Commentary: Are Lenders on Strike?

Alvin C. Harrell, Oklahoma City University School of Law
Commentary: Are Lenders on Strike?

By Alvin C. Harrell

This issue features the second part of our symposium on Banking Law and FIRREA. The Conference is indebted to the fine authors who have contributed their time and expertise to writing the articles for this symposium. Articles such as these contribute to a better understanding of the changes that are reshaping our financial system. As always, readers are encouraged to share their views by submitting comments or articles for publication in the Quarterly Report.

In reviewing these developments, your editor was reminded of some informal comments overheard last year following a seminar on FIRREA. One of the speakers had just returned from an overseas tour of the Pacific rim, where he had made a series of presentations to lawyers, bankers, government officials and others in that region interested in finance and commerce. He had embarked on this tour as FIRREA was being signed by the President, and he reported that as he tried to explain its contents to these foreign audiences, his remarks were met with indifference. When an audience finally realized it was true, he reported, the most common response was something in the nature of: "[w]hy would your country do this to itself?" Other seminar speakers in the group then reported similar experiences with domestic audiences, with one speaker suggesting that there must have been a mistake, causing the nation's war on drugs to be declared instead against financial institutions. 1

1. The analogy seems surprisingly appropriate, in view of the enforcement powers and criminal penalties provided under FIRREA, Sec. e.g., Luther, Regulatory Enforcement Authorities and Criminal Enforcements, supra. The apparently tangential director William Bennett remarks that this is not enough. Rejected by favoring "something analogous to the death penalty for high-level bankers who launder drug money." -See News-Minister, Daily Okla., Feb. 19, 1990, at 2.

The Quarterly Report is published four times a year. Please address all correspondence concerning editorial contents to Professor Alvin C. Harrell, Editor, Consumer Finance Law Quarterly Report, The Oklahoma City University School of Law, 2501 N. Blackweller, Oklahoma City, Oklahoma 73106.
the types of loans they may make to insiders until such time as the Director of the OTS provides otherwise.

Likewise, to the extent the requirements of section 22(h) and Regulation O are more restrictive than the provisions of section 563.43, the requirements of section 22(h) and Regulation O will govern. Section 563.43 allows certain types of loans (including home mortgages and various types of consumer loans) to be made to insiders on preferential terms, so long as the interest rate charged by the association is at least equal to the association's current cost of funds (or, in the case of a loan secured by a savings account held by the lending association, 1% above the rate of return on the savings account).28 Section 22(h) and Regulation O, on the other hand, require that insiders be treated the same as unaffiliated borrowers of comparable credit standing, and obligate a savings association to extend credit to an insider on the same terms as would be available to an unaffiliated borrower of the same credit standing seeking a comparable loan. Loan programs providing lower interest rates to insiders or waiving payment by insiders of fees normally charged to unaffiliated borrowers, available to insiders solely on the basis of their status as insiders, constitute preferential lending prohibited by section 22(h) and Regulation O.

The requirements of section 22(h) and Regulation O apply prospectively to loans made on and after the date of enactment of FIRREA (i.e., August 9, 1989). For purposes of Regulation O, a loan is considered to have been made at the time of the issuance of a binding commitment to extend credit.29 Thus, after August 9, 1989, no commitment may be issued to an insider for an extension of credit on preferential terms or without complying with the prior approval requirements summarized above, and any inconsistent policies concerning loans to insiders established by a savings association prior to enactment of FIRREA should be modified accordingly. Federal Reserve Board interpretations indicate that loans made to insiders on preferential terms prior to enactment of FIRREA should be handled as follows:30

1. Generally, any preferential loans to insiders should be modified as soon as practicable to remove any preferential terms.
2. Term loans may remain outstanding until maturity, even if the loans were made on preferential terms. Inasmuch as the renewal of a loan would constitute a new extension of credit for purposes of section 22(h) and Regulation O, preferential loans made prior to enactment of FIRREA should not be renewed. Similarly, inasmuch as renegotiation of an outstanding loan may also be considered a new extension of credit, an outstanding loan made on preferential terms should not be renegotiated (except to remove preferential terms).
3. Demand loans made to insiders on preferential terms prior to enactment of FIRREA should be called and renegotiated to conform the loan terms to those currently prevailing for comparable loans to unaffiliated borrowers of similar credit standing.
4. Although the legality of a line of credit authorized prior to enactment of FIRREA would, generally, be determined under the rules applicable to the lender at the time the line of credit was authorized, the definition of the term extension of credit is sufficiently broad to allow each draw on an outstanding line of credit to be treated as a new loan.31

28. 54 Fed. Reg. at 49,561 (to be codified at 12 C.F.R. § 563.43(a)(3)).
30. See Federal Reserve Regulatory Service 3-1069.
31. See supra note 22 (concurring prior approval of extensions of credit made pursuant to lines of credit).

Commentary: Are Lenders on Strike? Continued from page 148

The apocryphal nature of these comments should not be allowed to obscure a simple fact with potentially important consequences: American lenders feel besieged. While undoubtedly this has been true for much of the past 30 years, today a combination of factors that includes lender liability concerns, FIRREA, declining collateral values, bankruptcy developments, volatile interest rates, political trends, legal complexities, and sometimes hostile regulatory environment seem to have produced a heightened level of anxiety among lenders. The result has been noted elsewhere: With increasing frequency, lenders are afraid to lend.2 If this phenomenon spreads or becomes more pronounced, the consequences for our society could be enormous.

This represents an ironic reversal of earlier concerns, sometimes expressed during periods of rapid credit expansion, that liberal lending policies and junk bond financing would fuel inflation, over-excessive borrowings, and pose undue risks for the financial system. In the words of investment manager Marc Perkins:

The determining factor [in the supply of credit] is the psychology of the person willing to lend . . . [O]ne of the main reasons why credit growth has slowed is not because of lack of demand, but rather because the psychology of the lender has changed dramatically. And under the circumstances, it is going to be very difficult for the same kind of credit expansion to take the place in the early 1990s that we saw in the 1980s.3

With or without a national recession, these concerns are of more than academic interest. John Maynard Keynes described a theoretical "liquidity trap" (and a related "liquidity preference" scenario) in which the economy would not respond to monetary policy because prevailing economic conditions

(Continued from previous column)

(Continued on page 199)
V. Retroactive Effect

As noted briefly supra, in two areas Congress attempted to give retroactive effect to the enhanced enforcement powers of the bank regulatory agencies. By giving the regulators six years after separation in which to commence enforcement proceedings, the Conference Committee stated: "This section does not create a new offense; it is procedural in nature, and can therefore be applied retroactively to yet undiscovered misconduct and to currently pending supervisory matters that have been stayed awaiting Congressional action."

In addition, even though most of the provisions relating to expanded and increased civil money penalties were effective on the date of enactment, Congress made the increased maximum penalties of $5,000 and $25,000 applicable to conduct engaged in before the date of enactment if the conduct was not already subject to a notice initiating an administrative proceeding and had occurred after the completion of the last report of examination of the institution.52

VI. Conclusion

It remains to be seen whether the solution to the problems in our financial system lies in an ever-expanding regulatory authority, or whether there are other, perhaps more fundamental, problems that have yet to be addressed.

Commentary: Are Lenders on Strike?

(Continued from page 190)

discouraged credit demand. In these circumstances efforts by the central bank to promote economic activity by means of monetary policy were said to be akin to "pushing a string." While not wishing to disturb Lord Keynes' peaceful rest, it seems possible that in our present circumstances there may be some risk to monetary policy on the supply side as well. That is, to the extent that society has created structural impediments that unduly discourage lenders from taking risks, the timidity of lenders in extending credit may diminish the multiplier effect of fractional reserve banking and could frustrate the policy expectations of the central bank.

At this point it is pure speculation, and your author will leave serious economic analysis to those who are qualified to do so. But, hypothetically, consider for a moment the possible consequences that even a modest "supply side" credit crunch might have in the context of our current economic environment. The impact would be felt most immediately and most directly by those who represent at best a marginal credit risk: the poor, the disadvantaged, minorities, small businesses, depressed sectors and regions of the economy, the inner cities. Probably the professional class and political policy makers would be among the last to feel the pain (and hence to recognize the change). The monetary aggregates might well show healthy stability or even an upward trend. Indeed, none of this is inconsistent with a resurgence of inflation. But all the while a decline in lending at the local level could be undermining the engine of economic growth.

It should hardly need mention that the financial system is not just another business. The financial system provides the fuel for economic growth and serves as a conduit for converting liquid assets into investment and consumption. As a result, developments that affect the financial system play a special role in our economy. Laws that adversely affect a particular manufacturing sector may result in layoffs or a shift of production overseas, with industry-wide dislocations and adverse consequences for affected communities. But generally these effects will be

5. See, e.g., GWARNEY, ECONOMICS — PRIVATE AND PUBLIC CHOICE 212 (1978) (Emmanuel Guttman); HUTT, KEYNESIANISM — RETROSPECT AND PROSPECT 112-105 (1963); Modigliani, Liquidity Preference and the Theory of Interest and Money, in THE CRITICS OF KEYNESIAN ECONOMICS, at 112 (H. Hazlitt, ed. 1960). Keynes also described a related "natural investment schedule" and an "excess reserve trip" which could have similar consequences. See Guttman, supra, at 212-13.

6. This might be described as a kind of "Sky tax" for monetary policy. Jean Baptiste Say is credited with describing the basic rationale that "supply creates its own demand." See, e.g., Say, Of the Demand or Market for Product, in THE CRITICS OF KEYNESIAN ECONOMICS, at 12 (H. Hazlitt, ed. 1960). This concept is the basic tenet for what has come to be called "supply-side economics," which seeks to generate economic growth by directly stimulating investment and production ("supply"). See also Guttman, supra note 4, at 132-33. In contrast Keynes believed that "demand creates its own supply," so that government policies should stimulate aggregate demand as means of promoting economic growth. Id.


8. This point has been noted previously, in a different context, in the Journal. See Nutter, Reflecting on the New Risk-Based Capital Guidelines for Banking Institutions, 61 Consumer Fin. L. & Rep. 14, 74, 76 (1989).

9. Id. See also, e.g., Guttman, supra note 4, at 144-191.
institution in default or in danger of default.

3. Bank Conversion:
A thrift may convert from a thrift charter to a bank charter during the moratorium period, provided the bank remains a SAIF member until the end of the moratorium period.

An insured institution involved in a conversion must pay an exit fee to the fund it is leaving and an entrance fee to the fund it is entering. The fees were implemented for the purpose of preventing dilution of the fund being entered and avoidance of large losses in assessment fees by the fund being exited.25

Any bank holding company which controls a thrift may merge or consolidate the thrift with, or transfer the assets and liabilities to, any BIF member subsidiary bank, with the prior approval of the appropriate federal banking agency and the FRB. The FRB may not approve the transaction unless the assets of the subsidiaries of the bank holding company are at least equal to 200% of the total assets of the thrift.26 During the first year beginning after the enactment of FIRREA, a merger or consolidation pursuant to this provision may be undertaken only with thrifts which have tangible capital of less than 4%. During the second year, the thrift must have tangible capital of less than 5%. The deposits of a thrift which merges into a bank affiliate will continue to be subject to SAIF assessment fees and the bank will be required to continue payment of the fees.27

The FIRREA "qualified thrift lender" test which becomes effective July 1, 1991 may be a substantial deterrent to thrift acquisitions which result in thrift institutions remaining in existence as opposed to being converted or merged, because the earnings potential of thrifts is limited by the imposition of restrictions on "qualified thrift investments" and "portfolio assets."28 If the test is not met, conversion to a bank charter or limitations on permitted activities are required. A readressing of these statutory provisions by Congress could enhance the thrift acquisition opportunities for banks and bank holding companies.

26. 12 U.S.C. § 1815 (as amended by § 2065(c)(3)(E)(I)).
27. § 206 of FIRREA.
28. § 303 of FIRREA.

Commentary: Are Lenders on Strike?
(Continued from page 199)

localized, even in the case of large enterprises, and often the slack in one industry can be taken-up by growth in another. In contrast the financial system uniquely affects the entire economy. Public policies that blithely impose costs and penalties on this system, whether in pursuit of financial villains, political compromise, or social engineering, pose the risk of consequences that may ripple through the entire economy and affect personal and business decision-making nationwide, for years to come.10

Of course lenders are not on strike (as any bank public relations department would be quick to emphasize). And probably some retribution was in order after the excesses of the 1970s and 1980s. But a pendulum swings both ways, and the danger of an overreaction is everpresent in our political system. Although lenders are not on strike, in some areas we seem to be witnessing a kind of financial work slowdown, banking "by the book," characterized by risk-averse credit decisions and a heavy focus on technical regulatory compliance. While some may find this comforting, there is a price to be paid for this brand of banking conservatism; among other things it is unlikely to facilitate a continuation of the strong economic growth of the 1980s.11 Perhaps advocates of a strict regulatory regime in banking should take note of that old saying, that one had better be careful what one wishes for, because one may just get it.12

[The views expressed in this commentary are solely those of the author and do not reflect the views of the Conference on Consumer Finance Law or its Governing Committee. Opposing views are welcome and will be considered for publication.]

10. Policy makers have focused on maintaining public confidence in the depositary insurance aspect of the financial system, however, it is equally important that the public have confidence in the availability of credit.
