BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

OFFICE CORRESPONDENCE August 15, 1988

TO: Federal Open Market Committee

SUBJECT: Contingency Plans for Lending to Troubled Thrifts.

FROM: Ad Hoc Working Group*

I. Introduction

The significant continuing losses at a large number of savings and loan institutions coupled with the liquidity and solvency pressures on the Federal Savings and Loan Insurance Corporation ("FSLIC") raise the possibility of a precipitous decline in confidence in the savings and loan industry, FSLIC, or both. This development could lead to serious liquidity pressures at individual thrift institutions, produce a potential for a simultaneous run on troubled thrifts or on both troubled and healthy institutions and also hamper the ability of the Federal Home Loan Banks to adequately address these problems. In such circumstances, the Federal Reserve could be called upon to provide liquidity assistance.

The situations in which such assistance would be provided, and the manner of providing such assistance, raise

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important policy questions for the Federal Reserve System, including

- When should a FHL Bank or a thrift be considered not to have other sources of credit reasonably available? Should FHL Banks be expected to lend to each other.
- Should the Federal Reserve require concurrence or support from the Federal Home Loan Bank Board, the FSLIC or the Administration as a prerequisite to any lending?
- What collateral requirements should the system impose? To what extent should security interests be perfected or recorded?
- Should special conditions, such as lending an investment limitations be imposed on thrifts borrowing from the Federal Reserve?
- What special documentation or procedures are necessary for lending to thrifts or FHL Banks?

Board staff together with representatives of the Subcommittee of Counsel to the Conference of Presidents and representatives of the Subcommittee on Discounts and Credits to the Conference of Presidents have considered these issues and recommend that the Federal Reserve indicate that it expects thrift industry to continue to place primary reliance on the Federal Home Loan Banks (FHL Banks) for liquidity assistance, but that the Federal Reserve Banks should be prepared to lend to the FHL Banks if they should be unable to fund themselves in the market at reasonable rates. If the FHL Banks refuse to lend to a particular thrift, especially a large thrift, or decline to lend in the face of a run on thrift institutions generally, because of the possible systemic effects of this situation, Federal Reserve should be prepared to provide liquidity to individual thrifts, but only if an appropriate policy framework to govern such lending has been established.

II. The Thrift Industry Should Place Primary Reliance of the FHL Banks for Liquidity Assistance

In the past, the FHL Banks have provided normal liquidity assistance to member thrift institutions, even though since 1980 thrift institutions have had direct access to the discount window and have used the discount window from time to time for both adjustment and extended credit. Regulation A, as it was revised after the passage of the Monetary Control Act, specifically provides that borrowers should make maximum use of available specialized industry lenders before accessing Federal Reserve credit facilities.

Although in 1981 and 1982 a number of thrifts borrowed from the discount window under a Federal Reserve/Federal Home Loan Bank Board agreement for sharing the burden equally of providing liquidity to thrifts suffering sustained liquidity pressures, the major responsibility for provision of liquidity has been deemed to remain with the FHL Banks.

We believe there is no reason, even in the face of increased liquidity pressures on individual S&Ls, to change the arrangement under which the FHL Banks are primarily responsible for lending to thrifts. The FHL Banks are most familiar with their member institutions and have a priority claim, established by statute, on the assets of their members. Moreover, the FHL Banks and the Federal Home Loan Bank Board have preferred that the FHL Banks remain the major specialized lenders to the thrift industry. More recently, FHL Bank and Federal Home Loan Bank Board interest in Federal Reserve lending has essentially arisen in those cases where the troubled thrift had nearly exhausted collateral which was readily acceptable to a FHL Bank, with the near term prospect that additional loans might have to be secured by commercial loan collateral of doubtful quality that was not acceptable to that Bank.[1]

In view of this background, we believe that the thrift industry should continue to look to the FHL Banks for liquidity assistance and that this policy should be communicated to the FSLIC and to the FHL Banks. One of the major benefits of this approach would be to place pressure on the FHL Banks to continue to lend to the thrift industry to the maximum extent possible. Our concern is that if the Federal Reserve were seen as a readily available alternative source of liquidity, FHL Banks would continue to take large hair cuts, against even high quality collateral, and might curtail lending at a relatively

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[1] Although by regulation FHL Banks are authorized to lend on any collateral that has a readily ascertainable value and in which they are able to perfect a security interest (12 C.F.R. 525.7(b)(4)), in practice FHL Banks view eligible collateral narrowly and may limit collateral to one-to-four family mortgage and other high grade collateral, haircut conservatively.

early stage of a liquidity crisis in order to protect the interests of their members who count the FHL Banks' capital as part of their own capital and who depend on FHL Bank dividends as a significant source of income.

We also recommend, however, that if, in the judgment of the Federal Reserve, the FHL Banks are unable to provide liquidity support because these Banks are not able to access private capital markets on reasonable terms, Federal Reserve Banks should be prepared to lend to the FHL Banks. Lending to the FHL Banks has an important advantage over lending to individual thrifts, insofar as the Reserve Banks would become the beneficiaries of the collateral taken by the FHL Banks and the latter Banks would also be responsible for liquidating that collateral in order to meet their commitments to the Federal Reserve. In addition, the Federal Reserve would have available the approximately $13 billion of capital of the FHL Banks to satisfy any claims of the Reserve Banks.

In order to implement this policy, it would be necessary for the Board to find that "unusual and exigent circumstances" exist.[2] Under section 13(3) of the Federal

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2 Under section 13(13) of the Federal Reserve Act, Federal Reserve Banks may also lend to corporations other than depository institutions where the borrowing corporation posts collateral consisting of obligations guaranteed by the United States. However, it is questionable whether the provision contemplates lending to a government sponsored corporation solely on the collateral of its own creation.

Reserve Act, Federal Reserve Banks may not lend to corporations that are not depository institutions, unless the Board makes an "unusual and exigent circumstances" (UEC) finding; there must also be a finding by a lending Reserve Bank that credit is not available from other sources including the Treasury and other FHL Banks and that failure to obtain the credit would adversely affect the economy.[3]

In the event of a liquidity crisis at one or more thrift institutions, with possible systemic implications, particularly in a situation in which the FHL Banks would not have access to capital markets at reasonable spreads, such findings would be clearly justified. The willingness of the Federal Reserve to lend to the FHL Banks in these circumstances might by itself have a substantial calming effect on both depositors and financial markets. However, the Board may wish to make the decision now to invoke section 13(3) as part of the adoption of a policy of being prepared to lend to FHL Banks to moderate market sensitivities that might develop if the UEC finding were made after the FLH Bank were unable to access private capital markets.

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[3] The Treasury is authorized to purchase $4 billion in FHL Bank obligations if there is no alternate means to permit members to supply funds to the mortgage markets and the ability to supply funds is substantially impaired because of monetary stringency and a high level of interest rates (12 U.S.C. § 1431(i)).

III. Federal Reserve Lending to Individual Thrifts

There may be circumstances, however, in which FHL Banks may refuse to lend, despite the framework described above for providing liquidity to them, with systemic implications of importance to the Federal Reserve. Such circumstances might arise as a result of a general run on thrift institutions, or because a particularly large institution had exhausted its lendable collateral as determined by a FHL Bank.

In such circumstances, the Federal Reserve might wish to lend to individual thrift institutions despite the possibility of significant financial losses. Because of this possibility, it is important in this situation of systemic threat to focus on ways to prevent Federal Reserve resources from being seen as a permanent solution to the severe capital deficit of the thrift industry and to find ways in which Federal Reserve Banks can secure lending to individual institutions in the strongest way possible.

As a first step toward this objective, and in the direction of limiting Federal Reserve lending, it would be desirable to require that prior to or simultaneous with any Federal Reserve lending the FSLIC would call upon its $750 million line of credit with the Treasury and the FHL Banks exhaust any available credit from the Treasury.[4] The direct involvement of Treasury funds is important as a means of helping

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[4] See footnote 3.

to assure a joint Federal Reserve-Administration effort to develop a plan to present to Congress to deal in a fundamental way with the thrift problem. We consider it important that any policy that provides for Federal Reserve lending to thrifts should have as one of its major objectives the establishment of a framework, in cooperation with the Administration, that would provide a solution to the thrift problem. As only one advantage of this approach would be the possibility of avoiding continuing drains on Federal Reserve resources as the permanent solution rather than as a temporary source of liquidity.

We believe that it is also important, in connection with limiting on Federal Reserve lending, to formulate restrictions on the uses of the proceeds of this lending. For example, the Federal Reserve should place limits on the ability of thrift borrowers to expand their assets until the loans were repaid or limit the duration of their borrowing. This approach is consistent with Federal Reserve lending policy in other situations in the past.[5]

It would still be necessary, as part of a program of lending to individual thrifts (troubled or healthy), for the Federal Reserve Banks to take such measures as may be available

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5 As part of its 1981 program for lending to thrifts, the Federal Reserve required thrifts to apply temporary excess cash balances to the reduction of discount window loans, eschew securities investments and limit additional lending to outstanding commitments and other lending needed for the institution to remain viable in its immediate community, and encouraged thrifts to sell off marketable assets.

to minimize the possibility of lending losses. We recommend the following three steps:

1. Obtain whatever unencumbered collateral that is available, making the appropriate filings to assure a priority security interest despite the substantial administrative expense.
2. Obtain a FSLIC guarantee (taking into account any limits Congress may establish on FSLIC indebtedness) with a pledge of receivership assets.
3. Obtain a ratable interest in any collateral held by a FHL Bank, based on the amounts lent by the FHL Bank and the Federal Reserve Bank, or replace the FHL Bank loan with a Reserve Bank loan in order to obtain direct access to collateral pledged to the FHL Bank.

If the Committee concurs in this approach to dealing with the thrift problem, we will proceed to develop the appropriate documentation and procedures.