In Crisis

by Gregory R. Gajewski

I argued that both the FCS and the S&L crises arose from a mix of external and internal factors. So I believe that the solutions should be similar as well.

Two points deserve attention. First, ideally financial institutions should be declared insolvent and their owners replaced as near as possible to the time when the expected value of what the institution owes exceeds the value of what it is expected to earn. Second, the restructurings of both the FCS and the S&L industry fell short of instilling the discipline necessary to substantially reduce concerns about the safety and efficiency of our credit-delivery system.

If financial institutions were closed by their regulators as close as possible to the time when they became insolvent, a number of problems that led to the FCS and S&L crises would not arise. Such an approach would limit taxpayer exposure, since the institutions would be closed before their liabilities greatly exceeded their assets. More importantly, such a strict approach by regulators would instill discipline, and stimulate lenders to make more prudent lending decisions. For example, if FCS stockholders had believed their stock was at risk, and that regulators would close insolvent FCS institutions, the FCS probably would have been less aggressive in making farmland mortgages that bid up land values in the late 1970's. For S&L's, less fraud would have taken place. Owners would not have been as tempted to gamble with federally insured deposits to recover lost equity. They would have been put out of business when their ownership stake was lost. And the S&L-financed speculative real estate boom in the southwest would have been much less pronounced.

Nonetheless, the recent restructuring has changed the FCS somewhat. While the government still stands behind FCS bonds, FCS stockholders are explicitly on notice that their investments are not federally protected. And the federal exposure on the bonds will be much smaller as the new FCS insurance fund gets underway. The Farm Credit Assistance Act of 1987 created an insurance fund for the bonds that is similar to the fund for commercial bank deposits run by the FDIC. FCS institutions pay an insurance premium for the bond protection, much as commercial banks pay assessments to the FDIC. If one of the FCS lenders becomes insolvent, the Farm Credit Administration has the power to declare it insolvent and close it; then stockholders would lose, and bondholders would be paid off by the new insurance fund.

Let's hope this new system works. FCS institutions are just starting to pay into the new insurance fund this January, and so federal bailout dollars are backing the FCS bonds until 1993. In addition, as we have just seen with the S&L insurance fund, I believe the government would step in to protect FCS bondholders after 1993 if the FCS insurance fund were to collapse. But protecting bondholders is not nearly as detrimental as protecting the owners from losses.

For S&L's, the government-imposed restructuring was a step in the right direction. The regulatory and supervisory apparatus was overhauled and distanced from the industry. The minimum investment the owners must keep in their S&L was increased. Hopefully, the new standards will be enforced.

But the critical reform may turn out to be that commercial banks can now buy S&L's. So weak S&L's no longer need to flounder in a government safety net—they can be transformed into banks. Commercial banks can diversify their loans across all sectors of the economy, and thus face less risk if a sector, such as housing, were to experience a downturn.

As I see it, the critical remaining issue, aside from a stringent closure policy, is how to get specialized lenders to diversify risk away from their focal sector. To survive in today's volatile financial environment, the FCS needs to diversify away from farming and into other sectors. But the 1987 Act does not allow it to do so. Unfortunately, the rescue package for S&L's makes it more difficult for S&L's to diversify away from housing. But the stage is set for a back-door approach to the diversification problem for S&L's at least—commercial banks can buy them and make them over into better diversified institutions.

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