State management and stockholders, the ODGF approved each dividend requested and political appointees heading the ODSL repeatedly approved new branch offices and deferred meaningful disciplinary action, leaving the problem festering for their successors. As Home State's difficulties grew in size and complexity, the situation became as hard to handle as a box of unstable explosives.

In Maryland, the net worth of several large S&Ls was destroyed over a period of years by a variety of fraudulent self-enrichment activities. Although State examiners uncovered considerable evidence of irregularities, these institutions were permitted to adopt aggressive growth strategies in which high deposit rates were used to raise funds for use in highly speculative acquisition, development, and construction loans. As late as April 29, 1985, MSSIC's management refused to acknowledge either the depth of client insolvencies or the risks their operations imposed on MSSIC reserves.

Runs. What finally forced both the closure of Home State Savings and the MSSIC crisis were depositor runs. In talking about the abstract problem of depositor runs, authorities invariably focus on the concept of an irrational run. An irrational run occurs when, in response to false rumors, a substantial percentage of depositors try at the same time to remove their deposits from an economically solvent deposit institution. Such a run can be stopped by a credible flow of accurate information. Customers waste resources in that they would never have engaged in panic withdrawals if they could have been reliably informed about the institution's true condition.

In the face of concealed insolvencies, deposit-institution managers and regulators would be better-advised to contemplate the dangers of rational runs. In 1985, the runs experienced in Ohio and Maryland were rational, not irrational. They were based on quick-breaking information, not on inaccurate rumors. The largest institution in the ODGF insurance pool (Home State Savings) became economically so insolvent that its unrealized losses exceeded the insurance fund set up to support not only the deposits of this large firm, but also those issued by other members of what was a legislatively approved insurance pool. As news of this firm's problem began to reach the public, depositors lined up to withdraw funds first from the massively insolvent firm (and from a second, sister institution) and eventually from several of the weakest other institutions in the pool. Similar sequences of events encountered by other state-sponsored systems are described by Saulsbury (1985 and 1987).

In a rational run, the time and trouble of wending one's way through a long queue is not wasted. It represents an investment in preserving one's wealth. This is because anyone who manages to withdraw his or her deposits before an insolvency is officially declared is able to escape whole. Absenting government bailouts, depositors of record as of the instant an institution is closed have to absorb net insufficiencies in its and its guarantors' resources.

ODGF member associations were required to hold a reserve with the ODGF equal to two percent of their outstanding deposits (less if they were growing rapidly). Although these institutions were weakened by secular increases in interest rates and by the direct loss of roughly one third of their accounting net worth in the ODGF bankruptcy, the run on their deposits was directly occasioned by the unexpected reaction of Ohio politicians to the official discovery of Home State Savings' insolvency.

In Ohio, at the beginning of the run, authorities acted as if it were an irrational one. Depsite their lack of access to good information on the current extent of Home State's insolvency, State officials dared to presume that the ODGF could keep even its weakest client in operation. When the ODGF proved unable to demonstrate the truth of that claim, for almost a week politicians dared to presume that they could easily (i.e., at little cost to the Ohio taxpayer) support the deposits of all but the massively insolvent Home State. Instead of backstopping the resources of ODGF or its member institutions, State authorities declared the ODGF bankrupt, and the governor and legislature set up a new and grossly undercapitalized insurance fund to support the deposits of surviving ODGF members. Given the lack of private economic equity in many of the surviving ODGF member institutions, the resulting deterioration in the perceived (or conjectural) backing that Ohio politicians appeared to offer depositors in the wake of the Home

State failure made it eminently rational for depositors to line up to take their savings out of the weakest of the Ohio-insured S&Ls.

When it became clear that many of the other ODGF firms might have to be closed at potentially great depositor or taxpayer expense, the governor decided to suspend operations at the 70 remaining ODGF-insured institutions. The ostensible purpose of this partial banking holiday was to keep all existing depositors on an equal footing while buying time for a massive task force of examiners (borrowed largely from federal agencies) to develop reliable information by which which regulators could distinguish the set of roughly 20 hopelessly insolvent ODGF firms from the rest of the pool. However, I believe that, consciously or unconsciously, this unexpected and apparently panicky move had two deeper political purposes. These purposes were to put the ball into the Republican legislature's court and to pressure federal officials to relieve Ohio taxpayers by contributing financial resources to an ODGF bailout.

I draw this inference for three reasons. First, the absence of adequate accounting information on the condition of individual institutions cannot justify a decision to punish the managers, stockholders, and customers of the 50 sound and the 20 unsound ODGF members alike. A more proportioned response would be to impose dollar and frequency limits on depositors' withdrawal rights at ODGF firms or to suspend operations only at firms whose solvency definitely appeared questionable. In Maryland, rather than declaring a banking holiday, the governor halted crisis-creating runs by limiting depositor withdrawals at MSSIC institutions to $1,000 per month. Second, the move's broader effects were almost certainly anticipated. By increasing market participants' rational expectations of the probability that federal authorities might similarly mishandle pressures on the federal insurance funds, the banking holiday could be expected to weaken the dollar on foreign-exchange markets and to put upward pressure on deposit rates at federally insured banks and S&Ls. Extending the damage to out-of-state parties seems a likely strategy for loosening federal purse strings. Third, the alternative to this interpretation is to presume that, instead of following maximizing strategy, Ohio officials created so much havoc foolishly or incompetently.

Information Suppression. The element in the ODGF and MSSIC regulatory systems that most facilitated the coverup and most complicated the resolution of fund insolvencies is their reliance on historical-cost accounting. Although some S&L spokespersons want to blame all industry ills on "deregulation," post-1980 federal deregulation of deposit rates could have had only a secondary effect on the net worth of nonfederally regulated institutions. These institutions, which were not subject to federal deposit-rate ceilings, had been paying market rates of explicit interest throughout the 1970s and 1980s. Table 3 compares average explicit deposit rates paid by Home State and FSLIC-insured institutions between 1978 and 1985. What ODGF and MSSIC firms faced was a shift of the focus of federally insured institutions' future competition from implicit deposit rates (i.e., service and merchandise premiums) to explicit deposit rates.

It is important to recognize that weaknesses in insurers' information systems are design defects and not acts of God. Authorities show a propensity to keep themselves underinformed that suggests an intention of maintaining a deniability option.

If a system of market-value reporting had been in place and examiner ratings were public information, other fund members would have felt strong economic pressure to help with the prefailure monitoring of troubled clients. State officials could have determined far more quickly and more simply which of their member institutions were strong enough to survive without a sizeable government bailout. The determination would have been simpler because the primary task would have become to detect the presence or absence of fraudulent or flawed appraisals. This could have been accomplished by checking each firm's records on a sampling basis. Solvent firms whose appraisals checked out and those whose estimated irregularities did not exhaust the institution's capital could have been reopened promptly.

In this way, customers and managers of strong, well-managed firms could have been spared considerable suffering and examiner and regulatory resources could have been concentrated on weak and badly managed institutions. As things were, with book values based on historical cost, meaningful balance sheets for each institution had to be produced virtually from scratch.

It is also important to note that, in the absence of state-based or federal guarantees, the S&Ls in question would have had to release on a regular basis information sufficient to convince potential depositors of their continuing solvency. By assigning to state employees the task of examining in secret ODGF and MSSIC institutions for insolvency, state officials reduced the natural interest of depositors and other members of the state-based insurance pool in receiving timely information on the financial condition and investment strategies of insured firms. This effectively relieved deposit-institution managers of responsibility for communicating such information to their customers and cross-guarantors.

Another way to see both the rationality of the March, 1985 run on ODGF institutions and the way that ODGF guarantees and confidential monitoring reduced the quality of the information that insured S&Ls passed on to their depositors and cross-guarantors is to look at the experience of the six completely uninsured S&Ls that operated in Ohio at this time. To compete with government-guaranteed firms, market discipline had long ago forced these firms to indicate what their policies and financial condition were. One thrift (founded in 1895) had a resolute and well-publicized policy of demanding 35 percent equity on its mortgage loans, of never making a mortgage loan that was more than 15 years in initial maturity, and of employing a number of other well-publicized safeguards. Concerned and knowledgeable customers could clearly see that its cautious approach to mortgage lending preserved the market value of its net worth. This institution was able to gain deposits when state-insured institutions in other states were losing them and when metal safes in which to store currency at home became impossible to buy locally.

It is important to recognize that, although they were created at the behest of member institutions and operated outside of the civil service, each fund was a unique creature of its state legislature. Whenever a government-sponsored insurance corporation parcels out essential risk-management functions to government employees, the electorate is going to hold politicians responsible to some extent for any problems that ensue. This means that, no matter how long it took Ohio and Maryland politicians to recognize it, the public perceived the credit of the State to be backstopping ODGF and MSSIC resources.

Why Regulators Suppress Information. In view of such perceptions, why do state and federal politicians permit regulators to suppress information on the condition of insured deposit institutions? The short answer is that suppressing this information shields elected politicians from timely criticism for poor monitoring and regulatory performance. It also increases the credibility of politicians' attempts to deny responsibility for any mistakes that do emerge and leaves them asymmetrically free to bring forward information on whatever regulatory successes their regulatory agents may have achieved. In effect, restricting the flow of relevant information lessens market pressure on politicians and regulators and creates rents for them to share.

A longer answer is that it is a mistake to regard the recognition and action lags featured in the profession's standard model of dynamic policymaking (Kareken and Solow, 1963) as exogenous variables. For those charged with operating an incentive-incompatible deposit-insurance scheme, the recognition lag is lengthened by psychological propensities to deny painful facts and by natural as well as artificial blockages in the flow of information about the extent and consequences of client riskiness. A further danger is that, by the time the need for corrective action is recognized, the implicit losses the insurer has experienced may have become large relative to its reserves. The larger a fund's hidden economic insolvency, the more a public acknowledgement of this insolvency threatens to damage the careers of incumbent politicians and regulators. Large insolvencies dispose officials to adopt "best case planning." This means they elect to postpone effective action until the occurrence of an unrealistically "convenient" event which would have the capacity to replenish fund and client resources.

The idea that regulators' and politicians' careers would be damaged merely by alerting taxpayers to the insolvency is enshrined in the ancient practice of killing any messenger who brings bad news. The length of the odds against having their deception revealed by an exogenous meltdown during their watch tempts regulators and politicians to gamble on making a clean getaway. However, the probability that officials' getaway will be aborted -- as well as the size of the hidden economic losses experienced by the insurance fund -- increase at an increasing rate the longer the coverup is kept in place. Because transactions costs that decapitalized institutions incur in making the endgame financial plays that exploit an incentive-incompatible insurance fund are small, the speed with which hidden losses develop is subject to an acceleration that is absent from incentive-incompatible bureaucratic arrangements in the real sector. Whereas neglected physical capital (such as priceless marble monuments) decay at a fairly slow and steady pace, a benignly neglected deposit-insurance insolvency accelerates rapidly.

At any premeltdown date, each ODGF, MSSIC, and FSLIC regulatory gamble may be modelled as a dichotomous decision to coverup or not. To underscore the source of incentives to sacrifice the public interest, we assume a wholly self-interested and myopic (i.e., single-period) concern for maximizing the human capital of incumbent politicians and bureaucrats. (Myopia would follow from self-interest to the extent that one's career is not damaged by poor previous performance that does not reveal itself until after a new job has been secured.) We distinguish three states of the world: a clean getaway, an exogenous fund meltdown, and a truth-telling reform scenario. The value of officials' human capital in these states is designated as V_{CG}, V_M, and V_R, respectively. We assume that V_M and V_R are conditioned on, and fall with, the extent of the fund's hidden insolvency and that $V_{CG} > V_R > V_M$. Finally, we let p represent the probability that a coverup will succeed.

A bureaucracy that sought only to maximize the expected value of incumbent officials' human capital would follow a policy of forbearance and coverup as long as:

$$pV_{CG} + (1-p)\, V_M > V_R. \qquad (1)$$

Whenever V_R is substantially further below V_{CG} than V_R lies above V_M and the probability of a clean getaway remains high, it is unlikely that unscrupulously self-interested and myopic regulators would ever choose truthful reform. To illustrate the argument by numerical example, we may set:

$$V_{CG} = 2V_R = 3V_M.$$

Criterion (1) now specializes to:

$$pV_{CG} + (1-p)\ (1/3\ V_{CG}) > 1/2\ V_{CG}. \qquad (2)$$

In this case, not until the probability of a clean getaway fell below 1/4, would truth-telling and reform be selected.

The straightforwardness of incentives for officials to lie should lead one to wonder why official misrepresentations of the conditions of ODGF, MSSIC, and FSLIC were so long accepted at face value by watchdog institutions such as the popular press. Part of the answer lies in the high costs and low expected payoffs to investing in information extraction. Sticking one's neck out can hurt one's career prospects if an accuser fails to uncover a "smoking gun". It is dangerous to undertake a fishing expedition that challenges the conventional presumption that high-ranking public servants are predominantly (and extraordinarily) ethical, altruistic, and far-sighted individuals.

One of the ways in which this conventional presumption can be reinforced without invalidating the model just laid out is by insured institutions and lower-level officials selectively degrading the information about the size of hidden losses that flows to higher officials. Cultivating ignorance about the true state of affairs gives top officials a deniability option that makes it easier for them to scapegoat subordinates when and if a meltdown occurs. Deposition testimony given in ODGF litigation shows that, in the last months before the meltdown, the ODSL superintendent sought to inform the governor about the ODGF's worsening state, but that he deliberately chose to do this through channels rather than calling or writing the governor directly.

III. Chronology of ODGF Crisis and Its Resolution

Figure 1 shows that the ODGF promised to ensure member deposits in full. The seal posted by its clients prominently featured the word "Ohio" and a silhouette of the State.

Table 4 provides a rough chronology of salient events in the development and resolution of the ODGF crisis. This chronology identifies six stages to the crisis and its aftermath. Evidence of political and regulatory gambling is extensive. Once ESM's insolvency surfaced publicly, ESM, Home State, and the ODGF fell like a line of dominoes. Events support the view that the failure of the ODGF was a failure not of private enterprise, but of government regulation —a failure whose resolution was made more difficult by inadequacies in the ODGF information and regulatory-response system. Contrary to one popularly held view, federal policies of financial deregulation played at best a peripheral role in bringing about the failures of either ESM, Home State, or the ODGF.

IV. Six-Stage Chronology of MSSIC's Crisis and Resolution.

Table 5 is organized to show that the MSSIC case traverses the same six stages observed in Ohio. During a long loss-generation and regulatory-forbearance stage, a few large clients adopted high-flying investment strategies: in this case, placing funds raised by offering high deposit interest rates into a series of aggressive acquisition, development, and construction loans. Losses imposed by this strategy on the insurance fund were aggravated in several cases by corrupt activity by sometimes-desperate managers of economically insolvent member firms. MSSIC and State officials proved slow to face up to the growing economic insolvency of their fund, preferring to back the go-for-broke gambles being made by their troubled clients rather than to take the politically tough actions necessary to bring joint risk-taking under control.

The second stage developed when doubts about the insurance fund's repayment capacity and unfavorable publicity about individual firms occasioned a set of slow depositor runs. These runs eventually flowered into a fund meltdown when these runs were accelerated by a spectacular loss (e.g., in a failed securities firm) and breaking scandals. This acceleration forced authorities to close a particularly insolvent firm without at the same time being able to resolve the distribution of accrued losses.

Once the previously hidden insolvency of the insurance fund had been revealed in this way, three prolonged and partly overlapping stages ensued. First, the extent and terms of a politically optimal depositor bailout had to be worked out. This amounts to deciding the amount and distribution of taxpayer's contribution to ameliorating the losses suffered by aggrieved and politically activated depositors. Second, triage had to be performed to determine which of the 102 members of the fund could resume normal operations and when to allow them to do so. Finally, as an aftermath to the other stages, the legal system was asked to identify scapegoats, to punish guilty parties, and to force full or partial restitution of expenditures or commitments the State made for the benefit of MSSIC depositors.

V. Myopic Assessments of the Benefits and Costs of Restricting Information Flows

These chronologies are consistent with at least six generalizations, most of which illuminate FSLIC's problems. First, economic insolvencies at thrift institutions and at deposit insurers seldom develop overnight and often involve regulatory failure, wild speculation, and managerial fraud. For example, ESM was insolvent de facto for at least six years and engaged in questionable transactions from its very inception. Second, weaknesses in an insurer's information, monitoring, and regulatory-response system cloak dishonesty and create opportunities that tempt even honest managers of economically insolvent firms to speculate more and more boldly the longer a de facto insolvency persists. Third, when information on the unsafe and unsound practices of individual firms is uncovered by private accountants and government investigators, it does not flow freely to other regulatory entities or to managers and depositors of firms sharing a common insurer. Fourth, once an insolvency is discovered, top regulators and elected politicians as short-termers have career-oriented incentives to deny and cover up the insolvency. The costs of deferring the distribution of insolvency losses may be hidden from taxpayers for at least several years and the blame for the problem may even be shifted to representatives of the rival political party, while confronting the insolvency directly could "unfairly" damage politicians' and bureaucrats' professional reputations and re-employability in the private sector. Fifth, lack of information on the market values of troubled institutions' individual assets and liabilities makes depositor runs a rational response to bad news and tends to prolong any insolvency crisis by complicating and delaying regulatory efforts to measure the size of net-worth shortfalls. Sixth, once the size of an insurer's insolvency has been determined, aggrieved depositors become a potent political force (see Bowyer, Thompson, and Srinivasan, 1986). Political forces unleashed by the process of negotiating the distribution of insurer losses across different classes of taxpayers have a tendency to impose especially heavy burdens on surviving close competitors of the insolvent entities.

While all six points deserve study, the first two are treated extensively in other sources (e.g., in Benston et al., 1986 and Kane, 1985) and the third is an obvious consequence of bureaucratic competition between state and federal agencies and of opportunities for managers to corrupt individual accountants and investigators. The last three points receive primary emphasis here.

Restricting the flow of information on insured institutions' earnings and financial condition has the benefit for agency heads and for politicians of insulating them to a large extent from timely outside criticism of their performance as regulators. Voters can't knock what they can't see. This insulation increases public servants' personal autonomy, their immediate opportunities for reappointment or reelection, and their current value to potential outside employers. Having an option to understate the number and extent of troubled firms permits regulators and politicians to defer taking either responsibility or corrective action, if not indefinitely, at least until a politically or economically more convenient time. This option is valuable for two reasons. First, managers and stockholders of insolvent firms may be willing to pay a high price in political contributions for authorities to overlook their insolvent condition. Second, on average, the explicit compensation of top government officials is inferior to what they could command in the private sector. Presumably, government service offers sufficient implicit compensation to overcome this differential. In the short run, the option of concealing a developing problem may be used to increase implicit compensation by simplifying the jobs of individual regulators and politicians and by cosmetically enhancing their current reputations and immediate economic and political prospects by making their efforts appear far more successful to outside observers than they truly are.

Delayed insolvency resolution generates financial and political costs. Available evidence indicates that continually delaying the treatment of insolvency problems over long periods of time is bound to increase the discounted present value of the amount of insolvency observed (Barth, Brumbaugh, Sauerhaft, and Wang, 1986; Kane, 1987). Whether recognized fully or not, the political cost of having government regulators shape deposit institutions' information system and carry out their monitoring functions in secret is that the public is led to hold politicians and regulators at least partly responsible for whatever de jure insolvencies emerge. When a massive insolvency is observed, victimized depositors are bound to view weaknesses in the informational system and ineffective monitoring by public servants as governmental failures for which they should be recompensed. No matter how carefully formal arrangements may limit the government's de jure obligations, the government's de facto responsibility for overseeing the solvency of insured institutions imposes on government officials a conjectural obligation to make good the bulk of the losses that de jure insolvencies threaten to visit on individual depositors.

The frequency of legislative and executive elections and the rapid turnover of agency heads makes it reasonable for regulators and politicians to accept a more myopic tradeoff of clear and immediate benefits for distant and highly uncertain penalties than the representative taxpayer might be expected to prefer. Authorities must discount potential bailout costs not only for their futurity but also for the probability that these costs may accrue largely to rival politicians or to the successors of current officials (who may well belong to a rival party) rather than to themselves. This second round of discounting makes myopic officials all the more myopic.

VI. The Rationality of Runs in the Face of Politically Managed Information Flows

During the two months of political jockeying that followed the shutdown of the ODGF, Home State depositors who had not bothered to participate in the run objected vociferously to being labeled "unsophisticated." Spokespersons for these depositors claimed that their only mistake was "to believe politicians' assurances that their money was safe." Whether or not such misplaced trust can be classified as an archetypical form of naiveté, it is clear that financially sophisticated depositors recognized that state authorities made assurances that went beyond their knowledge base.

Although accounting data available in March 1985 could not tell state officials how massively Home State and the ODGF were economically solvent, Table 2 shows that the kind of information on file at the ODSL suggested that these entities were at the time deeply under water. As highly leveraged long lenders and short borrowers, many S&Ls found that the run-up in interest rates observed since 1965 had long since wiped out the economic value of firm-contributed capital. For years, the continued viability of these firms depended entirely on the credibility of deposit-insurance guarantees. In turn, the value of these guarantees did not rest on the accumulated reserves of state and federal deposit-insurance agencies. At all deposit-insurance agencies, reserves had fallen below the value of the unrealized losses that a careful analyst would assess to be potential claims against these reserves. Rather, the value of these guarantees depended on the conjecture that, in a crisis, incumbent politicians (no matter what their party affiliations happened to be) would invariably find it in their joint interest to recapitalize insolvent deposit-insurance funds.

During the run on Home State and its immediate aftermath, the applicability of this rational conjecture was undermined (albeit temporarily) in several ways. First, anyone familiar with the information system that State regulators had to work with recognized that the Governor's assurances as to the solvency of Home State and the adequacy of ODGF reserves clearly exceeded his capacity to know. This raised doubts about his veracity and his financial acumen. Second, his political ties to Home State's chief executive officer raised the possibility that conflicts of interest might be clouding his judgment. Third and most important, partly because of partisan skirmishing, the Governor and legislature simultaneously refused to backstop ODGF losses in the Home State failure and contributed only $50 million of State funds to a successor fund that was being asked to guarantee almost $4 billion in deposits at the 70 surviving S&Ls. Depositors of economically insolvent former ODGF member firms saw these actions as an attempt to get the Ohio taxpayer off the hook for unrealized losses at their firms, too. Even though engaging in a run on these institutions cost a depositor the sure time and trouble of standing in line and establishing new depository connections, doing so would cut off his (or her) exposure to losses from this unexpected turn in State financial policy. Net returns to an individual from running would grow with the size of his deposit balance and with his perception of the size of the unrecorded insolvency at his State-insured S&L. For all depositors, the incentive to withdraw deposit balances became stronger as state politicians tried to pass the buck.

In contrast to calling a banking holiday, the accepted way to stop a run is to keep an institution's offices open and to convince people in line and those contemplating joining them that the firm or its guarantor is able and willing to meet their demands. When a series of deposit institutions are simultaneously threatened by insolvency, the government's first job parallels that of the triage performed by medical officers in combat situations. It needs to decide formally and in a credible manner which should close and which can safely remain open. In implementing an indefinite banking holiday, Ohio officials underscored their inability to distinguish solvent institutions from insolvent ones. At the same time, they made it harder for the stronger ODGF institutions to maintain the confidence of their depositors or, by opening their books, to gain support from outside lenders.

The loss of confidence spread to other state's deposit-insurance systems. In Massachusetts and Pennsylvania, for example, institutions insured by state-sponsored corporations came under pressure from March on. It is particularly instructive to contrast the regulatory approaches followed in North Carolina and Maryland. In North Carolina, a well-capitalized and well-run private deposit-insurance corporation acted to strengthen its system while implementing a plan to phase itself out of the business in an orderly manner. It urged its clients to apply for federal coverage immediately. In Maryland, authorities followed a completely opposite line of action, claiming that for the Maryland legislature to prepare publicly for a run would undermine faith in the Maryland system and generate more trouble than it would save. In May 1985, Maryland found itself limiting withdrawals at state-insured institutions when it experienced a similar insolvency at the second-largest institution in its state-sponsored insurance system. North Carolina avoided the systemic problems Maryland experienced. This can be attributed in part to the unwillingness of Maryland authorities to swallow the unpleasant medicine of producing reliable information and shoring up its troubled insurance fund in timely fashion.

Rumors that a deposit institution or its insurer are insolvent are hard to refute when reliable information on their current financial conditions simply does not exist. In the short term, authorities can most reliably maintain confidence not by mindlessly denying and covering up the insolvency, but by demonstrating their willingness to back up the troubled entity. The more likely it is that politicians will fail to cover the losses of any class of depositor in full and in short order, the more sensible it is for depositors in that class to move their funds when credible flows of adverse information occur and/or depositor runs develop. If the troubled entity either turns out to be solvent or is bailed out with public funds, ex-depositors lose only the time and trouble of switching their business to a new firm. However, if an institution they could leave is eventually closed on disadvantageous terms, continuing depositors' percentage exposure to losses increases with every dollar of deposits that succeeds in leaving the firm before its demise becomes official.

VII. The Distribution of Bailout Costs

Resolving the Home State insolvency cost Ohio and federal taxpayers in two ways. First, the State legislature committed Ohio taxpayers to kick in whatever part of the $120 million promised to Hunter Savings as compensation for acquiring Home

State's institutional corpse proves not recoverable from court awards and negotiated settlements. Federal taxpayers share in this burden to the extent that affected taxpayers subsequently deduct incremental expenses and taxes from their federal tax bill. Second, in five ways explained in the last part of this section, taxpayers have had to pay the freight for recapitalizing the weakest of the S&Ls formerly insured by ODGF and MSSIC.

Because it was made essentially in cash, the first charge is easy to value. What is hard to assess is the extent to which these costs will ultimately be recovered as a result of legal settlements, the extent to which incremental burdens were shifted to federal taxpayers, and the extent to which Hunter Savings' winning bid was implicitly underwritten by federal taxpayers through FSLIC guarantees of Hunter itself. (Parallel issues arise in the Steubenville, DeGraf, and Valleywood deals.)

Neither type of assessment is attempted here. The rest of this section seeks instead to identify the conceptual components of the implicit costs of recapitalizing surviving S&Ls.

One element of this cost may be identified with the time that various depositors of surviving ODGF and MSSIC institutions were unable to withdraw deposits freely. At least some of these depositors and some of the parties with which they wished to do business suffered costly disruptions in their affairs. Moreover, firms that were on the verge of closing anyway gained the right to keep interest-rate bets on the table and, with the depositors of insolvent institutions, were able to develop additional political leverage on State legislators. The consequences of these further plays and disruptions must be counted as part of the cost of managing the ODGF and MSSIC failures.

A second element consists of a reduction in the value of customer relationships at surviving institutions. The holiday and withdrawal limitations are bound to have alienated some depositors and to have persuaded others at least to diversify their deposit balances over a wider class of institutions and deposit insurers. This damage is also time-related, in that for solvent firms a speedy determination of the viability of member firms and a policy of timely triage using some form of modified depositor payoff would have lessened losses of this type.

The third element (which developed only in Ohio) consists of the ex ante cost to Ohio taxpayers of transferring to FSLIC future liability for guaranteeing the deposits of reopened S&Ls. Although hard to evaluate, the present value of the interim contingent indemnifications the State promised the FSLIC through June 30, 1987 on the almost-$3.8 billion in deposits whose guarantees FSLIC took over was appreciable. The risk associated with this gamble cannot be ignored just because the State won its bet. Given the average extent of these firms' de facto undercapitalization and the volatility of the economic environment, it is doubtful that these contingent commitments could have been sold in the open market for less than 1 to 3 percent of the amount guaranteed. This implies an additional cost to Ohio taxpayers of between $38 and $112 million.

The fourth cost of bailing out the ODGF and MSSIC is subtle and much smaller. This component consists of the capitalized value of the speed-up in entry privileges that Ohio and Maryland politicians sold to out-of-state acquirers of moribund firms. (In October 1985, the Ohio legislature voted to open the state to interstate banking on October 1988.) The entry fees that Ohio and Maryland politicians collected from the likes of Chase Manhattan and Ahmanson came out of the hides of local banks and S&Ls. This is because they may be seen to have owned all "beneficial" interests in the entry barriers whose conditional lifting was conveyed. One does not have to favor such barriers to recognize that local trade associations had won and maintained them by investments in lobbying and other forms of political activity. Moreover, state officials may have sold these privileges too cheaply. Putting regulatory privileges on the auction block for distress sale is not a good way to maximize the price at which they are sold.

The fifth and final cost belongs entirely to federal taxpayers. It consists of massive Federal Reserve and Federal Home Loan Bank System efforts to keep the survivors open during the premeltdown period and to assist surviving firms to transfer speedily to FSLIC insurance after the meltdown occurred. These costs consist of below-market lending, an enormous reallocation of federal examination efforts, and (although FSLIC officials appear to have tightened rather than bent their qualification standards) lighter-than-market capital requirements that FSLIC sets in qualifying clients.

VIII. Lessons for Players in the Parallel Federal Game

What lessons should different parties learn from these crises. As a way of summarizing the previous analysis, this section lists the major players in what is a continuing and multilayered game of federal deposit-insurance "chicken" and the lessons they might draw from the ODGF and MSSIC debacles.

Politicians and Regulators. Politicians and regulators should learn at least four lessons. First, the absence of comprehensive market-value reports (even in the form of information that is held in confidence and not made available to the marketplace) encourages individual insolvencies and makes them hard to unwind promptly in cases where *de facto* insolvencies become public knowledge. Second, in the face of widespread economic insolvency and the increasing perfection of financial markets, differences in the party affiliation of the executive and legislative majority (as we have in Washington today) encourage political efforts to slip financially off the hook for unrealized deposit-institution losses that threaten to subject undercapitalized deposit-insurance agencies to the pressure of client runs. Third, when the dust settles, the regulatory bureaus that are held responsible for an observed crisis lose clients and administrative resources. Similarly, politicians and parties who can be made to appear responsible suffer some disruption. For Ohio and Maryland governors, political punishments can be inferred. Both governors experienced a subsequent collapse of campaigns for nomination to federal office. Fourth, half-baked efforts to stop an incipient run can easily make matters worse. In the face of a run, governmental assurances of an institution's solvency that are not backed by reliable information can undermine confidence in the government itself, as can inadequate efforts to recapitalize a threatened insurer. The $50 million injection of State funds the Ohio legislature first voted was so small as to insult the intelligence of most depositors. Sophisticated depositors saw that the mandated S&L "contribution" of $40 million provided no net increase in resources to the threatened firms so that, in pretending to create a $90 million fund, State legislators were being less than forthright. $90 million was probably too little anyway. Surviving S&Ls had to write off about $76 million in capital in the ODGF shutdown. It would have been safer to establish a fund whose aggregate size or reserve ratio equalled that of the prefailure ODGF. This would have required at least $120 million in State funds. Given existing surpluses in state income-tax collections and in the lottery, an appropriation of this size could have been handled as a commitment (i.e., as a contingent liability) without too much pain.

Politicians and regulators need to recognize that what transformed preexisting structural imbalances into a full-fledged crisis was not the insolvency of Home State Savings, but the absence of reliable and comprehensive information on the condition of other ODGF-insured S&Ls and authorities' failure to enunciate in timely fashion a credible policy for resolving the fallout of further insolvency generated by Home State.

Unlike the Governors of Ohio and Maryland, federal politicians have not been made to face up to the need to protect federal taxpayers from the secularly increasing costs of FDIC and FSLIC guarantees. As long as federal guarantees are underpriced and unreported, risk-taking at federally insured institutions will grow. Unless meaningful deposit-insurance reform is undertaken, bureaucratic breakdowns similar to those Ohio and Maryland experienced will occur eventually in the federal system. Regulators and politicians need to think through the problems such a breakdown could create and set up mechanisms to deal with them.

If faced with a series of official S&L insolvencies that exhaust FSLIC's liquid resources, a politically attractive solution that has the look of a contingency plan is for Congress to merge FSLIC into the FDIC. Given the solvency problems that the FDIC fund already faces on its own and the great difference in their corporate cultures, I believe that merging the two funds in the midst of a crisis in confidence might prove a recipe for disaster. Once one allows realistically for the contingent liability for potential FDIC assistance to actual and potential problem banks, the net reserves of the FDIC shrink to no more than a few billion dollars. Unless Congress and taxpayers are prepared to pledge unlimited amounts of crisis aid, the only effective alternatives are to recapitalize the federal insurance funds (perhaps most easily by putting both insurance funds on to the books of the U.S. Treasury) and to rationalize their information systems before a bureaucratic breakdown actually occurs.

Taxpayers (Including Well-Capitalized Deposit Institutions). Appropriate lessons for federal taxpayers are equally harsh. Incompletely financed and imperfectly monitored implicit subsidies to financial risk-bearing are currently hidden in the operations of government producers of financial regulatory services in the U.S. and other free-market countries (Benston *et al.*, 1986; Kane, 1985). Reductions in regulatory burdens that can be affected by aggressive financial firms are typically generated by shifting real costs surreptitiously onto various taxpayers. Most important of these hidden costs are unintended subsidies that flow from the improper pricing of explicit and implicit government financial guarantees. Concealing these subsidies from taxpayers makes their long-run effects destabilizing in that disinformation policies make it hard for taxpayers to fill the disciplinary role that stockholders and creditors play in a private firm.

The ability of powerful groups to extract government subsidies may be deemed to be part and parcel of the American system of free enterprise. No one should suppose that improving the flow of information about financial regulatory performance can end subsidies all together. A more reasonable goal is merely to make the production of selective subsidies more painful to the agents who benefit from their creation. The ODGF, MSSIC, and FSLIC cases provide evidence that a strong sense of shame underlies the subsidy-production process. In each case, givers and receivers of subsidies have devoted considerable energy to packaging their dealings in forms that prove hard to see and hard to measure even when seen. Perhaps because the need to obtain public esteem and approval is particularly great for those who seek political office, preserving at least the appearance of a public servant's personal honor and integrity appears to be an important goal, one that ranks above merely winning reelection or holding on to an agency job. A better-informed electorate might or might not force the prompt dismissal of regulatory rascals from their jobs. Nevertheless, the chance to engage in a post-government ex post settling up forms an important part of the implicit compensation earned by top government officials. Requiring authorities to provide appropriate evidence of how well public responsibilities are being handled would lessen the salaries that poor regulators could command in post-government employment.

Designing financial regulatory structures that work <u>with</u> rather than <u>against</u> efficient client adaptation provides the best chance of achieving society's long-run regulatory goals. First and foremost, this means preventing regulators and regulatees from continuing to distort the flow of information by which taxpayers assess their performance and finances.

The initial unwillingness of state authorities to back the ODGF and MSSIC reflects their closeness to taxpayers. State politicians recognize that state taxpayers didn't want to be riskbearers of last resort. However, at federal level, taxpayer obligations are more diffuse. The cost of FDIC and FSLIC guarantees has not yet become a pressing political issue.

The first lesson for taxpayers to learn is that contingent government guarantees are not costless. This can be brought out in cartoon fashion by picturing Ohio politicians as marrying insolvent ODGF institutions en masse to FSLIC and various institutional acquirers while ODGF depositors cheer and bound and gagged taxpayers and Ohio banks grimace in pain. To bring deposit-insurance costs back under control, the market value of each insurance fund's contingent guarantees should be reported regularly in ways that taxpayers can understand and monitor.

The second lesson is that, when the burden of bearing unrealized losses is finally distributed, some taxpayers are bound to be hit harder than others. The most exposed taxpayers figure to be surviving close competitors of the types of institutions whose losses actually bring down the system. Firms of the same institutional type as those who fail must expect to face higher post-failure insurance fees, while they and other close competitors will watch legislators and regulators sell off hard-earned regulatory privileges to entrants from outside the industry. To preserve their capital and markets in the long run, economically solvent institutions would be well-advised to separate themselves from the rest of the industry and to lobby for meaningful deposit-insurance reform.

It is important to note that in part healthy ODGF and MSSIC institutions contributed to their own victimization. First, they acquiesced in the defective information and monitoring systems that allowed other members' insolvencies to be hidden from public view. Second, in the face of the risk signal sent out by these members' high deposit rates, it is hard to believe that all of them could have failed to learn of their competitors' developing problems. To some extent, they engaged in ostrich-like acts of looking away from unpleasant evidence. Particularly in Ohio where ODGF firms were members of an insurance pool that required them to guarantee one another's liabilities, they faced incentives to monitor one another and to press for timely resolution of developing insolvencies. In the absence of an adequate State regulatory response to their whistle blowing, solvent institutions might have petitioned to switch their insurance to the FSLIC or (even better) the FDIC. In addition, well before any run actually began, ODGF firms might have established a continuing borrowing agreement with the Cleveland Fed as authorized by the 1980 Depository Institutions Deregulation and Monetary Control Act. Table 6 summarizes the limited extent to which the nation's 4,000-plus thrift institutions have used the Fed's discount window since it was opened to them in 1980.

Depositors. The principal lesson for depositors is that insured deposits are not necessarily riskless, even when they are issued by an apparently well-capitalized firm. During the Ohio banking holiday, depositors at economically solvent ODGF firms were held hostage to the interests of Ohio taxpayers and economically insolvent members of the ODGF insurance pool. To cope with deposit risk, depositors may want to diversify their funds across insurers and to demand information from their bank or savings institution that can let the more sophisticated among them assess for themselves what constitutes an adequate risk premium on the deposits they hold. Whenever a government insurer's finances look rocky, it is reasonable to treat its strongest clients as if sooner or later they are going to have to bear a portion of the costs of recapitalizing their insurer.

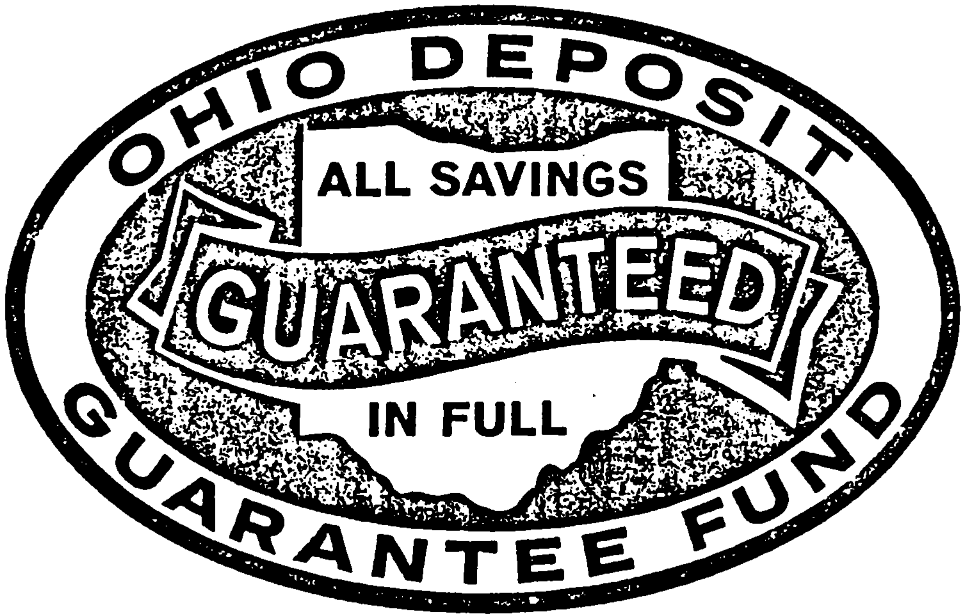
OHIO DEPOSIT
GUARANTEE FUND
ALL SAVINGS
GUARANTEED
IN FULL

Figure 1.

TABLE 1
STATE-BASED ENTITIES THAT OFFERED
DEPOSIT INSURANCE TO THRIFT INSTITUTIONS IN LATE 1984

Now Technically Insolvent

Fund Name	Date of Crisis	Rough Estimate of Deficiency
Industrial Bank Savings Guaranty Corporation (Colorado)	September 1987	$35 million
Maryland Savings-Share Insurance Corporation	May 1985	$350 million
Ohio Deposit Guarantee Fund	March 1985	$150 million
Utah Industrial Loan Guaranty Corporation	July 1986	$2 million in reserves covering $109 million in deposits in firms whose net asset values are uncertain.

Fully Divested Now of Thrift Clients

Georgia Credit Union Insurance Corporation	All 11 S&L members sought and obtained federal insurance after Ohio and Maryland crises.

Winding Down Operations

Name	Nature of Decision
California Thrift Guaranty Corporation	April 1984 failure of Western Community Money Center led to a July 1985 state law requiring members to obtain federal insurance by June 30, 1989.
Financial Institutions Assurance Corporation (North Carolina)	FIAC management response to Ohio and Maryland crises. The last remaining client expects to qualify for federal insurance in mid-1988.
Iowa Thrift Guaranty Corporation	1986 state law phased out insurance as existing CDs mature.

Operations Now Limited	
Name	Nature of Limitations Introduced
Pennsylvania Savings Association Insurance Corporation (created 1979)	After Ohio and Maryland crises, PSAIC board placed a $5 million cap on size of firm it would insure. On Sept. 1987, cap was raised to $20 million and a 7-percent net-worth requirement instituted. On April 1, 1988, PSAIC's 54 members had $129 million in deposits.
Massachusetts Cooperative Central Fund	Now limits members' deposit coverage to balances in excess of federal coverage ceiling
Massachusetts Mutual Savings Central Fund	Now limits members' deposit coverage to balances in excess of federal coverage ceiling

Source: Adapted from Saulsbury (1987) by telephone calls to authorities in particular states.

Table 2

Reported Size of Home State Savings, at Selected Dates during 1979-1985
(in $ million)

Date	Total Assets	Scheduled Items	Net Worth	Imbedded Losses on Selected Govt. & Agency Securities	Other Borrowed Money
6-30-79	286		11.7		65.1*
12-31-79	279	5.2	12.5		39.8
6-30-80	535.1	17.1	13.0		232.4
12-31-80	548.1	7.0	13.7		209.5
6-30-81	579.3	11.5	14.2	22.1	198.5
12-31-81	617.7	10.3	13.1		148.3
6-30-82	560.2	12.9	11.9	31.1	83.8
12-31-82	562.1	14.1	16.3		86.0
6-30-83	1,101.2	19.6	17.0		607.3
9-30-83	1,146.2		16.3	46.5 (some hedging)	614.9
12-31-83	1,146.9		15.8		610.0
3-31-84	1,148.4		16.2		589.0
6-30-84	1,101.2		17.2		561.2
9-30-84	1,420.2		20.1		755.3
12-31-84	1,438		19.7		713.2
2-28-85	1,424.5		20.5		685.7
4-30-85	626		6.2		

Source: 1979 through 6-30-83 figures and imbedded losses for 9-30-83 taken from ODSL examination reports, given in Appendix to OJSC testimony of Sylvester Hentschel. Later figures comes from Monthly Reports filed with the ODSL.

*This amount is in excess of allowable "additional borrowing" underregulations in effect at this time.

Note: The statutory net worth requirement was 3 percent either of current deposits or of the 5-year average of deposits.

ADDENDUM TO TABLE 2

TICKING TIME BOMB MEMO FILED ON HOME STATE SAVINGS
BY ODSL EXAMINER IN EARLY 1983

I have deliberately retained the working copy of this examination report several days past the mandatory five-day deadline because it is my understanding that the new Superintendent will not formally assume his duties in the office until the end of the second week in February.

I respectfully submit that the new Superintendent should be alerted to the veritable time-bomb that is ticking away in this association. Briefly stated, the problems can be summarized in the following two sentences. In June 1982 the association borrowed $84 million for one year from a small investment firm called E.S.M. Government Securities, Inc. located in Fort Lauderdale, Florida. As collateral for this borrowed money, the association assigned to E.S.M.'s control various types of securities which the association had bought for $209 million.

As stated in my examination report of July 10, 1982, should E.S.M. be unable for any reason to redeliver the securities in June 1983, the association will be confronted with a loss of $125 million. If that happens, the association's savings depositors will be required to bear a considerable portion of the loss. The association's net worth is less than $12 million and the total assets of the Ohio Deposit Guarantee Fund, of which the association is a member, are only about $65 million. The association does not have FSLIC insurance.

An association's loss exposure in transactions of this type should never exceed its net worth.

In view of former Superintendent Wideman's perfunctory letter transmitting this report to the association, I would appreciate receiving a copy of the board of directors' response when it is received.

February 8, 1983 Sylvester F. Hentschel

Table 3

Comparison of Weighted-Average Explicit Deposit Interest Rates at Home State Savings and FSLIC-Insured Savings Institutions at Selected Dates, 1978-85
(in percent per annum)

A. Calendar-Year Figures, 1978-1982

Year	Home State	FSLIC-Insured Institutions
1978	7.2	6.52
1979	8.7	7.31
1980	10.1	8.69
1981 H1	11.7	10.05
H2	13.3	11.34
1982	11.4	11.03

B. Monthly-Average Figures at ODSL Reporting Dates, 1980-1985

Year	Home State	FSLIC-Insured Institutions
6-30-80	10.5	9.05
6-30-81	12.1	10.74
6-30-82	13.0	11.22
9-30-83	10.4	9.40
4-30-85	9.8	9.22

Sources: ODSL examination reports on Home State Savings given in the Appendix to the OJSC testimony of Sylvester Hentschel; figures for FSLIC-insured institutions are from '82 Savings and Loan Sourcebook and '85 and '86 Savings Institution Sourcebook.

TABLE 4
CHRONOLOGY OF ODGF CRISIS AND RESOLUTION

1. Loss Generation and Regulatory Forbearance: ESM and Home State Savings
   - 1975: ESM incorporated; announced strategy is to make sophisticated financial plays via repurchase agreements.
   - Late 1976: U.S. Comptroller of the Currency finds apparent fraud at ESM. Forces a Florida bank to unwind its dealings with it. Report by Lou Frank calls ESM deals "sucker transactions." ESM put on a federal blacklist.
   - 1977-1981: ESM under investigation by SEC. Investigation is eventually dropped as too troublesome because the firm fought the agency so tenaciously.
   - 1979: Outside accountant at Alexander Grant & Co. learns of fictitious transactions. Accepts loans from an ESM official.
   - July 22, 1980: Examination of Home State uncovers violation in extent of nondeposit borrowing underway (including reverse repos)
   - Feb. 27, 1981: Federal Home Loan Bank of Chicago orders Unity Savings to cease and desist overcollateralized reverse repos with ESM.
   - August 24-28, 1981: At a training seminar, ODSL examiners learn ESM has poor standing with FHL Bank of Chicago
   - June 2, 1982: Home State concentration of repo business with ESM clearly surfaces as an issue at Ohio regulatory agency. Called a "time bomb" in draft examination report in October 1982 by Sylvester Hentschel, who assigns the firm the ODSL's lowest rating. According to the ODSL <u>Manual of Examinations</u>, "This rating is reserved for institutions with major and serious problems which management appears to be unable or unwilling to correct."
   - Oct.,1982-Feb.,1985: Examiners' recommendations are regularly overridden by the ODSL Superintendent, who sought guidance through channels from higher authorities. Home State managers repeatedly promise to reduce their exposure to losses in ESM and find ways to renege on these promises. Table 2 shows the kind of information state regulators received between 1979 and 1985.
   - January 28, 1985: Warner's personal balance-sheet position of $4.85 million is closed out at ESM.
   - March 4, 1985: ESM fails, $300 to $350 million short. Parallel to effect of Bevil, Bresler, and Schulman failure on Md. S&Ls.

2. The Failure of Home State Savings
   - March 6-8, 1985: Home State has cumulative deposit outflow of more than $150 million.
   - March 8, 1985: Home State signs borrowing agreement with Cleveland Fed and takes out first loan. Announces decision to leave offices closed on Saturday, March 9.
   - March 9, 1985: An insolvency of roughly $145 mil. found in Home State. Governor appoints conservator, claims to assign ODGF resources of roughly $134 mil. completely to Home State failure. Loss to other members of ODGF (who had carried their accumulated contributions

to ODGF reserves as capital) undermines their solvency. This clarifies the peril of permitting claims on deposit insurers to count as client assets without requiring an offsetting entry for contingent liabilities.

March 10, 1985: Governor rejects embryonic offer for Home State from First National Bank of Cincinnati and announces Home State will not reopen on Monday.

3. Runs at Other ODGF Members

March 11, 1985: Fed undertakes outreach program to assist surviving ODGF S&Ls to obtain borrowing documents.

March 13, 1985: Governor and legislature establish new fund with $50 mil. in state funds and a meaningless $40 mil. from ODGF S&Ls. Deposit outflows from four of the surviving ODGF S&Ls become heavy.

March 14, 1985: Major runs occur at 6 ODGF institutions.

4. Working Out the Terms of the ODGF Bailout

March 15, 1985: Banking Holiday (Contrasts ironically with image of fun and celebration as in film title, Holiday On Ice). Governor pats himself on back for providing "strong leadership." Does not necessarily entail "cost-minimizing" leadership.

March 15-17, 1985: State officials attempt to solicit bids for closed institutions from in-state and out-of-state bankers.

March 19, 1985: Game of Chicken with Feds ends. FSLIC promises to speed processing of applications from former ODGF-insured S&Ls. However, it slowed things by imposing much higher standards on these applicants than it required of its pre-existing clients.

March 20, 1985 (early AM): Legislature passes bill allowing openings with possibility of limiting customer withdrawals to $750 per month and authorizing indemnification of FSLIC for any loss incurred in ODGF S&Ls through July 1, 1987. Availability of Fed discount-window assistance to these firms is republicized by the Fed.

5. The Process of Reopening Viable ODGF Firms

March 26, 1985: 18 of the S&Ls are fully open, with only Home State and a few others fully closed. Only 2 or 3 experience continuing lines of depositors seeking withdrawals.

April 2, 1985: Out-of-state bid for Home State announced from Chemical. Deal said to require state to ante up at least $80 million.

April 3, 1985: Announced deadline for counterbids from in-state institutions. One received, but later withdrawn.

April 8, 1985: 5 more institutions open fully, for a total of 39; most others remain partially open.

April 11, 1985: Injunction handed down against using ODGF funds to assist Chemical Bank purchase of Home State.

April 16, 1985: Chemical bid for Home State set at roughly $50 mil. ($21 mil. takeover premium plus $30 mil. in new capital);

estimated $90-$129 mil. in state funds required to keep depositors whole. (Request for state aid set at $125 mil. after audit.)

May 2, 1985: Ohio House passes $91 million appropriation.

May 9, 1985: Ohio Senate passes $91 million bill. Issue moves to Conference Committee. Possibility of in-state bid from Transohio introduced in Senate bill.

May 16, 1985: Conference committee reports out a $125 mil. depositor bailout bill.

May 17, 1985: Senate deadlocks on Conference Committee bill at 16-16. (A cynic might interpret this as a way of advertising a vote for sale.)

May 21, 1985: Bill passes Senate 17-16. Chase and Ahmanson takeovers of other weak S&Ls is finalized.

May 29, 1985: American Financial Corporation subsidiary Hunter S&L outbids Chemical by $5 mil. Permits an in-state and non-cross-industry acquisition to occur. To some extent the $21 mil. takeover premium is financed by Hunter's piecemeal liquidation of acquired values and by FSLIC guarantees of Hunter. Hunter quickly sells off 2/3 of acquired branches to Ameritrust and First National Cincinnati Corp. for roughly $15 mil.

June 14, 1985: Home State offices re-open under new names.

June 30, 1985: Federal court orders liquidation of ESM. Bankruptcy trustee reports a recovery of only $23 mil. from ESM assets.

mid-December, 1985: Depositors of one institution (Valleywood Savings Association of Cincinnati) still face limitation on monthly withdrawals. Two institutions have not yet reopened at all (located in Steubenville and DeGraf).

Late Decembr, 1985: Closed ODGF institution in Steubenville reopens.

January 12, 1986: Last of closed ODGF institutions, People Savings of DeGraf, opens as Midwest Savings.

March 24, 1986: Valleywood offices open under new ownership, ending the last instance of depositor inconvenience.

6. Post-Resolution Legal Efforts to Designate Scapegoats and Recover State Monies

November 6, 1986: State of Ohio wins a $34 mil. settlement in federal court from ESM's former auditor.

December 13, 1986: State grand jury indicts five Home State and ESM executives on felony charges.

March 30, 1987: State court sentences Warner to 3-1/2 years in prison for unauthorized acts and orders him to pay $22 mil. in restitution to the State. (Appeal is pending.)

March 31, 1987: Former Home State President, Burton Bongard, is sentenced to 10 years in prison and ordered to pay $114 mil. in restitution.

June 19, 1987: Jury in Michigan acquits Warner of Federal charges of conspiracy, wire fraud, and interstate movement of fraudulently obtained funds. Jury foreman describes Warner as a victim of fraud rather than a perpetrator.

Sept. 3, 1987: State of Ohio settles pending civil suit in state court of claims against ESM's former auditor for $65 mil.

April 15, 1988: State settles damage suit against Home State's auditors for $5.6 million, an amount less than the estimated cost of bringing the suit.

July 7, 1988. Jury in Florida awards ESM trustee $22.6 million in civil damages from M. Warner on the grounds that he participated "in the fraudulent purposes" of ESM.

Sources: Newspaper and magazine accounts; Federal Reserve Bank of Cleveland, 1985 Annual Report; May-December, 1985 Hearings and Report of Ohio Joint Select Committee on Savings and Loans of the 116th Ohio General Assembly.

TABLE 5
CHRONOLOGY OF MARYLAND SAVINGS-SHARE
INSURANCE CORPORATION CRISIS

I. Loss Generation and Regulatory Forbearance Stage

November, 1962. Maryland Savings-Share Insurance Corporation (MSSIC) begins operations. Members required to have net worth equal to 4% of "free share accounts."

March 24, 1976. MSSIC board adopts by-law providing that MSSIC's insurance limit for "each separate account" of any association could not exceed the FSLIC limit by more than $10,000. Prior to 1976, coverage was determined by aggregating accounts with same owner by depositor, as FSLIC does.

May 25, 1978. MSSIC letter to First Progressive states that, as an officer of First Progressive, Jeffrey Levitt had diverted association funds to his own use.

July, 1981. MSSIC signs an "Insurance Agreement" with Old Court restricting its managers' freedom because the association's net worth had fallen below MSSIC's 3-percent trigger for such actions.

Sometime in 1982. Using a MSSIC-approved $2.2 mil. loan from First Progressive, Jeffrey Levitt and Allan Pearlstein solidify their control of First Progressive, which was operating under a MSSIC Insurance Agreement.

Sometime in 1983. Old Court and Progressive embark on aggressive growth strategy, fueling rapid asset growth by offering high interest rates to depositors.

May 6, 1983. Md. S&L Division examiners report numerous irregularities and violations of Division and MSSIC rules in connection with Old Court's program of high-risk lending.

February, 1984. MSSIC learns that First Progressive had made unauthorized investments with the approval of Levitt.

April, 1984. Examination of Old Court shows continuing violations of MSSIC rules.

April 23, 1984. Managerial obligations under the Insurance Agreement with Old Court are terminated after Old Court prepays its subordinated debenture to MSSIC.

May, 1984. MSSIC board discusses significant financial deterioration of First Progressive of Westminster, Md. and cites Old Court as "responsible at least in part." Preliminary examination by the S&L Division reveals "very weak operational standards" at both institutions.

August, 1984. MSSIC board notes that Old Court is growing rapidly by writing primarily large construction loans funded by jumbo CDs and exceeding agency's guidelines on the proportion of assets invested in such loans.

August, 1984. MSSIC staff recommends that Board direct Old Court by letter to cease and desist from further construction and land loan commitments.

November 1, 1984. Progressive is merged into Old Court.

December 12, 1984. MSSIC membership committee unanimously recommends that the Board issue a cease and desist order to Old Court.

2. Runs Begin and Regulatory Forbearance Continues

January 20, 1985. 60 Minutes carries segment on insolvency of Nebraska guaranty fund. Generates subsequent unease among MSSIC depositors.

February 27, 1985. MSSIC's Board resolves to subject Old Court to a cease and desist order and to require it to enter into an Operating Agreement. The cease and desist order is never issued and the Operating Agreement is not signed until April 23, 1985.

March 8, 1985. Home State Savings Bank is closed, rendering the Ohio Deposit Guaranty Fund insolvent.

March 16, 1985. MSSIC officials persuade administration officials to force withdrawal of General Assembly House Bill 1609, requiring all 102 MSSIC institutions to state in their ads that they are not backed by the full faith and credit of the state.

March 22, 1985. MSSIC sends cease-and-desist letter to Merrit Board indicating criminal activity. Letter is not shared with Federal officials until May 2.

March 25, 1985. Head of MSSIC circulates a reassuring memo to membership about MSSIC's reaction to the Ohio crisis.

April 8, 1985. Bevill, Bresler & Schulman Asset Management Corp. closes, imposing losses on MSSIC's second-largest institution, $839 mil. Old Court Savings and Loan, and on $370 mil. Merritt Commercial Savings and Loan. These institutions proceed to experience the first consumer runs of MSSIC crisis.

April 11, 1985. Officials from Md. Attorney General's office prepare memorandum mentioning difficulty in getting accurate information from state S&L division and MSSIC and recommending Governor to have "face-to-face" meetings to obtain facts. A third MSSIC S&L (Chesapeake) joins Chevy Chase S&L and Baltimore Country S&L in openly applying for FSLIC insurance.

April 16, 1985. Federal officials alert Governor's staff to a "silent run" on MSSIC institutions of $375 mil. over the previous two months. Roughly $7 bil. still in MSSIC institutions.

April 29, 1985. First of the "major crisis meetings" of Federal Reserve and FHLBB officials with Governor Hughes, his staff, state regulators, and top state lawyers. Feds predict a major run and describe some associations as at the "end of their ropes," giving special attention to the sorry state of Old Court. Officials from MSSIC and state S&L Division claim that installing new CEO at Old Court "would take care of it."

May 2, 1985. Second "crisis meeting." Federal officials are stunned to learn of previously withheld March 22 MSSIC letter. Conservatorship lawsuits considered for Old Court and Merritt.

May 2-8, 1985. Old Court continues to solicit deposits via radio advertisements, stressing the "Old Court advantage" of high interest rates, despite Attorney General's behind-the-scenes efforts to stop these ads as violations of the state's Consumer Protection Act.

May 8, 1985. Third "crisis meeting," this time without Governor Hughes who was in Israel. Old Court management change decided upon and press release drafted.

May 9, 1985. The Baltimore Sun runs story unfavorable to Old Court. Runs on Old Court offices accelerate. Criminal investigation into Merritt is formally announced.

May 10, 1985. Merritt loses $3 million in deposits in a Saturday morning run.

3. Crisis Stage

May 13, 1985. Old Court put into state-controlled conservatorship. New run begins at Merritt.

May 14, 1985. Governor Hughes proclaims a state of public crisis and emergency and imposes a $1,000-per-month limit on depositor withdrawals at MSSIC institutions. Discloses to reporters that 20 MSSIC institutions experienced a $630 mil. withdrawal over last few months and are now $370 mil. in debt to Fed. Merritt put into conservatorship. About 350 federal examiners are reported to be looking through books of MSSIC members.

4. Preliminary Loss Distribution

May 17, 1985. Special Session of General Assembly meets to pass legislation (signed by Governor on May 18) holding harmless all depositors in MSSIC associations, requiring MSSIC institutions with at least $40 mil. in assets to obtain FSLIC coverage by Dec. 31 (and smaller institutions to do so in two or four years), and authorizing the state to put equity into MSSIC institutions if necessary to help them qualify for FSLIC coverage. Largest MSSIC firm, $2.2 bil. Chevy Chase S&L, is conditionally approved for FSLIC coverage. Legislature merges MSSIC into a successor corporation, the Maryland Deposit Insurance Fund (MDIF). MSSIC's $160 mil. insurance fund and $80 mil. liquidity fund are transferred to MDIF, which receives authority to issue up to $100 mil. in general-obligation bonds. MDIF is to maintain depositor confidence while MSSIC institutions work out problems in qualifying for FSLIC insurance.

5. Reopening MSSIC Survivors and Unwinding the Affairs of the Mortally Wounded.

May 22, 1985. Governor amends his order to permit exemptions for mortgage payments, payroll costs, college tuition bills, medical care for the elderly, and settlement costs for home purchases.

12 large MSSIC institutions have now received conditional approval for FSLIC coverage. 16 former MSSIC institutions that can't qualify for federal insurance (mostly because they open only a few hours a week) reopen under MDIF, with Frederick Dewberry as acting director.

June 7, 1985. Maryland Court gives permission to roll back interest on passbooks and on matured and maturing CDs at Old Court to 5.5%. Deposits frozen.

July 28, 1985. President of Md. Senate complains about FSLIC toughness in qualifying former MSSIC thrifts. Only 14 have received FSLIC coverage to date. Only these and 60 smaller institutions now covered by MDIF have had the $1,000 withdrawal limitation lifted.

August 14, 1985 (approx). Community Savings and Loan (the 4th-largest of the former MSSIC firms) indicates that it must divest itself of real-estate syndication subsidiaries (including the spectacularly insolvent EPIC) as a precondition for obtaining FSLIC insurance.

More than $120 mil. of Community's $440 mil. in assets prove to be funding EPIC losses.

August 19, 1985. Governor freezes deposits at Community.

August 23, 1985. Melvin Brown appointed director of MDIF, which now backs 81 thrifts who have still not qualified for full federal insurance. (The other 21 MSSIC institutions have successfully switched to FSLIC and 18 more have received conditional approval.)

September 5, 1985. Community (which did not divest subs) is placed into conservatorship; deposit freeze is extended. EPIC begins filing bankruptcy papers.

October 18, 1985. Plan approved to unfreeze Old Court and Community deposits selectively for depositors undergoing "hardship."

November 1, 1985. Chase Manhattan Corp. opens 13-branch network in Md. acquired by taking over 3 troubled ex-MSSIC S&Ls (Merritt, Friendship, and Chesapeake). This form of out-of-state entry is authorized by an October 28 law permitting conversion of crippled S&Ls into full-service banks.

November 8, 1985. MDIF obtains court permission to place Old Court into receivership, to begin liquidation and to stop accrual of depositor interest. $175 mil. loss is now estimated at Old Court, $120 mil. at Community.

November 12, 1985. Governor signs executive order tightening rules on conflicts of interest in fees and on insider loans at state-chartered S&Ls and increasing state authority to place a violator into state-controlled receivership.

November 20, 1985. First Maryland placed into conservatorship.

December 16, 1985. Ridgeway S&L (Catonsville: $15 mil. in assets) is placed into conservatorship. MDIF is overseeing four crippled thrifts, including Old Court.

January 9, 1986. Loss estimates raised to $208 mil. at Old Court, $150 mil. at Community, and $16 mil. at First Maryland. Governor outlines plan to liquidate Old Court and to stretch out period repayments of deposits through December, 1989.

late March, 1986. Community conservatorship is transformed into a receivership.

May 2, 1986. Federal bankruptcy judge approves EPIC reorganization calling for a 5-to-7-year sale of EPIC's 20,000 homes. This clears way for a complicated transaction, conveying Community to Mellon Bank of Pittsburgh, which converts it into a commercial bank. Federal Reserve Board approves this restructuring on May 8, 1986.

June 26, 1986. First Maryland becomes third ex-MSSIC institution placed into receivership. Liquidation and depositor-repayment plan eventually adopted parallels Old Court's.

April 6, 1987. Maryland officials discuss a proposal to permit depositors of Old Court and First Maryland the option of redeeming their deposits (on which interest no longer accrues) at 85 to 90 cents on the dollar rather than waiting for period payments scheduled through December, 1989.

6. Legal Efforts to Identify Scapegoats and Recover State Monies

January 3, 1986. Levitt of Old Court is indicted on 25 counts of embezzlement and misappropriation of $14.6 mil. in connection with its failure.

March 26, 1986. Former owner of Merritt, Gerald Klein, is indicated on 40 criminal counts.

May 27, 1986. Levitt pleads guilty to criminal charges.

May 6, 1987. Alan Pearlstein is convicted on 4 counts of stealing from Old Court.

May 12, 1987. Law firm that simultaneously advised MSSIC and some of its clients settles State's malpractice suit for $27 million.

Sources: Newspaper accounts and <u>Report on the Maryland Savings and Loan Crisis to the Maryland General Assembly</u> by Wilbur D. Preston, Jr., Special Counsel, Jan. 8, 1986.

TABLE 6

THRIFT-INSTITUTION USE OF THE FEDERAL RESERVE DISCOUNT WINDOW BY CLASS OF INSTITUTION, 1980-1987

	S&Ls	Federal Savings Banks*	Mutual Savings Banks	Credit Unions	Industrial Banks*
1980	1	--	--	--	--
1981	24	--	9	2	--
1982	34	--	11	5	--
1983	19	--	4	2	--
1984	26	--	7	4	--
1985	65	--	7	4	5
1986	28	8	5	2	4
1987	9	8	17	9	4

Source: Telephone calls to Gary Gillam of Federal Reserve Board staff.

*Reporting categories added in 1985 and 1986.

REFERENCES

1. Barth, James R., R. Dan Brumbraugh, Jr., Daniel Sauerhaft, and George H.K. Wang, 1986. "Failure Costs of Government-Regulated Financial Firms: The Case of Thrift Institutions." Washington: Federal Home Loan Bank Board.

2. Benston, George, Robert Eisenbeis, Paul Horvitz, Edward Kane, and George Kaufman, 1986. Perspectives on Safe and Sound Banking: Past, Present, and Future, Cambridge, Mass.: MIT Press.

3. Bowyer, Linda E., A. Frank Thompson, and Venkat Srinivasan, 1986. "The Ohio Banking Crisis: A Lesson in Consumer Finance," The Journal of Consumer Affairs, 20, pp. 290-299.

4. Federal Reserve Bank of Cleveland, 1986. "Unfoldings in Ohio." Annual Report 1985.

5. Kane, Edward J., 1985. The Gathering Crisis in Federal Deposit Insurance. Cambridge: The MIT Press.

6. ___________, 1987a. "Who Should Learn What from the Failure and Delayed Bailout of the ODGF?" A Working Paper circulated in the Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago. pp. 306-325.

7. ___________, 1987b. "Dangers of Capital Forbearance: The Case of the FSLIC and 'Zombie' S&Ls." Contemporary Policy Issues, 5 (Jan. 1987), pp. 77-83.

8. ___________, 1988. "Changing Incentives Facing Financial-Services Regulators," Paper prepared for Perspectives on Banking Regulation Conference, Federal Reserve Bank of Cleveland.

9. Kareken, John, and Robert M. Solow, 1963. "Lags in Monetary Policy" in Stabilization Policies. A volume prepared for the Commission on Money and Credit, Englewood Cliffs, pp. 14-96.

10. Saulsbury, Victor L., 1985. "The Current Status of Non-Federal Deposit Insurance Programs." Issues in Bank Regulation, 8 (Spring), pp. 3-19.

11. ___________, 1987. "The Current Status of Private Insurance Funds and Their Membership." Regulatory Review (September/October), pp. 21-24.