

## Banking by David Goldman

### FSLIC's junk bonds doom agency

*Will Drexel Burnham's Michael Milkin underwrite the issue for the savings banks' deposit-insurance agency?*

Only partly as a joke, some senior staffers of the Federal Home Loan Board Bank have circulated a proposal that the agency's forthcoming \$10 billion debt issue be underwritten by Drexel Burnham's "junk bond" king, Michael Milkin. Since the FSLIC's paper has no better chance of repayment than the IOUs on which high-rolling corporate raiders pay 12% and up, why not treat it the same way, they suggested.

In fact, the FSLIC's debt-issue, authorized by the banking legislation President Reagan signed into law last month, will carry a high rating, but for reasons which doom the savings banks' deposit-insurance agency: Bondholders will be given a first lien on all future insurance premiums paid to the agency by its members. "Otherwise, nobody would buy them," one staffer commented.

Congress, now debating whether the Treasury will be able to spend any money at all after the federal debt ceiling expires Sept. 23, was in no mood to put real money into the bankrupt federal agency, which ran out of funds last February. Since then, the Federal Home Loan Board Bank has kept the 500 or more "brain-dead" S&Ls afloat, by administering what staffers call a "federally sponsored Ponzi racket," channeling new deposits into failing S&Ls in small amounts under the \$100,000 guarantee limit.

Under the just-passed banking legislation, the savings and loan industry supposedly will bail itself out,

by forcing healthy institutions to pay higher premiums to cover interest to bondholders. The scheme is faulty, for several obvious reasons.

First, the \$10 billion-plus the FSLIC will borrow barely dents the \$50 billion which the agency should spend to close out bankrupt institutions. It means that the federally-sponsored Ponzi game will continue, except for some cosmetic cleaning up of a few worst cases. Meanwhile, the FSLIC, by enticing new deposits into failed institutions to pay off older ones, will continue to add to its future bills.

Secondly, the S&L industry as a whole is losing money now, and likely to lose much more money later. Between 1985 and 1986, the delinquency rate on the S&Ls' average portfolio of mortgages rose from 2% to 4%. By mid-1987 it had risen, and remained, above 6%, an impossible figure for an industry whose average net worth stands at less than 1% of assets. The higher losses derive from the collapse of the commercial real-estate market, into which the S&Ls plunged under the impetus of banking deregulation early in the 1980s. That is, if only one-sixth of the delinquencies turn into losses, the industry will be insolvent.

Third, the shrinking number of profitable S&Ls will bear a proportionally greater burden of insurance premiums, as the higher level of losses work their way through the industry. These institutions are already scrambling to leave the savings-bank system, in order to evade the higher pre-

miums. Thus far, the regulators have prevented them. But FHLBB specialists believe they will find a means of escape before long, wiping out the premium-base of the FSLIC for good.

None of this, however, should worry regulators nearly as much as the implications of present market conditions for S&Ls.

Long-term government bond yields approaching 9.5% as of Sept. 2 are the harbinger of a drastic, across-the-board increase in interest rates. Savings banks still have on their books an enormous volume of mortgage-backed bonds, which represent a fifth of their total portfolio. These have lost a huge portion of their market value during the past 20 months' run-up in interest rates.

If short-term interest rates rise to the 8.5-9.0% level, perhaps half the thrifts in the country will lose money on the simple differential between the average earnings of their mortgage portfolios, and the cost of their deposits—apart from mounting losses. Even if the Federal Reserve were able to hold interest rates down on the short end of maturities, the continuing collapse of long-term bond prices can wipe out S&Ls' liquidity.

During the first half of 1987, savings banks substituted short-term sales of their long-term securities (so-called repurchase agreements), for deposits that were flowing out. Savings outflows exceeded inflows by \$15.6 billion, compared with a net inflow of \$1.7 billion over the same period in the past two years. Correspondingly, during the first half of 1987, thrift holdings of reverse repurchase agreements jumped by \$22.3 billion, almost double the increase posted during all of 1986. If long-term bond prices continue falling, the effective cost of money in repurchase agreements jumps in tandem, adding to savings banks' losses.